

2020

**INVESTMENT  
FUNDS** 

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**IN LUXEMBOURG**

2021

# ASSET MANAGERS TO FACE MACRO LEVEL PRESSURES AND PRODUCT DESIGN OPPORTUNITIES

Welcome to the 2022 edition of our Investment Funds in Luxembourg publication.

This past year, much like the two years that came before, showcased its own unique opportunities and challenges. Bottlenecks in energy supply just as the economy began to bounce back post-pandemic have caused energy prices to sky-rocket. Subsequent inflation spikes, exacerbated by supply chain disruptions *vis-à-vis* the situation in Ukraine and lockdowns in Asia, as well as tighter monetary policy have been edging the global economy into a recession. These cost pressures have cascaded into asset management. Not only are investors factoring climate concerns into their decision-making, but they are also demanding more value for money.

Despite the macro level pressures, we can find opportunities in the market that are both novel and abundant. Asset management is evolving and we are primed to take advantage right here in Luxembourg, especially within private equity, real estate and traditional assets.

**Private assets are more popular now than ever before.** In the past, such assets were out of reach for retail investors: investment structures were complex and barriers to entry were high. Recent technology and regulation advancements, however, have been driving innovation in this sector. Multiple crowdfunding platforms are making it easier to raise capital. Technology, in the form of improved communication and distribution channels, is making it simpler and faster for new investors to access private assets.

While the “how to” of private asset investing is becoming more accessible, so are the investment products themselves. The European Long-Term Investment Fund (ELTIF), a collective investment scheme allowing investors to inject money into companies and projects needing long-term capital, such as real estate or infrastructure, is one such example. Even though the adoption of ELTIF has been modest since its inception, this is set to change since proposed amendments by the European Commission in November 2021 (ELTIF 2) will allow asset managers to set shorter exit terms using an optional liquidity mechanism, making the product more appealing to retail investors. The overall alleviation of barriers to retail investors is viewed as bridging the gap between the AIFM regulation (distribution of AIF to professional investors) and the UCITS regulation (distribution of non-AIF to retail investors). With private equity increasing by almost 30% from 2020 to 2021 in Luxembourg, this is the fastest-growing asset class in the country. With the revised ELTIF we expect - and hope to see - accelerated adoption in the years to come.

**Real demand for real estate.** The EY Work Reimagined Survey (2021) revealed that 54% of employees would consider quitting if their desired level of work flexibility was not provided. It is no wonder then that over the past two years we have seen a rising interest in the residential market: specifically, more “livable spaces” and a shift to a single-family rental property to accommodate more time spent at home.

Demand for multi-family properties, student housing and new formats like co-living spaces has also been elevated. We are similarly seeing an increase in investment interest in senior housing such as assisted care and living facilities.

When we consider structures of real estate, green buildings are becoming a key driver of investment. Buildings currently make up 40% of global energy use and carbon emissions. Landlords are therefore facing a higher CapEx to meet current regulations and match investors’ demands. Further, older buildings are more prone to tax and regulatory penalties. There is, no doubt, an opportunity and incentive here to invent and deliver new possibilities for living and working.

**UCITS continue to be a globally recognized standard for traditional funds,** and Luxembourg remains by far the domicile of choice. Demand from both retail and institutional investors is set to keep increasing, fueled notably by household savings accumulated during the pandemic and the continuous growth of private retirement schemes.

While the demand and offer of sustainable financial products keeps increasing, the key challenge for retail fund managers and policy-makers will be to solidify investor confidence that their products do actually make a positive impact that is beneficial to stakeholders and communities. Robust assessment and enhanced disclosure of valuation, risks and costs remain high on the agenda to make this asset class shine even brighter.

**Sustainability continues to dominate agendas.** EU institutions multiply efforts to clarify what is expected from asset managers, fund boards and distributors in a context of tough competition, to capture market share and match the significantly raised expectations of investors. Those who champion sustainability today will emerge from this irreversible shift of paradigm. Future leaders will likely be those who make sure *now* that the means they deploy to match their ambitions do not ignore the technical challenges and ramifications of the multi-faceted topic along their value chain.

**Consolidating Luxembourg as an asset management center.** In June 2022, EY Luxembourg released its debut publication of the Luxembourg Attractiveness Survey, a report on the reality and perceptions of Foreign Direct Investment in Luxembourg. The report notably highlighted investor confidence in Luxembourg as a hub for finance. Almost 50% of respondents cited that “the unique pool of multilingual, high skilled talent” positively influences their decision to invest in Luxembourg. At the same time, over 65% of respondents flagged the “ability to attract and retain talent” as the biggest risk to Luxembourg’s future attractiveness for investment. While asset managers must undoubtedly seek new and innovative ways to overcome the challenges of today, to remain resilient in the face of a possible recession and to stay ahead of their competitors, it is clear that talent will ultimately determine their success in achieving these ends.

We thank you for your support over the past 12 months and look forward to discussing these topics with you in the year to come.



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## CHOOSING AN APPROPRIATE FUND VEHICLE AND OPERATING MODEL

EY supports asset managers, traditional and alternative investment fund houses through the choice of fund vehicle, the analysis of target markets, the definition of an efficient operating model and distribution strategy, and the selection of service providers.



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## 1.1. Introduction

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This Chapter introduces Luxembourg's investment fund industry and outlines Luxembourg's solutions for investment funds.

### 1.1.1. What is an investment fund?

An investment fund (often referred to as an undertaking for collective investment – UCI; collective investment undertaking – CIU; UCI is the term used in this *Technical Guide*) has the following characteristics:

- ▶ There is collective investment of funds
- ▶ The capital is raised from a number of investors
- ▶ The capital is invested in accordance with a defined investment policy for the benefit of those investors, generally in accordance with the principle of risk spreading

The shares or units of some UCIs may be distributed to the general public while others are reserved for certain circles of investors, such as informed, qualified or institutional investors. Depending on the structure of the UCI, these shares or units may be obtained through private placement, direct distribution, distributors or through stock exchanges.

The portfolio of collective investments may consist of transferable securities and/or other assets. Risk spreading is required to prevent excessive concentration of investments.

### 1.1.2. Why set up a UCI?

An investment fund, or UCI, can offer investors the possibility to:

- ▶ Generate current income or capital appreciation, or both
- ▶ Access a diversified portfolio of investments
- ▶ Benefit from professional management of the portfolio
- ▶ Share the associated costs
- ▶ Gain exposure to specific investments in the case of investors who are not able to access the investment directly, for example due to investor qualification requirements

## 1.2. Luxembourg's investment fund industry

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### 1.2.1. Why Luxembourg?

The success of Luxembourg in attracting investment funds and becoming a major financial center is based, above all, on investor preference which may be attributed to a number of factors such as:

- ▶ A long established outstanding international financial services reputation
- ▶ An unrivaled range of investment fund solutions
- ▶ A strong regulatory environment including accessibility, knowledge and responsiveness of the regulator
- ▶ Political, economic, social, legal and tax stability
- ▶ An ability to provide tax neutral efficiency solutions for all types of investment fund products
- ▶ Access to a unique multicultural, multilingual international workforce
- ▶ An integrated eco-system of service providers with deep expertise and ability to meet specific local and international markets
- ▶ Location and connectivity: at the heart of Europe with deep connectivity and easy access to the key international financial centers throughout Europe, Asia, the Middle-East and the Americas

UCIs, except for Reserved Alternative Investment Funds (RAIFs), are authorized and supervised by the Commission for the Supervision of the Financial Sector (*Commission de Surveillance du Secteur Financier* – CSSF).

The Luxembourg fund industry has, since 1988, been successfully represented and promoted by the Association of the Luxembourg Fund Industry (*Association Luxembourgeoise des Fonds d'Investissement* – ALFI). Since 2008, *Luxembourg for Finance*, the agency for the development of the financial center, has also been promoting the Luxembourg fund industry.

## 1.2.2. Key figures

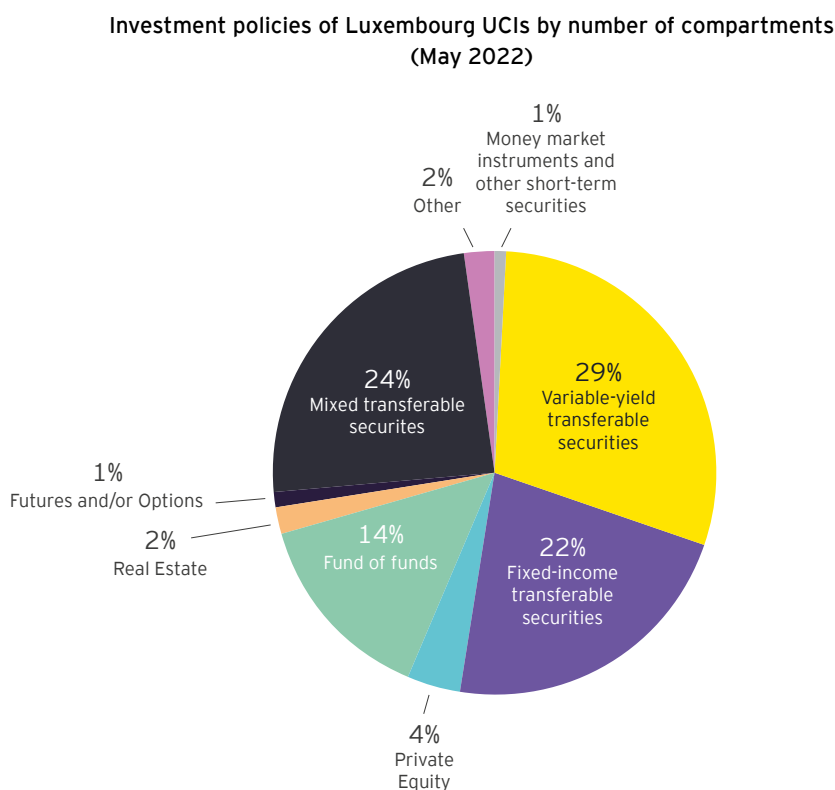
Luxembourg is the leading global center for UCIs. The first Luxembourg fund was established in 1959. By May 2022, there were 3,443 UCIs (excluding RAIFs), comprising 14,392 compartments (often referred to as sub-funds)<sup>1</sup>, with net assets of approximately EUR 5.37 trillion (US\$ 5.49 trillion), analyzed as follows:

Luxembourg UCIs										
Number and net assets by regime and basic structure (May 2022)										
	Number of UCIs				Total	Net assets in € billion				Total
	Common funds	Investment companies				Common funds	Investment companies			
	(FCP)	Variable capital (SICAV)	Other/ Fixed capital (SICAF)	SICARs		(FCP)	Variable capital (SICAV)	Other/ Fixed capital (SICAF)	SICARs	
<b>2010 Law</b>										
Part I (UCITS <sup>2</sup> )	837	803	0	0	1,640	686.335	3,732.423	0	0	4,418.758
Part II	110	123	2	0	235	46.575	116.592	0.272	0	163.439
SIF Law (SIFs)	284	1,027	41	0	1,352	217.885	453.913	35.953	0	707.751
SICAR	0	0	0	216	216	0	0	0	77.901	77.901
<b>Total</b>	<b>1,231</b>	<b>1,953</b>	<b>43</b>	<b>216</b>	<b>3,443</b>	<b>950.795</b>	<b>4,302.928</b>	<b>36.225</b>	<b>77.901</b>	<b>5,367.849</b>

Source: CSSF

In addition to the above, 1,865 RAIFs had been launched at 15 June 2022.

The following chart illustrates the investment policies of Luxembourg UCIs by number of compartments at the end of May 2022:



Source: CSSF

<sup>1</sup> Multiple compartment UCIs are covered in Section 2.3.2.

<sup>2</sup> Undertakings for Collective Investment in Transferable Securities.

## 1.3. Luxembourg's investment fund solutions

### 1.3.1. Fund regimes and passports

#### A. Introduction

Luxembourg offers an attractive range of solutions for the creation of UCIs. Luxembourg UCIs can be established under either of the following regimes:

Fund category	Product Regime	Common name of UCI
UCITS – Undertakings for Collective Investment in Transferable Securities	Part I of the Law of 17 December 2010, as amended, (the 2010 Law) on UCIs	UCITS
AIF – Alternative Investment Funds	Part II of the 2010 Law, as amended, on UCIs	2010 Law Part II UCI
	The Specialized Investment Fund Law (the SIF Law) of 13 February 2007, as amended	SIF
	The Reserved Alternative Investment Fund Law (the RAIF Law) of 23 July 2016, as amended	RAIF
	The Investment Company in Risk Capital Law (the SICAR Law <sup>3</sup> ) of 15 June 2004, as amended	SICAR <sup>4</sup>

#### B. Marketing passports

Most Luxembourg UCIs are marketed to investors in a number of countries.

Many Luxembourg UCIs – UCITS and Alternative Investment Funds (AIFs) – benefit from a “Product” passport enabling them to be marketed to investors in the European Union (EU)/European Economic Area (EEA)<sup>5</sup>, following a notification procedure. Marketing of Luxembourg UCIs which do not benefit from a “Product” passport is subject to the national regimes of the country where the marketing takes place.

UCITS can be marketed to all investors in the EU/EEA<sup>6</sup>. The UCITS passport means that the shares or units of UCITS can be marketed to all types of investors, both retail and professional, throughout the EEA, following a notification procedure.

The marketing of AIFs depends on whether or not they are managed in accordance with and subject to the full Alternative Investment Fund Manager (AIFM) requirements (“Full AIFM regime AIFs”). Full AIFM regime AIFs are AIFs which are managed by an authorized AIFM or authorized internally managed AIFs. Authorized AIFMs and authorized internally managed AIFs must meet the full requirements of the AIFM Directive<sup>7</sup> (AIFMD), which is transposed in Luxembourg by the AIFM Law<sup>8</sup>. AIFM compliance is required when the assets of all the AIFs under management exceed certain thresholds. Other AIFs are subject to a simplified AIFM registration regime (“Simplified AIFM registration regime AIFs”). Chapter 6 covers AIFM requirements in more detail.

<sup>3</sup> Not covered by this publication.

<sup>4</sup> Idem.

<sup>5</sup> The EEA includes EU Member States plus Iceland, Liechtenstein and Norway. The EEA Agreement establishes freedom to provide services across the EEA and any specific provisions.

<sup>6</sup> The EEA Agreement implements the UCITS Directive passports across the EEA by including reference to it in Annex, without any specific limitations.

<sup>7</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers, as amended.

<sup>8</sup> Law of 12 July 2013, as amended.



The marketing of AIFs may be summarized as follows:

- ▶ Full AIFM regime AIFs can be marketed to:
  - ▶ Professional investors in the EU/EEA: authorized AIFMs and authorized internally managed AIFs benefit from a passport permitting them to market the shares or units of the AIFs they manage to professional investors throughout the EU/EEA
  - ▶ Retail investors in the EU/EEA under stricter national rules: each EU/EEA Member State may permit authorized AIFMs and authorized internally managed AIFs to market the shares or units of the AIFs they manage to retail investors in the Member State. The Member State may also apply stricter requirements than those applicable to marketing to professional investors
- ▶ Simplified AIFM registration regime AIFs can be marketed to professional investors in the EU/EEA under national private placement regimes (i.e., subject to national requirements), where such regimes exist. The passport is not applicable. However, a specific regime exists for the managers of qualifying European Venture Capital Funds (EuVECA) and of qualifying European Social Entrepreneurship Funds (EuSEFs) which meet the requirements of the simplified EU/EEA regulatory regimes. Such managers can benefit from a “passport” permitting them to market the shares or units of the qualifying European funds they manage to suitably qualified investors throughout the EU/EEA (see Section 2.4.4.3.)
- ▶ EU/EEA professional investors may, on their own initiative, purchase the shares or units of any AIF, irrespective of the domicile of the AIF or AIFM, provided that there is no marketing (also referred to as “reverse solicitation”)
- ▶ In addition to the rules applicable to AIFs, SIFs and RAIFs can only be distributed to “well-informed investors” (see Section 2.4.3.2.)

#### Summary of marketing of Luxembourg UCIs in the EU/EEA

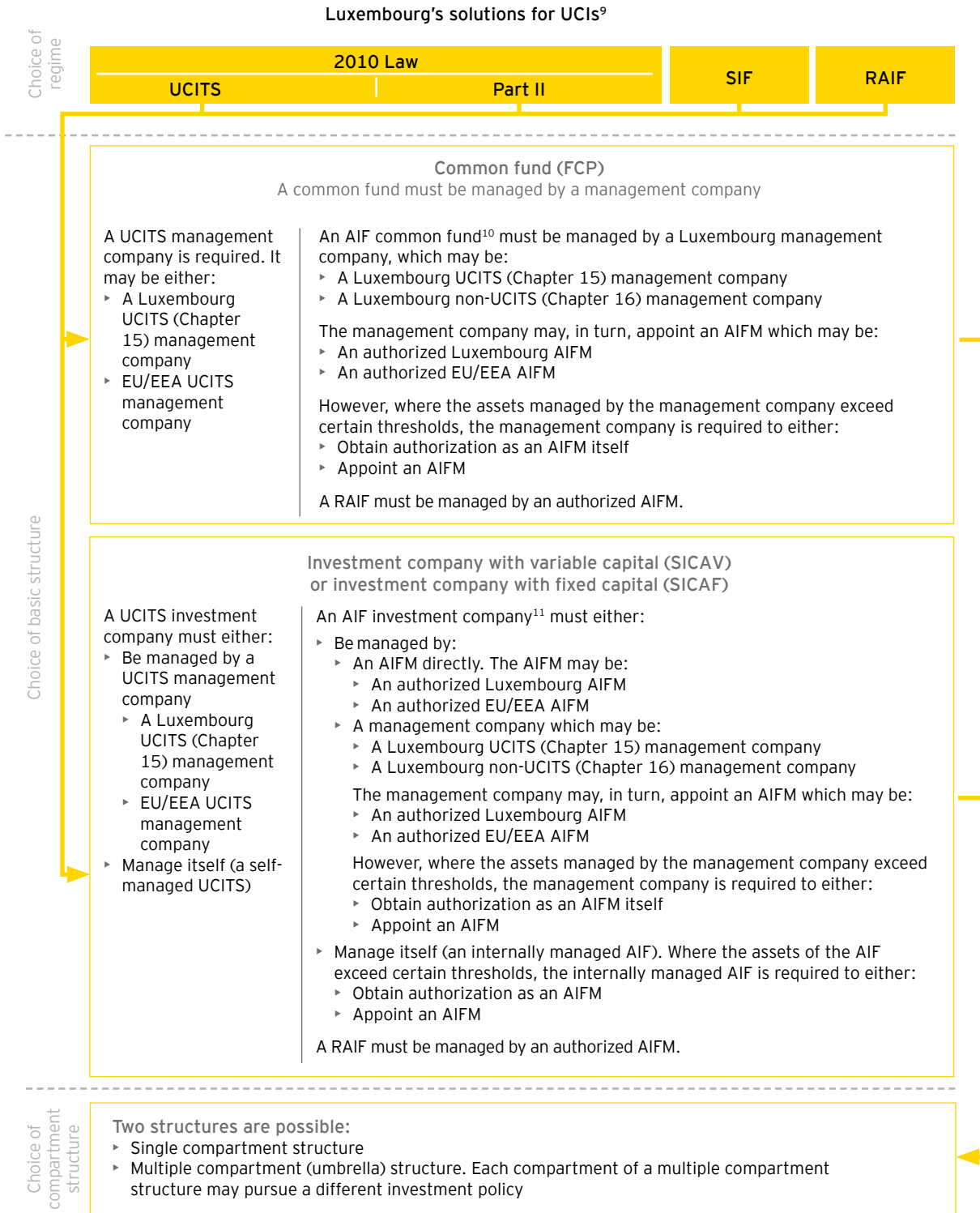
Products	Regulatory framework	Marketing regime	Investors
UCITS	UCITS	EU/EEA “passport”	Retail and professional
AIF	Full AIFM regime AIF	EU/EEA “passport”	Professional
	EuVECA and EuSEF	EU/EEA “passport”	Qualified
	Simplified AIFM registration regime AIF	National private placement regimes (NPPRs)	Professional
	Full AIFM regime AIF and, if relevant, simplified AIFM registration regime AIF	National retail distribution regimes, where applicable	Retail
	Any AIF (Full AIFM regime or simplified AIFM registration regime)	Reverse solicitation	Professional

Marketing outside the EEA is subject to each country’s national requirements.

Chapter 12 covers the marketing of UCIs.

C. Overview of fund regimes and basic structures

The choice of regime and basic structure is presented in schematic form below:



<sup>9</sup> Section 2.3.1. covers basic structures, Section 2.4.4. covers the requirements applicable to AIFs and Section 6.1. introduces management companies and AIFMs.

<sup>10</sup> This general outline does not cover the specific cases of certain partnerships; for further information, see Section 2.3.1.

<sup>11</sup> Idem.

The following table outlines the main characteristics of Luxembourg's investment fund regimes:

	Regimes			
	UCITS	2010 Law Part II	SIF	RAIF
Regulation	Regulated	Regulated	Regulated	Under the AIFMD - however see footnote below <sup>12</sup>
Regulator	CSSF	CSSF	CSSF	Under the AIFMD - however see footnote below <sup>13</sup>
Authorization procedure (see Chapter 3)	Prior to set-up	Prior to set-up	Prior to set-up	Not required
Structures available (see Chapter 2)	Common fund: FCP	Common fund: FCP	Common fund: FCP	Common fund: FCP
	Investment company: SICAV or SICAF	Investment company: SICAV or SICAF	Investment company: SICAV or SICAF	Investment company: SICAV or SICAF
Eligible investors <sup>14</sup> (see Section 1.3.1.B. and Chapter 2)	All	All	Well-informed investors <sup>15</sup>	Well-informed investors <sup>16</sup>
Distribution in EU/EEA <sup>17</sup> (see Section 1.3.1.B. and Chapter 12) to:				
▶ Retail investors	EU/EEA passport	National retail distribution requirements	National retail distribution requirements	National retail distribution requirements
▶ Professional investors	EU/EEA passport	EU/EEA passport if managed by an authorized AIFM <sup>18</sup> , otherwise national private placement regimes (NPPRs)	EU/EEA passport if managed by an authorized AIFM <sup>19</sup> , otherwise national private placement regimes (NPPRs)	EU/EEA passport of the authorized AIFM <sup>20</sup>
Maximum number of shareholders or unitholders (see Section 2.3.)	No limit	No limit	No limit <sup>21</sup>	No limit <sup>22</sup>
Minimum number of shareholders or unitholders (see Section 2.3.)	No minimum	No minimum	No minimum	No minimum
Minimum investment by a shareholder or unitholder (see Chapter 2)	None	None	EUR 125,000; less if certification	EUR 125,000; less if certification
Use of compartments (sub-funds) (see Section 2.3.2.)	Yes	Yes	Yes	Yes
Cross-investment between compartments (see Section 2.3.5.)	Yes, subject to conditions	Yes, subject to conditions	Yes, subject to conditions	Yes, subject to conditions

<sup>12</sup> The RAIF must be managed by an authorized AIFM which is supervised by the competent authority of its country of domicile. A RAIF is not however directly supervised by the CSSF.

<sup>13</sup> Idem.

<sup>14</sup> Additional restrictions may be included in the constitutional document or prospectus.

<sup>15</sup> See Section 2.4.2.1.B.

<sup>16</sup> See Section 2.4.3.2.

<sup>17</sup> EU Member States plus Iceland, Liechtenstein and Norway.

<sup>18</sup> See Chapter 6.

<sup>19</sup> Idem.

<sup>20</sup> Idem.

<sup>21</sup> Except in the case of a SIF or RAIF set up as a private limited liability company (S.à r.l.), in which case the maximum number of investors is 100.

<sup>22</sup> Idem.

	Regimes			
	UCITS	2010 Law Part II	SIF	RAIF
<b>Multiple share or unit classes</b> (see Section 2.3.3.)	Yes	Yes	Yes	Yes
<b>Eligible investments/strategy</b> (see Chapter 4)	Transferable securities such as equities, bonds, money market instruments (MMIs), investment funds and certain derivatives  Techniques and instruments related to transferable securities  Detailed restrictions apply	Some restrictions	No restrictions	No restrictions
<b>Diversification</b> (see Chapter 4)	Detailed requirements	General requirements	General requirements	General requirements
<b>Risk management</b> (see Chapter 7)	Detailed requirements	General requirements, and AIFM requirements (where applicable)	General requirements on risk management system, and AIFM requirements (where applicable)	AIFM requirements
<b>Fees/expenses including performance and advisory fees</b> (See Chapter 11)	Must be disclosed  Detailed guidelines for performance fees <sup>23</sup>	Must be disclosed  Detailed guidelines for performance fees <sup>24 25</sup>	Must be disclosed  Detailed guidelines for performance fees <sup>26</sup>	No detailed restrictions  Must be disclosed
<b>Transferability of shares or units</b> (see Chapter 2)	Generally freely transferable	Generally freely transferable	May or may not be freely transferable  Subject to informed investor qualification	May or may not be freely transferable  Subject to informed investor qualification
<b>Information for investors</b> (see Chapter 10)	Prospectus  Key Investor Information Document (KIID)  Financial statements <sup>27</sup>  Periodic disclosures <sup>28</sup>	Prospectus <sup>29</sup>  Key Investor Information Document (KIID)/Key Information Document (KID) may be required (see chapter 10)  Financial statements <sup>30</sup>  Periodic disclosures <sup>31</sup>	Prospectus or offering document <sup>32</sup>  Key Investor Information Document (KIID)/Key Information Document (KID) may be required (see chapter 10)  Financial statements <sup>33</sup>  Periodic disclosures <sup>34</sup>	Offering document <sup>35</sup>  Key Investor Information Document (KIID)/Key Information Document (KID) may be required (see chapter 10)  Financial statements <sup>36</sup>  Periodic disclosures <sup>37</sup>
<b>Required service providers</b> (see Chapter 6) <sup>38</sup>  (see Chapter 9)	UCITS management company (common fund, and investment company if not self-managed)  Luxembourg depositary	Luxembourg management company (common fund, and investment company if not internally managed) <sup>39</sup>  Luxembourg depositary	Luxembourg management company (common fund, and investment company if not internally managed) <sup>40</sup>  Luxembourg depositary	Luxembourg authorized AIFM  Luxembourg depositary

<sup>23</sup> In April 2020, ESMA issued *Guidelines on performance fees in UCITS and certain types of AIFs*. Please refer to Chapter 11 for further details.

<sup>24</sup> Idem.

<sup>25</sup> Guidelines apply to AIFs marketed to retail investors, except for closed-ended AIFs or open-ended AIFs which are not EuVECA or other venture capital AIFs, EuSEFs, private equity AIFs or real estate AIFs.

<sup>26</sup> Idem.

<sup>27</sup> At least audited annual and unaudited semi-annual financial statements.

<sup>28</sup> See Section 10.4.1.

<sup>29</sup> For full AIFM regime AIFs, information to be disclosed in the prospectus or separately (see Section 10.3.3.).

<sup>30</sup> At least audited annual and unaudited semi-annual financial statements.

<sup>31</sup> For full AIFM regime AIFs (see Section 10.4.2.).

<sup>32</sup> For full AIFM regime AIFs, information to be disclosed in the prospectus or separately (see Section 10.3.3.).

<sup>33</sup> At least audited annual financial statements.

<sup>34</sup> For full AIFM regime AIFs (see Section 10.4.2.).

<sup>35</sup> Information to be disclosed in the prospectus or separately (see Section 10.3.3.).

<sup>36</sup> At least audited annual financial statements.

<sup>37</sup> For full AIFM regime AIFs (see Section 10.4.2.).

<sup>38</sup> Main service providers only listed here; see Section 1.4.

<sup>39</sup> AIFM required if above threshold.

<sup>40</sup> Idem.

	Regimes			
	UCITS	2010 Law Part II	SIF	RAIF
Required service providers (Cont'd) (see Chapter 8)	Administration, registrar and transfer agent which must be in Luxembourg if the management company is in Luxembourg	Luxembourg administration, registrar and transfer agent	Luxembourg administration, registrar and transfer agent	Luxembourg administration, registrar and transfer agent
(see Section 10.5.10.)	Luxembourg auditor	Luxembourg auditor	Luxembourg auditor	Luxembourg auditor
Regulator reputational checks		Promoter <sup>41</sup>		Please see footnote below <sup>42</sup>
(see Chapter 5)	Portfolio manager and/or advisor	Portfolio manager and/or advisor		
(see Chapter 9)	Directors of UCI, or of management company <sup>43</sup>	Directors of UCI, or of management company <sup>44</sup>	Directors of SIF, or of management company <sup>45 46</sup>	
Listing possible (see Chapter 13)	Yes	Yes	Yes	Yes
Net asset value (NAV) calculation and redemption frequency (see Section 8.7.)	Minimum twice a month	Minimum monthly and, if managed by an authorized AIFM, the NAV must be calculated on the occasion of each issue	If managed by an authorized AIFM, on the occasion of each issue or subscription or redemption or cancellation of shares or units, and at least once a year  In any case, NAV required for reporting purposes	On the occasion of each issue or subscription or redemption or cancellation of shares or units, and at least once a year  In any case, NAV required for reporting purposes
Subscription and redemption price (see Section 8.7.3.)	NAV <sup>47</sup>	NAV <sup>48</sup>	Subscription and redemption conditions laid down in the constitutional document	Subscription and redemption conditions laid down in the constitutional document
Tax treatment in Luxembourg (see Section 11.3.)	No tax, except for annual subscription tax of 0.05% on the NAV unless a reduced rate or exemption applies  No withholding tax (WHT) on dividends paid	No tax, except for annual subscription tax of 0.05% on the NAV unless a reduced rate or exemption applies  No withholding tax (WHT) on dividends paid	No tax, except for annual subscription tax of 0.01% on the NAV unless an exemption applies  No withholding tax (WHT) on dividends paid	No tax, except for annual subscription tax of 0.01% on the NAV unless an exemption applies  RAIFs investing entirely in risk capital are subject to the tax regime applicable to SICARs  No withholding tax (WHT) on dividends paid

<sup>41</sup> Where the 2010 Law Part II UCI is not managed by a UCITS (Chapter 15) management company.

<sup>42</sup> RAIFs are not supervised by the CSSF. The AIFM is responsible for ensuring that the AIFs it manages comply with the AIFMD product rules.

<sup>43</sup> For self-managed UCITS, see Section 2.4.1.5.

<sup>44</sup> For internally managed AIFs, see Section 2.4.4.

<sup>45</sup> "Directors" means, in the case of public limited companies and in the case of cooperatives in the form of a public limited company, the members of the Board of Directors, in the case of partnerships, the managers or general partner, in the case of private limited liability companies, the manager(s) and in the case of common funds, the members of the Board of Directors or the managers of the management company.

<sup>46</sup> For internally managed AIFs, see Section 2.4.4.

<sup>47</sup> The net asset value per share or unit may be adjusted to incorporate a "swing factor" if swing pricing procedures are in place (see Section 8.7.4.).

<sup>48</sup> Idem.

### 1.3.2. Basic structures

The decision to create a UCI in contractual form (common fund – FCP) or in corporate form (an investment company, generally with variable capital – SICAV)<sup>49</sup> is primarily driven by tax, operational and marketing considerations. The following table details the main differences between common funds and investment companies:

	Basic structures	
	Common fund (FCP)	Investment company (SICAV or SICAF)
Management entity	Luxembourg management company which, in the case of an AIF, may appoint an AIFM	Self-managed investment company: Board of Directors, general partner or manager(s) <sup>50</sup> . Managed investment company: <ul style="list-style-type: none"> <li>▸ UCITS: a management company</li> <li>▸ AIF: a management company and/or an AIFM</li> </ul>
Control	Board of Directors of management company in conjunction with depositary	Board of Directors, general partner or manager(s) <sup>51</sup> and ultimately investors <sup>52</sup>
Shareholders' or unitholders' meetings	Unitholders' meetings are not mandatory for a common fund	At least one meeting of shareholders must be held annually
Taxable status	Tax transparent (with limited exceptions)	Not tax transparent (with limited exceptions)
Tax implications	Individual underlying investors may benefit from certain double taxation treaties (DTTs)	SICAV may directly benefit from certain DTTs <sup>53</sup>
VAT status (Value added tax)	VATable person (via its management company)	VATable person

Luxembourg's investment fund regimes and basic structures, and the requirements for each, are described in more detail in Chapter 2.

### 1.3.3. Traditional investment funds

Traditional investment funds include:

- Equity funds
- Bond funds
- Money market funds (MMFs)
- Mixed funds
- Multiple-asset class investment funds: investment funds with multiple compartments investing in different asset classes
- Funds of traditional investment funds

Appendix I describes in more detail what UCIs are and explains the various types of funds and asset classes.

Traditional investment funds may be set up under any of Luxembourg's investment fund regimes (i.e., as UCITS, 2010 Law Part II UCIs, SIFs or RAIFs) using any of the basic structures mentioned previously.

<sup>49</sup> See also Section 2.3.

<sup>50</sup> In the case of public limited companies and in the case of cooperatives in the form of a public limited company, the members of the Board of Directors, in the case of partnerships, the managers or general partner and in the case of private limited liability companies, the manager(s).

<sup>51</sup> Idem.

<sup>52</sup> Except in the case of a partnership.

<sup>53</sup> See Circular L.G. - A n°61 on Certificates of Residence for Luxembourg UCIs.

## 1.3.4. Alternative investment funds (AIFs)

Alternative investment funds (AIFs) include:

- ▶ Hedge funds
- ▶ Real estate funds
- ▶ Private equity funds
- ▶ Debt funds
- ▶ Infrastructure funds
- ▶ Thematic funds such as AIFs:
  - ▶ Investing in specific sectors, such as healthcare
  - ▶ Investing in collectibles, such as luxury goods
  - ▶ Investing in intangible assets, such as patents
  - ▶ Meeting specific criteria, such as responsible investment criteria
- ▶ Multiple-asset class AIFs: AIFs with multiple compartments investing in different asset classes, sometimes with interlinked compartments
- ▶ Funds of AIFs
- ▶ European long-term investment funds (ELTIFs)

Appendix I describes in more detail what UCIs are and explains the various types of funds and asset classes.

AIFs are generally set up either as 2010 Law Part II UCIs, SIFs or RAIFs. Any of the basic structures may be used for 2010 Law Part II UCIs, SIFs or RAIFs. Certain types of AIFs are subject to specific rules (Section 2.6.). AIFs may also be set up as ELTIFs (Section 2.4.5.).

UCITS may, to a limited extent, pursue alternative investment strategies (so-called “alternative UCITS”).

A number of vehicles may be used in conjunction with AIFs, for example to hold the underlying investments. Luxembourg vehicles which may be used in conjunction with AIFs include commercial companies, referred to as SOPARFIs and securitization vehicles (see Section 2.7.).

## 1.3.5. Funds of funds and master-feeder structures

There are two main types of UCIs which significantly invest into other UCIs: funds of funds and master-feeder structures.

### 1.3.5.1. Funds of funds

A fund of funds invests into several other UCIs. A key role of the manager of a fund of funds is the selection and monitoring of the underlying UCIs.

It is possible to create funds of funds under any of Luxembourg’s fund regimes, subject to the applicable eligibility criteria and diversification requirements (see Chapter 4).

Funds of funds may, for example, offer investors diversification and therefore lower risk than direct investment into the underlying UCIs.

### 1.3.5.2. Master-feeder structures

In master-feeder structures, the feeder UCI invests most of its assets in a master UCI. Therefore, the management of a significant portion of the portfolio of the feeder UCI is effectively performed by the manager of the master UCI.

A feeder UCITS is a non-diversified investment structure investing into a diversified product (master UCITS), permitting the pooling of assets. In a UCITS master-feeder structure, a feeder UCITS invests at least 85% of its assets in a master UCITS. It may invest up to 15% of its assets in liquid assets, financial derivative instruments for hedging purposes or, in the case of investment companies, property essential for the direct pursuit of business. An existing UCITS may be converted into a feeder UCITS. Alternatively an existing UCITS may become a master UCITS. A feeder UCITS may also change its master UCITS. The master UCITS, or one or more of the feeder UCITS, can be located in different EEA Member States. Master and feeder UCITS can be created under Luxembourg's UCITS regime (Part I of the 2010 Law, as amended) or the UCITS regime of another EEA Member State. See also Section 2.3.4.1.

In an AIF master-feeder structure, a feeder AIF invests at least 85% of its assets in another AIF, invests in more than one master AIF where those master AIFs have identical investment strategies, or has otherwise an exposure of at least 85% of its assets to such a master AIF. Master and feeder AIFs can be created under any of Luxembourg's AIF regimes, the AIF regime of another EEA Member State or a third country. However, for the AIFM of the feeder AIF to benefit from the AIFM marketing passport, the feeder AIF must invest into a master AIF that is managed by an authorized AIFM (see Section 12.5.).

Master-feeder structures may be used by asset managers as a distribution mechanism to facilitate access to certain markets. For example, some French investors may prefer to invest in a local UCITS. An asset manager which currently only offers a Luxembourg domiciled UCITS may take advantage of the UCITS master-feeder provisions and create a feeder UCITS domiciled in France which invests in the master UCITS domiciled in Luxembourg. This structure will enable the manager to distribute to such French investors while managing only one portfolio of investments.

### 1.3.6. Specific types of UCIs

Specific types of UCIs can be created under Luxembourg's UCI regimes. These include:

- ▶ Money market funds (MMFs)
- ▶ Exchange traded funds (ETFs)
- ▶ Index tracking UCIs
- ▶ UCIs using efficient portfolio management (EPM) techniques, such as securities lending and repurchase transactions
- ▶ UCITS using financial derivative instruments (FDIs)
- ▶ Structured UCIs
- ▶ Hedge funds
- ▶ Real estate funds
- ▶ Private equity funds
- ▶ Debt/Credit funds
- ▶ Infrastructure funds
- ▶ European long-term investment funds (ELTIFs)

Requirements applicable to specific types of UCIs are covered in Section 2.6.



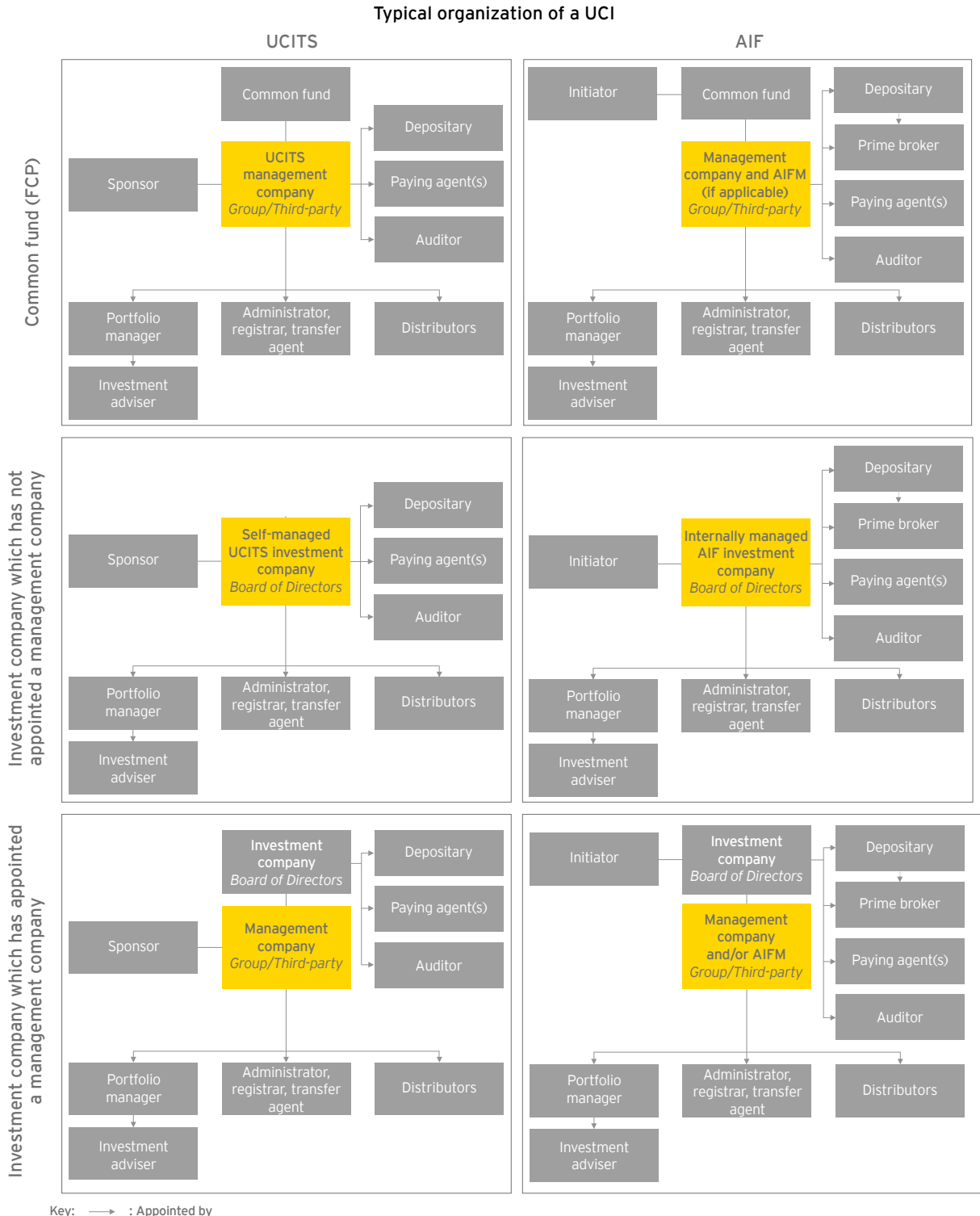
## 1.4. Organization of a UCI and its service providers

This section outlines the typical organization of a UCI, summarizes the roles of the main service providers and outlines the factors impacting the choice of organizational model.

### 1.4.1. Typical organization of a UCI

As part of the formation procedures of a UCI, several service providers must be appointed.

The following diagrams show illustrative examples of the organization of UCIs; other models may be possible.



A RAIF must be managed by an authorized AIFM; it cannot be an internally managed AIF.

## 1.4.2. UCI service providers

This section outlines the principal duties of the main service providers. The appointment of service providers is covered in Section 6.3.1.B.

### A. Sponsor, initiator or promoter

For UCITS management companies, the CSSF may ask a “sponsor” to issue a letter of assurance (or “sponsorship”), in which the sponsor commits to the CSSF, that the management company respects, and will continue to respect, the applicable prudential requirements (see also Chapter 6). In practice, the “sponsor” will generally be the main shareholder of the management company, or a group entity to which the main shareholder belongs.

The creator of a UCI is generally referred to in Luxembourg as the promoter in the case of 2010 Law UCIs and the initiator in the case of SIFs. These terms are not defined in Law. A promoter is required for a 2010 Law Part II UCI which is not managed by a UCITS (Chapter 15) management company.

The initiator or promoter generally plays one or more important roles in the activity of the UCI. For example, the initiator or promoter may:

- ▶ Be the portfolio manager or advisor
- ▶ Play a role in the oversight of the activity of the UCI, generally by being represented on the Board of Directors of the UCI or its management company and/or Alternative Investment Fund Manager (AIFM)
- ▶ Be a shareholder of the management company
- ▶ Play a role in the distribution of the UCI

The role of “sponsor” of a Chapter 15 management company replaces the role of “promoter” of a UCI managed by a UCITS management company (see Chapter 6).

See also Sections 1.4.3. and 3.3.2.

### B. Management company or AIFM

Management companies and AIFMs are companies that manage UCIs. “Management” includes, in general, portfolio management, administration and distribution. A common fund (FCP) must be managed by a management company. An investment company can appoint a management company or an AIFM, or manage itself (see also Section 1.4.3.1. and Chapter 6). A RAIF must be managed by an authorized AIFM; it cannot manage itself.

### C. Portfolio manager

The portfolio manager manages the UCI (there may be a range of portfolio managers for different compartments) with respect to the investment, divestment and reinvestment of the assets of the UCI. It is a delegate of the UCI, if the UCI is self/internally managed, or of its management company.

### D. Investment advisor

The investment advisor advises the portfolio manager, the management company or the UCI itself with respect to the investment, divestment and reinvestment of the assets of the UCI. It does not make decisions.

### E. Administrator

The administrator is, *inter alia*, responsible for keeping the accounting records of the UCI, calculating the NAV, assisting in preparing the financial statements, and acting as a contact with the CSSF and the independent auditor<sup>54</sup>. Administration is further discussed in Chapter 8.

### F. Registrar and transfer agent

The registrar and transfer agent is responsible for keeping the principal register of shareholders or unitholders of the UCI, and for arranging the issue, transfer, allotment, conversion, subscription, redemption and/or purchase and sale of shares or units of the UCI (see also Chapter 8).

### G. Domiciliation agent

The domiciliation agent provides the registered office of the UCI. It is responsible for providing office accommodation and other facilities to the UCI, keeping all correspondence of the UCI, and arranging payment of bills on behalf of the UCI (see also Chapter 8).

<sup>54</sup> | In this *Technical Guide*, we use the term “Independent auditor” for Approved statutory auditor.

#### H. Distributor

Distributors are intermediaries who perform one or both of the following activities:

- Actively market the shares or units
- Receive subscription and redemption orders as appointed agents of the UCI

See also Section 12.9.1.

#### I. Nominee

Nominees act as intermediaries between investors and the UCI of their choice.

See also Section 12.9.2.

#### J. Market maker

Market makers are intermediaries participating on their own account and at their own risk in subscription and redemption transactions of UCI shares or units.

See also Section 12.9.3.

#### K. Depositary

The depositary is, *inter alia*, responsible for the safekeeping of the assets of the UCI, and for the day-to-day administration of the assets (e.g., receipts, sales, dividends), based on instructions received from the asset managers or management company (unless they conflict with the constitutional document). It also plays an oversight role. See also Chapter 9.

#### L. Prime broker

A prime broker is an entity subject to prudential regulation and ongoing supervision, which:

- Offers one or more services to professional investors primarily to finance or execute transactions in financial instruments as counterparty
- May also provide other services such as clearing and settlement of trades, custodial services, securities lending, customized technology and operational support facilities<sup>55</sup> (see Section 9.8.)

#### M. Paying agent

The paying agent arranges for payment of distributions made by the UCI. A paying agent may be required in each country where the UCI is distributed. Generally, the depositary and its network will provide paying agent services (see Section 9.4.1.). Paying agent is a term used differently in the context of the EU Savings Directive (see Section 11.3.4.1).

#### N. Independent auditor

The financial statements of a UCI must be audited by a Luxembourg independent auditor (*réviseur d'entreprises agréé* – see Section 10.5.10.).

### 1.4.3. Organizational model considerations

The choice of organizational model for the UCI, its management and service providers will depend on a number of factors, including:

- The basic structure of the UCI
- Preference for a group entity or a third party
- The other fund ranges of the group. Where the group has fund ranges in multiple jurisdictions, it may consider cross-border management
- Service provider considerations

#### 1.4.3.1. Basic structure of the UCI

A common fund (FCP) has no legal personality and must be managed by an authorized management company, regardless of whether it is created under the 2010 Law, the SIF Law or the RAIF Law. The board of directors/managers of the management company, in conjunction with the depositary, has ultimate control of the common fund. The management company is responsible for the common fund, including the appointment and oversight of service providers.

On 16 July 2019, the existing RAIF Law was amended to clarify that a RAIF set up as an FCP may have as management company an entity set up under Chapter 15, 16 or 18 of the 2010 Law. The management company must also be authorized as an AIFM (see Section 6.2.1.B.) or appoint an external AIFM (see Section 6.1.4.).

<sup>55</sup> | Based on the AIFM Directive and AIFM Law definition of a “prime broker”.

An investment company must appoint an approved management company or designate itself as “self-managed”<sup>56</sup>. The board of directors of the investment company, and ultimately the shareholders, control the investment company. The board of directors is responsible for the investment company, including the appointment and oversight of service providers. It may appoint a management company to manage the investment company, in which case the oversight of some of the service providers is delegated to the appointed management company. The sponsor, initiator or promoter is usually represented on the board of directors of the investment company.

Both common funds and investment companies can be single or multiple compartment (sub-fund), and each compartment can have one or more share classes.

It is also possible to create master-feeder structures. In master-feeder structures, the feeder UCI invests most of its assets in a master UCI.

The key differences between the basic structures of UCIs are summarized in Section 1.3. The basic structures, multiple compartment UCIs, and share or unit classes are described in more detail in Section 2.3. and the requirements for UCIs by specific regime (UCITS, Part II 2010 Law, SIF and RAIF) in Section 2.4. Master-feeder structures are covered in Section 2.3.4.1.

### 1.4.3.2. Group or third party

Sponsors, initiators and promoters can choose between “group” or “third-party” models. In the “group” model, the UCI or management entity (management company or AIFM) is created within the group of the sponsor, initiator or promoter, or an existing group structure is used. In the “third-party” model, the sponsor, initiator or promoter uses a third party. Third parties may also make available independent Board Members and key function holders.

#### A. UCI

Sponsors, initiators and promoters generally create their own UCIs.

However, some portfolio managers and investment advisors choose a UCI created by a third party. In this case, a new UCI will be created by the third party, or a new compartment will be created in an existing multiple compartment UCI (see Section 2.3.2.) of the third party; they will then be appointed as the portfolio manager of, or investment advisor to, the compartment.

An option open to sponsors, initiators and promoters who wish to offer UCI products to their clientele, but do not wish to create or manage the products, is to “white label” third-party products. In this case, the third party creates and manages the UCI, but the product is generally marketed under the brand of the sponsor, initiator or promoter. The association with the third party will depend on the model implemented.

“White labeling” enables the same product to be offered to different clients by different sponsors and promoters, such as private banks.

Under one model, specific share or unit classes are created for each sponsor, initiator or promoter within an existing UCI. In this case, the product is generally primarily marketed under the brand of the third party.

Under another model, some of the fund documentation is branded by the sponsor, initiator or promoter. The third party is, for example, referred to in the fund documentation (e.g., as management company and/or board of the UCI).

The requirements on key investor information document (KIID) of a UCITS restrict, to a certain extent, white labeling of UCITS. The KIID must, in general, be provided to investors before they invest. The KIID must be used without alterations or supplements in all Member States where the UCITS is notified (see Sections 10.3.2. and 12.2.1.).

#### B. Management entity

Sponsors, initiators and promoters who require or wish to use the services of a management company or AIFM (referred to as a “management entity” in this *Technical Guide*) have the following options:

- Create a new group management entity, or use their existing group management entity

In practice, the group to which the initiator belongs usually holds a majority shareholding in the management company and is represented on the board. The group to which the initiator belongs thereby controls the management company and the group entity will be considered the “sponsor” of the management company (see also Section 6.2.2.B.).

<sup>56</sup> | A RAIF must be managed by an authorized AIFM; it cannot manage itself.

- ▶ Appoint a third-party management entity

A number of groups and independent management entities offer “third-party” management services.

In the “third-party management entity” model, the initiator or promoter generally does not control the management entity. It may or may not be represented on one of the key committees, such as an investment committee.

### C. Key function holders

When appointing key function holders, sponsors, initiators and promoters have the choice between persons belonging to the group and external (“independent”) persons. Independent persons may make themselves available on a one-to-one basis, or be made available by a “third-party” entity to which they belong.

Key function holders may include:

- ▶ Members of the board of directors of the UCI (see Chapter 5) and management company or AIFM (see also Section 5.1.6.1.)
- ▶ Senior management (also known as “conducting officers” – see Section 5.1.6.2.)
- ▶ Control functions (see Section 6.3.2.1.)

A number of specialist firms offer “third-party” key function holders.

### 1.4.3.3. Cross-border management

The UCITS and AIFM Directives<sup>57</sup> have introduced “management” passports. The passports allow a management entity (management company or AIFM) to manage UCIs (UCITS and AIFs, respectively) cross-border – i.e., in EU/EEA Member States other than their home Member State (“host” Member States).

UCIs may be managed cross-border either directly (free provision of services) or via a branch. Branches themselves do not benefit from a management passport.

UCIs which have not appointed a management entity do not have a management passport.

The following table illustrates the cross-border management possibilities under selected group models:

Management configurations	UCIs which can be managed	
	Local UCIs	UCIs in host Member State(s)
Management company managing:		
▶ Directly	✓	✓
▶ Via a branch in host Member State	X	✓
Self-managed UCIs	✓	X

See also Section 6.3.4.

### 1.4.3.4. Group management models

Asset management groups, particularly those operating in multiple jurisdictions, have a number of options for the management of their UCIs.

UCITS management companies and AIFMs may combine authorizations within a single entity and obtain a “dual” authorization as UCITS management company and AIFM. A “dual” authorized management entity is authorized to manage both UCITS and AIFs and can use the “management” passport to perform the activities for which it has been authorized in other EU/EEA Member States. It also benefits from “product” passports to market the UCITS products it manages to any type of investor and the AIF products it manages to professional investors, in all EU/EEA Member States.

The optimal model will probably be based on one or a combination of the following:

- ▶ The “super” model: creating a single management entity (a management company and/or AIFM) for an ensemble of UCIs, or converting an existing management company to a “super” entity

Typically “super” management entities will manage UCIs cross-border (see also Section 1.4.3.3.).

- ▶ The “multiple” model: local management entities in each UCI domicile, or for specific fund ranges

<sup>57</sup> Under the “UCITS IV” recast of the UCITS Directive.

- ▶ The “third-party” model: appointing one or more third-party management entities. Under this model, one third-party “super” management entity or multiple third-party management entities are appointed rather than setting up group management entities (see also Section 1.4.3.2.)
- ▶ The “self-managed” model: self-managed UCITS and internally managed AIFs (which are subject to the AIFM Law) are required to comply with most of the requirements applicable to management entities (see Section 6.2.1.C.). However, neither self-managed UCITS nor internally managed AIFs benefit from a passport enabling them to provide cross-border services

An increasing number of self-managed UCIs are appointing management entities.

The following table briefly summarizes possible management models for UCITS and AIFs:

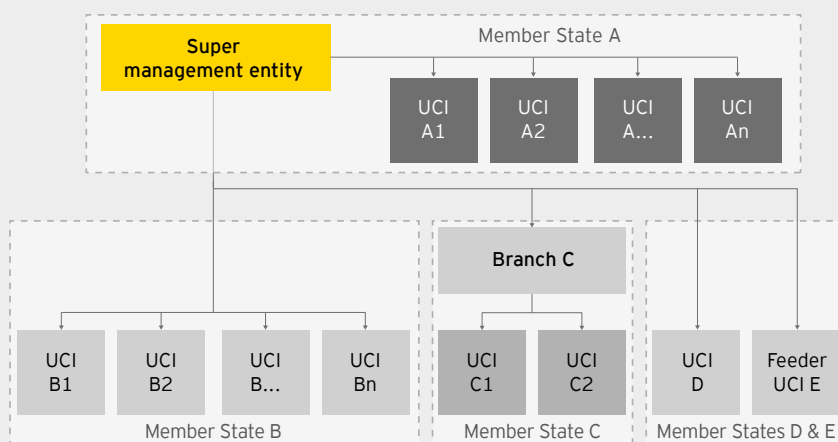
**Possible management models for UCITS and AIFs**

	UCITS	AIF	UCITS and AIF
“Super” model	“Super management company”	“Super AIFM”	“Super ManCo and AIFM”
“Multiple” model	Multiple management companies	Multiple management companies and/or AIFMs	Multiple management companies and multiple AIFMs
“Third-party” model	“Third-party management company”	“Third-party AIFM”	“Third-party management company and AIFM”
“Self-managed” model	Self-managed UCITS investment company	Internally managed AIF investment company	N/A

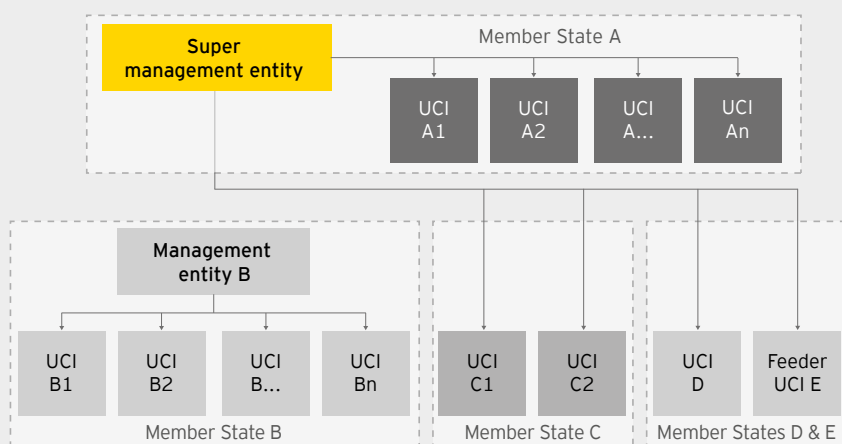
## Emerging mixed models

Two “mixed” models are emerging in practice:

- ▶ **“Super” entity model, potentially combining both branches and free provision of services:** These asset management groups will convert existing management entities in some Member States into branches of a single “Super” entity, and make use of free provision of services to manage UCIs in new Member States where the group does not operate (such as feeder UCITS in new domiciles). The following is an illustrative example of this model:



- ▶ **Home Member State “Super” entity plus international domicile entity model:** These asset management groups will opt to keep a management entity in their home domicile, and another in an international fund domicile. One of the management entities will be selected to provide cross-border services to UCIs in other Member States. The following is an illustrative example of this model:



### 1.4.3.5. Service provider models

Two important considerations when selecting service providers are whether the service provider is a group company or third party, and the domicile of the proposed service provider.

#### A. Group or third party

Where the UCI or management company is part of a financial group, the board of a UCI and/or its management entity may choose between group service providers and third parties. In certain cases, a service provider may be created by two or more groups as a joint venture.

In certain cases, delegation within a group is relevant from a regulatory perspective. For example:

- ▶ Management entities may consider delegation to a group internal audit function (see Section 6.3.2.1.C.)
- ▶ IT infrastructure of a management company may be provided by a group company (see Section 6.3.2.2.A.)
- ▶ Conflicts of interest must be considered in a group context (see Section 6.4.1.)
- ▶ In the context of the AIFM letter box provisions, when assessing whether an AIFM delegates the performance of investment management functions (portfolio management and risk management) to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself, one of the factors to be taken into account is whether the delegate is part of the same corporate group as the AIFM (see Section 6.3.3.1.H.)

## B. Domicile

Management entities are subject to the delegation requirements of their home Member State. They must also comply with the requirements of the home Member State of the UCIs they manage (the “host Member State” where the UCIs are managed on a cross-border basis) on the constitution and functioning of the UCIs.

In certain cases, asset management groups may therefore have the choice between service providers in:

- ▶ The domicile of the management company
- ▶ The domicile of the UCI
- ▶ Another country

An asset management group may therefore implement one or a combination of the following service provider models:

- ▶ Single service provider:
  - ▶ Centralized: A single service provider is selected to serve the UCIs in all host Member States from a central location
  - ▶ Decentralized: Service providers from the same financial services group are selected – generally one in each host Member State
- ▶ Multiple service providers: Service providers from different financial services groups are selected to serve different UCIs

From a Luxembourg perspective, there are a number of minimum rules which apply in relation to the domicile of service providers to UCIs, including the following:

- ▶ Administration (see also Chapter 8):
  - ▶ UCITS:
    - ▶ A Luxembourg UCITS management company which manages a Luxembourg UCITS is authorized to delegate the administration of the UCITS to an entity established in Luxembourg which is authorized to provide administration services and has adequate organization in order to perform the administration
    - ▶ A Luxembourg UCITS management company which manages a UCITS domiciled in another Member State is authorized to delegate the administration of the UCITS to an entity established in either:
      - ▶ Luxembourg
      - ▶ The Member State where the UCITS is domiciled
 The entity must be authorized to provide administration services and have an adequate organization in order to perform the administration
    - ▶ Luxembourg AIFs (including Part II 2010 Law UCIs, SIFs and RAIFs): The central administration of the UCI must be in Luxembourg
  - ▶ Depository: The depository of a Luxembourg UCI must be established in Luxembourg (see also Chapter 9)

### 1.4.4. Restructuring a UCI

Asset management groups may decide to restructure UCIs for a variety of reasons including, *inter alia*, optimization of operating models, cost reduction, economies of scale and focusing on certain target investor markets.

Typical types of restructuring of UCIs include:

- ▶ Restructuring UCIs:
  - ▶ Conversion of Luxembourg UCIs: 2010 Law UCIs into SIFs or RAIFs and *vice versa* (where possible) (see Section 3.6.1.) or from one basic structure to another (see Section 3.6.2.)
  - ▶ Conversion of an existing UCITS to a feeder UCITS (see Section 3.6.3.)
  - ▶ A feeder UCITS changing into a master UCITS (see Section 3.6.3.)
- ▶ Mergers of UCIs (see Section 3.7.)
- ▶ Creation of a side pocket, typically to hold illiquid assets (see Section 2.3.6. and 3.8.)
- ▶ Transferring foreign UCIs to Luxembourg (see Section 3.9.)
- ▶ Liquidation of UCIs and compartments (see Section 3.10.)



# 02

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## UCI STRUCTURES AND SPECIFICITIES

EY supports asset managers, traditional and alternative investment fund houses with the choice of fund vehicle and the creation of a fund structure that meets the relevant regulatory and tax requirements.



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## 2.1. Introduction

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This Chapter covers:

- ▶ The principal regulations applicable to Luxembourg investment funds (Undertakings for Collective Investment – UCIs)
- ▶ The types of structures of UCIs:
  - ▶ The basic structures of UCIs (common funds and investment companies)
  - ▶ Single and multiple compartment UCIs
  - ▶ Share or unit classes
  - ▶ Master-feeder structures
  - ▶ Co-management and pooling of assets
  - ▶ Cross investment between compartments of multiple compartment UCIs
  - ▶ Side pockets
- ▶ The requirements applicable to:
  - ▶ Undertakings for Collective Investment in Transferable Securities (UCITS)
  - ▶ 2010 Law Part II UCIs
  - ▶ Specialized Investment Funds (SIFs)
  - ▶ Reserved Alternative Investment Funds (RAIFs)
  - ▶ Alternative Investment Funds (AIFs): Full Alternative Investment Fund Manager (AIFM) regime AIFs and simplified AIFM registration regime AIFs
  - ▶ European Venture Capital Funds (EuVECAs) and European Social Entrepreneurship Funds (EuSEFs)
  - ▶ European Long-Term Investment Funds (ELTIFs)
- ▶ Minimum capital requirements
- ▶ The requirements applicable to specific types of UCIs:
  - ▶ Money market funds (MMFs)
  - ▶ UCITS exchange-traded funds (ETFs)
  - ▶ Index tracking UCITS
  - ▶ UCIs using efficient portfolio management (EPM) techniques, such as securities lending, repurchase transactions and certain risk hedging transactions using financial derivative instruments (FDIs)
  - ▶ UCITS using FDIs
  - ▶ Structured UCITS
  - ▶ Hedge funds
  - ▶ Real estate funds
  - ▶ Private equity funds
- ▶ Vehicles used in conjunction with AIFs, with a focus on Luxembourg vehicles:
  - ▶ *Sociétés de Participations Financières* (SOPARFI)
  - ▶ Securitization vehicles

## 2.2. Principal regulations

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The principal regulations applicable to Luxembourg UCIs comprise Luxembourg laws, regulations and circulars issued by the Commission for the Supervision of the Financial Sector (*Commission de Surveillance du Secteur Financier* – CSSF), and also certain Grand-ducal regulations. The laws and regulations are set out below.

The principal law on UCIs is the Law of 17 December 2010, as amended (the 2010 Law), which covers:

- ▶ Part I: UCITS
- ▶ Part II: Other UCIs (2010 Law Part II UCIs)
- ▶ Part III: Foreign UCIs
- ▶ Part IV: Management companies (see Chapter 6)
- ▶ Part V: General provisions applicable to UCITS and Part II UCIs

The 2010 Law, *inter alia*, transposed the UCITS Directive (Directive 2009/65/EC – often referred to as UCITS IV) into Luxembourg Law.

The Law of 10 May 2016 (2016 Law) transposed the *Directive 2014/91/EU of 23 July 2014 on UCITS as regards depositary functions, remuneration policies and sanctions* (UCITS V) thereby amending the 2010 Law and the AIFM Law. The 2016 Law came into force on 1 June 2016.

UCITS V focuses on three main areas:

- Revision of the depositary regime that applies to UCITS and their depositaries
- Introduction of rules on remuneration policies and practices that need to be applied by UCITS management companies and self-managed UCITS investment companies
- Harmonization of administrative sanctions and other administrative measures applicable to the CSSF

Level 2 measures relating to the implementation of UCITS V have been adopted by the European Commission on 17 December 2015.

The Law of 13 February 2007, as amended, (the SIF Law) covers SIFs.

Two European Union (EU) Regulations, each creating a fund regime, are directly applicable in Luxembourg: Regulation (EU) No 345/2013 of 17 April 2013 on European Venture Capital Funds (EuVECA), as amended, and Regulation (EU) No 346/2013 of 17 April 2013 on European Social Entrepreneurship Funds (EuSEFs), as amended.

The Law of 12 July 2013 on Alternative Investment Fund Managers, as amended, (the AIFM Law), transposing the AIFM Directive (Directive 2011/61/EU), lays down requirements applicable to AIFs.

Regulation (EU) No 760/2015 of 29 April 2015 on European Long-Term Investment Funds (ELTIFs) became applicable in Luxembourg on 9 December 2015. The purpose of this regulation is to boost European long-term investments in the real economy.

The regulation applies to EU AIFs that are marketed in the EU under the ELTIF label. Only authorized EU AIFMs may manage and market ELTIFs. ELTIFs are subject to additional rules requiring them, *inter alia*, to invest at least 70% of their capital in clearly-defined categories of eligible assets (generally illiquid assets). Trading in assets other than long-term investments will only be permitted up to a maximum of 30% of their capital (generally liquid assets). An ELTIF is not required to offer redemption rights before the end of its life. This must be clearly indicated as a specific date in the ELTIF rules or instruments of incorporation and disclosed to investors. ELTIFs target both professional and retail investors in the EU. See Section 2.4.5.

The Law of 23 July 2016, as amended, introduced Reserved Alternative Investment Funds (the RAIF Law). The RAIF Law lays down requirements applicable to the creation and operation of RAIFs.

On 30 June 2017, the final text of Regulation (EU) No 2017/1131 of the European Parliament and of the Council of 14 June 2017 on *money market funds* was published in the Official Journal of the European Union. The Regulation is applicable to all funds and compartments that qualify as MMFs as per the definition set out in Article 1 of the Regulation.

On 10 April 2018, the European Commission published a Delegated Regulation amending and supplementing the MMF Regulation *with regard to simple, transparent and standardised securitisations and asset-backed commercial papers, requirements for assets received as part of reverse repurchase agreements and credit quality assessment methodologies*.

On 17 April 2018, the European Commission published Commission Implementing Regulation (EU) 2018/708 *laying down implementing standards with regard to the template to be used by managers of money market funds when reporting to competent authorities as stipulated by Article 37 of Regulation (EU) 2017/1131 of the European Parliament and of the Council* (the MMF Regulation).

On 21 March 2018, the European Securities and Markets Authority (ESMA) published its *Guidelines on stress test scenarios under Article 28 of the MMF Regulation*, in which they established common reference parameters of the scenarios to be included in the stress tests, taking into account the factors specified in Article 28(1) of the MMF Regulation. The last update of these guidelines is dated 4 May 2022.

## 2.3. Types of structures of UCIs

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UCITS, 2010 Law Part II UCIs, SIFs and RAIFs<sup>1</sup> can be structured:

- In contractual form as a common fund (FCP). An FCP must be managed by a management company
- In corporate form as an investment company:
  - With variable capital (SICAV)
  - With fixed capital (SICAF)

While a UCITS must be open-ended<sup>2</sup>, non-UCITS can be open-ended or closed-ended. The different basic structures are outlined in Section 2.3.1.

A UCI may take the form of a single compartment UCI (a “stand alone” UCI) or a multiple compartment UCI (a multiple “sub-fund” UCI, also known as an “umbrella” UCI). Multiple compartment UCIs are covered in Section 2.3.2. Share or unit classes can be created within a single UCI, or within one or several compartments of a multiple compartment UCI; this is covered in Section 2.3.3.

<sup>1</sup> It is also possible to structure RAIFs in other forms. Common funds and investment companies are expected to be the most frequently adopted structures.

<sup>2</sup> The shares or units of open-ended UCIs are, at the request of holders, redeemed directly or indirectly, out of the UCI's assets.

In order to manage portfolios in an efficient manner, it is also possible to create master-feeder structures as outlined in Section 2.3.4.1. and to co-manage or to pool funds, as outlined in Section 2.3.4.2.

Cross investment between compartments of a multiple-compartment UCI is permitted under certain conditions, as described in Section 2.3.5. Side pockets, typically to hold illiquid assets as described in Section 2.3.6., may be created in exceptional circumstances.

## 2.3.1. Basic structures

### 2.3.1.1. Common fund

Common fund (*fonds commun de placement* – FCP)

An FCP is a co-proprietorship whose joint owners are only liable up to the amount they have contributed and whose ownership rights are represented by units.

An FCP has no legal personality and must be managed by an authorized management company:

- A UCITS common fund must be managed by a Luxembourg UCITS (Chapter 15) management company or a management company established in another EU/European Economic Area (EEA) Member State<sup>3</sup>
- An AIF common fund must be managed by a Luxembourg management company. The management company may either:
  - Manage the AIF itself; where the assets of all the AIF managed by the management company exceed certain thresholds, the management company will be required to obtain authorization as an AIFM
  - Appoint an authorized AIFM in Luxembourg or another EU/EEA Member State

Management companies and AIFMs are covered in Chapter 6.

An FCP is deemed in most cases to be tax transparent.

The constitutional document of a common fund is the management regulations (also known as fund rules). The management regulations of a Luxembourg common fund are subject to Luxembourg Law (see Section 10.2.1.).

### 2.3.1.2. Investment company

- Investment company with variable capital (*société d'investissement à capital variable* – SICAV)
- Investment company with fixed capital (*société d'investissement à capital fixe* – SICAF)

An investment company with variable capital (SICAV) is a company whose capital is always equal to its net assets. No formalities are required for increases and decreases in capital.

The share capital of an investment company with fixed capital (SICAF) may only be increased or decreased by way of a decision of the general meeting of shareholders to be held before a notary, and subject to applicable publication requirements. However, the capital may be increased by the SICAF's managing body directly, without requiring an extraordinary general meeting of shareholders to decide upon the increase, via the authorized share capital mechanism. In such a case, notarization and publication requirements will still apply.

An investment company may:

- Be managed by an authorized management company or AIFM:
  - A UCITS investment company may appoint either:
    - A Luxembourg UCITS (Chapter 15) management company
    - A UCITS management company established in another EU/EEA Member State<sup>4</sup>
  - An AIF investment company (or in the case of a limited partnership or a partnership limited by shares, the managing general partner or the manager) may appoint either:
    - An authorized AIFM, which may either be:
      - A Luxembourg AIFM
      - Another EU/EEA Member State AIFM
    - A Luxembourg management company, which may either be:
      - A Luxembourg UCITS (Chapter 15) management company
      - A Luxembourg non-UCITS (Chapter 16) management company

<sup>3</sup> The EEA Member States are the European Union (EU) Member States plus Iceland, Liechtenstein and Norway. The reference to the EEA is clarified in Section 1.3.1.B.

<sup>4</sup> Idem.

The management company may either:

- Manage the AIF itself. However, where the assets of all the AIF managed by the management company exceed certain thresholds, the management company will be required to:
  - Obtain authorization as an AIFM
  - Appoint an authorized AIFM
- Appoint an authorized AIFM which may either be:
  - A Luxembourg AIFM
  - Another EU/EEA Member State AIFM
- Manage itself:
  - A UCITS investment company that manages itself is called a self-managed UCITS. The specific requirements applicable to self-managed UCITS are covered in Sections 2.4.1.5. and 6.2.1.C.
  - An AIF investment company that manages itself is called an internally managed AIF<sup>5</sup>. Where the AIF is in the form of a limited partnership or a partnership limited by shares, and the purpose of the manager of the partnership is limited to the AIF, such AIF may also be considered an internally managed AIF. However, where the assets of the AIF exceed certain thresholds, the internally managed AIF is required to either:
    - Obtain authorization as an AIFM
    - Appoint an authorized AIFM

The specific requirements applicable to internally managed AIF are covered in Section 6.2.1.C.

Management companies and AIFMs are covered in Chapter 6.

The constitutional document of an investment company is the articles of incorporation (also known as instruments of incorporation, articles of association or statutes) or partnership agreement (see Section 10.2.2.).

UCIs established as investment companies are also subject to the Luxembourg laws covering commercial companies (in particular, the Law of 10 August 1915 on commercial companies, as amended – the 1915 Law) insofar as the law governing the UCI (the 2010 Law, the SIF Law or the RAIF Law) does not derogate from it<sup>6</sup>.

Investment companies may, in some cases, be subject to the requirements on remuneration policies in the financial sector (see Section 6.4.3.).

While a 2010 Law SICAV must be set up as a public limited company (*société anonyme* – S.A.) or a European company (S.E.), a SIF SICAV and a RAIF SICAV can be set up as a public limited company, a private limited liability company (*société à responsabilité limitée* – S.à r.l.), a partnership limited by shares (*société en commandite par actions* – S.C.A.), a limited partnership (*société en commandite simple* – S.C.S.), a special limited partnership (*société en commandite spéciale* – S.C.Sp.), or a cooperative company organized as a public limited company (*société coopérative organisée sous forme de société anonyme* – S.Co S.A.). A SICAV set up as a public limited company or a private limited liability company may be created for a single shareholder, enabling SICAVs to be incorporated by a single entity/person and permitting their creation for a single investor.

A 2010 Law Part II SICAF, a SIF SICAF or a RAIF SICAF may take any commercial company form, such as the aforementioned legal forms or, in addition, the form of an unlimited company (*société en nom collectif*).

SICAVs and SICAFs incorporated under the form of a capital company (S.A., S.à r.l., S.C.A., S.Co S.A. or S.E.) are not tax transparent, while those investment companies formed as a partnership (S.C.S or S.C.Sp.) are generally treated as tax transparent entities.

<sup>5</sup> Special limited partnerships are not legal entities; they cannot manage themselves.

<sup>6</sup> UCIs established as European investment companies must meet the requirements imposed on Luxembourg public limited companies by the 1915 Law, insofar as the Law the UCI is under does not derogate from it, as well as certain other provisions set out in the Law of 25 August 2006 on the European company, as amended.

The following table details the main differences between the corporate forms which may be used to create investment companies:

### Main corporate forms of investment companies

	Public limited company	European company	Private limited liability company	Partnership limited by shares	Special limited partnership <sup>7</sup>	Limited partnership	Cooperative company organized as a public limited company
French name	<i>Société Anonyme</i>	<i>Société Européenne</i> <sup>8</sup>	<i>Société à Responsabilité Limitée</i>	<i>Société en Commandite par Actions</i>	<i>Société en Commandite Spéciale</i>	<i>Société en Commandite Simple</i>	<i>Société Coopérative organisée sous forme de Société Anonyme</i>
Common abbreviation	S.A.	S.E.	S.à r.l.	S.C.A.	S.C.Sp.	S.C.S.	S.Co S.A.
Possible use by investment companies	<ul style="list-style-type: none"> <li>▸ 2010 Law SICAV or SICAF</li> <li>▸ SIF Law SICAV or SICAF</li> <li>▸ RAIF Law SICAV or SICAF</li> </ul>	<ul style="list-style-type: none"> <li>▸ 2010 Law SICAV or SICAF</li> <li>▸ SIF Law SICAV or SICAF</li> <li>▸ RAIF Law SICAV or SICAF</li> </ul>	<ul style="list-style-type: none"> <li>▸ 2010 Law Part II SICAF</li> <li>▸ SIF Law SICAV or SICAF</li> <li>▸ RAIF Law SICAV or SICAF</li> </ul>	<ul style="list-style-type: none"> <li>▸ 2010 Law Part II SICAF</li> <li>▸ SIF Law SICAV or SICAF</li> <li>▸ RAIF Law SICAV or SICAF</li> </ul>	<ul style="list-style-type: none"> <li>▸ 2010 Law Part II SICAF</li> <li>▸ SIF Law SICAV or SICAF</li> <li>▸ RAIF Law SICAV or SICAF</li> </ul>	<ul style="list-style-type: none"> <li>▸ 2010 Law Part II SICAF</li> <li>▸ SIF Law SICAV or SICAF</li> <li>▸ RAIF Law SICAV or SICAF</li> </ul>	<ul style="list-style-type: none"> <li>▸ 2010 Law Part II SICAF</li> <li>▸ SIF Law SICAV or SICAF</li> <li>▸ RAIF Law SICAV or SICAF</li> </ul>
Legal entity	Yes	Yes	Yes	Yes	No	Yes	Yes
Listing possible	Yes	Yes	No	Yes	No	No	No
Minimum subscribed share capital <sup>9</sup>	EUR 30,000	EUR 120,000	EUR 12,000	EUR 30,000	None	None	None
Transferability of shares/units	Free, subject to restriction in articles of association	Free, subject to restriction in articles of association	Restricted	Free, subject to any restrictions in articles of association	Free, subject to any restrictions in articles of association	Requires unanimous consent of all the partners	Not transferable to third parties
Notarial deed	Yes	Yes	Yes	Yes	No <sup>10</sup>	No <sup>11</sup>	Yes
Minimum number of shareholders, partners or members	1	1	1	2 (1 general partner and 1 limited partner)	2 (1 general partner and 1 limited partner)	2 (1 general partner and 1 limited partner)	7
Maximum number of shareholders, partners or members	Unlimited	Unlimited	100	Unlimited	Unlimited	Unlimited	Unlimited
Minimum number of Directors or managers	One tier: 3 Directors; Two tier <sup>12</sup> : 2 members of management Board, 3 members of supervisory Board <sup>13</sup>		3 managers <sup>14</sup>	3 managers or a general partner (whose Board is composed of at least 3 members)	3 managers or a general partner <sup>15</sup> (whose Board is composed of at least 3 members)	3 managers or a general partner <sup>16</sup> (whose Board is composed of at least 3 members)	3 Directors <sup>17</sup>

<sup>7</sup> The AIFM Law implemented significant amendments to the 1915 Law, including the clarification of the partnership regimes and the introduction of a special limited partnership (*société en Commandite Spéciale* – S.C.Sp.).

<sup>8</sup> More generally known by the Latin name *societas europaea*.

<sup>9</sup> Minimum capital requirements are covered in Section 2.5.

<sup>10</sup> According to corporate law, the partnership may be created via the execution of a partnership agreement in the form of a private deed. However, a notarial deed may be required under fund law (e.g., under the RAIF Law).

<sup>11</sup> Idem.

<sup>12</sup> Whereas a one tier structure has a single governing body, a two tier structure has a management board and a supervisory board. The management board has the power to execute all activities necessary to achieve the company's objectives and must have at least two members (one member is permitted if the share capital of the company is less than EUR 500,000, or if the company has a single shareholder). The supervisory board is in charge of the supervision of the company and cannot play a role in the day-to-day management of the company.

<sup>13</sup> Where there is more than one shareholder.

<sup>14</sup> In practice.

<sup>15</sup> Expected minimum requirement.

<sup>16</sup> Expected minimum requirement.

<sup>17</sup> In practice.

### Main corporate forms of investment companies

	Public limited company	European company	Private limited liability company	Partnership limited by shares	Special limited partnership <sup>7</sup>	Limited partnership	Cooperative company organized as a public limited company
Audit requirements	A UCITS must have its financial statements audited within 4 months of its financial year end. A UCI set up under Part II of the 2010 Law, SIF Law or RAIF Law is required to have its financial statements audited within 6 months of the UCI's year end (4 months if the UCI is admitted to trading on a regulated market). See Chapter 10	A UCITS must have its financial statements audited within 4 months of its financial year end. A UCI set up under Part II of the 2010 Law, SIF Law or RAIF Law is required to have its financial statements audited within 6 months of the UCI's year end (4 months if the UCI is admitted to trading on a regulated market). See Chapter 10	A UCI set up under Part II of the 2010 Law, SIF Law or RAIF Law is required to have its financial statements audited within 6 months of the UCI's year end (4 months if the UCI is admitted to trading on a regulated market). See Chapter 10	A UCI set up under Part II of the 2010 Law, SIF Law or RAIF Law is required to have its financial statements audited within 6 months of the UCI's year end (4 months if the UCI is admitted to trading on a regulated market). See Chapter 10	A UCI set up under Part II of the 2010 Law, SIF Law or RAIF Law is required to have its financial statements audited within 6 months of the UCI's year end (4 months if the UCI is admitted to trading on a regulated market). See Chapter 10	A UCI set up under Part II of the 2010 Law, SIF Law or RAIF Law is required to have its financial statements audited within 6 months of the UCI's year end (4 months if the UCI is admitted to trading on a regulated market). See Chapter 10	A UCI set up under Part II of the 2010 Law, SIF Law or RAIF Law is required to have its financial statements audited within 6 months of the UCI's year end (4 months if the UCI is admitted to trading on a regulated market). See Chapter 10

In practice, an investment company is generally set up as an S.A. or an S.à r.l. or, in the case of a partnership, an S.C.S. or an S.C.A.

### 2.3.2. Multiple compartment UCIs

Multiple compartment UCIs (otherwise known as umbrella funds) are UCIs which comprise, or may comprise, two or more compartments (sub-funds), each with different features – generally a different investment policy/strategy.

Different compartments may, for example, invest in different asset classes.

Multiple compartment structures are favored by the larger promoters and initiators of UCIs.

The assets of each compartment of a multiple compartment UCI are generally segregated and the accounting records of each compartment are kept separate.

Multiple compartment UCIs are recognized under Article 181 of the 2010 Law, Article 71 of the SIF Law and Article 49 of the RAIF Law. Multiple compartment UCIs may be created provided their constitutional document expressly permits it and specifies the applicable operational rules, and their prospectus or offering document specifies the investment policy and specific features of each compartment. By way of derogation from Civil Code, the rights of investors and of creditors concerning a compartment, or which have arisen in connection with the creation, operation or liquidation of a compartment, are limited to the assets of that compartment (i.e., segregation of assets and liabilities on a compartment by compartment basis – protected cell concept), unless a clause included in the constitutional document provides otherwise.

Investors may, if permitted by the constitutional document, prospectus or offering document, “switch” all or part of their investment from one compartment to another, in principle without incurring significant charges.

By permitting investors to switch between compartments, promoters and initiators may retain in the same UCI those investors who wish to change their investment strategy.

### A. All multiple compartment UCIs

All multiple compartment UCIs must meet the following requirements:

- ▶ The constitution of a multiple compartment UCI must ensure that each compartment is treated as a separate entity having its own funding, capital gains and losses, expenses, etc.
- ▶ The opening of a new compartment requires CSSF approval (except UCIs set up under the RAIF Law) and a prospectus or offering document update
- ▶ The UCI must have a single name and each compartment should have a distinct name
- ▶ The UCI must have a single depository (i.e., the same depository for all compartments); the depository may use a sub-custodian network
- ▶ The UCI must have a single auditor (i.e., the same auditor for all compartments)
- ▶ Shareholders or unitholders may, in principle, be able to move from one compartment to another without incurring significant charges; the fund documentation of the UCI may restrict this possibility
- ▶ The constitutional document must state the presentation currency of the combined financial statements of the UCI, obtained by aggregating the various compartments
- ▶ The net asset value (NAV) of a share or unit is calculated by reference to the net assets of the compartment for which that share or unit has been issued, by reference to the net assets of the share or unit class in which this share or unit has been issued. The value of shares or units in respect of the same UCI consequently differs between compartments, and within one compartment, between share or unit classes
- ▶ Subscription and redemption of shares or units of each compartment must, for 2010 Law UCIs, be executed at a price obtained by dividing the NAV of each compartment (or, where relevant, of each share or unit class) by the number of shares or units in circulation; SIFs and RAIFs are required to follow the rules laid down in their constitutional document (see Sections 8.7. and 8.8.)
- ▶ Certificates or other documents evidencing the rights of shareholders or unitholders may only differ in respect of the designation of the particular compartment for which they are issued
- ▶ Diversification rules specified by the applicable law or the CSSF must be complied with by each compartment (see however Section 4.2.2.8.2.)

One compartment of a multiple compartment UCI may invest in other compartments of the same UCI (see Section 2.3.5.).

### B. Multiple compartment common funds

In addition to the requirements described in Section 2.3.2.A., multiple compartment common funds must meet the following conditions:

- ▶ The UCI must have a single management company (i.e., the same management company for all compartments)
- ▶ The UCI must have a set of management regulations, either global or per compartment, which define the general rules of valuation, supervision, subscription and redemption and investment restrictions

### C. Multiple compartment investment companies

In addition to the requirements described in Section 2.3.2.A., multiple compartment investment companies must meet the following conditions:

- ▶ The investment company must have a capital represented by shares, which consequently implies that:
  - ▶ There is a single share capital expressed in a single currency
  - ▶ The nominal or par value is expressed in that same currency
  - ▶ The annual accounts are also expressed in that same currency

However, the NAV of each compartment or, where relevant, of each share class, is denominated in the currency of the relevant compartment or share class (see Section 2.3.3.).

- ▶ Each share of the same type gives the right to one vote. The CSSF recommends that the equality of voting rights is emphasized in the articles of incorporation. In addition, the articles of incorporation should distinguish between those decisions in which all shareholders have an interest and are taken at the company's general meeting of shareholders and those concerning the particular shareholders of one compartment and are taken at the general meeting of shareholders of that compartment (see also Sections 10.2.2. and 10.6.)<sup>18</sup>
- ▶ The articles of incorporation must list the conditions for suspension of the NAV calculation and the subscription and redemption of shares of the UCI and of an individual compartment

## 2.3.3. Share or unit classes

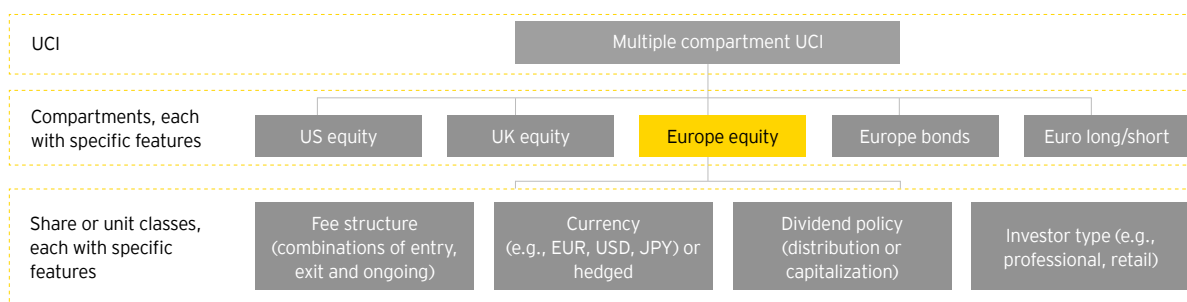
Multiple share or unit classes may be created within a UCI or, in the case of a multiple compartment UCI, within a compartment.

<sup>18</sup> | Subject to restrictions for cross investments (see also Section 2.3.5.).



While the investment policy is defined at the level of the UCI or the compartment, share or unit classes permit the implementation of features, generally customized to one or more specific needs or preferences, such as a specific fee structure, currency of denomination, hedging policy, dividend policy, investor type or country of distribution.

#### Structure of a possible multiple compartment, multiple share or unit class structure<sup>19</sup>



Identification numbers (such as ISIN - International Security Identification Number) are attributed at the level of the share or unit class.

The UCITS Directive recognizes the possibility for UCITS to offer different share classes to investors but it does not prescribe whether, and to what extent share classes of a given UCITS can differ from each other.

Following observation of the diverging national practices as to the types of share class that were permitted, ranging from very simple share classes, e.g., with different levels of fees, to much more sophisticated share classes, e.g., with potentially different investment strategies, on 30 January 2017, ESMA issued an opinion on *share classes of UCITS* which covers the extent to which different types of units or shares (share classes) of the same UCITS can differ from one another.

In its Opinion, ESMA sets out four high-level principles which UCITS must follow when setting up different share classes in order to ensure a harmonized approach across the EU:

- ▶ Common investment objective: Share classes of the same UCITS should have a common investment objective reflected by a common pool of assets. ESMA considers that hedging arrangements at share class level - with the exception of currency risk hedging - are not compatible with the requirement for a UCITS to have a common investment objective
- ▶ Non-contagion: UCITS management companies should implement appropriate procedures to minimize the risk that features specific to one share class could have a potentially adverse impact on other share classes of the same UCITS. In this respect, ESMA is of the view that, amongst other rules, the over-hedged positions should not exceed 105% of the NAV of the share class and the under-hedged positions should not fall short of 95% of the portion of NAV of the share class which is to be hedged against currency risk
- ▶ Pre-determination: All features of the share class should be pre-determined before the UCITS is set up
- ▶ Transparency: Differences between share classes of the same UCITS should be disclosed to investors when they have a choice between two or more classes

In order to mitigate the impact on investors in share classes that were established prior to this Opinion and are not compliant with these principles, ESMA is of the view that the share classes should be allowed to continue operations. However, such share classes had to be closed to new investors by 30 July 2017, and to additional investment by existing investors by 30 July 2018.

ESMA's Opinion was adopted by the CSSF following its Press Release on 13 February 2017. New share classes must immediately comply with the common principles contained within the ESMA's Opinion for setting up share classes in UCITS.

In its FAQ concerning the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment, the CSSF provided the following clarifications:

#### A. Common investment objective

- ▶ Currency hedging arrangements which systematically hedge out part or all of the foreign currency exposure in the common pool of assets into the share class currency are compatible with the principle of a common investment objective provided all the requirements set forth in the ESMA's Opinion are met

#### B. Non-contagion

- ▶ Share classes providing a partial hedge of currency risk (for example, 50%) are permitted
- ▶ With respect to share classes which are hedged against currency risk, should the hedging ratio fall out with the 95%-105% range, CSSF Circular 02/77 does not apply. The CSSF expects the UCITS management companies or UCITS itself to define and implement monitoring and control processes/procedures for ensuring compliance with the hedging ratios on an ongoing basis

<sup>19</sup> This graphic is designed to illustrate a multiple-compartment, multiple share or unit class structure; it is not designed to represent a typical structure.

On 9 January 2018, the Association of the Luxembourg Fund Industry (ALFI) issued its first conclusions on technical issues further to discussions with the CSSF in relation to ESMA's Opinion on UCITS share classes. ALFI clarified that there is no requirement to set up hedging contracts at share class level but that both derivatives and collateral attributable to every share class must be identifiable at any time and that it is up to each promoter/sponsor to adopt the most adequate model to ensure compliance with the allocation of collateral at share class level taking into account the specificities of each fund concerned.

#### C. Pre-determination

- ▶ All the features of a share class should be pre-determined before the share class is set up, including the systematic hedging out of the currency risk. The ESMA's Opinion does not provide for any discretionary elements in the currency risk hedging strategy. However, the discretion as to the type of derivative instrument used to hedge the currency risk and the operational implementation are not limited by the pre-determination requirement

#### D. Transparency

- ▶ The UCITS should provide a list in the form of readily available information which should be kept current with respect to share classes with contagion risk. The list can be addressed by means of a website publication provided the prospectus includes a link to the relevant website
- ▶ The prospectus should provide the details of the types and main characteristics of the share classes such as, *inter alia*, fee structure, dividend policy, investor type, currency or currency risk hedging. An exhaustive list of all individual shares with all their individual characteristics is not necessary. Additional information on share classes issued (e.g., list of share classes offered or effectively launched) should be available to investors either on request and free of charge, or through a reference in the prospectus to an internet website, where such information can be found
- ▶ If an update to the prospectus includes changes to the rights/interests of the investors, a notice to the investors is required

### 2.3.4. Management of assets

In addition to the traditional management of assets, assets may be managed using master-feeder structures or co-management or pooling to manage portfolios in an efficient manner.

#### 2.3.4.1. Master-feeder structures

In master-feeder structures, the feeder UCI invests most of its assets in a master UCI. Therefore, the management of a significant portion of the portfolio of the feeder UCI is effectively performed by the manager of the master UCI.

Master-feeder structures can be created under any of Luxembourg's fund regimes. They can also be created in combination with foreign UCIs – the Luxembourg UCI being the master and the foreign UCI the feeder and *vice versa*.

Taxation issues in relation to master-feeder structures are covered in Section 11.3.

#### A. UCITS

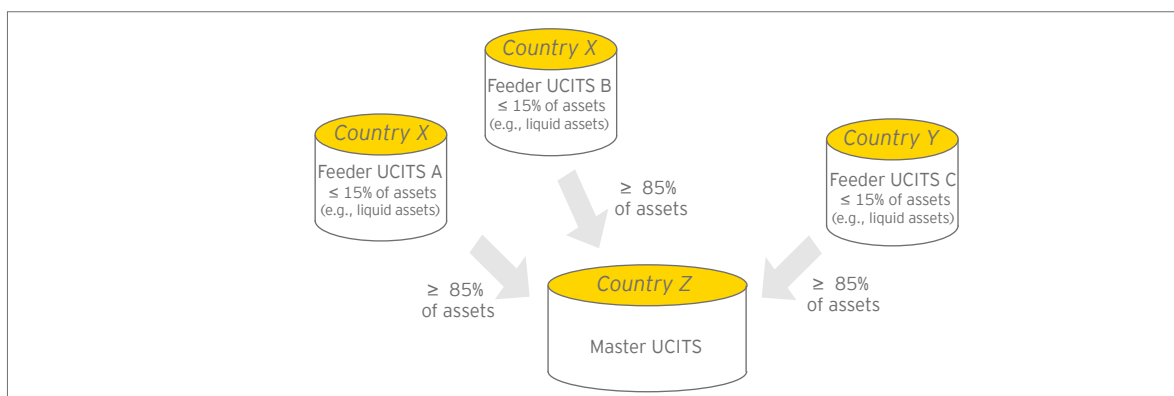
Specific requirements are applicable to master-feeder UCITS structures – i.e., where both the master and feeder are UCITS.

UCITS are, *inter alia*, required to meet detailed diversification requirements (see Section 4.2.2.). The possibility to create a feeder UCITS represents a specific derogation from UCITS investment rules, and is therefore subject to specific requirements. These are outlined in the remainder of this section.

Master-feeder UCITS structures are covered by Chapter 9 of the 2010 Law.

To be deemed a master-feeder UCITS structure under the 2010 Law, the feeder UCITS must invest at least 85% of its assets into a single master UCITS. The feeder UCITS may invest up to 15% of its assets in ancillary liquid assets, FDIs which may only be used for hedging or, in the case of investment companies, moveable and immoveable property essential for the direct pursuit of business (see also Section 4.2.2.8.1.VII.).

### Possible master-feeder scenario



A master UCITS cannot itself be a feeder and cannot invest in a feeder UCITS.

The master UCITS and the feeder UCITS can be located in different EU/EEA Member States.

Before investing into a master UCITS, the feeder UCITS need to obtain approval from the CSSF. The master UCITS and feeder UCITS are required to enter into an agreement, *inter alia*, to provide the feeder UCITS with all documents and information necessary for the feeder UCITS to be able to comply with the requirements of the 2010 Law. The minimum content is detailed in CSSF Regulation 10-5 and includes, *inter alia*:

- ▶ Access to information, including:
  - ▶ How and when the master UCITS provides the feeder UCITS with its constitutional document, prospectus and Key Investor Information Document (KIID), information on delegation of portfolio management and risk management functions, and, where applicable, internal operating documents
  - ▶ The details of constitutional document or bilateral agreement breaches that the master UCITS will notify to the feeder UCITS, the manner and the timing thereof (see Section 8.8.1.1.)
  - ▶ Where the feeder UCITS uses financial derivative instruments for hedging purposes, how and when the master UCITS will provide the feeder UCITS with information about its actual exposure to financial derivative instruments to enable the feeder UCITS to calculate its own global exposure
  - ▶ A statement that the master UCITS will inform the feeder UCITS of any other information-sharing arrangements entered into with third parties, and, where applicable, how they will be made available to the feeder UCITS
  - ▶ Basis of investment and divestment by the feeder UCITS, standard dealing arrangements and events affecting dealing arrangements (see Section 8.8.1.1.)
- ▶ Standard arrangements for the audit report
- ▶ Changes to standing arrangements
- ▶ The applicable law (i.e., the law of the master's and/or feeder's home Member State) and that both UCITS agree to the exclusive jurisdiction of the courts of that Member State

Where both the master UCITS and feeder UCITS are managed by the same management company, the agreement may be replaced by internal conduct of business rules, which should cover, *inter alia*:

- ▶ Measures to mitigate conflicts of interest that may arise between the feeder UCITS and the master UCITS, or between the feeder UCITS and other shareholders and unitholders of the master UCITS, to the extent that these are not sufficiently addressed by the measures applied by the management company (see Section 6.4.1.)
- ▶ Basis of investment and divestment by the feeder UCITS, standard dealing arrangements, and events affecting dealing arrangements (see Section 8.8.1.1.)
- ▶ Standard arrangements for the audit report

The prospectus of the feeder UCITS must declare explicitly its status as a feeder UCITS. The prospectus must include, *inter alia*, information on the investment objectives and policies of both master UCITS and feeder UCITS, a summary of the agreement (or internal conduct of business rules) between master UCITS and feeder UCITS, costs and tax implications as well as an indication of where to obtain the prospectus of the master UCITS (see also Section 10.3.1.J.).

Master UCITS and feeders UCITS may have different depositaries and auditors. Such depositaries and auditors must enter into information-sharing agreements (see also Section 9.4.6.2.).

An existing UCITS may convert to a feeder UCITS. A feeder UCITS may also change its master UCITS. Prior to making such changes, the UCITS must inform its shareholders or unitholders and provide certain information to them including, *inter alia*, its KIID and the KIID of the master UCITS. The shareholders or unitholders will then have 30 days to request the redemption of their shares or units free of charge (except for divestment costs) (see also Section 3.6.3.).

If any distribution fee or commission is received due to the investment of the feeder UCITS in the master UCITS (by the feeder UCITS itself, its management company or by any other person acting on behalf of the feeder UCITS or its management company), this distribution fee or commission should be paid to the feeder UCITS.

An existing UCITS may become a master UCITS.

A master UCITS should immediately inform the supervisory authority of its home Member State of the identity of each feeder UCITS that invests in its shares or units. The master UCITS must not charge subscription or redemption fees to the feeder UCITS.

### B. SIFs

SIF feeder structures are permitted under the SIF diversification rules that specify that SIFs are not subject to the SIF diversification rules if they invest into target UCIs subject to risk diversification principles that are at least comparable to those relevant to SIFs (see Section 4.3.).

### C. AIFs

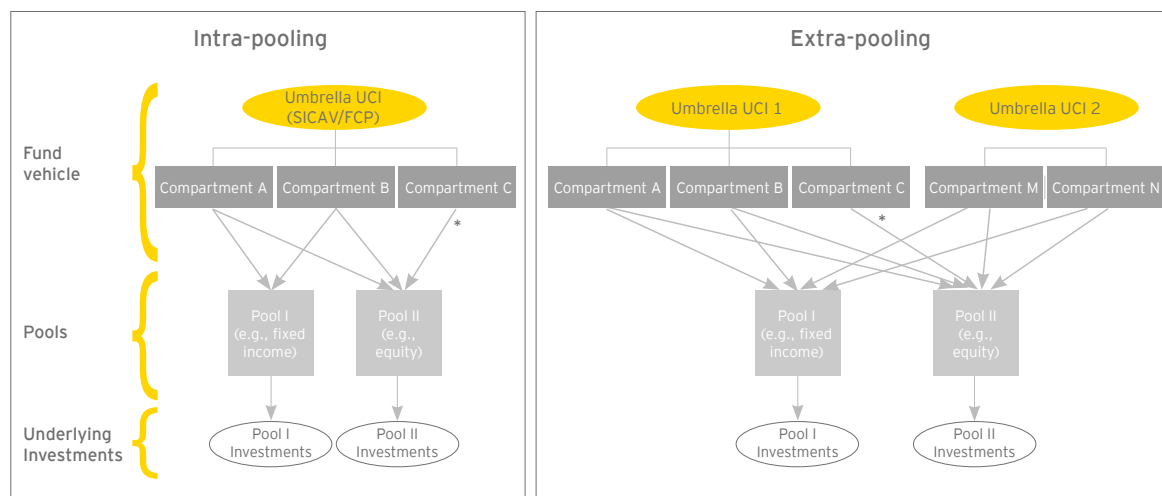
Under the AIFM Law and the AIFM Directive, an authorized AIFM is permitted to market feeder AIFs to professional investors in the EU/EEA with a passport only if the master AIF is managed by an authorized EEA AIFM (see Section 12.5.2.1.1.).

## 2.3.4.2. Co-management and pooling of assets

To ensure EPM and provided the investment policies so permit, the management of a UCI may decide to co-manage, or pool, certain assets within a single fund vehicle (intra-pooling) or between two or more Luxembourg fund vehicles (extra-pooling). Cross-border pooling between fund vehicles domiciled in different national jurisdictions may also be permitted. The assets being co-managed are commonly referred to as a "pool". Pooling enables different compartments of a fund or funds to invest in a pool or several pools of assets. This arrangement is an administrative process that can reduce portfolio management, administration, and custody costs without changing the legal rights and obligations of shareholders or unitholders.

The pools are not legal entities and are not directly accessible to investors. Each of the co-managed funds remains entitled to its specific assets, and responsible for its liabilities. Where the assets of one or more funds are pooled, the assets of the pool attributable to each fund will initially be based on the value of the assets allocated to the pool. Subsequently, each fund's portion of the pool will vary according to withdrawals from and additional allocations to the pool.

Each line item held within the pool, as well as all gains and losses generated by the pool, must be allocated to each fund investing in the pool in accordance with the ratio of the pool each fund is entitled to.



\* In the scenario, Compartment C invests 100% in Pool II

There is an ongoing industry discussion on the application of pooling techniques following the publication of CDRs 2018/1618 and 2018/1619 amending the AIFM and UCITS Directives respectively.

The impact of the European Market Infrastructure Regulation (EMIR) should be carefully considered in the framework of existing and future pooling structures. Whether pools are considered as legal entities under EMIR depends on each specific situation.

## 2.3.5. Cross investment

Multiple compartment UCIs are permitted to invest in other compartments of the same UCI (cross investment) as long as certain conditions are met.

Conditions to be met in the case of cross investment		
	2010 Law UCIs	SIFs/RAIFs
Such investment is provided for in the:		
▸ Constitutional document	X	<sup>20</sup>
▸ Prospectus or offering document	X	X
The target compartment does not invest in the investing compartment	X	X
Not more than 10% of the assets of the target compartment must be invested in other compartments of the same UCI	X	<sup>21</sup>
The voting rights of the investing compartment in relation to its investment into the target compartment are suspended during the period of investment	X	X
The value of cross investments must not be taken into account in calculating the net assets in the context of meeting the minimum net asset requirements	X	X

## 2.3.6. Creation of a side pocket

Where a UCI or a compartment thereof is invested in illiquid assets, some or all of these assets may, under certain conditions, be transferred to a side pocket. Side pockets may be created within 2010 Law UCIs, SIFs and RAIFs. However, a side pocket may only be created within a UCITS in very limited circumstances. Side pockets may not be used to solve temporary valuation problems.

The two main types of side pocket are:

- A spin-off from an existing share class or unit class to a new share class or unit class
- A spin-off from an existing compartment to a new compartment

On the date of creation of the side pocket, the illiquid assets are allocated to the new share class, unit class or compartment – the side pocket. The investors of the existing share class, unit class or compartment receive shares or units in the side pocket on a *pro rata* basis according to their holding in the existing share class, unit class, or compartment.

The side pocket is closed to any new subscriptions and suspended for redemptions (and conversions).

The manager is required to manage the assets in the side pocket with the objective of realizing them in the best interests of, and distributing the proceeds to, investors. Upon the sale of the assets in the side pocket, its shares or units are redeemed or cancelled.

The fast-track procedure for the creation of a side pocket, as well as the use of a side pocket to address illiquid assets resulting from the Ukraine crisis are outlined in Section 3.8.

## 2.4. Specific requirements by regime

This section outlines specific requirements applicable to 2010 Law UCIs, SIFs, RAIFs and ELTIFs.

In addition to the requirements outlined in this section, UCIs may be subject to specific requirements on:

- Investment rules, covered in Chapter 4
- Portfolio management
- Risk management and valuation, covered in Chapter 7
- Prospectus and issuing document and financial reporting, covered in Chapter 10
- Marketing, covered in Chapter 12

Requirements common to all Luxembourg AIFs, including 2010 Law Part II UCIs, SIFs, RAIFs and ELTIFs, are covered in Section 2.4.4.

Requirements applicable to investment companies that have not appointed a management company (self-managed UCITS and internally managed AIFs) are covered in Section 6.2.1.C.

<sup>20</sup> | In practice, for SIFs and RAIFs, such information may also be disclosed in the constitutional document.

<sup>21</sup> | There is no provision in either the SIF Law or RAIF Law relating to the 10% limit.

## 2.4.1. UCIs established under the 2010 Law

### 2.4.1.1. Definition of a UCI under the 2010 Law

This section outlines the provisions of the 2010 Law that must be complied with by UCITS and 2010 Law Part II UCIs.

#### A. *Collective investment of funds*

There must be collective investment of funds, which is understood to be the mutual investment of capital raised from individual investors. Such investments may be made in transferable securities or other assets; they must be made in compliance with the applicable investment restrictions (UCITS and 2010 Law Part II UCIs are subject to different investment restrictions – see Chapter 4), as well as the fund documentation (see Chapter 10). The objective of this investment is to generate income or obtain capital appreciation. Consequently, a UCI may normally not acquire holdings where, beyond seeking return, the objective is to achieve a position of significant influence or control over the long term. As an exception, Part II UCIs that invest in venture capital (see Section 4.2.3.3.) may acquire significant holdings or control as this is indicative of the nature of such investment policy rather than a desire for control.

#### B. *Raised from the public*

The funds invested collectively must be raised from the public. The public is approached when the raising of funds is not confined to a restricted circle of investors.

#### C. *Diversification of risk*

The investments arising from the collective investment of funds must be made according to the principle of diversification of risk, to prevent the risk attached to an excessive concentration of investments (see also Section 4.2.).

### 2.4.1.2. Promoters and initiators of 2010 Law UCIs

A promoter is required for a 2010 Law Part II UCI that is not managed by a UCITS (Chapter 15) management company (see Section 1.4.2.A.).

In general, the promoter or initiator is represented in the governing bodies of the UCI, or is a shareholder of the management company of a common fund (FCP).

### 2.4.1.3. Distinction between Part I (UCITS) and Part II UCIs

The 2010 Law distinguishes between UCITS (set up under Part I of the 2010 Law) and Part II UCIs (set up under Part II of the 2010 Law). The distinction between UCITS and 2010 Law Part II UCIs is covered in Section 1.3.

### 2.4.1.4. Requirements applicable to UCITS (Part I UCIs)

In addition to complying with the definition of a UCI in Section 2.4.1.1., a UCITS must:

- ▶ Comply with the specific investment and borrowing rules (see Section 4.2.2.)
- ▶ Be open-ended – i.e., the shares or units of the UCITS are, at the request of holders, redeemed directly or indirectly out of the UCITS' assets
- ▶ Have an approved UCITS management company (authorized either under Chapter 15 of the 2010 Law or under the UCITS Directive, as amended, in another Member State), or alternatively in the case of an investment company, designate itself as "self-managed" and comply with most of the requirements applicable to a UCITS management company (see Section 2.4.1.5.)

In accordance with Article 3 of the 2010 Law, specifically excluded from Part I are UCIs:

- ▶ That are closed-ended (see Section 2.3.)
- ▶ That raise capital without promoting the sale of their shares or units to the public within the EU or any part of it
- ▶ The shares or units of which, under their constitutional document, may only be sold outside the EU (even though they may be listed on the Luxembourg Stock Exchange - LuxSE)
- ▶ For which the specific investment and borrowing rules (see Section 4.2.2.) are inappropriate in view of their investment and borrowing policies

### 2.4.1.5. Requirements applicable to a self-managed UCITS

As stated in Section 2.4.1.4., a UCITS investment company must either appoint a management company (that complies with Chapter 15 of the 2010 Law – see Chapter 6) or designate itself as “self-managed” (all common funds are managed by a management company). The requirements applicable to a self-managed investment company as stated in Articles 27 and 39 of the 2010 Law and in CSSF Circular 18/698 may be summarized as follows:

- ▶ Minimum capital at date of authorization is EUR 300,000 (see also Section 2.5.)
- ▶ The application for authorization must be accompanied by a business plan (program of activity), setting out, *inter alia*, the organizational structure of the UCITS (see also Section 3.3.2.)
- ▶ It may only manage assets of its own portfolio and may not, under any circumstances, manage assets on behalf of a third party

A self-managed UCITS must also comply with most of the requirements applicable to a UCITS management company (see Section 6.2.1.C.).

### 2.4.1.6. Delegation by investment companies

A self-managed UCITS investment company must comply with the rules on delegation applicable to a UCITS management company (see Section 6.3.3.).

2010 Law Part II investment companies are required to comply with the requirements on delegation similar to those applicable to Chapter 16 management companies (see Section 6.3.3.). Those qualifying as full AIFM regime AIFs are required to comply with the provisions of the AIFM Law in relation to delegation (see Section 2.4.4.1.).

### 2.4.1.7. 2010 Law investment companies exercising voting rights

A 2010 Law investment company that has designated a management company but has not specifically mandated the management company to exercise the voting rights attached to the instruments held in its portfolio is required to develop and disclose its own strategy for the exercise of voting rights and how it implemented it in practice (see Section 5.1.3.B).

## 2.4.2. SIFs

### 2.4.2.1. Objective of a SIF

The primary objective of a SIF must be the collective investment of the funds raised from its investors while applying the principle of risk diversification.

#### A. Collective investment of funds

There must be collective investment of funds, which is understood to be the mutual investment of capital raised from individual investors.

#### B. Raised from “well-informed investors”<sup>22</sup>

SIFs can only raise capital from well-informed investors who are able to understand and assess the risks associated with investment in such a fund. “Well-informed investors” are:

- ▶ Institutional investors
- ▶ Professional investors
- ▶ Other types of investors who have declared in writing that they are well-informed investors, and meet either of the following criteria:
  - ▶ They invest a minimum of EUR 125,000

The CSSF has clarified that in the case of co-investment into the SIF by more than one investor, each investor must invest the minimum amount.

- ▶ They have an appraisal from a bank, an investment firm or a management company (all of these with a European passport) certifying that they have the appropriate expertise, experience and knowledge to adequately understand the investment made in the SIF

Directors<sup>23</sup> and other persons involved in the management of the SIF are exempt from these requirements.

<sup>22</sup> The CSSF translates the original French term “*investisseurs avertis*” as “well-informed investors”.

<sup>23</sup> “Directors” means, in the case of public limited companies and cooperatives in the form of a public limited company, the members of the board of directors; in the case of partnerships, the managers or general partner; in the case of private limited liability companies, the manager(s); and in the case of common funds, the members of the board of directors or the managers of the management company.

### C. Diversification of risk

The investments of the SIF must be made according to the principle of diversification of risk. See also Section 4.3.

#### 2.4.2.2. Risk management

Risk management requirements applicable to SIFs are covered in Section 7.4.

#### 2.4.2.3. Conflicts of interest

SIFs must be structured and organized in such a way as to mitigate the risk of any conflict of interest, which may potentially adversely affect the interests of the investors, such conflict of interest being between the SIF and, where applicable, any person involved in the activities of the SIF or directly or indirectly related to the SIF. In case of potential conflicts of interest, the SIF is required to protect the interests of its investors.

CSSF Regulation 15-07 (which repealed CSSF Regulation 12-01) details the conflicts of interest requirements to be applied by SIFs (those qualifying as internally managed registered AIFM, those managed by an external registered AIFM, those managed by a non-EU AIFM and those that are non-AIFs). This Regulation entered into force on 1 February 2016.

For the purpose of identifying potential conflicts of interest whose existence may damage the interests of the SIF, SIFs must take into account, as a minimum, whether any person involved in the activities of the SIF, or directly or indirectly linked to the SIF, is in any of the following situations:

- The person is likely to make a financial gain, or avoid a financial loss, at the expense of the SIF
- The person has an interest in the outcome of a service provided to the SIF or to another client, of an activity carried out for their benefit, or of a transaction carried out on behalf of the SIF or another client, which is distinct from the interest of the SIF in that outcome
- The person has a financial or other incentive to favor the interests of another client or group of clients over the interests of the SIF
- The person carries on the same activities for the SIF as for one or several clients that are not SIFs
- The person receives or will receive from a person other than the SIF an inducement in relation to the collective portfolio management activities performed for the benefit of the SIF in the form of monies, goods or services other than the standard commission or fee for that service

The Regulation requires SIFs to establish, implement and maintain an effective written conflicts of interest policy that:

- Identifies, in relation to collective portfolio management activities performed by or on behalf of the SIF, the circumstances that constitute or may potentially give rise to a conflict of interest entailing a material risk of damage to the interests of the SIF
- Defines the procedures to be followed and the measures to be taken to manage conflicts of interest

The conflicts of interest policy must be proportionate to the organizational structure of the SIF, and to the nature, scale and complexity of its activities.

Where the SIF belongs to a group, the conflicts of interest policy must take into account the potential conflicts of interest resulting from the structure and activities of other members of the group. The conflicts of interest procedures and measures must ensure that persons engaged in activities entailing a conflict of interest act with a level of independence that is appropriate to the size and activities of the SIF and of the group to which it belongs and to the extent of the risk of damage to the interests of the SIF.

SIFs are also required to establish, implement and maintain a policy to prevent any relevant person from entering into personal transactions that may give rise to conflicts of interest.

SIFs are also required to set up an adequate policy to prevent or manage any conflicts of interest resulting from the exercise of voting rights attached to instruments held.

The Regulation requires SIFs to keep, and regularly update, a record of the types of collective portfolio management activities performed by or on behalf of the SIF for which a conflict of interest entailing a material risk of damage to the interests of the SIF has arisen, or may arise.

Where the organizational and administrative arrangements made by the SIF to manage conflicts of interest are not sufficient to guarantee, with reasonable confidence, that risks of damage to the interests of the SIF or its investors will be prevented, the Directors must be informed promptly so that they can take any measure necessary to ensure that the SIF will act in its best interests and those of its investors. The SIF is required to inform the investors of any such conflicts of interest and explain the measures adopted by the SIF (see also Section 10.4.4.1.).

SIFs are required to confirm to the CSSF that they have established a conflicts of interest policy in their application for authorization (see Section 3.3.).

Conflicts of interest requirements applicable to management companies and AIFMs are covered in Section 6.4.1.



#### 2.4.2.4. Delegation

When a SIF or its management company delegates one or more of their own functions to third parties, such delegation must be made with a view to conduct operations in a more efficient manner and the following conditions must be complied with:

- ▶ The CSSF must be adequately informed of any delegation
- ▶ The mandate cannot prevent the effectiveness of supervision of the SIF, and in particular must not prevent the SIF from acting, or the SIF from being managed, in the best interests of the investors
- ▶ When the delegation concerns portfolio management, the following requirements must be met:
  - ▶ The mandate may only be given to persons or entities that are authorized or registered for the purpose of asset management and subject to prudential supervision
  - ▶ In case of delegation to a third country undertaking, there must be cooperation arrangements between the CSSF and the supervisory authority of the third country
  - ▶ Where the conditions of the previous bullet point cannot be met, the delegate must be of sufficiently good repute and sufficiently experienced, and the delegation is subject to the prior approval of the CSSF
  - ▶ Portfolio management functions cannot be delegated to the depositary
- ▶ When the delegation concerns risk management, the requirements outlined in Section 7.4.4. must be met
- ▶ The directors of the SIF, or of its management company in case of a common fund, must be able to demonstrate that:
  - ▶ The delegate is qualified and capable of undertaking the functions in question
  - ▶ The delegate was selected with all due care
  - ▶ The SIF is in a position to monitor effectively the delegated activity, to give further instructions at any time to the delegate or to withdraw the mandate with immediate effect to protect the interests of the investors
- ▶ The prospectus or offering document of the SIF must list the delegated functions

### 2.4.3. RAIFs

#### 2.4.3.1. Objective of a RAIF

The sole objective of a RAIF must be the collective investment of the funds raised in assets with the aim of spreading the investment risks and giving investors the benefit of the results of the management of the assets.

“Management”, in the context of the RAIF Law, means an activity comprising at least the service of portfolio management.

#### 2.4.3.2. Investors

Similar to SIFs, the securities, or partnership interests, of RAIFs are reserved to one or several well-informed investors. A well-informed investor is:

- ▶ An institutional investor
- ▶ A professional investor
- ▶ Any other investor who:
  - ▶ Has stated in writing that he/she adheres to the status of a well-informed investor, and either:
    - (i) Invests a minimum of EUR 125,000 in the RAIF, or
    - (ii) Has an assessment from a credit institution, an investment firm, a UCITS management company or an authorized AIFM certifying his/her expertise, experience and knowledge to adequately appraise an investment in a RAIF

#### 2.4.3.3. Management

A RAIF must be managed by an authorized AIFM. Unlike a SIF, a RAIF cannot be a non-AIF, nor can it be managed by a simplified registration regime AIFM. The AIFM may be established in Luxembourg, in another Member State of the EU, or located in a third country, once the AIFMD passport is available to that third country.

#### 2.4.3.4. Regulation and supervision

The RAIF itself is not subject to approval or supervision by the CSSF. Given that a RAIF is required to be managed by an authorized AIFM, it is regulated under the AIFM Law but is only indirectly supervised by the CSSF through the supervision of its AIFM.

#### 2.4.3.5. Eligible assets and diversification of risk

The RAIF Law provides flexibility with respect to types of investments and does not stipulate specific investment rules or restrictions.

RAIFs may pursue traditional and alternative investment strategies. However, RAIFs that hold investments in risk capital (direct or indirect contribution of assets to entities in view of their launch, development or listing on a stock exchange) may be able to adopt a similar tax regime to that applicable to *Sociétés d'investissement en capital à risque* (SICARs)<sup>24</sup>.

The investments of a RAIF must be made, however, in accordance with the principle of risk spreading unless the RAIF invests solely in risk capital.

### 2.4.3.6. Risk management

As all RAIFs are AIFs, the risk management requirements of AIFs apply - see Section 7.3.

### 2.4.3.7. Cross-border marketing and management

As a RAIF is managed by an authorized AIFM, it benefits from an EU passport for marketing to professional investors in the EU. The AIFM Law allows the management of RAIFs in the EU on a cross-border basis.

Marketing of RAIFs is discussed further in Chapter 12.

Depositary requirements for RAIFs are discussed in Chapter 9.

The document and reporting as well as audit requirements for RAIFs are discussed in Chapter 10.

The taxation of RAIFs is discussed in Chapter 11.

## 2.4.4. Requirements applicable to AIFs

AIFs, including 2010 Law Part II UCIs and SIFs, will either fall into one of the following categories:

- Full AIFM regime:
  - AIFs managed by an authorized AIFM
  - Authorized internally managed AIFs
- Simplified AIFM registration regime AIFs (i.e., where the AIF assets under management fall below the *de minimis* thresholds outlined in Section 6.1.3.D.):
  - AIFs managed by simplified registration regime AIFMs
  - Simplified AIFM registration regime internally managed AIFs
- EuVECAs and EuSEFs
- ELTIFs

All RAIFs are full AIFM regime AIFs managed by an authorized AIFM.

### 2.4.4.1. Full AIFM regime AIFs

AIFs managed by authorized AIFMs must be managed in accordance with AIFM Directive requirements. These requirements are implemented in Luxembourg by the AIFM Law.

Internally managed AIFs that are in scope of the AIFM Law must also be managed in accordance with AIFM Law requirements.

AIFM compliance is required when the assets under management of all AIFs managed by an AIFM, or of an internally managed AIFs, exceed certain thresholds (see Section 6.1.3.D.).

AIFM requirements are covered in Chapter 6. The specific requirements applicable to authorized internally managed AIFs are covered in Section 6.2.1.C.

The relevant provisions of the AIFM Law must be applied by full AIFM regime AIFs, or the AIFM acting on their behalf. The provisions include those on:

- Investments in securitization vehicles (see Section 4.5.)
- Major holdings and control over portfolio companies (see Section 4.6.)
- Risk management, including leverage (see Section 7.3.)
- Delegation of functions (see Section 6.3.3.)
- The depositary of the AIF (see Chapter 9)
- Valuation (see Section 7.6.)
- Information provided to investors (see Chapter 10)
- Marketing (see Chapter 12)

Requirements that must be met by feeder AIFs to benefit from the marketing passport are covered in Section 2.3.4.1.C.

<sup>24</sup> | SICARs are not covered in this publication.

#### 2.4.4.2. Simplified AIFM registration regime AIFs

AIFs managed by simplified registration regime AIFMs are impacted by AIFM requirements. Simplified registration regime AIFMs are subject to registration and reporting requirements, which include, *inter alia*, the requirement to provide detailed information to the CSSF on each AIF they manage (see Section 6.1.3.E. and Section 6.2.1.E.).

Simplified AIFM registration regime internally managed AIFs are subject to the same registration and reporting requirements as simplified registration regime AIFMs.

Simplified registration regime AIFMs and simplified AIFM registration regime internally managed AIFs may choose to “opt in” under the AIFM Law to benefit from the rights granted to AIFMs (in particular passports). In this case, they must comply with all the provisions of the AIFM Law (see Section 2.4.4.1.).

Simplified registration regime AIFMs are required to monitor their assets under management and, when the assets under management exceed the relevant *de minimis* threshold on more than a temporary basis, apply for authorization as an AIFM (see Section 6.2.1.E.).

#### 2.4.4.3. EuVECAs and EuSEFs

The managers of qualifying EuVECAs and of qualifying EuSEFs that are subject to a simplified EU/EEA regulatory regime can benefit from a “passport” permitting them to market the shares or units of the qualifying European funds they manage to suitably qualified investors throughout the EU/EEA.

The applicable regimes are:

- ▶ Regulation on European Venture Capital Funds (EuVECA)s<sup>25</sup>
- ▶ Regulation on European Social Entrepreneurship Funds (EuSEFs)<sup>26</sup>

The regimes create labels (“designations”) for investment funds investing primarily in small and medium-sized enterprises (SMEs) and offer their managers “passports” enabling them to market their EuVECAs and EuSEFs to suitably qualified investors throughout the EU/EEA.

Since 1 March 2018<sup>27</sup>, the EuVECA and EuSEF regimes are available to both authorized and registered AIFMs. Before this date, only registered AIFMs or AIFMs authorized after the initial onboarding of EuVECAs or EuSEFs were allowed to manage EuVECAs or EuSEFs. The regimes are also available to internally managed AIFs.

The two regimes are voluntary. If a manager chooses not to meet the requirements of one of the regimes and not to benefit from one of the passports, the Regulations do not apply; existing national rules and general EU rules continue to apply.

The managers of EuVECAs and EuSEFs are covered in Section 6.2.1.G.

The applicable investment restrictions are covered in Section 4.7.

The information to be disclosed to investors before they invest is covered in Section 10.3.8.

The annual reporting requirements are covered in Section 10.5.4.

The marketing of EuVECAs and EuSEFs is covered in Section 12.6.3.

The audit requirements are covered in Section 10.5.4.

#### 2.4.5. ELTIFs

On 29 April 2015, the European Parliament and the Council of the European Union adopted Regulation (EU) 2015/760 that created the ELTIF. The purpose of this regulation is to boost European long-term investments in the real economy. The Regulation entered into force on 8 June 2015 and became applicable in Member States from 9 December 2015.

Following ESMA’s final report on *Draft technical standards under the ELTIF regulation* of June 2016, Commission Delegated Regulation (EU) 2018/480 of 4 December 2017, entering into force on 12 April 2018, supplemented Regulation (EU) 2015/760 with regard to *regulatory technical standards on financial derivative instruments solely serving hedging purposes, sufficient length of the life of the European long-term investment funds, assessment criteria for the market for potential buyers and valuation of assets to be divested and the types and characteristics of the facilities available to retail investors*, by setting out:

- ▶ The criteria for establishing circumstances in which the use of FDIs solely serves for hedging purposes
- ▶ The circumstances in which the life of an ELTIF is considered sufficient in length
- ▶ The criteria for the assessment of the market for potential buyers
- ▶ The criteria for the valuation of the assets to be divested
- ▶ Specifications on the facilities available to retail investors

<sup>25</sup> Regulation (EU) No 345/2013 of 17 April 2013 on European venture capital funds, as amended.

<sup>26</sup> Regulation (EU) No 346/2013 of 17 April 2013 on European social entrepreneurship funds, as amended.

<sup>27</sup> Regulation (EU) No 2017/1991 amending Regulation (EU) No 345/2013 of 17 April 2013 on European venture capital funds and Regulation (EU) No 346/2013 of 17 April 2013 on European social entrepreneurship funds.

On 25 November 2021, the European Commission unveiled a proposal amending the ELTIF Regulation.

The new regime should enhance the attractiveness of ELTIFs as vehicles for infrastructure, real estate and SMEs financing.

	Eligibility of real and infrastructure assets as well as SME financing	Minimum safeguards for long-term investments compared to pure private equity	Access to retail investors with a product passport and retail distribution process
Retail investors	<ul style="list-style-type: none"> <li>▶ Broadened definition of eligible real assets allowing difficult-to-quantify assets</li> <li>▶ Minimum share of eligible assets lowered to 60%</li> <li>▶ Minimum investment in real asset lowered to EUR 1 million</li> <li>▶ Possibility to pursue fund-of-funds strategies</li> <li>▶ Eligible securitizations covering residential mortgage-backed securities, commercial loans, corporate loans and trade receivables</li> <li>▶ Eligibility of investment in small capitalization up to EUR 1 billion</li> </ul>	<ul style="list-style-type: none"> <li>▶ Eligibility of third-country investments under certain conditions</li> <li>▶ Co-investment becomes possible where conflicts of interest are identified, managed and disclosed</li> <li>▶ Two weeks renunciation period without any penalties</li> <li>▶ Most diversification thresholds of the current regime will be doubled</li> <li>▶ Eligibility of investment raised to up to 30% of units of a single ELTIF, EuVECA, EuSEF, UCITS or EU AIF managed by an EU AIFM</li> <li>▶ Borrowing threshold raised to 50% of the ELTIF value</li> <li>▶ Optional liquidity mechanism can be set up under certain conditions to be further specified in a delegated act</li> </ul>	<ul style="list-style-type: none"> <li>▶ Removal of the ELTIF suitability assessment for investors</li> <li>▶ Deletion of the minimum entry ticket of EUR 10,000</li> <li>▶ Deletion of the maximum aggregate of 10% of financial portfolio not exceeding EUR 500,000</li> <li>▶ Two weeks renunciation period without any penalties</li> <li>▶ Removal of the requirement to provide investor facilities (alignment with provisions from the cross-border distribution of funds regime)</li> <li>▶ Possibility to set up a master-feeder ELTIF where prospectuses disclose:               <ul style="list-style-type: none"> <li>▶ A minimum investment of 85% or more of the feeder ELTIF's assets in the master ELTIF</li> <li>▶ Information on the investment objective and policy</li> <li>▶ A description of the master-feeder ELTIF</li> <li>▶ A description of tax implications specific to the master-feeder structure</li> </ul> </li> </ul>
Professional investors	<ul style="list-style-type: none"> <li>▶ Minimum share of eligible assets lowered to 50% for professional ELTIFs</li> <li>▶ Eligibility of investment raised to up to 100% of units of a single ELTIF, EuVECA, EuSEF, UCITS or EU AIF managed by an EU AIFM</li> </ul>	<ul style="list-style-type: none"> <li>▶ Borrowing threshold raised to 100% of the ELTIF value</li> </ul>	

A few changes have also been incorporated to facilitate the authorization of the ELTIF and streamline the separation of those provisions that address the authorization of the ELTIF and that of the AIFM.

#### A. Authorization and investors

Only EU AIFs are eligible to apply for and to be granted authorization as an ELTIF. ELTIFs may be marketed to retail and professional investors.

#### B. Eligible investments

Eligible investments of an ELTIF include:

- ▶ Eligible investment assets, being:
  - ▶ Equity or quasi-equity instruments
  - ▶ Debt instruments issued by a qualified portfolio undertaking<sup>28</sup>
  - ▶ Loans granted by the ELTIF to a qualifying portfolio undertaking<sup>29</sup> with a maturity no longer than the life of the ELTIF

<sup>28</sup> A qualified portfolio undertaking is defined by Regulation (EU) 2015/760 as a portfolio undertaking other than a collective investment undertaking that fulfils the following requirements: (i) it is not a financial undertaking, (ii) it is an undertaking that is not admitted to trading on a regulated market or on a multilateral trading facility; or is admitted to trading on a regulated market or on a multilateral trading facility and at the same time has a market capitalization of no more than EUR 500 million and (iii) it is established in a Member State, or in a third country provided that the third country is not a high-risk and non-cooperative jurisdiction identified by the Financial Action Task Force and that the third country has signed an agreement with the home Member State of the manager of the ELTIF and with every other Member State in which the units or shares of the ELTIF are intended to be marketed to ensure that the third country fully complies with Article 26 of the *Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and Capital* and ensures effective exchange of information in tax matters, including any multilateral tax agreements.

<sup>29</sup> Idem.

- ▶ Units or shares of one or several other ELTIFs, EuVECAs and EuSEFs provided that those ELTIFs, EuVECAs and EuSEFs have not themselves invested more than 10% of their capital in ELTIFs
- ▶ Direct holdings or indirect holdings via qualified portfolio undertakings<sup>30</sup> of individual real assets with a value of at least EUR 10,000,000 or its equivalent in the currency which, and at the time when, the expenditure is incurred
- ▶ Assets eligible for UCITS (see Section 4.2.2.3.)

An ELTIF is not permitted to:

- ▶ Short sell assets
- ▶ Take direct or indirect exposure to commodities
- ▶ Enter into securities lending, securities borrowing, repurchase transactions, or any other agreement that has an equivalent economic effect and poses similar risks, if thereby more than 10% of the assets of the ELTIF are affected
- ▶ Use FDIs, except for hedging purposes of the ELTIF's other investments

Commission Delegated Regulation 2018/480 defines hedging and the circumstances under which it can be used in the ELTIF context.

### C. Conflicts of interest

An ELTIF is not permitted to invest in an eligible investment asset in which the manager of the ELTIF has or takes a direct or indirect interest, other than by holding units or shares of the ELTIFs, EuVECA, or EuSEFs that it manages.

### D. Composition and diversification requirements

An ELTIF must comply with the following diversification requirements:

- ▶ An ELTIF must invest at least 70% of its capital in eligible investment assets
- ▶ An ELTIF should invest no more than:
  - ▶ 10% of its capital in instruments issued by, or loans granted to, any single qualifying portfolio undertaking
  - ▶ 10% of its capital directly or indirectly in a single real asset

An ELTIF may raise both of the above 10% limits to 20% provided that the aggregate value of the assets held by the ELTIF in qualifying portfolio undertakings and in individual real assets in which it invests more than 10% of its capital does not exceed 40% of the value of the capital of the ELTIF.

- ▶ 10% of its capital in units or shares of any single ELTIF, EuVECA or EuSEF
- ▶ 5% of its capital in assets eligible to UCITS (see Section 4.2.2.3.), when those assets have been issued by any single body

An ELTIF may raise the 5% limit to 25% where bonds are issued by a credit institution that has its registered office in a Member State and is subject by law to special public supervision designed to protect bond holders.

- ▶ The aggregate value of units or shares of ELTIFs, EuVECA and EuSEFs in an ELTIF portfolio should not exceed 20% of the value of the capital of the ELTIF
- ▶ The aggregate risk exposure to a counterparty of the ELTIF from over-the-counter (OTC) derivative transactions, repurchase agreements, or reverse repurchase agreements should not exceed 5% of the value of the capital of the ELTIF
- ▶ Companies that are included in the same group for the purpose of consolidated accounts should be considered as a single qualifying portfolio undertaking or a single body for the purpose of calculating the diversification limits

### E. Concentration requirements

An ELTIF cannot acquire more than 25% of the units or shares of a single ELTIF, EuVECA or EuSEF.

An ELTIF should comply with the concentration limits set out in the last bullet point of Section 4.2.2.4. with respect to its holdings in assets eligible for UCITS.

### F. Borrowing requirements

An ELTIF may borrow cash provided that such borrowing fulfils the following conditions:

- ▶ It represents no more than 30% of the value of the capital of the ELTIF
- ▶ It serves the purpose of investing in eligible investment assets, except for loans referred to in Section 2.4.5.B.
- ▶ It is contracted in the same currency as the assets to be acquired with the borrowed cash
- ▶ It has a maturity no longer than the life of the ELTIF
- ▶ It encumbers assets that represent no more than 30% of the value of the capital of the ELTIF

<sup>30</sup> | Idem.

### G. Redemption policy

Investors will not be able to request redemption of their shares or units in an ELTIF before the end of its life unless certain conditions are met.

The marketing of ELTIFs is discussed in Chapter 12.

## 2.5. Minimum capital

UCITS with a management company, 2010 Law Part II UCIs, SIFs and RAIFs must have a minimum capital/net assets of EUR 1,250,000, which must be achieved within six months of the date of authorization in the case of 2010 Law UCIs and 12 months in the case of SIFs and RAIFs.

For a self-managed SICAV under Part I of the 2010 Law, the minimum capital at the date of authorization is EUR 300,000. Internally managed AIFs that are full AIFM regime AIFs must have an initial capital of EUR 300,000.

Measures are to be taken when the capital of the UCI falls below one-fourth and two-thirds of the minimum capital (see also Section 3.10.1.).

Any share premium paid in addition to the subscribed capital is taken into account to compute the minimum capital requirements.

The shares or units of an investment company must be fully subscribed. Those of a 2010 Law SICAV must be fully paid up. However, in the case of a SIF or RAIF investment company, only 5% of the amount of the subscription per share or unit has to be paid up. This will enable structures such as private equity funds to make capital calls over a period of time.

## 2.6. Requirements applicable to specific types of UCIs

Types of UCIs subject to specific requirements include:

- ▶ MMFs, which are currently subject to the Regulation defining the requirements to be met for investment funds to be labeled as MMFs (see Section 2.6.1.)
- ▶ UCITS ETFs, which are subject to specific rules and disclosure requirements and must meet additional requirements in relation to the protection of investors dealing on a secondary market (see Section 2.6.2.)
- ▶ Index-tracking UCITS, which are subject to disclosure and reporting requirements (see Section 2.6.3.)
- ▶ UCIs using EPM techniques, such as securities lending and currency hedging transactions, which are subject to specific rules (see Section 4.2.2.6.) and disclosure requirements (see Chapter 10) on the use of such techniques
- ▶ UCITS using FDIs, including, *inter alia*, FDI on financial indices, which are subject to specific rules (see Section 4.2.2.3.F.) and disclosure requirements (see Chapter 10)
- ▶ Structured UCITS, which are subject to specific disclosure requirements (see Section 2.6.6.)
- ▶ Hedge funds, which are subject to specific requirements (see Section 2.6.7.)
- ▶ Real estate funds, which are subject to specific requirements (see Section 2.6.8.)
- ▶ Private equity funds, which are subject to specific requirements (see Section 2.6.9.)

See also Appendix I.3. on the types of UCIs.

### 2.6.1. Money market funds (MMFs)

On 30 June 2017, the final text of *Regulation (EU) No 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds* was published in the Official Journal of the European Union (the "MMF Regulation"). The regulation applies to all funds and compartments that qualify as MMFs as per the definition set out in Article 1 of the Regulation.

The Regulation stipulates that MMFs must be set up as one of the following types:

- ▶ A variable NAV (VNAV) MMF
- ▶ A public debt constant NAV (CNAV) MMF
- ▶ A low volatility NAV (LVNAV) MMF

It also foresees two categories of MMFs:

- ▶ Standard MMFs
- ▶ Short-term MMFs

As described in the Regulation, a UCITS or an AIF is permitted to use the designation “money market fund” in relation to itself or the units or shares it issues only where the UCITS or the AIF has been authorized in accordance with the Regulation. In addition, no collective investment undertaking can be established, marketed or managed in the EU as an MMF unless it has been authorized in accordance with the Regulation. Such authorization is valid for all Member States.

The Regulation applies to UCITS and AIFs. It lays down detailed requirements on MMF eligible assets, investment policies and risk management, valuation rules, specific requirements for public debt CNAV MMFs and LVNAV MMFs, rules in relation to external support, and transparency requirements.

In summary, the Regulation provides that, *inter alia*:

- CNAV MMFs will invest 99.5% of their assets in public debt instruments
- Standard MMFs can only be VNAV MMFs
- The three types of MMFs can be short-term MMFs
- MMFs will be required to diversify their portfolios, invest in high quality assets, follow strict liquidity and concentration requirements and have sound stress testing processes in place. As such MMFs will be subject to strict eligible asset rules and diversification rules (see Section 4.8.) and risk management procedures (see Section 7.6.5.)
- Assets of MMFs should be valued at least once a day using mark-to-market whenever possible
- Managers of CNAV MMFs and LVNAV MMFs must establish and apply rigorous liquidity management procedures for ensuring weekly liquidity thresholds applicable to such funds including application of liquidity fees and redemption gates in certain circumstances to stem sudden outflows
- Weekly reporting should be made to investors on the maturity breakdown of the portfolio, net yield, weighted average life and maturity of the portfolio, credit profile and details of the top ten investments of the MMF

On 10 April 2018, the European Commission published the Delegated Regulation (EU) 2018/990 amending and supplementing the MMF Regulation with regard to *simple, transparent and standardised securitisations and asset-backed commercial papers, requirements for assets received as part of reverse repurchase agreements and credit quality assessment methodologies*. This Regulation followed ESMA's *Final Report on technical advice, draft implementing technical standards and guidelines under the MMF Regulation*, issued on 13 November 2017.

The Delegated Regulation provides updates with respect to:

- Quantitative and qualitative liquidity requirements of assets received as part of a reverse repurchase agreement
- Criteria for:
  - The validation of internal credit quality assessment methodologies
  - Quantifying credit risk, and the relative risk of default of the issuer and of the instrument in which the MMF invests
  - Establishing qualitative indicators in relation to the issuer of the instrument in which the MMF invests
  - Establishing qualitative credit risk indicators in relation to the issuer of instruments in which the MMF invests
- Overrides of outputs of an internal credit quality assessment methodology
- Material changes
- Quantitative and qualitative credit quality requirements for liquid transferable securities or MMIs, other than those that fulfil the requirements set out in Article 10 of the MMF Regulation, received as part of a reverse repurchase agreement

ESMA's *Guidelines on stress test scenarios under the MMF Regulation* are updated on a yearly basis. In particular, common reference parameters are reviewed and eventually adjusted to take into consideration the latest market developments. ESMA issued the latest update, implemented by CSSF Circular 22/817, on 4 May 2022.

On 17 April 2018, the European Commission published Commission Implementing Regulation (EU) 2018/708 *laying down implementing standards with regard to the template to be used by managers of money market funds when reporting to competent authorities as stipulated by Article 37 of Regulation (EU) 2017/1131 of the European Parliament and of the Council* (the MMF Regulation). This implementing Regulation was based on ESMA's *Final Report on technical advice, draft implementing technical standards and guidelines under the MMF Regulation*, issued on 13 November 2017.

On 28 January 2020, CSSF Circular 20/736 implemented ESMA's *Guidelines on the reporting to competent authorities under Article 37 of the MMF Regulation* in Luxembourg.

CSSF Circular 20/734 clarifies specific technical aspects of the reporting MMFs are required to perform.

For 2010 Law UCIs, a reduced tax rate is applicable in the cases described in Section 11.3.2.2.2.

After analyzing the liquidity challenges faced by MMFs during COVID-19, ESMA published, on 16 February 2022, its Opinion laying out proposals to amend the MMF Regulation.

The main proposals address the following topics:

1. Threshold effects for constant NAV (CNAV)
  - a. Removing the possibility to use amortized cost for LVNAV MMFs
  - b. Decoupling regulatory thresholds from suspensions/gates/redemption fees for LVNAV/CNAV MMFs
2. Liquidity related issues:
  - a. Mandatory availability of at least one liquidity management tool (LMT) for all MMFs which can be activated by the manager of the MMF
  - b. Amendments of the daily/weekly liquidity assets ratios of VNAV (and LVNAV) MMFs, as well as the pool of eligible assets, including public debt assets, which can be used to satisfy these liquidity ratios
  - c. Inclusion/reinforcement of the possibility to temporarily use liquidity buffers in times of stress
3. Crisis preparedness:
  - a. Enhancement of reporting requirements
  - b. Enhancement of the stress testing framework
  - c. Clarification of the requirements on external support
  - d. New disclosure requirements on ratings

The aim of these proposals is to provide financial markets with stability by reducing the risk of liquidity stress and by enhancing the preparedness of MMFs for crises.

## 2.6.2. UCITS exchange-traded funds (ETFs)

UCITS ETFs are subject to ESMA's *Guidelines on ETFs and other UCITS issues*, as amended. The amended version of the guidelines modifies the original provision on diversification of the collateral received by UCITS in the context of the EPM techniques and OTC financing derivative transactions.

With respect to UCITS ETFs<sup>31</sup>, these guidelines require:

- ▶ Use of the "UCITS ETF" identifier in the sub-fund/fund name, constitutional document, prospectus, KIID, and marketing communications. This English identifier should be used independently of the language of the document. The identifiers "UCITS ETF", "ETF", or "exchange-traded fund" cannot be used by other UCITS
- ▶ Prospectus, KIID, and marketing communication disclosure on the policy on portfolio transparency and where information on the portfolio and the indicative NAV (iNAV) can be obtained
- ▶ Prospectus disclosure on how the iNAV is calculated and the frequency of calculation
- ▶ Prospectus, KIID, and marketing communication disclosures for an actively-managed UCITS ETF:
  - ▶ Specific statement of fact that it is actively managed
  - ▶ Strategy to meet the stated investment policy, including any intention to outperform an index
- ▶ Treatment of secondary market investors:
  - ▶ Inclusion of a warning in the prospectus and marketing communications, to the effect that shares or units purchased on the secondary market are generally not redeemable from the ETF
  - ▶ Providing secondary market investors with the possibility to sell their shares or units back to the ETF in case the stock exchange value of the shares or units of the ETF varies significantly from the NAV (e.g., in case of market disruption)

Disclosure requirements are covered further in Chapter 10.

CSSF Circular 14/592 implemented the amended version of the Guidelines dated August 2014.

<sup>31</sup> A UCITS ETF is a UCITS where at least one share or unit class of which is traded throughout the day on at least one regulated market or Multilateral Trading Facility with at least one market maker, which takes action to ensure that the stock exchange value of the shares or units does not significantly vary from the shares or units' NAV and where applicable the iNAV.



## 2.6.3. Index-tracking UCITS

For index-tracking UCITS, ESMA's *Guidelines on ETFs and other UCITS issues*, as amended, require:

- ▶ Prospectus disclosure on the description of the index, including a link to information on its underlying components, how the index will be tracked and implications in terms of exposure to the underlying index and counterparty risk, anticipated tracking error (in normal market conditions), and factors impacting the ability of the UCITS to track the performance of the index. The prospectus can direct investors to a website where the exact compositions of indices are published
- ▶ Summary KIID disclosure on how the index will be tracked and implications in terms of exposure to the underlying index and counterparty risk
- ▶ Annual and semi-annual report disclosures on actual tracking error, explanation of any divergence with anticipated tracking error, and annual tracking difference

For index-tracking leveraged UCITS, the Guidelines require:

- ▶ Compliance with the limits and rules on global exposure, either through the commitment or VaR approach
- ▶ Prospectus disclosure and KIID disclosure, in summary form, on the leverage policy, associated costs and risks, impact on returns, impact of any reverse leverage (short exposure), and description of how the performance may differ significantly from the multiple of the index over the medium to long term

Disclosure requirements are covered further in Chapter 10 and global exposure is covered in Section 7.2.

## 2.6.4. UCIs using EPM techniques

UCIs using EPM techniques, such as securities lending and currency hedging transactions, are subject to specific rules (see Section 4.2.2.6.) and disclosure requirements (see Chapter 10).

## 2.6.5. UCITS using FDIs

UCITS using FDIs, including, *inter alia*, FDIs on financial indices, are subject to specific rules (see Section 4.2.2.3.F.) and disclosure requirements (see Chapter 10).

## 2.6.6. Structured UCITS

Structured UCITS are defined as UCITS that provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features. They include capital-protected and guaranteed UCITS.

Structured UCITS are subject to specific requirements in relation to risk management (see Section 7.2.), the prospectus (see Section 10.3.1.), and the KIID (see Section 10.3.2.).

## 2.6.7. Hedge funds

Hedge funds under Part II of the 2010 Law are subject to specific requirements in relation to:

- ▶ Investments rules for hedge funds (see Section 4.2.3.2.) and future contracts and/or options UCIs (see Section 4.2.3.4.)
- ▶ Prospectus for hedge funds (see Section 10.3.1.1.) and future contracts and/or options UCIs (see Section 10.3.1.3.)
- ▶ Financial reporting for future contracts and options UCIs (see Section 10.5.1.2.)

Full AIFM regime AIFs using a prime broker are subject to specific requirements (see Section 9.8.) and to disclosure requirements (see Section 10.3.5.).

## 2.6.8. Real estate funds

Real estate UCIs under Part II of the 2010 Law are subject to specific requirements in relation to:

- ▶ Investments rules (see Section 4.2.3.5.)
- ▶ Prospectus (see Section 10.3.1.4.)
- ▶ Financial reporting (see Section 10.5.1.3.)

## 2.6.9. Private equity funds

Venture capital UCIs under Part II of the 2010 Law are subject to specific requirements in relation to:

- ▶ Investments rules (see Section 4.2.3.3.)
- ▶ Prospectus (see Section 10.3.1.2.)
- ▶ Financial reporting (see Section 10.5.1.1.)

Full AIFM regime AIFs are subject to specific requirements on major holdings and control over portfolio companies (see Section 4.6.).

## 2.7. Vehicles used in conjunction with AIFs

Alternative assets are often held through holding vehicles, typically holding companies (often referred to as special purpose vehicles (SPVs) or special purpose entities). Such holding vehicles may be owned either exclusively by the AIF or its AIFM on its behalf, or as joint ventures, for example with other AIFs.

Typically, holding vehicles are used in AIF structures to hold assets such as:

- Real estate properties for real estate AIFs
- Unlisted companies for private equity AIFs

Other non-AIF vehicles may also be used in conjunction with AIF for other purposes – for example, to structure investments into AIFs.

Luxembourg vehicles used in conjunction with AIFs include commercial companies, referred to as SOPARFIs, and securitization vehicles. This section provides a brief description of these vehicles. SOPARFIs and securitization vehicles are not covered in detail in this *Technical Guide*.

### 2.7.1. SOPARFIs

SOPARFI (*Société de Participations Financières*) is the name usually given to Luxembourg companies whose main corporate purpose is the holding of participations in other companies. The SOPARFI is not a specific vehicle or regime; like other Luxembourg companies it is subject to the 1915 Law.

SOPARFIs play a central role in the structuring of cross-border transactions.

SOPARFIs are fast and inexpensive to incorporate. SOPARFIs are unregulated vehicles that can be set up in any Luxembourg corporate form; the most common corporate forms are the public limited company and the private limited liability company.

SOPARFIs are not subject to risk spreading requirements or restricted to any specific types of investments.

The taxation of SOPARFIs is covered in Section 11.3.3.3.A.

### 2.7.2. Securitization vehicles

Securitization vehicles (SPVs) acquire receivables or bear risks associated with commitments taken or activities carried out by third parties and, in exchange, issue securities whose return is directly linked to the risks borne.

Luxembourg securitization vehicles are also occasionally used in combination with AIFs.

The Law of 22 March 2004 on securitization, as amended (the Securitization Law), provides a legal framework for securitization. It offers initiators flexibility to develop workable and efficient structures for securitization transactions.

Luxembourg securitization vehicles may be regulated by the CSSF or unregulated where the securitization vehicle does not make more than three issuances of securities to the public during the year.

The Securitization Law offers investors a very flexible regime for securitization vehicles, a high level of protection and legal certainty as well as a generally tax-neutral treatment in Luxembourg. Under the Securitization Law, any tangible or intangible asset or activity with a reasonably ascertainable value or predictable future stream of revenues can be securitized. Securitization structures can range from traditional to the most innovative (e.g., such as simple repackaging, term transactions, and commercial paper conduits).

Luxembourg securitization vehicles can either be set up as corporate entities (*sociétés de titrisation*), or funds with no legal personality managed by a management company (*fonds de titrisation*). These can be set up as single or multi-compartment vehicles; each compartment can issue several tranches of securities. The assets of each compartment can be segregated (the protected cell concept). A single securitization vehicle can be established to carry out an entire securitization transaction, or separate securitization vehicles can be established – one to acquire the assets or bear the risks, and another to issue securities to the investors. Multiple layer securitization structures with two or more acquisition or issuing vehicles can be created to optimize the risk-spreading.

A reference to the Securitization Law in the constitutional documents should be sufficient to enable the entity to benefit from the provisions of Luxembourg's securitization regime.

The taxation of Luxembourg securitization vehicles is covered in Section 11.3.3.3.B.

# 03

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## **AUTHORIZATION, SUPERVISION, RESTRUCTURING AND LIQUIDATION**

EY supports asset managers, traditional and alternative investment fund houses with fund set-up and application for authorization, as well as restructuring and liquidation.



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### 3.1. Introduction

This Chapter describes the procedures to be followed when setting up or amending a UCI in Luxembourg, as well as ongoing supervisory requirements. This Chapter also sets out requirements and considerations for conversions and mergers of UCIs, the fast-track authorization procedure for the creation of a side pocket, transfer of foreign UCIs to Luxembourg and liquidation of UCIs and compartments, as well as dormant compartments.

In addition, conversions and mergers of UCIs should be considered not only from a regulatory perspective (covered in this Chapter) but also from an expenses and taxation perspective (see Chapter 11).

### 3.2. Pre-launch considerations

UCITS, 2010 Law Part II UCIs and SIFs must obtain authorization from the CSSF prior to launch.

RAIFs are supervised indirectly under the AIFMD but are not subject to direct approval or supervision by the CSSF. A RAIF must be managed by an authorized AIFM. As such, a RAIF is indirectly supervised through the prudential supervision carried out by the competent authority of its AIFM.

In practice, a large amount of preparatory work is performed by the sponsor, initiator, promoter, management company (if applicable and already existing), professional advisors and main service providers before submission of the application for authorization of a UCI.

Typically, such work carried out prior to authorization will deliberate and decide upon, *inter alia*:

Investment policy	Distribution strategy	Fund structuring	Governance
Fee structures	Key fund pre-launch considerations		Service providers
Fund information	Valuation & accounting	Operations	Controls

The fund management options, including appointing an existing management company, setting up a new management company, or setting up a self-managed UCITS or an internally managed AIF, are covered in Section 1.4.3. and Chapters 2 and 6.

The costs associated with the set-up of a UCI are outlined in Section 11.2.

### 3.3. Authorization

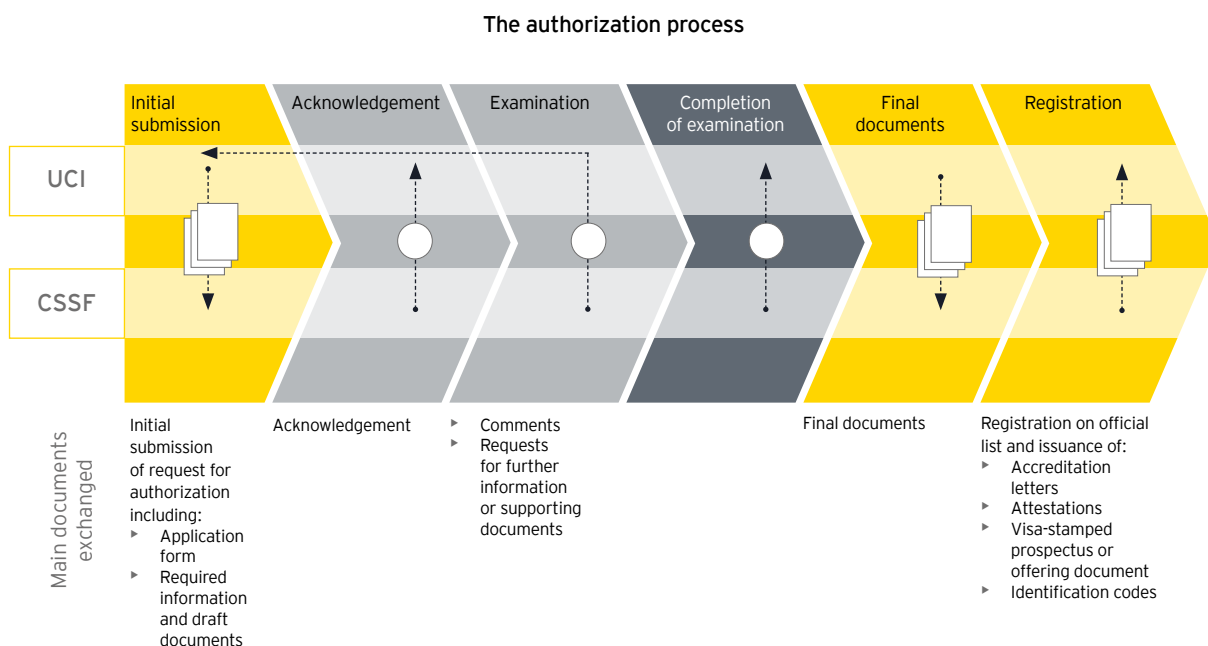
A Luxembourg UCI or its management entity acting on its behalf is required to submit an application for authorization to the CSSF and obtain authorization before commencing activities. This section describes the authorization process and the required information and documents to be provided in the application for authorization.

In addition, an AIF, including 2010 Law Part II UCIs and SIFs, will either be a full AIFM regime AIF or a simplified AIFM registration regime AIF. Where the AIF has not appointed a management entity (i.e., an internally managed AIF), it will also be required to obtain authorization as an AIFM, or will be subject to registration as a simplified AIFM registration regime AIF. For further information, see Section 2.4.4.

A RAIF is not required to obtain authorization from the CSSF. The authorized AIFM of a RAIF may be established in Luxembourg or in another Member State of the EU. The AIFM will need to obtain authorization to manage AIFs from its competent authority.

### 3.3.1. Authorization process

The authorization process for setting up a new UCI or a new compartment of an existing UCI can be summarized as follows:



- ▶ Initial submission to the CSSF of request for authorization

The request for authorization is submitted in the form of an application file which should include:

- ▶ Application form for the set-up of a UCI

The CSSF requires a request to be created in the “UCI Approval” application available under the eDesk portal of the CSSF.

Once the request is duly completed with supporting documents attached, the request is to be submitted to the CSSF directly via the eDesk.

The CSSF AML/CFT investment fund market entry form has to be provided in complement of the application questionnaire.

On 12 June 2021, the CSSF published a Frequently Asked Question (“FAQ”) regarding the completion of the AML/CFT market entry form in the eDesk.

This form must be sent when a licensing application is submitted for all funds supervised by the CSSF. These forms must be renewed when requesting approval of an additional sub-fund or when updating outdated information previously submitted at umbrella fund level.

- ▶ Required information and draft documents (see Section 3.3.2.)

The application file should be submitted exclusively via the CSSF eDesk portal.

Access to the eDesk portal requires the creation of a user account. Any person connecting to the eDesk portal is free to create a user account. In order to make a request on behalf of an entity, the account of the employee or representative must first be linked to the entity.

The CSSF recommends applicants to file an application only once all components of the project are available in final draft form.

- ▶ Acknowledgement of receipt of the application file

The CSSF will acknowledge receipt of the application file within two working days and indicate the officer in charge of examining the application.

- ▶ Transmission of comments and, where relevant, further requests of information or documents after initial examination

Within 10 working days of its acknowledgment of the receipt of the authorization application, the CSSF will provide feedback to the applicant (or contact person designated in the application form). The CSSF may:

- ▶ Make comments on the information and documents transmitted
- ▶ Require further information and/or supporting documents to complete the file or explain specific considerations of the application

This phase may be repeated until the CSSF is fully satisfied with the information and documentation submitted.

In case the applicant does not respond to requests for additional information from the CSSF within a reasonable period of time not exceeding three months, the CSSF will contact the applicant to clarify whether the application is to be continued or withdrawn.

- ▶ Completion of examination phase

Once the CSSF informs the applicant about the completion of the examination phase of the application, changes of scope or alterations of the last draft versions of constitutional documents on the basis of which the examination has been completed are no longer permitted.

Any such alterations at this stage will result in the application returning to the examination phase.

- ▶ Submission of final version of compulsory documents

The applicant submits to the CSSF the final clean version of the required documents as agreed upon and retained during examination. Prospectuses or offering documents have to be submitted in accordance with the requirements of CSSF Circular 19/708 of 28 January 2019 on the electronic transmission of documents to the CSSF (see Section 10.9.1.). The constitutional document and agreements have to be submitted in signed form.

- ▶ Registration on the official list

Upon satisfactory receipt of all required documents as requested, the CSSF will proceed with the registration of the UCI on the relevant official list. 2010 Law UCIs and SIFs are entered by the CSSF on official lists which are published on the website of the CSSF and in the official gazette (*the Mémorial*).

In parallel, the CSSF will, within five working days:

- ▶ Issue, where applicable, the official authorization letter, the related attestations (for UCITS) and identification codes
- ▶ Register the documentation
- ▶ Return a visa-stamped version of the prospectus or offering document previously submitted via the e-file system

Specific authorization procedures relating to European money market funds (MMFs) are outlined in Section 3.3.3.

On 10 March 2021, the CSSF published statistics on the processing time of initial authorizations of regulated investment vehicles, highlighting that authorization requests which include cross-border aspects and a wide range of investment strategies may add a degree of complexity and are therefore not directly comparable to investment vehicles purely set up for a more local group of investors.

The CSSF took this opportunity to remind best practices to submitting entities, in particular:

- ▶ Only submit applications once definitive and complete in content (avoid incomplete/fragmented files)
- ▶ Submit applications in accordance with CSSF guidelines
- ▶ Provide transparent and relevant supporting documentation in a proactive manner:
  - ▶ Explanatory memorandum for complex files, outlining characteristics, structure, investment policies, strategies, instruments targeted and compliance with legal/regulatory provisions
  - ▶ Prospectus/KIID which is adequate, understandable and not misleading
- ▶ Provide timely and exhaustive response to CSSF requests for clarification
- ▶ Mark-up of amendments
- ▶ Avoid substantial changes when examination in progress
- ▶ Submit final documents in a timely manner: Final prospectus to be visa-stamped, signed final documents requested at the end of the examination letter
- ▶ Avoid change to validated draft prospectus

### 3.3.2. Required information and draft documents

The application file submitted to the CSSF must include the application form and the following information and documents in English, French or German (all documents in one language only):

- ▶ Draft constitutional document: management regulations (common funds) or articles of incorporation (investment companies) (see Section 10.2.)
- ▶ Draft prospectus for 2010 Law UCIs (see Section 10.3.1.) or offering document for SIFs (see Section 10.3.6.)
- ▶ Draft KIID for UCITS (see Section 10.3.2.)
- ▶ Information on the members of the governing body (see Chapter 5) and senior management (where applicable – see also Chapter 6) including:
  - ▶ Name and position
  - ▶ *Curriculum vitae* (up-to-date, including place and date of birth, dated and signed, CSSF template optional)
  - ▶ Declaration of honor (CSSF template required)
  - ▶ Extract of criminal record (or affidavit only if criminal record extract cannot be obtained)
- ▶ Information on:
  - ▶ Management company (if applicable)
  - ▶ Draft articles of incorporation of the general partner, if the UCI is structured as a limited partnership
  - ▶ Structure of the investment company, including a program of activity and human and technical infrastructure for self-managed investment companies (see also Section 6.2.1.C.)
- ▶ Information on the promoter of 2010 Law Part II UCIs which are not managed by a Chapter 15 (UCITS) management company including:
  - ▶ Contact details
  - ▶ Description
  - ▶ Organization chart of the group
  - ▶ Track record and relevant experience
  - ▶ List of authorized activities
  - ▶ Certificate from supervisory authority and audited financial reports of the last three years (where available)
- ▶ Information on:
  - ▶ Portfolio manager and investment advisor, including certificate from supervisory authority and audited financial reports of the last three years (where available)
  - ▶ Administration (see Chapter 8)
  - ▶ Depositary (see Chapter 9)
  - ▶ Auditor (see Section 10.5.10.)
  - ▶ Other delegates (see also Sections 2.4.1.6., 2.4.2.4. and 6.3.3.)
- ▶ Description of investment policy (for each compartment):
  - ▶ NAV calculation frequency
  - ▶ Portfolio manager and/or investment advisor
  - ▶ Investment policy
  - ▶ Use of financial derivative instruments (FDIs) (see Chapter 4)
  - ▶ Use of efficient portfolio management (EPM) techniques (see Chapter 4)
  - ▶ Strategy
  - ▶ Countries of distribution
  - ▶ Target investors
  - ▶ For UCITS:
    - ▶ Global exposure calculation method (see Section 7.2.)
    - ▶ Names of share or unit classes
    - ▶ Range of synthetic risk and reward indicator (SRRI) (see Section 10.3.2.1.)
    - ▶ Information on value-at-risk (VaR) approach (if applicable) (see Section 7.2.)
- ▶ Description of valuation principles (see Sections 7.6. and 8.7.)
- ▶ Information on marketing or offering of the shares or units including:
  - ▶ The terms and conditions pertaining to subscriptions and redemptions (see Section 8.8.)
  - ▶ Marketing strategy, target investors, and distribution channels (see Chapter 12)
  - ▶ Distributors, supervision and compliance with anti-money laundering and counter terrorist financing (AML/CFT) requirements (see Section 8.8.4.)
- ▶ For UCITS: Information on the risk management process (see Section 7.2.)

- ▶ For SIFs:
  - ▶ Description of the risk management system (see Section 7.4.5.)
  - ▶ Confirmation that a conflicts of interest policy has been set up (see Section 2.4.2.3.)
- ▶ Investment companies which have not appointed a management company (self-managed UCITS – see Section 2.4.1.5.; and internally managed AIFs - see Section 2.4.4.1.) should submit information to demonstrate how they will comply with the applicable requirements:
  - ▶ For self-managed UCITS, see Section 6.2.1.C. on the applicable requirements. The application for authorization must be accompanied by a business plan (see Section 2.4.1.5.)
  - ▶ For internally managed AIFs subject to the AIFM Law - see Section 6.2.1.C on the applicable requirements and Section 6.2.1. on the authorization process
  - ▶ For simplified AIFM registration regime internally managed AIFs, see Section 6.2.1.E. on the applicable requirements

The CSSF does not require a promoter (see also Section 1.4.2.A.) for:

- ▶ UCITS
- ▶ 2010 Law Part II UCIs which are managed by a Chapter 15 (UCITS) management company
- ▶ SIFs

In practice, the application for authorization of a SIF should also include information on the initiator:

- ▶ Identity of the initiator
- ▶ Evidence of authorization/regulation of the initiator (such as a certificate from the supervisory authority), if any
- ▶ Audited financial reports of the initiator (where available); where audited financial statements are not available, the CSSF will expect information on the track record of the initiator

The CSSF will not perform detailed checks on the status or financial position of the portfolio manager; this being left to the due diligence of the investors.

Since 30 July 2021, the CSSF no longer requests nor assesses all agreements concluded between a UCI and its services providers during the examination of an application file. However, the applicant should submit to the CSSF a copy of final signed agreements deemed core at the end of the examination, along with a standardized letter confirming compliance of these agreements with applicable legal and regulatory requirements.

The CSSF published Press Release 21/05 on the simplification of the submission process for a new compartment within an existing UCI. The simplified process requires completion of a new questionnaire applicable to UCIs subject to the 2010 Law, SIFs and SICARs. One questionnaire must be completed for each compartment for which approval is requested.

The new questionnaire was introduced with immediate effect and was since updated on 20 January 2022.

This specific questionnaire further standardizes the information necessary for the examination of the application, replacing the following four application questionnaires previously in use:

- ▶ Application questionnaire for additional sub-fund(s)
- ▶ Specific Investment Policy Questionnaire for additional sub-funds of an existing UCITS
- ▶ UCI/2010 Law Part II UCI/SIF Specific Sub-Fund Investment Policy Questionnaire
- ▶ Specific Investment Policy Questionnaire for additional sub-funds of an existing SIF or UCI Part II

The new questionnaire includes information in relation to:

- ▶ Benchmarks Regulation
- ▶ European Markets Infrastructure Regulation (EMIR)
- ▶ Sustainable Finance Disclosure Directive (SFDR)

This new questionnaire may be downloaded on the CSSF website where additional guidance can be found.

The Fund Pre-Inception Readiness Review questionnaire was initially introduced on 30 July 2021 and needs to be submitted with the application file. In this questionnaire, the IFM must confirm that all preparatory work and assessments required by regulation have been completed and that the IFM is ready to onboard the new UCI or compartment after authorization.



### 3.3.3. Authorization for European money market funds

On 30 June 2017, the final text of Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 *on money market funds* was published in the Official Journal of the European Union.

The Regulation applies to all funds and compartments that qualify as money market funds (“MMFs”) as per the definition set out in Article 1 of the Regulation, as amended (MMF Regulation). Funds and compartments wishing to qualify as MMFs must apply for authorization as MMFs meeting the relevant requirements set out below.

The MMFs must be set up as one of the following types:

- A variable net asset value (VNAV)
- A public debt constant net asset value (CNAV)
- A low volatility net asset value (LVNAV)

As described in the MMF Regulation, a UCITS or an AIF may use the designation “money market fund” or “MMF” in relation to itself or the units or shares it issues only where the UCITS or the AIF has been authorized in accordance with the MMF Regulation. In addition, no UCI may be established, marketed or managed in the European Union as an MMF unless it has been authorized in accordance with the MMF Regulation. Such authorization will be valid for all Member States.

No UCI will be authorized as an MMF unless the competent authority of the MMF is satisfied that the MMF will be able to meet all the requirements of the MMF Regulation.

The authorization requirements for UCITS and AIFs are described below:

#### a) UCITS authorization

A UCITS-MMF will need to be authorized under both the UCITS and MMF regimes. Where a UCI has already been authorized as a UCITS, it may apply for authorization as an MMF in accordance with the procedure foreseen in the MMF Regulation, as follows:

- For the purposes of authorization as a UCITS MMF, a UCI must submit to its competent authority all of the following documents:
  - The fund rules or instruments of incorporation of the MMF, including an indication of which type of MMF it is
  - Identification of the manager of the MMF
  - Identification of the depositary
  - A description of, or any information on, the MMF available to investors
  - A description of, or any information on, the arrangements and procedures needed to comply with the requirements of the MMF Regulation
  - Any other information or document requested by the competent authority of the MMF to verify compliance with the requirements of the MMF Regulation

#### b) AIF authorization

An AIF will be authorized as an MMF only if the competent authority of the MMF approves the application submitted by an AIFM that has already been authorized under the AIFM Directive to manage an MMF that is an AIF, and also approves the fund rules and the choice of the depositary.

When submitting the application for managing an MMF that is an AIF, the authorized AIFM must submit to its competent authority all of the following documents:

- The written agreement with the depositary
- Information on delegation arrangements regarding portfolio and risk management and administration of the AIF
- Information about the investment strategies, the risk profile and other characteristics of the MMFs that are AIFs that the AIFM manages or intends to manage

The competent authority of the MMF may ask the competent authority of the AIFM for clarification and information concerning the documentation referred to in the first paragraph above or an attestation as to whether MMFs fall within the scope of the AIFM's management authorization. The competent authority of the AIFM should respond within 10 working days of such request.

The AIFM must immediately inform the competent authority of the MMF of any subsequent modifications to the authorization documentation.

The competent authority of the MMF can refuse the application of the AIFM only in the event that any of the following applies:

- The AIFM does not comply with the MMF Regulation
- The AIFM does not comply with the AIFM Directive
- The AIFM is not authorized by its competent authority to manage MMFs
- The AIFM has not provided the required authorization documentation

Before refusing an application, the competent authority of the MMF must consult the competent authority of the AIFM.

Authorization of an AIF as an MMF must not be subject to a requirement either that the AIF be managed by an AIFM authorized in the AIF home Member State or that the AIFM pursues or delegates any activities in the AIF home Member State.

Within two months of submission of a complete application, the AIFM will be informed whether or not authorization of the AIF as an MMF has been granted. The competent authority of the MMF will not grant authorization of an AIF as an MMF if the AIF is legally prevented from marketing its units or shares in its home Member State.

### 3.3.4. Constitution of a RAIF

A RAIF does not need to obtain authorization from the CSSF. A RAIF may be set up under three different legal forms: common fund (FCP), investment company with variable capital (SICAV) and a RAIF which does not have the legal form of an FCP or a SICAV. The constitutional formalities are as follows:

- ▶ The constitution of the RAIF must be recorded in a notarial deed within five working days of its constitution
- ▶ Within 15 working days of the ascertainment of the constitution by notarial deed, a notice with an indication of the AIFM that manages the RAIF must be deposited with the Luxembourg Trade and Companies Register
- ▶ Within 20 working days of the constitution, the RAIF must be registered on a list held by the Luxembourg Trade and Companies Register. The constitutive documents of a RAIF vary depending on its legal form:
  - ▶ FCPs are established by the adoption of management regulations by the management entity. The management regulations must be filed with the Luxembourg Trade and Companies Register
  - ▶ A notice of deposit is published in the "*Recueil électronique des sociétés et associations*" (RESA)
  - ▶ The management regulations should contain the information listed in Section 10.2.1.
  - ▶ The provisions of the management regulations are deemed to be accepted by unitholders upon acquisition of units
- ▶ The constitutive documents of RAIFs established as SICAVs are the articles of incorporation. Contents of the articles of incorporation are set out in Section 10.2.2.

In addition, RAIFs are required to establish an offering document which has to include all information necessary for investors to make an informed judgment on the opportunity to invest in the RAIF and the risks related thereto.

## 3.4. Updates to the application for authorization

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The granting of authorization by the CSSF implies an obligation for the members of the governing body of the relevant UCI to notify the CSSF on their own initiative of any change regarding the substantial information on which the CSSF based its examination of the initial application before implementing the change. Such changes may include, *inter alia*:

- ▶ Change in the constitutional document
- ▶ Change of the registered address
- ▶ Corporate events (merger, liquidation, spin off, etc.)
- ▶ Change in governance of an investment company (e.g., board members, conducting persons)
- ▶ Closure of a compartment(s)
- ▶ Change of denomination of a UCI and/or compartment(s)
- ▶ Change of investment policy/investment restrictions of a UCI and/or compartment(s)
- ▶ Change of set-up characteristics of a UCI and/or compartment(s) (e.g., consolidation currency, compartment currency, type of share classes)
- ▶ Change of rules in respect of subscriptions or redemptions
- ▶ Change of management company
- ▶ Change of a service provider (e.g., depositary bank, administrator, asset managers, domiciliation agent, independent valuer, paying agent, distributors, independent auditor)

For RAIFs, key elements of the issuing document must be updated before any new issuance of securities or of partnership interests.

### 3.4.1. Process for amending an existing UCI

The process to amend an existing UCI, or one or several of its compartments, can be summarized as follows:

- ▶ Initial submission of the request for approval of the amendments, together with the necessary documents (see Section 3.4.2.)
- ▶ Acknowledgement of receipt of the amendment file by the CSSF
- ▶ Transmission of comments and possibly further requests of information after initial examination by the CSSF
- ▶ Completion of examination phase
- ▶ Submission of final version of required documents
- ▶ Record of the amendments after entry into force and issuance by the CSSF of an official letter

### 3.4.2. Required information and documents

The amendment file should contain at a minimum a detailed explanatory letter of the contemplated amendment(s), the relevant CSSF identifier of existing undertaking or compartment(s) subject to amendment, any supporting documents, any notices to the investors, where applicable, a new marked-up version of the prospectus, constitutional document, KIID (for UCITS) and contracts where applicable. See also Section 10.9.

For open-ended 2010 Law UCIs, the CSSF may assess, on a case-by-case basis and based on the information provided, whether the proposed change should be deemed material and, where appropriate, require notification to investors. Such a material change may, in principle, not be implemented until after the expiration of a notification period of one month. Non-EU jurisdictions may impose a notification period exceeding one month.

During the one-month period before the entry into force of the material change, investors have the right to request, without any repurchase or redemption charge, the repurchase or redemption of their shares or units. In addition to the possibility to redeem shares or units free of charge, the UCI may also offer to investors the option to convert their shares or units into shares or units of another UCI (or, in case the change affects only one compartment, into shares or units of another compartment of the same UCI) without any conversion charges.

The CSSF may nevertheless agree, through a duly supported request for derogation made in advance, to not require such a notification period with the ability for investors to redeem or convert their holdings free of charge (for example, in cases where all the investors in the relevant UCI agree with the contemplated change). Similarly, the CSSF may agree to only require a notification period to duly inform the investors of the relevant change before it becomes effective, but without the ability for investors to redeem or convert their holdings free of charge.

## 3.5. Ongoing supervision

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The CSSF supervises UCIs (excluding RAIFs) on a continuous basis.

2010 Law UCIs are required to electronically submit the final version of their prospectuses and KIID (for UCITS) and, on an ongoing basis, their financial reports, as well as monthly, quarterly and annual financial information, to the CSSF (see Chapter 10). Reporting in accordance with CSSF Circulars 21/788 where applicable, and 21/790 also has to be provided to the CSSF for 2010 Law UCIs (see Section 10.5.10.3.).

SIFs are required to electronically submit the final version of their offering document and, on an ongoing basis, their financial reports, as well as monthly and annual financial information, and from 30 June 2022 reporting in accordance with CSSF Circulars 21/788 where applicable, and 21/790, to the CSSF (see Chapter 10).

The CSSF also has the right, either directly or through an intermediary, to examine the books and records of a UCI.

The depositary is required to provide the CSSF on request with all the information that it has obtained in the exercise of its duties and which is necessary to enable the CSSF to monitor compliance by the UCITS with the 2010 Law (see Section 9.4.1.).

## 3.6. Restructuring UCIs

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It is possible to convert UCIs from one legal regime to another and/or from one basic structure to another. For example, it may be possible to convert a 2010 Law Part II UCI to a UCITS or an FCP to a SICAV. However, it is not possible to convert a UCITS into another type of UCI.

It may be possible to liquidate a UCI and, with shareholder or unitholder consent, contribute its assets to a new UCI.

Restructuring of a Luxembourg UCI is subject to authorization; a new or updated application for authorization should be submitted to the CSSF (see Sections 3.3. and 3.4.). The reasons for the restructuring of the UCI should be explained in the application.

### 3.6.1. Conversion between regimes

A UCI created under Part II of the 2010 Law may be converted into a UCITS, a SIF, or a RAIF; a SIF can be converted into a UCITS, a 2010 Law Part II UCI or a RAIF; a RAIF may be converted into a UCITS, a 2010 Law Part II UCI or a SIF. However, a UCITS cannot be converted into a 2010 Law Part II UCI, a SIF or a RAIF.

Requirements or considerations to take into account include, for example:

Requirement/ consideration	Conversion from a RAIF to a SIF, 2010 Law Part II UCI or UCITS	Conversion from a 2010 Law Part II UCI to a SIF	Conversion from a SIF to a 2010 Law Part II UCI or UCITS	Conversion from a 2010 Law Part II UCI to a UCITS
Investment restrictions (see Chapter 4)	Investment rules applicable to UCITS, 2010 Law Part II UCIs and SIFs are more restrictive than those applicable to RAIFs	Investment rules applicable to a 2010 Law UCI are more restrictive than those applicable to a SIF	Investment rules under the 2010 Law are more restrictive than those applicable to a SIF. Investment rules applicable to UCITS are more restrictive than those applicable to 2010 Law Part II UCIs	Investment rules applicable to UCITS are more restrictive than those applicable to 2010 Law Part II UCIs
Qualification of shareholders or unitholders	SIF investors are also required to meet the “well-informed investor” criteria. No requirement to meet “well-informed investor” criteria under the 2010 Law	2010 Law UCI investors may not meet the “well-informed investor” criteria required for SIFs, described in Section 2.4.2.1.B. Action may need to be taken to ensure that all investors qualify as “well-informed investors”	No requirement to meet “well-informed investor” criteria under the 2010 Law	In principle, no impact
Investors’ approval of conversion	Constitutional document needs to be adapted to the SIF Law or 2010 Law requirements, as applicable  Shareholders or unitholders need to approve the conversion and must be notified of changes to the prospectus	Constitutional document needs to be adapted to the SIF Law requirements  Shareholders or unitholders need to approve the conversion and must be notified of changes to the prospectus	Constitutional document needs to be adapted to the 2010 Law requirements  Shareholders or unitholders need to approve the conversion and must be notified of changes to the offering document	Constitutional document needs to be adapted to the UCITS requirements  Shareholders or unitholders need to approve the conversion and must be notified of changes to the offering document
Service provider agreements	Amendments will need to be made to existing agreements	Amendments will need to be made to existing agreements	Amendments will need to be made to existing agreements	Amendments will need to be made to existing agreements
Promoter or initiator (see Section 1.4.2.A.)	A UCITS management company or a self-managed UCITS is required to have a sponsor. No promoter is required  The CSSF requires detailed information on the promoter of a 2010 Law Part II UCI that is not managed by a UCITS (Chapter 15) management company  For a SIF, information on the initiator is required	The CSSF should be contacted to ensure that they have sufficient information on the initiator	The CSSF requires detailed information on the promoter of a 2010 Law Part II UCI that is not managed by a UCITS (Chapter 15) management company	A UCITS management company or a self-managed UCITS is required to have a sponsor. No promoter is required
Cross-border distribution (see Chapter 12)	The authorities of the countries where the UCI is distributed should be contacted on conversion	The authorities of the countries where the UCI is distributed should be contacted on conversion	The authorities of the countries where the UCI is distributed should be contacted on conversion	The authorities of the countries where the UCI is distributed should be contacted on conversion
Tax implications (see Chapter 11)	Subscription tax will generally be levied at between 0.01% or 0.05% per annum of the net asset value, unless exemption applies	Subscription tax will generally be levied at 0.01% per annum of the net asset value, unless exemption applies	Subscription tax will generally be levied at between 0.01% or 0.05% per annum of the net asset value, unless exemption applies	Subscription tax will generally be levied at between 0.01% or 0.05% per annum of the net asset value, unless exemption applies

Requirement/ consideration	Conversion from a RAIF to a SIF, 2010 Law Part II UCI or UCITS	Conversion from a 2010 Law Part II UCI to a SIF	Conversion from a SIF to a 2010 Law Part II UCI or UCITS	Conversion from a 2010 Law Part II UCI to a UCITS
NAV production (see Chapter 8.7.)	2010 Law UCIs must publish their NAVs at least twice a month (UCITS) or monthly (2010 Law Part II UCIs)  A SIF must publish its NAV at least annually	A SIF must publish its NAV at least annually	2010 Law UCIs must publish their NAVs at least twice a month (UCITS) or monthly (2010 Law Part II UCIs)	UCITS must publish their NAVs at least twice a month
Financial reporting (see Chapter 10)	2010 Law UCIs are required to produce semi-annual reports including unaudited financial statements, annual reports including audited financial statements in accordance with financial reporting requirements which are more detailed for UCITS than 2010 Law Part II UCIs and reporting in accordance with CSSF Circulars 21/788, where applicable, and 21/790  A SIF is required to produce annual reports including audited financial statements as well as reporting in accordance with CSSF Circulars 21/788, where applicable and 21/790. No requirement to produce a semi-annual report <sup>1</sup>	A SIF is required to produce an annual report including audited financial statements as well as reporting in accordance with CSSF Circulars 21/788, where applicable, and 21/790. No requirement to produce a semi-annual report <sup>2</sup>	2010 Law UCIs are required to produce semi- annual reports including unaudited financial statements, annual reports including audited financial statements in accordance with financial reporting requirements which are more detailed for UCITS than 2010 Law Part II UCIs, and reporting in accordance with CSSF Circulars 21/788, where applicable and 21/790	More detailed financial reporting requirements apply to UCITS than 2010 Law Part II UCIs
Offering document (see Chapter 10)	2010 Law UCIs must prepare a prospectus. Specific requirements apply to the prospectus of a UCITS. In addition, a UCITS must prepare a KIID  A SIF must prepare an offering document and if it is an AIF, a KID (see Chapter 10)	A SIF must prepare an offering document, and if it is an AIF, a KID (see Chapter 10)	2010 Law UCIs must prepare a prospectus and a KID. A UCITS must prepare a prospectus and a KIID	Specific requirements apply to the prospectus of a UCITS. In addition, a UCITS must prepare a KIID
Risk management (see Chapter 7)	UCITS are required to comply with detailed risk management requirements. There are no specific risk management requirements for 2010 Law Part II UCIs; however, if the UCI is managed by an authorized AIFM, AIFM risk management requirements apply. A SIF is required to implement risk management systems. If the SIF is managed by an authorized AIFM, AIFM risk management requirements apply	A SIF is required to implement risk management systems. If the SIF is managed by an authorized AIFM, AIFM risk management requirements apply	UCITS are required to comply with detailed risk management requirements. There are no specific risk management requirements for 2010 Law Part II UCIs; however, if the UCI is managed by an authorized AIFM, AIFM risk management requirements apply	UCITS are required to comply with detailed risk management requirements

Subject to the UCI's documentation and to shareholder approval, a 2010 Law Part II UCI and a SIF may request the CSSF for the withdrawal of their authorization and to amend their denomination and more generally their constitutive documentation to delete all references to the 2010 Law and the SIF Law respectively. They would thereafter become unregulated AIFs which may then request RAIF status under the RAIF Law, subject to appointing an authorized AIFM.

<sup>1</sup> Unless it is a listed closed-ended UCI (see Section 10.5.1.).

<sup>2</sup> Idem.

### 3.6.2. Conversion from one basic structure to another

It is possible to convert UCIs from one basic structure to another, either directly or indirectly.

The conversion of common funds (FCPs) and investment companies with fixed capital (SICAFs) into investment companies with variable capital (SICAVs) is foreseen under the 2010 Law and the SIF Law.

The conversion of SICAVs and SICAFs into FCPs is not foreseen under the investment fund laws.

In general, the process of conversion requires, *inter alia*:

- A new application for authorization (see Section 3.3.) or an update to the application (see Section 3.4.)
- Shareholder or unitholder approval or consent to the proposed change

It may also be possible to contribute the assets and liabilities of a compartment of one UCI to a compartment of another UCI (see also Section 3.9.3.). Some of the considerations outlined herein are relevant in this case.

The key considerations when converting between basic structures include:

- **Governance:** While an investment company has a Board of Directors, general partner or manager, and is ultimately controlled by the shareholders, a common fund has no legal personality and is controlled by its management company. The Board of Directors, general partner or managers of an investment company are responsible for the appointment of service providers, whereas for a common fund, the management company appoints the service providers
- **Taxation:** Investment companies have a legal personality and are therefore subject to taxation. Common funds do not have a legal personality and are therefore generally considered tax transparent

The differences between common funds and investment companies are summarized in Section 1.3.2.

Basic structures are covered in Section 2.3.1.

#### A. Conversion into an investment company (SICAV or SICAF)

The conversion of an FCP to a SICAV or SICAF involves, *inter alia*:

- Application for authorization from the CSSF for the conversion and the creation of the new investment company (see Section 3.3.)
- Incorporation of the new investment company
- Approval by unitholders of the FCP
- Change of contractual arrangements

On 16 July 2019, the RAIF Law was amended to allow RAIF FCPs to be converted, in a similar manner to SIF FCPs, into SICAVs. The FCP's documentation should be amended by resolution of a general meeting, passed with a two-thirds majority present or represented, regardless of the portion of capital represented.

A SICAF can be converted into a SICAV and *vice versa*. There are two possible scenarios:

- If the contemplated new SICAV or SICAF structure has been incorporated in the same legal form as the existing SICAF or SICAV, only the amendment of the articles of incorporation is required
- If this is not the case (e.g., if a private limited liability company – S.à r.l. – is converted into a public limited company – S.A.), the investment company must follow the procedure for conversion into another company. The procedure depends on the type of company created

The conversion involves, *inter alia*:

- Application for authorization from the CSSF for the conversion (see Section 3.4.)
- If relevant, creation and incorporation of the new investment company
- Approval by the shareholders
- If relevant, in particular in case of incorporation of the new investment company:
  - Change of contractual arrangements
  - The contribution of the investment company's assets and liabilities to the new investment company
  - The liquidation of the dissolving investment company, if relevant (see Section 3.10.)

#### B. Conversion into a common fund (FCP)

The conversion of SICAVs and SICAFs into FCPs is not foreseen under the investment fund laws. It is not possible to exchange the shares of an investment company for units of an FCP, and the voting rights of shareholders in investment companies may not be withdrawn without shareholder approval.

There may be practical alternatives to conversion, such as: the liquidation of the investment company and the creation of a new FCP with contribution by the shareholders of the SICAV or SICAF of the assets and liabilities to the new FCP, or, for UCITS, through mergers by absorption.

### 3.6.3. Conversion of UCITS into feeder UCITS and change of master UCITS

An existing UCITS may become a feeder UCITS (see also Section 2.3.4.1.). A feeder UCITS may change its master UCITS.

In both cases, the feeder UCITS must inform, and provide certain information to, its shareholders or unitholders including:

- ▶ A statement that the competent authority of the feeder UCITS home Member State approved the investment of the feeder UCITS in shares or units of the master UCITS
- ▶ The KIID of the master UCITS and the feeder UCITS
- ▶ The date when the feeder UCITS starts to invest in the master UCITS or, if it has already invested therein, the date when its investment will exceed the applicable limit (see Section 4.2.2.8.1.III.)
- ▶ A statement that the shareholders or unitholders have the right to request, within 30 days, the repurchase or redemption of their shares or units free of charge (except for divestment costs). That right becomes effective from the date the feeder UCITS has provided the information to its shareholders or unitholders

The taxation implications of the conversion of a UCITS into a feeder UCITS and changes of master UCITS are covered in Section 11.3.6.

Specific provisions cover the cases of liquidation (see Section 3.10.3.) and merger or division of the master UCITS (see Section 3.7.2.1.).

## 3.7. Mergers of UCIs

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The 2010 Law, as amended, permits cross-border as well as domestic mergers of UCITS and lays down detailed requirements to be met. The provisions of the 1915 Law relating to mergers are not applicable to mergers of UCITS.

The provisions of the 2010 Law on mergers of UCITS are not applicable to mergers of 2010 Law Part II UCIs or SIFs.

The taxation implications of mergers of UCIs are covered in Section 11.3.6.

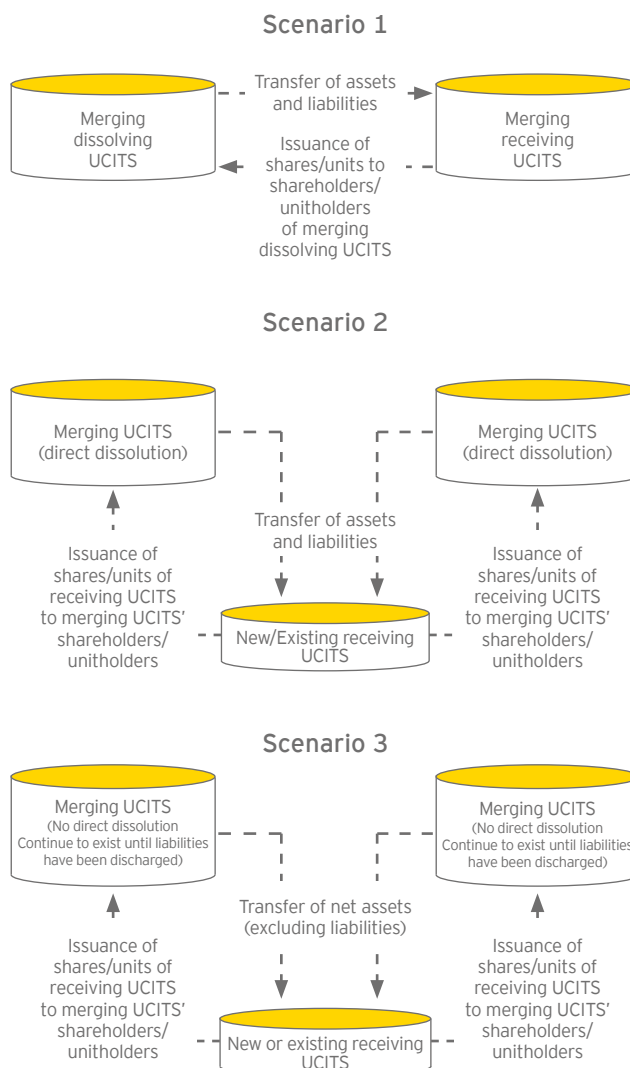
The remainder of this section focuses on the mergers of UCITS.

### 3.7.1. Principle and the common draft terms of mergers

#### 3.7.1.1. Principle

A merger takes place between one or more UCITS or compartment thereof (“merging UCITS”) and a receiving UCITS or compartment thereof (“receiving UCITS”). There are three possible merger scenarios:

1. The merging UCITS transfers all of its assets and liabilities to an existing receiving UCITS. In exchange, the receiving UCITS issues shares or units to the shareholders or unitholders of the merging UCITS; the receiving UCITS may also make a cash payment. The merging UCITS are dissolved.
  
2. The merging UCITS transfer all of their assets and liabilities to a receiving UCITS that they form. In exchange, the receiving UCITS issues shares or units to the shareholders or unitholders of the merging UCITS; the receiving UCITS may also make a cash payment. The merging UCITS are dissolved.
  
3. The merging UCITS transfer their net assets to a receiving UCITS, which may be another compartment of one of the merging UCITS, a new UCITS that they form or another existing UCITS. The merging UCITS continue to exist until their liabilities have been fully discharged.



The merger or the division of a master UCITS will result in the liquidation of the feeder UCITS unless the CSSF grants approval to the feeder UCITS for one of the following:

- ▶ Continuing to be a feeder UCITS of the master UCITS or another UCITS resulting from the merger or division of the master UCITS
- ▶ Investing at least 85% of its assets in shares or units of another master UCITS not resulting from the merger or the division
- ▶ Amending its constitutional document in order to convert into a UCITS that is not a feeder UCITS

For any merging UCITS investment company that ceases to exist, the effective date of the merger must be recorded by notarial deed.

#### 3.7.1.2. Common draft terms of merger

The merging UCITS and the receiving UCITS must draw up common draft terms of the merger comprising, *inter alia*, (i) the type of merger and the name(s) of the UCITS involved, (ii) the rationale for the proposed merger, (iii) the expected impact of the proposed merger on the shareholders or unitholders of both the merging UCITS and the receiving UCITS, (iv) the criteria adopted for valuation of the assets and, where applicable, the liabilities on the planned effective date of the merger, (v) the calculation method of the exchange ratio, (vi) the planned effective date of the merger, (vii) the respective fund rules applicable to the transfer of assets and the exchange of shares or units, and (viii) the instruments of incorporation of the receiving UCITS or in case of a merger described in Scenarios 2 and 3 (if there is the creation of a new receiving UCITS), the constitutional document of the newly constituted receiving UCITS.



## 3.7.2. Authorization

### 3.7.2.1. The merging UCITS established in Luxembourg

Where a merging UCITS is established in Luxembourg, the merger is subject to prior authorization by the CSSF.

The merging UCITS must provide to the CSSF an authorization file including the following information:

- ▶ The common draft terms of the proposed merger duly approved by the merging UCITS and the receiving UCITS
- ▶ An up-to-date version of the prospectus and KIIDs of the receiving UCITS (if established in another Member State)
- ▶ Statements issued by the depositaries of the merging UCITS and the receiving UCITS, respectively, confirming compliance of certain elements of the common draft terms of the proposed merger with the constitutional document of the relevant UCITS
- ▶ Information that will be provided by the merging UCITS and the receiving UCITS to their respective shareholders or unitholders

This authorization file can be provided to the CSSF in Luxembourgish, French, German or English.

If the authorization file is not complete, the CSSF will request additional information within a maximum of 10 working days.

Where the receiving UCITS is not established in Luxembourg and once the authorization file is complete, the CSSF must immediately submit copies of the authorization file to the competent authority of the receiving UCITS home Member State.

The CSSF will authorize the merger, providing all relevant conditions have been met, within 20 working days of submission of the complete information. The National Competent Authority of the receiving UCITS does not have to approve the merger. However, the CSSF and the competent authority of the receiving UCITS will assess whether they are satisfied with the proposed information to be provided to the shareholders or unitholders of the merging and receiving UCITS, respectively.

Where approval by the shareholders or unitholders of mergers between UCITS is required, the constitutional document must lay down the quorum and majority requirements applicable. Common draft terms of the merger have to be approved by a simple majority of shareholders or unitholders, without however requiring more than 75% of the votes cast by the shareholders or unitholders present or represented at the meeting.

For any merging UCITS investment company that ceases to exist, the effective date of the merger must be recorded by notarial deed.

### 3.7.2.2. The merging UCITS established in another Member State and the receiving UCITS established in Luxembourg

The CSSF must receive copies of the authorization file (except the up-to-date version of the prospectus and KIID of the receiving UCITS) from the competent authority of the merging UCITS home Member State.

The CSSF and the competent authority of the merging UCITS home Member State will consider the potential impact of the proposed merger on shareholders or unitholders of the receiving UCITS and the merging UCITS, respectively, to assess whether appropriate information is being provided to shareholders or unitholders.

If the CSSF considers it necessary, it may require, in writing, within 15 working days of receipt of the copies of the complete information, that the receiving UCITS modifies the information to be provided to its shareholders or unitholders.

The CSSF will inform the competent authority of the merging UCITS home Member State within 20 working days of being notified thereof whether it is satisfied with the modified information to be provided to the shareholders or unitholders of the receiving UCITS.

## 3.7.3. Third-party involvement, information and other rights of shareholders or unitholders

The depositaries of the merging UCITS and the receiving UCITS verify the compliance of certain elements of the common draft terms of the proposed merger (including the identification of the type of merger and of the UCITS involved, the planned effective date of the merger, and the rules applicable to the transfer of assets and the exchange of units) with the 2010 Law, as amended, and the constitutional documents of their respective UCITS (see also Section 9.4.6.3.).

A merging UCITS established in Luxembourg must request an independent auditor to validate (i) the criteria adopted for the valuation of the assets and, if necessary, liabilities, (ii) the calculation method of the exchange ratio, and, where applicable, (iii) the cash payment per share or unit. The independent auditor must also validate the actual exchange ratio.

Investors in the merging and receiving UCITS have the right to redeem their shares or units, or convert them into shares or units of another UCITS with similar investment policies and managed by the same management company or by a related company, free of charge (except for any disinvestment costs).

Information on the proposed merger must be provided to shareholders or unitholders of both the merging and the receiving UCITS, only after the CSSF has authorized the proposed merger, and at least 30 days before the deadline for redemption or conversion. This information shall include the following:

- ▶ The background to and the rationale for the proposed merger
- ▶ The possible impact of the proposed merger on the shareholders or unitholders of both the merging UCITS and the receiving UCITS (including, *inter alia*, any material differences in respect of investment policy and strategy, costs, expected outcome, periodic reporting, possible dilution in performance, and, where relevant, their tax treatment)
- ▶ Any specific rights shareholders or unitholders have in relation to the proposed merger (including, *inter alia*, the right to obtain additional information, the right to obtain a copy of the report of the independent auditor or, if applicable, of the depositary, and the right to request the redemption or, as the case may be, the conversion of their shares or units without charge)
- ▶ The relevant procedural aspects and the planned effective date of the merger
- ▶ A copy of the KIID of the receiving UCITS

### 3.7.4. Costs and investment limits

The legal, advisory and administrative costs associated with the preparation and the completion of the merger are to be borne by the management company unless the relevant UCITS are self-managed.

In practice, administrative merger costs are generally borne by the investment manager, sponsor or an affiliated entity.

While ensuring observance of the principle of risk-spreading, the receiving UCITS may derogate from certain diversification rules (see Sections 4.2.2.8.1.I.(1) to (8), II., III. and IV.) for a period of six months starting from the effective date of the merger.

## 3.8. Authorization of a side pocket

The CSSF has implemented a fast-track authorization procedure for the creation of side pockets for non-UCITS. Side pockets are described in Section 2.3.6.

On 31 March 2022, the CSSF published *Ukraine Crisis: FAQs on the application of LMTs by investment funds*. The FAQs cover various liquidity management tools (LMTs) which may be available to UCIs, including side pockets, to address illiquid assets resulting from the Ukraine crisis. They provide guidance to the governing body of the UCI in its assessment of the UCI's situation, as well as insights on the different options available to the governing body and on the conditions of use of relevant tools.

The fast-track procedure can be used when the assets to be side pocketed represent less than 20% of the total net assets of the UCI or compartment, and where the fees are charged to the side pocket at a reduced level. Where the assets represent more than 20%, the CSSF will treat each application on a case-by-case basis; this will imply an assessment of whether suspension or liquidation is not more appropriate than the creation of the side pocket.

To create a side pocket, the following requirements must be met:

- ▶ The management company of the common fund or the governing body of the investment company must confirm that the proposed side pocketing is not contrary to the constitutional document of the UCI
- ▶ The illiquidity of the assets to be side pocketed must be fully established
- ▶ The administration must be technically capable of servicing the side pocket
- ▶ The assets must be realized as soon as they become liquid

The following information must be submitted to the CSSF with the application for authorization to create a side pocket:

- ▶ Description of the illiquid assets: The percentage of the assets to be side pocketed and the reasons for side pocketing the assets
- ▶ Side pocketing option: The choice of creation of a new share class or unit class or compartment, and the reasons leading to this choice
- ▶ Description of the fees to be charged to the side pocket:
  - ▶ The fees charged to the side pocket are normally expected to be at a reduced level (i.e., less than the total expense ratio (TER) of the compartment initiating the side pocket) as the management and administrative services rendered to the side pocket are deemed to be provided less actively and/or at a reduced level
  - ▶ Except for legal expenses for legal actions to preserve the rights and value in relation to the illiquid assets, only charges that are described in the prospectus can be applied

The fast-track procedure cannot be used where there is any charging of specific or additional charges in relation to the side pockets not in line with the aforementioned principles.

- ▶ Communication to investors: This includes communication on the implementation of the side pocketing option, information on any charges related to the side pocket or the assets therein, and a holdings report at a frequency similar to that of the compartment initiating the side pocket
- ▶ Communication to other authorities, if applicable
- ▶ Confirmation that periodic reports will describe the side pockets existing at the time of their issue

The CSSF will generally provide its authorization or submit comments and observations to the applicant within one week of receipt of the application. Once the side pocket application is approved, the CSSF requires a minimum quarterly information on the state and the evolution of the side pocket. The CSSF must be informed immediately when a side pocket is paid out or terminated.

For UCIs whose manager is subject to the AIFM Law, side pockets may be one element of the special liquidity management arrangements implemented by AIFMs; this is covered in Section 7.3.6.C.

## 3.9. Transfer of foreign UCIs to Luxembourg

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### 3.9.1. Transfer options

The main options to transfer a foreign UCI to Luxembourg can be summarized as follows:

- ▶ Redomiciliation by transfer of the registered office of the foreign UCI to Luxembourg otherwise known as transfer of registered office
- ▶ Contribution of the assets and liabilities of the foreign UCI to an existing or newly created Luxembourg UCI, or one or more compartments thereof
- ▶ Cross-border merger between the foreign UCI and a Luxembourg UCI, or one or more compartments thereof

When transferring a foreign UCI, there are a number of factors to consider, such as eligibility of the assets and compliance with investment limits, qualification of investors, investor approval, compliance with anti-money laundering and counter terrorist financing requirements, and taxation.

### 3.9.2. Redomiciliation by transfer of the registered office to Luxembourg

The transfer of the registered office consists of the relocation of the registered office of the foreign UCI to Luxembourg.

The 1915 Law, as amended, provides the concept of the continuity of legal entities, thereby permitting a foreign UCI to transfer its registered office to Luxembourg. The transfer of registered office is, therefore, permitted for investment companies. However, it is not permitted for common funds.

To transfer the registered office, the following process would normally be followed:

- ▶ A corporate decision is made by the shareholders and/or governing body of the foreign UCI to relocate the registered office
- ▶ If applicable, a notification is sent to the foreign regulator
- ▶ The fund documentation of the foreign UCI is amended to comply with Luxembourg law
- ▶ Prior approval of the CSSF is obtained before the transfer (see Sections 3.3. and 3.4.)
- ▶ Local service providers are appointed
- ▶ An extraordinary general meeting (EGM) of shareholders, in front of a Luxembourg notary, is required to ratify the transfer

In practice, it is advisable to obtain a formal legal opinion confirming that the laws of the country of origin allow such continuation of the legal personality of the foreign UCI after the transfer of its registered office in a foreign country.

### 3.9.3. Contribution of the assets and liabilities to a Luxembourg UCI

The principle of a contribution in kind is that the foreign UCI contributes all of its assets and liabilities to an existing or newly incorporated Luxembourg UCI, or a compartment thereof. In exchange, the receiving UCI issues shares or units to the shareholders or unitholders of the foreign UCI.

To contribute the assets and liabilities of a foreign UCI to a Luxembourg UCI, the following process would normally be followed:

- ▶ The constitutional document and offering documents of the Luxembourg UCI would need to permit contributions in kind
- ▶ Prior approval of the CSSF would be obtained before the contribution in kind (see Section 3.3.)
- ▶ Contributed assets would need to be eligible assets for the receiving Luxembourg UCI (see Chapter 4)
- ▶ Investors of the foreign UCI would need to be eligible in accordance with the applicable requirements (see Section 2.4.)

- ▶ The shareholders and/or governing body of the Luxembourg UCI would need to approve the contribution in kind before it takes effect
- ▶ A report would be issued by an independent auditor to confirm, *inter alia*, that the value of the contribution in kind corresponds at least to the number and to the value of the shares or units to be issued

### 3.9.4. Cross-border merger with a Luxembourg UCI

The principle of the cross-border merger is that the foreign UCI transfers all of its assets and liabilities to an existing or newly incorporated Luxembourg UCI, or a compartment thereof. In exchange, the receiving Luxembourg UCI issues shares or units to the shareholders or unitholders of the foreign UCI.

To merge a foreign UCI with a Luxembourg UCI, the requirements on mergers of Luxembourg UCIs have to be met (see in Section 3.7.).

## 3.10. Liquidation of UCIs and compartments

### 3.10.1. Liquidation of a UCI

The liquidation procedure for a UCI depends on the reason (voluntary or legally required) and on the legal structure. It is mainly governed by the 1915 Law, the 2010 Law, the SIF Law and the RAIF Law, as amended. Taxation on dissolution is covered in Section 11.3.2.4.

#### 3.10.1.1. Voluntary liquidation

##### 3.10.1.1.1. Investment companies

###### A. Liquidation scenarios

There are three possible voluntary liquidation scenarios for investment companies:

- ▶ According to the 1915 Law, as amended, the shareholders of a UCI set up as an investment company can voluntarily decide to dissolve the company and put it into liquidation at an EGM
- ▶ If the capital falls below two-thirds of the minimum capital of EUR 1,250,000, the governing body of the UCI must submit the question of the dissolution to the shareholders at an EGM. No quorum is prescribed; the decision is made by a simple majority of the shares represented at the EGM
- ▶ If the capital falls below one-fourth of the minimum capital of EUR 1,250,000, the dissolution may be resolved by shareholders holding one-fourth of the shares at an EGM

In the second and third types of voluntary liquidation, the EGM must be held within 40 days of the date of ascertainment that the net assets have fallen below two-thirds or one-fourth of the minimum capital, as the case may be.

In the case of RAIFs, if the constitutive documents of the investment company do not provide for general meetings or if the capital of the investment company is below one-fourth of the minimum capital for a period exceeding two months, the directors or managers must put the RAIF into liquidation and, as the case may be, within a further three months, request the District Court to pronounce the dissolution and liquidation of the RAIF.

###### B. Liquidation process

UCIs that have only one (remaining) ultimate shareholder may be dissolved if the shareholder decides to dissolve the UCI. In such cases, the appointment of a liquidator is not required however, the UCI's auditor is required to issue an independent report on the financial statements of the UCI covering the period from the beginning of the accounting period to the beginning of the liquidation period (i.e., until the date that the UCI is removed from the official list of the CSSF). The dissolution of the UCI is formalized by a notary deed.

In all other cases (including cases where the one (remaining) shareholder decides not to apply the simplified process referred to in the preceding paragraph), the liquidation process involves a liquidator. The liquidator's main responsibility is to realize the assets and to settle the liabilities.

The key phases of voluntary liquidation are summarized as follows:

- ▶ An EGM is convened before a public notary in order to, *inter alia*:
  - ▶ Resolve the dissolution and the liquidation of the investment company
  - ▶ Appoint a liquidator and determine its responsibilities. The liquidator has to obtain prior approval from the CSSF before being appointed by the shareholders
- ▶ In practice, the UCI's auditor issues an independent report on the financial statements of the UCI covering the period from the beginning of the accounting period to the beginning of the liquidation period (i.e., until the date that the UCI is removed from the official list of the CSSF)

Additional EGMs may be held to authorize certain actions, such as the contribution of the UCI's assets to other companies, or to inform shareholders of the progress of the liquidation.

- The liquidator issues its liquidation report
- The independent auditor of the UCI issues a report on the liquidator's report and the liquidation accounts for the period from the beginning of the liquidation to the end of the liquidation
- A final EGM is convened (generally by private deed) in order to, *inter alia*:
  - Present the liquidator's report
  - Present and approve the independent auditor's report on the liquidator's report and the liquidation accounts
  - Approve the liquidator's report
  - Grant discharge to the liquidator and the independent auditor
  - Indicate the place where the corporate books and records are to be kept for a period of at least five years after the publication of the closing of the liquidation in the Official Gazette (*Mémorial*)

### 3.10.1.1.2. Common funds

#### A. Liquidation scenarios

The management company of a common fund can define the possible liquidation scenarios in the management regulations. The management company is entitled, or obliged, to liquidate the common fund if one of these defined scenarios occurs.

#### B. Liquidation process

The liquidation process for a common fund is generally described in the management regulations.

In general, the appointment of a liquidator is mandatory. However, in situations where there is only one remaining unitholder or where the total number of units outstanding is redeemed, the appointment of a liquidator is not required.

The liquidation of the common fund generally takes place as follows:

- The liquidator – generally the management company itself, or any other liquidator approved by the CSSF – realizes the assets, settles the liabilities and divides the remaining net asset value between the unitholders in proportion to the number of units held by them
- In practice, the auditor issues an independent report on the financial statements of the UCI covering the period from the beginning of the accounting period to the beginning of the liquidation period (i.e., until the date that the UCI is removed from the official list of the CSSF)
- The liquidator issues its liquidation report
- The independent auditor of the UCI then issues a report on the liquidator's report and the liquidation accounts for the period from the beginning of the liquidation to the end of the liquidation

### 3.10.1.2. Required liquidation

#### 3.10.1.2.1. Investment companies

A UCI whose authorization has been withdrawn may be judicially liquidated upon request of the CSSF or of the Public Prosecutor.

#### 3.10.1.2.2. Common funds

A common fund may also be legally required to be liquidated in the following cases:

- Upon the expiry of a period which may be fixed by or foreseen in the management regulations
- In case of bankruptcy of its management company
- In case of cessation of duties by the management company or by the depositary, if they have not been replaced within two months (until replaced, the depositary must continue to act in the interests of the unitholders)
- Where the net assets of the common fund have fallen, for more than six months, below one fourth of the legal minimum
- If authorization of the common fund is withdrawn (in the case of UCITS, 2010 Law Part II UCIs and SIFs)
- In all other cases provided for in the management regulations

With respect to UCITS, 2010 Law Part II UCIs and SIFs, if the net assets fall below two thirds of the legal minimum of EUR 1,250,000, the management company must immediately inform the CSSF which may require the common fund to be put into liquidation.

### 3.10.2. Liquidation of a compartment

Compartments of UCIs can be liquidated (i.e., permanently closed) separately as if they were separate entities.

For a UCI incorporated as an investment company, the articles of incorporation state whether the decision to liquidate a compartment should be taken by the governing body or by the shareholders. In the latter case, the articles of incorporation should clarify whether all the shareholders of the UCI should take part in the vote, or only the shareholders of the compartment.

For a common fund, the governing body of the management company is entitled to decide to liquidate a compartment. The management regulations can require the management company to submit the decision to liquidate the compartment to the unitholders; in this case, the management regulations should clarify whether all the unitholders of the UCI should take part in the vote, or only the unitholders of the compartment.

The liquidation of the last compartment of a UCI implies, as a consequence, the liquidation of the UCI.

CSSF Circular 12/540 covers, *inter alia*, compartments in liquidation: a compartment needs to be removed from the prospectus or offering document at its next update and at the latest within six months of the date of the decision by the board of directors to either:

- Liquidate the compartment
- Close the compartment by realizing and distributing all assets to the investors

No specific auditor's report is required on the liquidation (i.e., closure) of a compartment at the liquidation date. The liquidation is covered by the audit of the annual financial statements. However, the auditor may, at the request of the UCI, perform agreed-upon procedures on the liquidation NAV and report the results of such procedures.

### 3.10.3. Liquidation of feeder or master UCITS

The liquidation of a master UCITS entails the liquidation of the feeder UCITS unless the CSSF approves either of the following:

- The investment of at least 85% of the assets of the feeder UCITS in shares or units of another master UCITS – i.e., change of master UCITS (see Section 3.6.3.)
- The amendments of the constitutional document of the feeder UCITS in order to allow it to convert into an ordinary, non-feeder UCITS

In case of voluntary liquidation, the liquidation of the master UCITS cannot take place in the three-month period following the date on which the master UCITS informed all of its shareholders or unitholders and the CSSF of the binding decision to liquidate.

The merger or the division of a master UCITS implies as a consequence the liquidation of the feeder UCITS unless the CSSF approves specific provisions (see Section 3.7.1.1.).

## 3.11. Dormant compartments

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CSSF Circular 12/540 on *non-launched compartments, compartments awaiting reactivation and compartments in liquidation* covers both compartments under the 2010 Law and the SIF Law. Share or unit classes within compartments are not covered by this Circular.

The Circular lays down that:

- Non-launched compartments: New compartments approved by the CSSF, but which have not issued shares or units, have to be launched within a period of 18 months following the date of the CSSF authorization letter
- Compartments awaiting reactivation: Compartments that become inactive after the redemption of all of the shares or units can remain inactive for up to 18 months following the date on which they became inactive

Non-launched compartments and compartments that have not been reactivated within the 18-month period must be removed from the prospectus or offering document at its next update and at the latest within an additional six-month period from the end of the 18 month period. Marketing materials must also be adapted. If the compartment does not appear in the prospectus or offering document, the CSSF considers that the proposed launch of the compartment has been abandoned.

# 04

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## INVESTMENT RULES

EY supports asset managers in defining fund investment objectives and policies, analyzing asset eligibility and reviewing compliance with investment restrictions.



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## 4.1. Introduction

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This Chapter summarizes investment and borrowing rules applicable to UCITS, 2010 Law Part II UCIs, SIFs, AIFs, RAIFs, EuVECAs, EuSEFs, money market funds (MMFs), and ELTIFs. UCITS are subject to detailed investment and borrowing rules.

2010 Law Part II UCIs are subject to less detailed investment and borrowing rules that are specific to the type of UCI: UCIs investing in transferable securities, hedge funds, venture capital funds, futures contracts and options funds, and real estate funds.

SIFs and RAIFs are subject to general diversification requirements.

Self-managed UCITS, UCITS management companies and AIFMs managing and/or marketing AIFs in the European Union (EU) are subject to specific requirements in relation to their investments in securitization positions.

AIFs managed by authorized AIFMs and internally managed AIFs that are subject to the AIFM Law (full AIFM regime AIFs) are subject to specific requirements in relation to their investments in major holdings and control of non-listed companies and issuers.

The managers of qualifying EuVECAs and EuSEFs are required to comply with specific investment restrictions in order to benefit from the passport for the marketing of their EuVECAs and EuSEFs.

Funds using the label “Short-term money market fund” or “Money market fund” are subject to specific eligible asset requirements and diversification rules.

ELTIFs are subject to specific eligible asset requirements and diversification rules.

In the context of investment rules, CSSF Circular 02/77, entitled *Protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment* (the Circular), establishes guidelines for the Luxembourg fund industry when dealing with net asset value (NAV) calculation errors and breaches of investment restrictions.

On 7 July 2020, the CSSF issued a Frequently Asked Questions document (FAQ) providing certain clarifications relating to the application of the Circular 02/77. The FAQ clarifies, *inter alia*, the scope of application of the Circular, the governance and organizational requirements and the process to select the method of correction for non-compliance with the investment rules. Details on the provisions of the Circular and content of the FAQ are set out in Section 8.8.

## 4.2. UCIs under the 2010 Law

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### 4.2.1. Introduction

#### 4.2.1.1. UCITS and Part II UCIs

The investment and borrowing rules for UCITS (Part I UCIs) are set out in Section 4.2.2.

The investment and borrowing rules for 2010 Law Part II UCIs are set out in Section 4.2.3.

Disclosure requirements for 2010 Law UCIs (e.g., prospectus and financial statement disclosures) are covered in Chapter 10.

#### 4.2.1.2. Multiple compartment UCIs

In the case of multiple compartment UCIs, the investment and borrowing restrictions must be complied with by all compartments, except those relating to significant influence over an issuer (see Sections 4.2.2.8.2. and 4.2.3.1.C.), which apply to all compartments collectively (Article 48 (1) of the 2010 Law, as amended, and Chapter J of Circular 91/75, as amended).



## 4.2.2. UCITS

This Section introduces the concepts of “core” and “non-core” eligible assets and the regulations setting out the investment and borrowing rules applicable to UCITS. It then outlines the investment and borrowing rules, which can be classified as follows:

- ▶ Eligible assets (see Section 4.2.2.3. for a summary and Section 4.2.2.7. for further details)
- ▶ Diversification requirements (see Section 4.2.2.4. for a summary and Section 4.2.2.8. for further details)
- ▶ Borrowing requirements, rules relating to the granting of loans, and short selling (see Section 4.2.2.5. for a summary and Section 4.2.2.9. for further details)
- ▶ Techniques and instruments relating to transferable securities and money market instruments (MMIs) (see Section 4.2.2.6. for a summary and Section 4.2.2.10. for further details)

### 4.2.2.1. Core and non-core eligible assets

A UCITS must invest in “eligible assets”. There are two types of eligible assets, which are, for the purposes of this Chapter of the Technical Guide, defined as “core” and “non-core”. “Core” and “non-core” eligible assets are not terms used in the regulations.

Core eligible assets are assets that are eligible for investment by UCITS under Article 41 (1) of the 2010 Law, as amended. They include:

A. *Transferable securities admitted to or dealt in on a regulated market, including:*

- ▶ Structured financial instruments (SFIs)
- ▶ Transferable securities or MMIs embedding derivatives
- ▶ Recently issued transferable securities or MMIs

B. *MMIs*

C. *Deposits*

D. *Closed-ended UCIs*

E. *Open-ended UCIs*

F. *Financial derivative instruments (FDIs), including FDIs on financial indices*

G. *Ancillary assets*

Non-core eligible assets are assets that are eligible for investment by UCITS under Article 41 (2) a) of the 2010 Law, as amended, sometimes referred to as the “trash ratio”. The trash ratio may only include transferable securities and MMIs.

No more than 10% of net assets may be invested in non-core investments. Where assets are only eligible as non-core investments, this is indicated in this section.

Precious metals and certificates representing them are assets specifically prohibited by the 2010 Law.

### 4.2.2.2. Applicable regulations

The basic investment and borrowing rules for UCITS are set out in the 2010 Law. These rules have been clarified by a Grand-Ducal Regulation, CSSF Circulars and the European Securities and Markets Authority’s (ESMA<sup>1</sup>) guidelines. Such clarifications remain applicable under the 2010 Law.

The investment and borrowing rules of the 2010 Law transpose the requirements of the UCITS Directive. To further clarify the definition of eligible investments (“eligible assets”) for a UCITS and to ensure consistent interpretation and implementation of the UCITS Directives across all EU Member States, the European Commission issued a Directive clarifying certain definitions (Directive 2007/16/EC of 19 March 2007 - the Eligible Assets Directive).

ESMA has issued two sets of additional guidelines clarifying certain parts of this Directive:

- ▶ *Eligible assets for investment by UCITS* of March 2007, as amended. ESMA’s guidelines concerning eligible assets for investment by UCITS were amended in September 2008
- ▶ *Eligible assets for investment by UCITS - The classification of hedge fund indices as financial indices* of July 2007

The Grand-Ducal Regulation of 8 February 2008 (the “Grand-Ducal Regulation”) concerning certain definitions of the 2010 Law transposes the Eligible Assets Directive into national regulation.

CSSF Circular 08/339 of 19 February 2008, as amended by CSSF Circular 08/380 of 26 November 2008, reproduces ESMA’s two sets of *Guidelines of the Committee of European Securities Regulators (CESR) concerning eligible assets for investment by UCITS*.

<sup>1</sup> | The Committee of European Securities Regulators (CESR) became the ESMA on 1 January 2011.

CSSF Circulars 11/512<sup>2</sup>, 08/356, and 91/75<sup>3</sup> also provide some clarifications relevant to the investment and borrowing rules of UCITS.

ESMA's *Guidelines on ETFs and other UCITS issues* of 18 December 2012, as amended, impact UCITS using efficient portfolio management (EPM) techniques, such as securities lending, sale and repurchase agreements (repos) and purchase and resale agreements (reverse repos), as well as specific categories of UCITS: exchanged-traded funds (ETFs), index-tracking UCITS (including leveraged index-tracking UCITS), UCITS entering into total return swaps (TRS), and UCITS investing in financial indices. ESMA's guidelines also cover the management of collateral for over-the-counter (OTC) financial derivative instrument (FDI) transactions and EPM techniques.

ESMA has issued a *Q&A on the Application of the UCITS Directive*. It covers, *inter alia*, regulated markets, investment limits, issuer concentration, master feeder structures, UCITS investing in other UCITS with different investment policies, and ESMA's *Guidelines on ETFs and other UCITS issues*.

CSSF Circular 14/592 dated 30 September 2014 implements the version of ESMA's guidelines published on 1 August 2014.

The CSSF also issued on 8 December 2015 an *FAQ concerning the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment in transferable securities* (as amended) and covering, *inter alia*, eligible assets and diversification rules.

On 30 June 2017, the final text of Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds was published in the Official Journal of the European Union. The Regulation, as amended, applies to funds and compartments that qualify as MMFs as per the definition set out in Article 1 of the Regulation.

#### 4.2.2.3. Eligible assets - summary

This section provides a high level overview of the eligible assets for investment by UCITS.

As regards eligible assets, the CSSF clarified that a UCITS should clearly disclose in its investment policy the categories of eligible assets in which it is authorized to invest:

- In order to achieve its investment goals
- For treasury purposes
- In case of unfavorable market conditions

If a UCITS invests in a category of assets that is not foreseen in its investment policy, the provisions of Circular CSSF 02/77 apply.

##### A. *Transferable securities - for example, ordinary shares and bonds*

Transferable securities which are listed on or dealt in on a regulated market are eligible as core investments. Transferable securities which are not listed on or dealt in on a regulated market are eligible as non-core investments only.

To be transferable, the following criteria must be met:

- The potential loss on the investment is limited to the amount paid to acquire it
- The liquidity of the instrument must not compromise the ability of the UCITS to meet its repurchase obligations
- A reliable valuation must be available for the investment
- Appropriate information on the investment must be available
- The instrument must be negotiable - i.e., there are no limitations on its transferability
- The acquisition of the investment must be consistent with the investment policy of the UCITS
- The risks associated with the investment must be adequately captured by the risk management process of the UCITS

Detailed requirements are outlined in Section 4.2.2.7.1.

##### *Structured financial instruments (SFIs) - for example, certificates on stock indices, commodities or real estate*

Provided they meet the aforementioned transferable securities criteria, financial instruments backed by or linked to the performance of other assets (which may not be eligible assets) are included within the definition of transferable securities.

Detailed requirements are outlined in Section 4.2.2.7.2.

<sup>2</sup> As amended by CSSF Circular 18/698.

<sup>3</sup> As amended by CSSF Circulars 05/177, CSSF 18/697 and CSSF 22/811.

#### *Transferable securities or MMIs embedding derivatives – for example, convertible bonds*

A transferable security or MMI may embed a derivative, i.e., it is an instrument that contains a component fulfilling the following criteria:

- ▶ Some or all of the cash flows of the transferable security or the MMI (host contract) can be modified according to a variable, and therefore vary in a way similar to a stand-alone derivative
- ▶ Its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract
- ▶ It has a significant impact on the risk profile and pricing of the transferable security or MMI

For those transferable securities or MMIs embedding a derivative, the underlying of the embedded derivative instrument must consist of eligible assets for a UCITS.

Detailed requirements are outlined in Section 4.2.2.7.3.

#### *Recently issued transferable securities or MMIs*

Recently issued transferable securities and MMIs not yet listed on or dealt in on a regulated market are permitted provided that the terms of issue include an undertaking that an application will be made for admission to a regulated market and that such admission is secured within one year of issue.

Detailed requirements are outlined in Section 4.2.2.7.4.

### *B. MMIs – for example, commercial papers*

MMIs are eligible as core investments if they meet the following criteria:

- ▶ They are normally dealt in on the money market
- ▶ They are liquid
- ▶ They have a value that can be accurately determined at any time
- ▶ Either:
  - ▶ They are listed on an official stock exchange or traded on a regulated market
  - ▶ Their issue or issuer is regulated for the purpose of protecting investors and savings and one of the following criteria is met:
    - ▶ They are issued or guaranteed by a state or local authority or a supranational issuer
    - ▶ They are issued by an undertaking that has securities which are dealt in on a regulated market
    - ▶ They are issued or guaranteed by an establishment subject to sufficient prudential supervision
    - ▶ They are issued by a securitization vehicle that benefits from a secured banking liquidity line

Detailed requirements are outlined in Section 4.2.2.7.5.

The specific requirements applicable to MMFs are covered in Section 4.8.

### *C. Deposits with credit institutions*

Deposits are eligible as core investments if they meet the following criteria:

- ▶ They are with a credit institution that has its registered office in an EU Member State or, if located in a non-Member State, it is subject to equivalent prudential rules
- ▶ They are repayable on demand or have the right to be withdrawn
- ▶ They have a maturity of up to 12 months

### *D. Closed-ended UCIs*

Closed-ended undertakings for collective investment (UCIs) are eligible as core investments if they are listed on or dealt in on a regulated market, meet the transferable securities criteria (see Section 4.2.2.3.A.), and if:

- ▶ They are subject to corporate governance mechanisms equivalent to those applied to companies

ESMA's guidance on investments in closed-ended UCIs in contractual form:

In assessing whether the corporate governance mechanisms for UCIs in contractual form are equivalent, the following factors are indicators, which can be used as guidance:

- a) Unitholders' rights. The management regulations (or other contract on which the UCI is based) should provide for:
  - ▶ Right to vote of the unitholders in the essential decision-making processes of the UCI (including appointment and removal of the asset management company, amendment to the contract that set up the fund, modification of investment policy, merger, and liquidation)
  - ▶ Right to control the investment policy of the UCI through appropriate mechanisms
- b) It is understood that the assets of the UCI should be separate and distinct from those of the asset manager and the UCI will be subject to liquidation rules adequately protecting the unitholders

- ▶ They are managed by an entity subject to national regulation for the purpose of investor protection

Listed closed-ended hedge funds may, therefore, be eligible as core investments provided these criteria are met.

Unlisted closed-ended UCIs may be eligible as non-core investments if the aforementioned criteria are met (including the transferable securities criteria).

UCITS may not invest in closed-ended funds for the purpose of circumventing the investment limits.

The CSSF clarified that it is not necessary to analyze the eligibility of the underlying assets of the closed-ended fund provided that the fund itself meets the transferable securities criteria.

#### E. Open-ended UCIs

Shares or units of open-ended UCITS and other UCIs, including ETFs, are eligible as core investments if:

- ▶ Their sole object consists of collective investment in transferable securities or in other liquid financial assets that are eligible assets for UCITS, they raise capital from the public, and they operate on the principle of risk-spreading
- ▶ Their shares or units are, at the request of holders, repurchased or redeemed, directly or indirectly, out of their assets
- ▶ They are subject to supervision considered by the CSSF to be equivalent to that laid down in EU Law and the cooperation between authorities is sufficiently ensured

ESMA's guidance:

In assessing whether a UCI is subject to equivalent supervision, the following factors can be used to guide a decision on equivalence:

- ▶ Memoranda of Understanding (bilateral or multilateral), membership of an international organization of regulators, or other cooperative arrangements (such as an exchange of letters) to ensure satisfactory cooperation between the authorities
  - ▶ The management company of the target UCI, its rules, and choice of depositary have been approved by its regulator
  - ▶ Authorization of the UCI in an Organization for Economic Co-operation and Development (OECD) Member State
- ▶ The level of protection for shareholders or unitholders in the other UCIs is equivalent to that provided for shareholders or unitholders of a UCITS (asset segregation, borrowings, lending, etc.)

ESMA's guidance:

In assessing whether the level of protection is equivalent, the following factors can be used to guide a decision on equivalence:

- ▶ Rules guaranteeing the autonomy of the management of the UCI, and management in the exclusive interest of the unitholders
- ▶ The existence of an independent trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision. Where an independent trustee/custodian is not a requirement of local law as regards collective investment schemes (CIS), robust governance structures may provide a suitable alternative
- ▶ Availability of pricing information and reporting requirements
- ▶ Redemption facilities and frequency
- ▶ Restrictions in relation to dealings by related parties
- ▶ The extent of asset segregation
- ▶ The local requirements for borrowing, lending and uncovered sales of transferable securities, and MMIs in relation to the portfolio of the UCI

- ▶ They produce semi-annual and annual reports
- ▶ They do not invest, according to their constitutional document, more than 10% of their net assets in other UCITS or UCIs

The CSSF clarified that:

- ▶ It is not possible for a UCITS to invest in feeder funds
- ▶ Open-ended SIFs can be eligible investments for a UCITS provided they meet the eligibility criteria for open-ended UCIs and are managed by an authorized AIFM
- ▶ UCITS master funds can be eligible investments for a UCITS which is not a feeder fund provided they meet the eligibility criteria for open-ended UCIs
- ▶ A UCITS master fund can invest in funds or be a fund of funds provided its target funds meet the eligibility criteria for open-ended UCIs

ESMA clarified, with respect to UCITS investing in other UCITS or UCIs with different investment strategies or investment restrictions, that the prospectus of a UCITS should clearly disclose whether, in the case of fund of fund investments, the target fund(s) may have different investment strategies or restrictions.

Where the fund rules or instruments of incorporation and prospectus of a UCITS expressly rule out certain types of assets or derivative use without any reservations, UCITS management companies/self-managed investment companies should carry out proportionate due diligence to ensure that fund of fund investments do not result in a circumvention of the investment strategies or restrictions set out in the fund rules or instruments of incorporation and prospectus of the investing UCITS.

#### F. Financial derivative instruments (FDIs)

For FDIs to be eligible, the underlying asset of the FDI must be a core eligible asset – a transferable security, deposit, MMI, closed or open-ended fund, financial index, interest rates, foreign exchange rates or currency.

If the acquisition or use of an FDI could result in the delivery or the transfer of non-eligible assets, the FDI, regardless of its nature, is not eligible.

OTC FDIs must meet the following criteria:

- ▶ The counterparties must be subject to prudential supervision, approved by the CSSF
- ▶ They must be subject to daily, reliable, and verifiable valuation
- ▶ They must be able to be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the UCITS' initiative

Eligible FDIs include, but are not limited to, futures, options, swaps (interest rate swaps, currency swaps, TRS, credit default swaps (CDS), etc.), forwards, and contracts for differences.

Detailed requirements are outlined in Section 4.2.2.7.6.

##### *FDIs on financial indices*

To be eligible as the underlying of an FDI, financial indices must meet the following criteria:

- ▶ Be sufficiently diversified
- ▶ Represent an adequate benchmark for the market it refers to
- ▶ Be published in an appropriate manner

Based on these eligibility criteria, eligible indices may, *inter alia*, consist of commodity and metal indices, real estate indices, private equity indices, or hedge fund indices.

Detailed requirements are outlined in Section 4.2.2.7.7.

#### G. Ancillary assets

Movable and immovable property may be acquired by an investment company if it is essential for its business.

Ancillary liquid assets may be held.

The CSSF clarified that ancillary liquid assets should be limited to bank deposits at sight, such as cash held in current accounts with a bank accessible at any time, in order to cover current or exceptional payments, or for the time necessary to reinvest in core eligible assets for a period of time strictly necessary in case of unfavorable market conditions. It also mentioned that initial and variation margins relating to FDIs are not considered as ancillary liquid assets but as collateral received or posted.

The CSSF also clarified that loans do not constitute eligible investments for UCITS (neither as core nor non-core investments) as they do not qualify as:

- ▶ MMIs, or
- ▶ Transferable securities

within the meaning of the definitions included in the Law of 17 December 2010, as amended, and Grand-Ducal Regulation of 8 February 2008, further clarified by the CESR *Guidelines concerning eligible assets for investment by UCITS*, March 2007.

On 29 November 2021, the CSSF published its *FAQ Virtual Assets* which provides guidance on virtual assets and similar financial innovations. Virtual assets are defined in Article 1 (20b) of the Law of 12 November 2004 on the fight against money laundering and terrorist financing, as amended.

The CSSF indicated that entities under its prudential supervision must bear in mind that investing in virtual assets is not suitable for all kinds of investors and/or all investment objectives. Therefore UCITS are not allowed to invest directly or indirectly in virtual assets. The CSSF reminded the industry that the definition of virtual assets in the context of the above article excludes, *inter alia*, digital assets that fulfil the conditions of financial instruments within the meaning of the Law of 5 April 1993 on the Financial Sector. Any assets that qualify as financial instruments, such as shares of companies active in the virtual asset ecosystem, are not subject to the above position and could potentially fall within the scope of eligible investments for UCITS.

#### 4.2.2.4. Diversification requirements - summary

This section provides a high level overview of the diversification requirements for UCITS.

As well as meeting the eligible assets criteria, the investments of UCITS must meet the following diversification requirements:

- ▶ No more than 10% of net assets may be invested in transferable securities or MMIs issued by the same body. In certain cases, a higher limit may be applied (where the issuer or issuance meets specific criteria, and in the case of index replicating UCITS)
- ▶ No more than 20% of net assets may be invested in deposits with the same body
- ▶ The risk exposure to a counterparty in an OTC FDI transaction may not exceed 10% of net assets in the case of a credit institution and 5% in other cases
- ▶ The total value of transferable securities and MMIs held in issuing bodies in each of which is invested more than 5% of net assets must not exceed 40% of net assets
- ▶ No more than 20% of net assets may be invested in any combination of the following with a single body:
  - ▶ Transferable securities or MMIs
  - ▶ Deposits
  - ▶ OTC FDIs
  - ▶ Techniques and instruments relating to transferable securities and MMIs
- ▶ No more than 20% of net assets may be invested in a single UCITS or other UCI (for the purposes of applying this limit, each compartment of a target multiple compartment UCI is considered as a separate issuer)
- ▶ No more than 30% of net assets may be invested in aggregate in shares or units of other UCIs (excluding UCITS)
- ▶ A UCITS (or its management company in the case of a common fund) may not acquire any shares carrying voting rights which would enable it to exercise significant influence over the management of an issuing body
- ▶ Furthermore, a UCITS may acquire no more than:
  - ▶ 10% of the non-voting shares of the same issuer
  - ▶ 10% of the debt securities of the same issuer
  - ▶ 25% of the shares or units of the same UCI
  - ▶ 10% of the MMIs issued by the same issuer

Detailed requirements are outlined in Section 4.2.2.8.

#### 4.2.2.5. Borrowing requirements and rules relating to the granting of loans and short selling - summary

This section provides a high level overview of the borrowing requirements and the rules relating to the granting of loans and short selling for UCITS.

Neither an investment company, a management company, nor a depositary acting on behalf of a common fund may borrow. However, there are certain exceptions to this rule, including:

- ▶ Up to 10% of net assets may be borrowed on a temporary basis only
- ▶ Up to 10% of net assets in the case of an investment company may be borrowed to acquire property essential for the business
- ▶ The combined amount of such borrowings may not in total exceed 15% of net assets
- ▶ Back-to-back loans may be acquired and are not considered as borrowings for the purposes of these limits

Granting of loans or acting as guarantor on behalf of third parties is not permitted.

Short selling of securities is not permitted.

Detailed requirements are outlined in Section 4.2.2.9.

#### 4.2.2.6. Techniques and instruments relating to transferable securities and MMIs – summary

This section provides a high level overview of the techniques and instruments relating to transferable securities and MMIs that can be used by UCITS.

Techniques and instruments relating to transferable securities and MMIs may be employed provided they are used for the purpose of EPM and do not result in the UCITS diverging from its investment objectives or in a risk profile higher than that described in its sales documents.

Such techniques and instruments may include, *inter alia*:

- ▶ Securities lending transactions
- ▶ Sale with the right of repurchase transactions
- ▶ Reverse repurchase and repurchase agreement transactions
- ▶ Certain hedging transactions using FDIs

Physical short selling of borrowed securities is not a permitted activity. It may be possible to use FDIs to create synthetic short positions.

Permitted techniques and instruments should meet the following criteria:

- ▶ Be economically appropriate and realized in a cost-effective manner
- ▶ Be entered into for at least one of the following reasons:
  - ▶ Risk reduction
  - ▶ Cost reduction
  - ▶ Generation of additional capital or income for the UCITS, provided that risk levels and diversification remain consistent
- ▶ Be captured by the risk management process

Detailed requirements are outlined in Section 4.2.2.10.

#### 4.2.2.7. Detailed rules regarding eligible assets

##### 4.2.2.7.1. Transferable securities – definitions and requirements

Transferable securities that are admitted to an official listing on a regulated market or dealt in on another regulated market that operates regularly and is recognized and open to the public are eligible as core investments. Stock exchanges or other regulated markets that are outside the EU and used by UCITS should be specified in the constitutional document.

Transferable securities are defined in Article 1 of the 2010 Law as:

- ▶ Shares and other securities equivalent to shares (“shares”)
- ▶ Bonds and other forms of securitized debt (“debt securities”)
- ▶ Any other negotiable securities that carry the right to acquire such transferable securities by subscription or exchange, excluding techniques and instruments (see Section 4.2.2.10.(1))

1. *The Grand-Ducal Regulation<sup>4</sup> clarifies that transferable securities should meet the following criteria:*

- (1) The potential loss, which the UCITS may incur as a result of holding the securities, should be limited to the amount paid for them

ESMA’s clarification: A partly paid security must not expose the UCITS to a loss beyond the amount to be paid for it.

- (2) The liquidity of the securities must not compromise the ability of the UCITS to repurchase or redeem its shares or units at the request of the shareholders or unitholders

ESMA’s clarification: In determining liquidity, the following may need to be taken into account:

- ▶ Volume and turnover in the security
- ▶ If the price is determined by supply and demand in the market, the issue size and the portion of the issue that the asset manager plans to buy, and evaluation of the opportunity and timeframe to buy or sell
- ▶ Where necessary, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument, as may the comparability of the available prices
- ▶ In assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered

The CSSF clarified that, in determining liquidity, the entire portfolio must be taken into consideration and not only transferable securities considered individually.

<sup>4</sup> | The Grand-Ducal Regulation of 8 February 2008.

Financial instruments which are admitted to or dealt in on a regulated market (see Section 4.2.2.7.1.II.(1)) are presumed not to compromise the ability of the UCITS to repurchase or redeem its shares or units at the request of the shareholders or unitholders.

- (3) A reliable valuation is available for them:
  - (i) In the case of securities admitted to or dealt in on a regulated market, in the form of accurate, reliable and regular prices, which are either market prices or prices made available by valuation systems independent from issuers
  - (ii) In the case of other securities, in the form of a periodic valuation that is derived from information from the issuer of the security or from competent investment research
- (4) Appropriate information is available for them:
  - (i) In the case of securities admitted to or dealt in on a regulated market, in the form of regular, accurate, and comprehensive information on the security or, where relevant, on the portfolio of the security
  - (ii) In the case of other securities, in the form of regular and accurate information on the security or, where relevant, on the portfolio of the security
- (5) They are negotiable - i.e., there are no limitations on their transferability

ESMA's clarification: There is a presumption, but not a guarantee, that transferable securities admitted to trading on a regulated market are negotiable. The presumption does not apply if the UCITS knows or ought to reasonably know that a particular security is not negotiable.

- (6) Their acquisition is consistent with the investment objectives or the investment policy, or both
- (7) Their risks are adequately captured by the risk management process of the UCITS (see Section 7.2.)

ESMA's clarification: The security's risk and its contribution to the overall risk profile of the portfolio must be assessed on an ongoing basis.

The CSSF clarified as regards investments in Special Purpose Acquisition Companies (SPACs) that they may constitute eligible investments for UCITS, provided they meet the above mentioned eligibility criteria. However, SPACs may include different kinds of risks such as dilution, liquidity, conflicts of interests or the uncertainty as to the identification, evaluation and eligibility of the target company. Moreover, the structure of SPACs can be complex and their characteristics may vary largely from one SPAC to another, meaning that UCITS need to carefully study the structure of each SPAC. Consequently, before investing into SPACs, UCITS must perform a detailed risk assessment covering all material risks to which the UCITS will be exposed as a result of the investment. Given the risk profile of SPACs, such pre-trade assessment should notably also comply with the provisions of Article 26 (4) of the CSSF Regulation 10-4 requiring management companies, on the basis of reliable and up-to-date information both in quantitative and qualitative terms, to formulate forecasts and perform analyses concerning the investment's contribution to the UCITS' portfolio composition, liquidity and risk and reward profile. With regard more specifically to liquidity risk, the assessment should ensure that, at all times, the liquidity of the SPAC investments does not compromise the ability of the UCITS to repurchase its units at the request of unitholders. Based on the foregoing, the CSSF is of the opinion that a UCITS' investment in SPACs should, in principle, be limited to a maximum of 10% of a UCITS' NAV, provided that such SPAC investments fulfil all applicable eligibility requirements, are appropriately disclosed in UCITS prospectuses and are captured adequately by the risk management process of the UCITS.

## II. Regulated Market

### (1) "Regulated market"

A "regulated market" within the context of the 2010 Law is a regulated market in the sense of the Markets in Financial Instruments Directive (MiFID II)<sup>5</sup>. European Economic Area (EEA)<sup>6</sup> regulated markets appear on the relevant European Commission list.

### (2) "Regulated market which operates regularly and is recognized and open to the public"

Circular 91/75, as amended, defines a regulated market which operates regularly and is recognized and open to the public as follows:

- ▶ "Regulated": The essential characteristic of a regulated market is the clearing, which presupposes the existence of a central market organization for the processing of orders. Such a market may also be distinguished by multilateral order matching (general matching of bid and offers enabling the setting of a single price), transparency (maximum information distribution among buyers and sellers giving them the possibility to follow the evolution of the market so that they may ensure that their orders have been carried out at current conditions), and the neutrality of its organizer (the organizer's role must be limited to recording and supervision)

<sup>5</sup> Markets in Financial Instruments Directive (MiFID II), Directive 2014/65/EU, as amended.

<sup>6</sup> The EEA Member States are the EU Member States plus Iceland, Liechtenstein, and Norway.



- ▶ “Recognized”: The market must be recognized by a state or by a public authority delegated by that state or by another entity recognized by the state or by that public authority, such as a professional association
- ▶ “Operating regularly”: Securities admitted to this market must be dealt in at a certain fixed frequency (no sporadic dealings)
- ▶ “Open to the public”: The securities dealt in thereon must be accessible to the public

#### 4.2.2.7.2. Structured financial instruments (SFIs) - for example, certificates

Provided they meet the transferable securities criteria, financial instruments backed by or linked to the performance of other assets (which may not be eligible assets) are included within the definition of transferable securities.

##### CSSF’s clarification:

The eligibility analysis of SFIs, i.e., transferable securities linked to the performance of other underlying assets through an FDI, comprises different steps.

In order to qualify as eligible assets in accordance with Sections 4.2.2.7.1. or 4.2.2.7.4. (Article 41 (1) a) – d) of the 2010 Law, as amended) and as transferable securities, the SFIs must first meet the transferable securities criteria (see Section 4.2.2.7.1.I.).

Secondly, the security should be analyzed to determine if there is an embedded FDI (see Section 4.2.2.7.3. for criteria). There are two possible situations:

##### (a) Transferable securities embedding an FDI

In this case, the investment manager must apply the “look-through” principle and verify the eligibility of the underlying assets in accordance with the eligibility criteria for FDIs (see Section 4.2.2.7.6. for criteria):

- ▶ If the underlying assets of the FDIs qualify as eligible assets (in accordance with Sections 4.2.2.7.1. and 4.2.2.7.4. and Sections 4.2.2.7.5.II. and III., 4.2.2.3.C., D and E – Article 41 (1) of the 2010 Law, as amended), the transferable securities are eligible as core investments for the UCITS
- ▶ If the underlying assets of the FDIs do not qualify as eligible assets, the transferable securities are not eligible investments for the UCITS in accordance with Sections 4.2.2.7.1. or 4.2.2.7.4.

Nevertheless, if the underlying assets of the FDIs qualify as non-core investments, the transferable securities are eligible as non-core investments.

When a transferable security embeds an FDI, the risk management process requirements apply to this FDI (see Section 7.2.).

##### (b) Transferable securities not embedding an FDI

In principle, in this case, the investment manager is not required to apply the “look-through” principle and does not have to verify the eligibility of the underlying assets in accordance with the eligibility criteria for FDIs.

Nevertheless, a UCITS must always be managed in accordance with the principle of risk diversification – i.e., it is not acceptable for a UCITS to exclusively invest in different transferable securities that are all linked to the performance of the same underlying asset.

As a consequence, the principle of risk diversification applies to each transferable security as well as to its underlying assets independently of the fact that the transferable security embeds or does not embed an FDI.

The investment manager and the officers responsible for the UCITS must provide for means to satisfy the principle of risk diversification.

##### Other CSSF’s clarification

With respect to transferable securities that do not embed a derivative, the application of a 20% limit of the net assets to each underlying asset of such transferable securities that do not embed a derivative has to be respected. This limit may be raised up to 35% for a single underlying asset.

#### 4.2.2.7.3. Transferable securities and MMIs embedding FDIs

- (1) Such financial instruments must meet the criteria for transferable securities (see Section 4.2.2.7.1.) or MMIs (see Section 4.2.2.7.5.) and must contain a component that fulfills the following criteria:
  - Some or all of the cash flows that otherwise would be required by the transferable security, which functions as a host contract, can be modified according to a specific interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone FDI
  - Its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract
  - It has a significant impact on the risk profile and pricing of the transferable security
- (2) A transferable security or MMI should not be regarded as embedding an FDI where it contains a component that is contractually transferable independently of the transferable security or the MMI

ESMA states that collateralized debt obligations (CDOs) or asset-backed securities using FDIs will generally not qualify as SFIs embedding FDIs, except if they are:

- Leveraged
- Not sufficiently diversified

Where a product is structured as an alternative to an OTC FDI, its treatment should be similar to that of an OTC FDI.

ESMA has indicated that the following instruments may embed FDIs:

- Credit linked notes
- Convertible bonds
- Exchangeable bonds
- SFIs whose performance is linked to the performance of a bond index
- SFIs whose performance is linked to a basket of shares
- SFIs with a fully guaranteed nominal value whose performance is linked to the performance of a basket of shares

UCITS using SFIs embedding FDIs must respect the principles of the 2010 Law regarding FDIs.

For those transferable securities or MMIs embedding an FDI, the underlying of the embedded FDI must consist of assets eligible for a UCITS.

For example, catastrophe bonds and delta one certificates may be eligible provided the transferable securities criteria are met (see Section 4.2.2.7.1.I.). However, leverage loans will not be eligible because they do not qualify as transferable securities or MMIs.

#### 4.2.2.7.4. Recently issued transferable securities or MMIs

Recently issued transferable securities and MMIs not yet listed on or dealt in on a regulated market are permitted as core investments provided that:

- They first meet the transferable securities criteria (see Section 4.2.2.7.1.I.) or MMIs criteria respectively (see Section 4.2.2.7.5.I.)
- Secondly, the terms of issue include an undertaking that application will be made for admission to a regulated market (see Section 4.2.2.7.1.II.(1)) or another regulated market that operates regularly and is recognized and open to the public (see Section 4.2.2.7.1.II.(2)) and that such admission is secured within one year of issue

As stated in Section 4.2.2.7.1.I.(2), the liquidity of the securities must not compromise the ability of the UCITS to repurchase or redeem its shares or units at the request of the shareholders or unitholders. This requirement should also be carefully considered in respect of recently issued transferable securities and MMIs not yet listed on or dealt in on a regulated market.

#### 4.2.2.7.5. MMIs - for example, commercial papers

##### I. MMIs

- (1) Article 1 of the 2010 Law, as amended, defines MMIs as instruments meeting all the following criteria:
- ▶ Normally negotiated on a money market (see Section 4.2.2.7.5.I.(2))
  - ▶ That are liquid (see Section 4.2.2.7.5.I.(3))
  - ▶ Whose value can be determined with precision at any time (see Section 4.2.2.7.5.I.(4))

The Grand-Ducal Regulation<sup>7</sup> clarifies that MMIs should be understood to mean those that are either admitted to trading or dealt in on a regulated market or are not admitted to trading.

ESMA's clarifications:

Gaining exposure to precious metals through investment in MMIs is forbidden.

Short selling of MMIs is prohibited.

- (2) MMIs normally dealt in on the money market should be understood to mean those that meet one of the following conditions:
- (a) Have a maturity at issuance not exceeding 397 days
  - (b) Have a residual maturity not exceeding 397 days
  - (c) Undergo regular yield adjustments at least every 397 days
  - (d) Have a risk profile, including credit and interest rate risks, that corresponds to that of financial instruments that have a maturity not exceeding 397 days or are subject to a yield adjustment at least every 397 days

ESMA's clarification:

Treasury and local authority bills, certificates of deposit, commercial papers, and banker's acceptances will usually meet the criterion "normally dealt in on the money market".

- (3) Liquid MMIs are those that can be sold at limited cost in an adequately short timeframe, taking into account the UCITS' obligations to repurchase or redeem its shares or units at the request of the shareholders or unitholders.

ESMA advises that when assessing the liquidity of MMIs, the following should be considered:

- ▶ Frequency of trades and quotes for the MMI
- ▶ Number of dealers willing to buy and sell the MMI, time needed to sell the MMI, method of soliciting offers, and method of transfer
- ▶ Size of the issuance/program
- ▶ Possibility to repurchase, redeem, or sell the MMI in a short period, at limited cost, and with short settlement delay

When assessing the liquidity of the UCITS, ESMA advises that the following factors should be taken into consideration to ensure that any single MMI does not affect the liquidity of the UCITS:

- ▶ Shareholder or unitholder structure and concentration of shareholders or unitholders
- ▶ Purpose of funding of shareholders or unitholders
- ▶ Quality of information on the UCITS' cashflow
- ▶ Prospectus guidelines on limiting withdrawals

- (4) MMIs that have a value that can be accurately determined at any time means:
- ▶ They allow the UCITS to calculate its NAV in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm's length transaction
  - ▶ They are based either on market data or on valuation models including systems based on amortized cost

<sup>7</sup> | The Grand-Ducal Regulation of 8 February 2008.

ESMA is of the view that if an amortization method is used to assess the value of an MMI, the UCITS must ensure that this will not result in a material discrepancy between the value of the MMI and the value calculated according to the amortization method. ESMA is of the view that this would generally be the case in either of the following cases:

- MMI with a residual maturity of less than three months and with no specific sensitivity to market parameters, including credit risk
- UCITS investing solely in high-quality instruments with, as a general rule, a maturity, or residual maturity, of at most 397 days, or regular yield adjustments in line with such maturities and with a weighted average maturity of 60 days. The high quality of the instruments should be adequately monitored, taking into account both the credit risk and the final maturity of the instrument

The aforementioned principle, along with adequate procedures defined by the UCITS, should avoid situations where discrepancies between the value of the MMI as defined in Section 4.2.2.7.5.I.(4) and the value calculated according to the amortization method would become material, either at the individual MMI level or at the UCITS level. The UCITS' procedures might include updating the credit spread of the issuer or selling the MMI.

ALFI's recommendations on the use of amortized cost as the valuation basis for sub-three month paper are outlined in Section 7.6.1.

## II. MMIs dealt in on a regulated market

- (1) MMIs normally dealt in on the money market or admitted to, or dealt in on, a regulated market are presumed to be liquid and to have a value that can be accurately determined at any time. As such, they are eligible as core investments

## III. MMIs not dealt in on a regulated market

- (1) MMIs not dealt in on a regulated market are also permitted as core investments if the issue or issuer is regulated for the purpose of protecting investors and savings (see Section 4.2.2.7.5.III.(2) and one of the following criteria is met:
  - They are issued or guaranteed by a central, regional or local authority or central bank of an EU Member State, the European Central Bank, the EU, a non-EU Member State, in the case of a Federal State, by one of the members making up the federation, or by a public international body to which at least one EU Member State belongs
  - They are issued by an undertaking any securities of which are dealt in on regulated markets
  - They are issued or guaranteed by an establishment subject to prudential supervision in accordance with criteria defined by EU Law or by an establishment that is subject to and complies with prudential rules considered by the CSSF to be at least as stringent as those of EU Law (see Section 4.2.2.7.5.III.(3))
  - They are issued by other bodies belonging to categories approved by the CSSF under various specific conditions
- (2) *Instruments of which the issue or issuer is regulated for the purpose of protecting investors and savings*
  - (a) For MMIs that are not dealt in on a regulated market but the issuer is regulated, the following criteria must be met:
    - Fulfill one of the criteria for MMIs normally dealt in on the money market and all the criteria for MMIs that are liquid and MMIs that have a value that can be accurately determined at any time
    - Appropriate information must be available for them, including information that allows an appropriate assessment of the credit risks related to the investment in such instruments
    - Freely transferable
  - (b) For MMIs described in (a), and issued by an undertaking the securities of which are dealt in on a regulated market (second bullet of Section 4.2.2.7.5.III.(1)), or issued by other bodies belonging to the categories approved by the UCITS' competent authority (fourth bullet of Section 4.2.2.7.5.III.(1)), or issued by a local or regional authority of a Member State or by a public international body but are not guaranteed by a Member State, or, in the case of a Federal State that is a Member State, by one of the members of the federation, appropriate information as mentioned in (a) second bullet should consist of:
    - Information on both the issue or the issuance program and the legal and financial situation of the issuer prior to the issuance of the MMI
    - Updates of this information on a regular basis and whenever a significant event occurs
    - Verification of this information by qualified third parties not subject to instructions from the issuer
    - Available and reliable statistics on the issue or the issuance program

ESMA's view is that regular updates should normally occur on an annual basis and that third parties should specialize in the verification of legal or financial documentation and be composed of persons meeting professional standards of integrity.

- (c) For MMIs described in (a) and issued or guaranteed by an establishment subject to prudential supervision (third bullet of Section 4.2.2.7.5.III.(1)), appropriate information as mentioned in (a) second bullet should consist of:
    - ▶ Information on the issue or the issuance program or on the legal and financial situation of the issuer prior to the issue of the MMI
    - ▶ Updates of this information on a regular basis and whenever a significant event occurs
    - ▶ Available and reliable statistics on the issue or the issuance program or other data enabling an appropriate assessment of the credit risks related to the investment in such instruments
  - (d) For MMIs referred to in the third bullet of Section 4.2.2.7.5.III.(1), except those referred to in (b) and those issued by the European Central Bank or by a central bank of a Member State, appropriate information as mentioned in (a) should consist of information on the issue or the issuance program or on the legal and financial situation of the issuer prior to the issue of the MMI
- (3) *Establishment which is subject to and complies with prudential rules considered by the CSSF to be at least as stringent as those of EU Law*

The reference to an establishment that is subject to and complies with prudential rules considered by the CSSF to be at least as stringent as those laid down by EU Law should be understood as a reference to an issuer that is subject to and complies with prudential rules and fulfils one of the following criteria:

- ▶ It is located in the EEA
- ▶ It is located in an OECD Member State belonging to the Group of Ten<sup>8</sup>
- ▶ It has at least investment grade rating
- ▶ It can be demonstrated on the basis of an in-depth analysis of the issuer that the prudential rules applicable to that issuer are at least as stringent as those laid down by EU Law

#### 4.2.2.7.6. Financial derivative instruments (FDIs)

Eligible FDIs include, but are not limited to, futures, options, swaps (interest rate swaps, currency swaps, TRS, CDS, etc.), forwards, and contracts for differences.

- (1) FDIs (including equivalent cash-settled instruments) that are dealt in on a regulated market or OTC are permitted as core investments provided that:
- ▶ The underlying consists of transferable securities (see Section 4.2.2.7.1.), recently issued transferable securities (see Section 4.2.2.7.4.), MMIs (see Sections 4.2.2.7.5.II. and III.), deposits with credit institutions (see Section 4.2.2.3.C.), closed-ended UCIs (see Section 4.2.2.3.D.), open-ended UCIs (see Section 4.2.2.3.E.), financial indices (see Section 4.2.2.7.7.), interest rates, foreign exchange rates, or currencies, in which the UCITS may invest in accordance with the law and its constitutional document
  - ▶ The counterparties to OTC FDIs are institutions subject to prudential supervision, approved by the CSSF

CSSF's clarification: Counterparties to OTC FDIs must be establishments:

- ▶ Authorized by a financial authority
- ▶ Subject to prudential supervision
- ▶ Either be located in the EEA or in a country belonging to the Group of Ten<sup>9</sup> or have at least an investment grade rating
- ▶ Specialized in such transactions

If the counterparty does not fulfil any of the three first criteria, a UCITS has to demonstrate that the prudential rules applicable to such counterparty are equivalent to those laid down in EU Law.

- ▶ In the case of OTC FDIs, the counterparties are institutions subject to prudential supervision and belonging to the categories approved by the UCITS' competent authority and the OTC FDIs are subject to a reliable and verifiable valuation (see Section 4.2.2.7.6.(3)) on a daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the UCITS' initiative

FDIs should meet the following criteria:

- ▶ They allow the transfer of the credit risk of an asset independently from the other risks associated with that asset
- ▶ They do not result in the delivery or in the transfer of assets other than eligible assets of UCITS
- ▶ They comply with the criteria for OTC FDIs
- ▶ Their risks are adequately captured by the risk management process of the UCITS

FDIs on commodities (including non-financial indices) are not considered to be eligible assets.

<sup>8</sup> The 10 prosperous industrial nations that agreed in 1962 to lend money to the International Monetary Fund (IMF). They are Belgium, Canada, France, Italy, Japan, The Netherlands, Sweden, Germany, UK, and the USA. They inaugurated Special Drawing Rights. Switzerland, although not a member of the IMF, is a party to the general arrangements to borrow, which the G10 countries established to provide additional credit facilities. Luxembourg is also an associate member.

<sup>9</sup> Idem.

- (2) The global exposure relating to FDIs must not exceed the total net asset value (NAV) of the UCITS (see also Chapter 7)
- (3) *“Reliable and verifiable valuation”*
- The requirements for a “reliable and verifiable valuation” are outlined in Section 7.6.1.B.
- (4) TRS or similar instruments

Where a UCITS enters into a total return swap or invests in other FDIs with similar characteristics:

- The assets held by the UCITS should comply with the investment limits set out in Sections 4.2.2.8.1. I.- IV. and 4.2.2.8.2. For example, when a UCITS enters into an unfunded swap, the UCITS’ investment portfolio that is swapped out should comply with the aforementioned investment limits
- The underlying exposures of the FDIs must be taken into account to calculate the investment limits laid down in Sections 4.2.2.8.1. I. and II.

Where the counterparty has discretion over the composition or management of the UCITS’ investment portfolio or of the underlying of the financial derivative instrument, the agreement between the UCITS and the counterparty should be considered as an investment management delegation arrangement and should comply with the UCITS requirements on delegation.

#### 4.2.2.7.7. FDIs on financial indices

Financial indices are defined as those meeting the following criteria:

- (a) They are “sufficiently diversified”

To be sufficiently diversified, the following criteria must be fulfilled:

- The index must be composed in such a way that price movements or trading activities regarding one component do not unduly influence the performance of the whole index
- Independent of whether the index is composed of core or non-core eligible assets, the index must be composed in such a way that the diversification limit of 20% (or, if justified, 35%) must be respected in relation to:
  - Investment in either shares or debt securities, or both, issued by the same body
  - Other components of the index (e.g., a commodity)

- (b) They “represent an adequate benchmark for the market to which they refer”

To represent an adequate benchmark for the market to which they refer, the following criteria must be fulfilled:

- The index measures the performance of a representative group of underlying components in a relevant and appropriate way
- The index is revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers following criteria that are publicly available
- The underlying components are sufficiently liquid, which allows users to replicate the index, if necessary

- (c) They “are published in an appropriate manner”

To be published in an appropriate manner, the following criteria must be fulfilled:

- Their publication process relies on sound procedures to collect prices and to calculate and to subsequently publish the index value, including pricing procedures for components where a market price is not available
- Material information on matters such as index calculation, rebalancing methodologies, index changes or any operational difficulties in providing timely or accurate information is provided on a wide and timely basis

ESMA’s guidelines state that indices based on FDIs on commodities or indices on property may be eligible provided they comply with the criteria set down for financial indices.

If the composition of the index is not sufficiently diversified, its underlying assets have to be combined with the other assets of the UCITS (see Sections 4.2.2.8.1.I. (1) to (7), 4.2.2.8.1.II. (1) and 4.2.2.8.1.IV. (1)).

CSSF’s clarification: The governing body of a UCITS should have a methodology for the use of FDIs with financial indices as underlying assets. This detailed methodology should describe how the investment policy is impacted by its exposure to financial indices.

The ESMA’s *Guidelines on ETFs and other UCITS issues* clarified that: UCITS should not invest in a financial index that has a single component that has an impact on the overall index return that exceeds the relevant diversification requirements, i.e., 20%/35%. In the case of a leveraged index, the impact of one component on the overall return of the index, after having taken into account the leverage, should respect the same limits.

A UCITS should not invest in commodity indices that do not consist of different commodities. Sub-categories of the same commodity (for instance, from different regions or markets or derived from the same primary products by an industrialized process) should be considered as being the same commodity for the calculation of the diversification limits. For example, WTI Crude Oil, Brent Crude Oil, Gasoline, or Heating Oil contracts should be considered as being all sub-categories of the same commodity (i.e., oil). Sub-categories of a commodity should not be considered as being the same commodity if they are not highly correlated. With respect to the correlation factor, two components of a commodity index that are sub-categories of the same commodity should not be considered as highly correlated if 75% of the correlation observations are below 0.8. For that purpose, the correlation observations should be calculated (i) on the basis of equally-weighted daily returns of the corresponding commodity prices and (ii) from a 250-day rolling time window over a five-year period.

A UCITS should be able to demonstrate that an index satisfies the index criteria in Sections 4.2.2.8.1.IV. and 4.2.2.7.7.(a)-(c), including that of being a benchmark for the market to which it refers. For that purpose:

- ▶ An index should have a clear, single objective in order to represent an adequate benchmark for the market
- ▶ The universe of the index components and the basis on which these components are selected for the strategy should be clear to investors and competent authorities
- ▶ If cash management is included as part of the index strategy, the UCITS should be able to demonstrate that this does not affect the objective nature of the index calculation methodology

An index should not be considered as being an adequate benchmark of a market if it has been created and calculated on the request of a market participant or a very limited number of market participants and according to the specifications of those market participants.

UCITS should not invest in financial indices:

- ▶ Whose rebalancing frequency prevents investors from being able to replicate the financial index. Indices that rebalance on an intra-day or daily basis do not satisfy this criterion. For the purpose of these guidelines, technical adjustments made to financial indices (such as leveraged indices or volatility target indices) according to publicly available criteria should not be considered as rebalancing in the context of this paragraph
- ▶ Whose full calculation methodology (*inter alia*, enabling investors to replicate the financial index) is not disclosed by the index provider. This includes providing detailed information on index constituents, index calculation (including effect of leverage within the index), rebalancing methodologies, index changes, and information on any operational difficulties in providing timely or accurate information. Calculation methodologies should not omit important parameters or elements to be taken into account by investors to replicate the financial index. This information should be easily accessible, free of charge, to investors and prospective investors, for example, via the internet. Information on the performance of the index should be freely available to investors
- ▶ That do not publish their constituents together with their respective weightings. This information should be easily accessible, free of charge, to investors and prospective investors, for example, via the internet. Weightings may be published after each rebalancing on a retrospective basis. This information should cover the previous period since the last rebalancing and include all levels of the index
- ▶ Whose methodology for the selection and the rebalancing of the components is not based on a set of pre-determined rules and objective criteria
- ▶ Whose index provider accepts payments from potential index components for inclusion in the index
- ▶ Whose methodology permits retrospective changes to previously published index values (“backfilling”)

The UCITS should carry out and appropriately document due diligence on the quality of the index. This due diligence should take into account whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the investment strategy and whether the index represents an adequate benchmark. The due diligence should also cover matters relating to the index components. The UCITS should also assess the availability of information on the index including:

- ▶ Whether there is a clear narrative description of the benchmark
- ▶ Whether there is an independent audit and the scope of such an audit
- ▶ The frequency of index publication and whether this will affect the ability of the UCITS to calculate its NAV

The UCITS should ensure that the financial index is subject to independent valuation.

#### 4.2.2.7.8. Securitizations

With respect to UCITS investing in securitizations, in addition to ensuring that securitizations meet the eligible assets rules, self-managed UCITS and UCITS management companies are subject to requirements outlined in Section 4.5.

#### 4.2.2.7.9. Virtual assets

On 29 November 2021, the CSSF published its *FAQ Virtual Assets* which provides guidance on virtual assets and similar financial innovations. Virtual assets are defined in Article 1 (20b) of the Law of 12 November 2004 on the fight against money laundering and terrorist financing, as amended.

The CSSF indicated that entities under its prudential supervision must bear in mind that investing in virtual assets is not suitable for all kinds of investors and/or all investment objectives.

Therefore, UCITS are not allowed to invest directly or indirectly in virtual assets. The CSSF reminded the industry that the definition of virtual assets in the context of the above article excludes, *inter alia*, digital assets that fulfil the conditions of financial instruments within the meaning of the Law of 5 April 1993 on the Financial Sector. Any assets that qualify as financial instruments, such as shares of companies active in the virtual asset ecosystem, are not subject to the above position and could potentially fall within the scope of eligible investments for UCITS.

#### 4.2.2.8. Detailed rules regarding diversification

##### 4.2.2.8.1. Concentration rules

###### I. General rules

- (1) No more than 10% of net assets may be invested in transferable securities or MMIs issued by the same body
- (2) The total value of transferable securities and MMIs held in issuing bodies in each of which the UCITS has invested more than 5% of net assets must not exceed 40% of net assets. This limit does not apply to:
  - ▶ Deposits and OTC FDIs made with financial institutions subject to prudential supervision
  - ▶ Transferable securities and MMIs referred to in Sections 4.2.2.8.1.I.(3) and 4.2.2.8.1.II.(1)
  - ▶ Investments in other UCITS or UCIs
- (3) The limit of 10% in Section 4.2.2.8.1.I.(1) is increased to 25% for certain debt securities if they are issued by a credit institution with registered office in an EU Member State and subject to public supervision designed to protect the holders of debt securities (in the case of bankruptcy). In addition, the total value of such debt securities held in such issuing bodies in each of which the UCITS has invested more than 5% of net assets must not exceed 80% of net assets.
- (4) No more than 20% of net assets may be invested in deposits with the same body

The CSSF clarified that the 20% limit applies to ancillary liquid assets. It indicated that this limit should only be temporarily breached for a period of time strictly necessary when, because of exceptionally unfavorable market conditions, circumstances so require and where such breach is justified having regard to the interests of the investors, for instance in highly serious circumstances such as the September 11 attacks or the bankruptcy of Lehman Brothers in 2008.

The CSSF also clarified that the 20% limit does not apply to margin accounts. However, in order to avoid undue exposure to a single body, margin accounts should be taken into consideration in the 20% global limit applicable to an issuer under article 43(2) of the Law of 2010. In addition, margin accounts may be subject to the 5%/10% OTC counterparty risk under article 43(1) of Law of 2010 according to Point III.5 of Circular CSSF 11/512 on risk management, implementing point 1 of Box 27 of ESMA's guidelines 10-788, and ESMA's opinion 2015/ESMA/880.

- (5) The risk exposure to a counterparty in an OTC FDI transaction may not exceed 10% of net assets in the case of a credit institution and 5% in other cases

The risk exposures to a counterparty arising from OTC FDI transactions and EPM techniques should be combined when calculating the counterparty risk limits.

ESMA's *Guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS* and CSSF Circular 11/512, as amended, clarifications:

The types of collateral that are eligible for the purpose of limiting the counterparty risk linked to EPM transactions also apply in the framework of OTC FDI transactions (see Section 4.2.2.10.(6) (b)).

The UCITS needs to define and apply appropriate and prudent discounts.



Collateral received by the UCITS, other than cash, cannot be sold, reinvested or pledged. Cash collateral can only be reinvested in risk-free assets that are eligible under the 2010 Law, i.e., eligible assets that do not provide a yield greater than the risk-free rate.

Reinvestment of cash collateral should be taken into account within the diversification limits applicable.

ESMA clarified further that only netting arrangements in accordance with the definition and conditions set out in the guidelines referred to above may be taken into account when calculating issuer concentration limits.

- (6) No more than 20% of net assets may be invested in any combination of the following with a single body:
- ▶ Transferable securities or MMIs
  - ▶ Deposits
  - ▶ OTC FDIs
  - ▶ Techniques and instruments relating to transferable securities and MMIs
- (7) The limits set out in Sections 4.2.2.8.1.I.(1) – (6) and 4.2.2.8.1.II.(1) may not be combined; thus investments in transferable securities or MMIs issued by the same body, in deposits or FDIs made with this body must under no circumstances exceed in total 35% of the net assets.
- (8) Companies which are included in the same group for the purposes of consolidated accounts, as defined in *Directive 2013/34/EU*<sup>10</sup> on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, as amended, or in accordance with recognized international accounting rules, are regarded as a single body for the purpose of calculating the limits.

CSSF's clarification on single body:

The CSSF considers that the notion of "group", as defined in Section 4.2.2.8.1.I.(8), does not apply with respect to the application of the limits referred to in Sections 4.2.2.8.1.I.(1), (2), (4), (5) and (6). Consequently, the CSSF considers that the notion of body referred to in Section 4.2.2.8.1.I.(1) should be interpreted as issuer.

The restrictions set out in Section 4.2.2.8.1.I.(2) also apply to the individual issuer.

Furthermore, the CSSF considers that consolidation of accounts allows the presentation of the accounts of a group of companies with common interests and considers that the companies comprised within the scope of consolidation are part of the same group. Consequently, Section 4.2.2.8.1.I.(8) applies to all consolidated companies.

The CSSF also considers, by analogy with the provisions referred to in Section 4.2.2.8.1.I.(6), that the investment restriction relating to the notion of group provided for in Section 4.2.2.8.1.I.(8) applies to all instruments (including deposits and transactions on derivatives) of the group companies.

## II. Exception for securities issued by governments

- (1) The limit of 10% in Section 4.2.2.8.I.(1) is increased to 35% if the transferable securities are issued or guaranteed by an EU Member State or its local authorities, by a non-Member State of the EU or by public international bodies of which one or more EU Member States are members
- (2) The CSSF may authorize investment of up to 100% of net assets in at least six different transferable securities, issued or guaranteed by an EU Member State, its local authorities, a non-Member State of the EU or public international bodies of which one or more EU Member States are members, of which one issue may not account for more than 30% of the total

The CSSF will only grant such an authorization if it considers that shareholders or unitholders in the UCITS have protection equivalent to that of shareholders or unitholders in UCITS complying with the concentration limits laid down in Section 4.2.2.8.1.I. and Section 4.2.2.8.1.II.(1).

Such UCITS must indicate the States, the local public authorities or public international bodies issuing or guaranteeing securities in which they intend to invest more than 35% of their net assets in:

- ▶ Their constitutional document
- ▶ Their prospectus or marketing communications, drawing attention to such authorization

<sup>10</sup> Directive 2013/34/EU repeals Directives 78/660/EEC and 83/349/EEC.

ESMA clarified that pursuant to Article 54(1) of the UCITS Directive, UCITS cannot invest up to 100% of their assets in transferable securities or money markets instruments that are not issued nor guaranteed by a Member State, one or more of its local authorities, a third country or a public international body to which one or more Member States belong. ESMA also reminded the industry that Article 54(1) of the UCITS Directive unambiguously provides that if a UCITS holds more than six issues in transferable securities and MMIs issued or guaranteed by a Member State, one or more of its local authorities, a third country or a public international body to which one or more Member States belong, all the issues should respect the 30% limit (i.e., even if the UCITS holds more than 6 issues).

### III. Exception for investments in other open-ended UCIs

- (1) No more than 20% of net assets may be invested in a single UCITS or other UCI (for the purposes of applying this limit, each compartment of a target multiple compartment UCI is considered as a separate issuer)
- (2) No more than 30% of net assets may be invested in aggregate in shares or units of other UCIs (excluding UCITS)
- (3) Where investments are made in other UCITS and/or other UCIs that are linked to the investing UCITS (i.e., the same management company or a company linked to the management company), subscription or redemption fees may not be charged to the investing UCITS

Where a “substantial proportion” of net assets are invested in other UCIs that are linked to the investing UCITS, the prospectus must disclose the maximum level of management fees that may be charged both to the UCITS itself and to the other UCIs in which it intends to invest. In its annual report, it must indicate the “maximum percentage” of management fees charged both to the UCITS itself and to the other UCIs in which it invests.

CSSF’s clarifications:

- “Substantial portion” is considered to be more than 50% of the net assets of the UCITS
- The “maximum percentage” of management fees that must be disclosed in the annual report should exclude commission that has been retroceded

### IV. Exception for index replicating UCITS

- (1) Index replicating UCITS are those that replicate the composition of the underlying assets of the index, including the use of FDIs and other techniques and instruments

The limit of 10% mentioned in Section 4.2.2.8.1.I.(1) is raised to 20% (or, if justified, 35%) for investment in either shares or debt securities, or both, issued by the same body where the investment policy is to replicate an index that is recognized by the CSSF.

The CSSF bases its recognition on the following criteria:

- Composition of the index is sufficiently diversified (see Section 4.2.2.8.1.IV.(2))
- Index represents an adequate benchmark (see Section 4.2.2.8.1.IV.(3)) for the particular market
- Index is published in an appropriate manner (see Section 4.2.2.8.1.IV.(4))

- (2) *Sufficiently diversified*

An index whose composition is sufficiently diversified is an index that complies with the risk diversification rules of the second sub-paragraph of Section 4.2.2.8.1.IV.(1).

- (3) *Represents an adequate benchmark*

An index that represents an adequate benchmark is an index whose provider uses a recognized methodology that generally does not result in the exclusion of a major issuer to the market to which it refers.

- (4) *Published in an appropriate manner*

An index that is published in an appropriate manner is an index that is accessible to the public and the provider of which is independent from the index-replicating UCITS.

### V. Provisional derogations from investment restrictions

- (1) The aforementioned investment restrictions need not be complied with when exercising subscription rights; however the UCITS must remedy the situation as a priority objective. In addition, recently formed UCITS may derogate from Sections 4.2.2.8.1.I.(1) to (7), II., III., and IV. during the first six months

CSSF's clarification:

The derogation period starts in principle from the date of the authorization by the CSSF of the UCITS, or in case of an umbrella fund, of the compartment. However, for a UCITS/compartment not launched since its authorization date, the derogation period starts from the date of its first net asset value. In this case, the first net asset value date must be communicated to the CSSF and must occur within 18 months of the date of the authorization of the UCITS/compartment as foreseen under point 2 of CSSF Circular 12/540.

- (2) Following mergers, the receiving UCITS may derogate from Sections 4.2.2.8.1.I.(1) to (7), II., III. and IV. during the first six months following the effective date of the merger (see Section 3.7.4.).

*VI. Investment in other compartments*

- (1) A compartment of a UCITS may, subject to the requirements of the constitutional document as well as the prospectus, subscribe, acquire, and/or hold securities to be issued or issued by one or more compartments of the same UCITS without that UCITS, when it is formed as an investment company, being subject to the requirements of the 1915 Law with respect to the subscription, acquisition, and/or the holding by the company of its own shares, provided all the following conditions are met:
- ▶ The target compartment does not, in turn, invest in the compartment invested in this target compartment
  - ▶ Not more than 10% of the assets of the target compartment must be invested in other compartments of the same UCI/UCITS
  - ▶ Voting rights, if any, attaching to the relevant securities are suspended for as long as they are held by the compartment concerned
  - ▶ As long as these securities are held by the UCI/UCITS, their value will not be taken into consideration for the calculation of the net assets of the UCI for the purposes of verifying the minimum threshold of the net assets imposed by the 2010 Law, as amended

CSSF's clarification:

The following restrictions also apply:

- ▶ The target compartment may not invest, according to its constitutional document, more than 10% of its net assets in other UCITS or UCIs
- ▶ No more than 20% of net assets may be invested in a single target compartment

*VII. Rules regarding master-feeder structures*

- (1) A feeder UCITS or a compartment of a feeder UCITS must invest at least 85% of its assets in shares or units of another UCITS or compartment thereof (the master UCITS)
- (2) A feeder UCITS may hold up to 15% of its assets in one or more of the following:
- ▶ Ancillary liquid assets
  - ▶ FDIs, which may be used only for hedging purposes
  - ▶ Movable and immovable property that is essential for the direct pursuit of its business, if the feeder UCITS is an investment company
- (3) A master UCITS or a compartment thereof:
- ▶ Must have, among its shareholders or unitholders, at least one feeder UCITS
  - ▶ Must not be itself a feeder UCITS
  - ▶ Must not hold units of a feeder UCITS

**4.2.2.8.2. Rules regarding significant influence over an issuer**

- (1) An investment company or a management company acting in connection with all the UCITS common funds it manages may not acquire any shares carrying voting rights that would enable it to exercise significant influence over the management of an issuing body
- (2) Furthermore, a UCITS may acquire no more than:
- ▶ 10% of the non-voting shares of the same issuer
  - ▶ 10% of the debt securities of the same issuer
  - ▶ 25% of the shares or units of the same UCI
  - ▶ 10% of the MMIs issued by the same issuer

**CSSF's clarification:**

For the purpose of the rules mentioned under (2) above the term UCITS means compartments. UCITS remain responsible to apply the 25% limit of the shares or units of the same UCI at the compartment level of the target UCI or at the umbrella level of the entire target UCI.

- (3) The restrictions of Sections 4.2.2.8.2.(1) and (2) are not applicable to:
- Transferable securities and MMIs issued or guaranteed by an EU Member State or its local authorities or by a non-Member State of the EU
  - Transferable securities and MMIs issued by public international bodies of which one or more EU Member States are members
  - Shares held in an intermediary incorporated in a non-Member State of the EU that invests mainly in securities issued by that State and where such holding is the only way in which the UCITS can hold these securities
  - Shares held by an investment company in the capital of subsidiaries carrying on only the business of management, advice, or marketing in the country where the subsidiary is located, regarding the repurchase of shares or units at the request of shareholders or unitholders
- (4) In the case of a multiple compartment UCITS, the restrictions in Section 4.2.2.8.2.(2) limiting the holding of securities of one issuer also apply to all compartments taken together.

#### 4.2.2.9. Detailed borrowing rules and rules relating to granting of loans and short selling

The following section includes a detailed analysis of borrowing, lending, and short selling rules applicable to UCITS.

- (1) In general, neither an investment company nor the management company nor depositary acting on behalf of a common fund may borrow. However, there are three exceptions to this rule:
- Up to 10% of net assets may be borrowed on a temporary basis only
  - Up to 10% of net assets in the case of an investment company may be borrowed to acquire property essential for the business
  - The combined amount of such borrowings may not in total exceed 15% of net assets
  - Back-to-back loans may be acquired and are not considered as borrowings for the purposes of these limits

**CSSF's clarifications:**

- A UCITS cannot use its borrowing entitlement to finance additional investments or for investment purposes, except if the requirements of the next bullet point are met
- A UCITS may borrow up to 10% of its net assets on a temporary basis (i.e., on a non-revolving basis) either to:
  - Meet redemptions
  - For investment purposes under certain conditions: borrowing must be temporary in the sense that it must mature in a reasonable period of time, taking into account the conditions under which it was concluded, and that such borrowing must not be permanently part of the investment policy of the UCITS – i.e., borrowings for investment purposes must not be performed on a recurring basis
- The balances of the current accounts held with the same legal counterparty, whatever the currency, may be netted in the fund currency for the calculation of the 10% limit referred to in the previous bullet provided all the following conditions are met:
  - The UCITS' current accounts are free of pledge
  - The contracts signed by the UCITS and the counterparty governing these current accounts foresee such netting
  - The law that governs aforementioned contracts allows such netting
- Compensation of debit and credit balances with different legal entities is not permitted
- The management of the UCITS remains responsible for ensuring that any borrowing is reimbursed within a reasonable delay taking into account the conditions under which it has been granted

- (2) Granting of loans or acting as guarantor on behalf of third parties is not permitted (acquiring transferable securities that are not fully paid is allowed)
- (3) Short selling of securities is not permitted. However, it may be possible to use FDIs to create synthetic short positions

#### 4.2.2.10. Detailed rules regarding techniques and instruments relating to transferable securities and MMIs

- (1) Techniques and instruments relating to transferable securities and to MMIs may be employed provided they are used for the purpose of EPM and do not result in the UCITS diverging from its investment objectives or in a risk profile higher than that described in its sales documents

Such techniques and instruments may include, *inter alia*:

- Securities lending transactions
- Sale with the right of repurchase transactions
- Reverse repurchase and repurchase agreement transactions
- Certain hedging transactions using FDIs

In September 2008, ESMA removed securities borrowing from the list of techniques and instruments relating to transferable securities and MMIs permitted for use for the purpose of EPM. Therefore, the physical short selling of borrowed securities is not a permitted activity (neither is short selling in general).

In line with this amendment to ESMA's guidelines, CSSF Circular 08/380 updates CSSF Circular 08/339.

The risk exposures to a counterparty arising from OTC FDI transactions and EPM techniques should be combined when calculating the counterparty risk limits.

Permitted techniques and instruments should meet the following criteria:

- Be economically appropriate and realized in a cost-effective manner
- Be entered into for at least one of the following reasons:
  - Risk reduction
  - Cost reduction
  - Generation of additional capital or income for the UCITS, provided that risk levels and diversification remain consistent
- Be captured by the risk management process

According to ESMA's *Guidelines on ETFs and other UCITS issues*, all revenues arising from EPM techniques, net of direct and indirect operational costs, should be returned to the UCITS.

On 18 December 2020, the CSSF issued a Frequently Asked Questions document (FAQ) to clarify certain requirements in terms of prospectus disclosures, revenues and costs/fees, conflicts of interest and best execution applicable to securities financing transactions (SFTs), including securities lending transactions, repurchase agreements ("repos") and reverse repurchase agreements ("reverse repos"), buy-sell back and sell-buy back transactions, as well as TRS (please refer to further details in Sections 6.4.1.C., 10.3.1.O. and 11.2.2.)

- (2) Certain techniques and instruments relating to transferable securities and MMIs

CSSF Circular 08/356 of 4 June 2008 (as modified by CSSF Circular 11/512 of 30 May 2011, as amended) outlines rules applicable to UCIs when they employ certain techniques and instruments relating to transferable securities and MMIs.

CSSF's clarification:

CSSF Circular 08/356 does not apply to MMFs authorized under the MMF Regulation.

The techniques and instruments covered by the Circular are:

- Securities lending transactions (see Section 4.2.2.10.(3))
- Sale with the right of repurchase transactions (see Section 4.2.2.10.(4))
- Reverse repurchase and repurchase agreement transactions (see Section 4.2.2.10.(5))

The corporate governance principles of the UCI should address the case of securities lending operations taking place when a general assembly of the issuer of the securities is to be held.

- (3) Securities lending transactions

A UCITS may lend its securities:

- Directly
- Via a standardized lending system organized by a recognized securities clearing institution
- Via a lending system organized by a financial institution subject to prudential supervision rules considered by the CSSF as equivalent to those prescribed by EU Law and specialized in these types of transactions

A UCITS' involvement in such transactions is subject to the following rules:

- ▶ A UCITS may enter into a securities lending transaction only if the counterparty meets the following criteria:
  - ▶ It is subject to prudential supervision rules considered by the CSSF as equivalent to those laid down in EU Law. In case the financial institution acts on its own account, it is to be considered as the counterparty in the securities lending agreement
  - ▶ If the counterparty is a related party to the UCITS, attention must be paid to conflicts of interest, which might result therefrom

CSSF's clarification: Counterparties to EPM techniques must be establishments:

- ▶ Authorized by a financial authority
- ▶ Subject to prudential supervision
- ▶ Either located in the EEA or in a country belonging to the Group of Ten<sup>11</sup> or have at least an investment grade rating
- ▶ Specialized in such transactions

If the counterparty does not fulfil any of the three first criteria, a UCITS has to demonstrate that the prudential rules applicable to such counterparty are equivalent to those laid down in EU Law.

- ▶ The UCITS must receive, at the same time or prior to the transfer of securities lent, collateral that meets the requirements set out in Section 4.2.2.10.(6)(b). If, however, the securities lending transaction takes place via a lending system, then securities lent may be transferred before the receipt of the collateral if the intermediary concerned ensures proper completion of the transaction and, in lieu of the borrower, provides the UCITS with eligible collateral assets
- ▶ The UCITS should ensure, at all times, that the level of such transactions entered into at any one time permits the UCITS to meet its redemption obligations
- ▶ The UCITS should ensure that it is able at any time to recall any security lent out or terminate any securities lending agreement it has entered

#### (4) Sale with the right of repurchase transactions

##### (a) Purchase of securities with a repurchase option

A UCITS is permitted to enter into a contract to purchase securities with the seller retaining the right to repurchase the securities from the UCITS at a price and date agreed between the two parties.

Such transactions are subject to the following rules:

- ▶ The counterparties to these transactions must be subject to prudential supervision rules considered by the CSSF as equivalent to that prescribed by EU Law

CSSF's clarification: Counterparties to EPM techniques must be establishments:

- ▶ Authorized by a financial authority
- ▶ Subject to prudential supervision
- ▶ Either located in the EEA or in a country belonging to the Group of Ten<sup>12</sup> or have at least an investment grade rating
- ▶ Specialized in such transactions

If the counterparty does not fulfil any of the three first criteria, a UCITS has to demonstrate that the prudential rules applicable to such counterparty are equivalent to those laid down in EU Law.

- ▶ Throughout the duration of the transaction, a UCITS is not permitted to sell the securities it acquired as part of the transaction before the counterparty has exercised its option or until the repurchase date has passed, unless the UCITS has other means of coverage
- ▶ The UCITS should ensure, at all times, that the level of such transactions entered into at any one time permits it to meet its redemption obligations
- ▶ Securities that are the subject of a purchase with repurchase option transaction are limited to:
  - ▶ Short-term bank certificates or MMIs (as defined in Section 4.2.2.7.5.1.)
  - ▶ Bonds issued or guaranteed by an OECD Member State, by their local public authorities, or by supranational institutions and undertakings with EU, regional, or worldwide scope
  - ▶ Shares or units issued by MMFs calculating a daily NAV and being assigned a rating of AAA or its equivalent

<sup>11</sup> The 10 prosperous industrial nations that agreed in 1962 to lend money to the International Monetary Fund (IMF). They are Belgium, Canada, France, Italy, Japan, The Netherlands, Sweden, Germany, UK, and the USA. They inaugurated Special Drawing Rights. Switzerland, although not a member of the IMF, is a party to the general arrangements to borrow, which the G10 countries established to provide additional credit facilities. Luxembourg is also an associate member.

<sup>12</sup> Idem.

CSSF's clarification:

Only credit ratings issued or backed by credit rating agencies registered or certified in the EU may be used for regulatory purposes. An updated list is available on the ESMA's website.

- ▶ Bonds issued by non-governmental issuers offering adequate liquidity
- ▶ Shares quoted or negotiated on a regulated market of an EU Member State or on a stock exchange of an OECD Member State, on the condition that these shares are included in a main index
- ▶ Securities purchased as part of a purchase with option to repurchase transaction, when combined with the rest of the UCITS' portfolio, comply with the UCITS' investment policies and restrictions

(b) Sale of securities with a repurchase option

Conversely, the UCITS is also permitted to sell securities with a repurchase option. In a similar manner to the transaction described in Section 4.2.2.10.(4)(a), the contract entered into with the buyer would allow the UCITS the right to repurchase the securities from the buyer at a price and date agreed between the two parties on entering into the contract.

UCITS entering into sales of securities with repurchase option transactions must, however, adhere to the following rules:

- ▶ The counterparties to these transactions must be subject to prudential supervision rules considered by the CSSF as equivalent to that prescribed by EU Law

CSSF's clarification: Counterparties to EPM techniques must be establishments:

- ▶ Authorized by a financial authority
- ▶ Subject to prudential supervision
- ▶ Either located in the EEA or in a country belonging to the Group of Ten<sup>13</sup> or have at least an investment grade rating
- ▶ Specialized in such transactions

If the counterparty does not fulfil any of the three first criteria, a UCITS has to demonstrate that the prudential rules applicable to such counterparty are equivalent to those laid down in EU Law.

- ▶ On maturity of the repurchase option, the UCITS must have sufficient assets available to be able to pay, if applicable, the amount agreed to buy back the securities, and continue to comply with the investment policy and restrictions

(5) Reverse repurchase and repurchase agreement transactions

(a) Reverse repurchase transactions

Such transactions involve the UCITS entering into a forward transaction at the maturity of which the counterparty (seller) has the obligation to repurchase the assets sold and the UCITS has the obligation to return the assets received under the transaction.

A UCITS can only enter into such transactions if the following rules are complied with:

- ▶ The counterparties to these transactions must be subject to prudential supervision rules considered by the CSSF to be equivalent to those prescribed by EU Law

CSSF's clarification: Counterparties to EPM techniques must be establishments:

- ▶ Authorized by a financial authority
- ▶ Subject to prudential supervision
- ▶ Either located in the EEA or in a country belonging to the Group of Ten<sup>14</sup> or have at least an investment grade rating
- ▶ Specialized in such transactions

If the counterparty does not fulfil any of the three first criteria, a UCITS has to demonstrate that the prudential rules applicable to such counterparty are equivalent to those laid down in EU Law.

<sup>13</sup> The 10 prosperous industrial nations that agreed in 1962 to lend money to the International Monetary Fund (IMF). They are Belgium, Canada, France, Italy, Japan, The Netherlands, Sweden, Germany, UK, and the USA. They inaugurated Special Drawing Rights. Switzerland, although not a member of the IMF, is a party to the general arrangements to borrow, which the G10 countries established to provide additional credit facilities. Luxembourg is also an associate member.

<sup>14</sup> Idem.

- ▶ The UCITS may not sell or pledge/give as security the securities purchased as part of the contract throughout the life of the contract, unless it has other means of coverage
- ▶ The value of the reverse repurchase transactions is kept at a level that allows the UCITS to meet its redemption obligations at all times
- ▶ Securities that may be purchased in a reverse repurchase agreement must be:
  - ▶ Short-term bank certificates or MMIs (as defined in Section 4.2.2.7.5.1.)
  - ▶ Bonds issued or guaranteed by an OECD Member State, by their local public authorities or by supranational institutions and undertakings with EU, regional or worldwide scope
  - ▶ Shares or units issued by money market UCIs calculating a daily NAV and being assigned a rating of AAA or its equivalent

CSSF's clarification:

Only credit ratings issued or backed by credit rating agencies registered or certified in the EU may be used for regulatory purposes. An updated list is available on the ESMA's website.

- ▶ Bonds issued by non-governmental issuers offering adequate liquidity
- ▶ Shares quoted or negotiated on a regulated market of an EU Member State or on a stock exchange of an OECD Member State, on the condition that these shares are included in a main index
- ▶ Securities purchased through a reverse repurchase transaction must, when combined with the rest of the UCITS' portfolio, comply with the UCITS' investment policies and restrictions

(b) Repurchase agreement transactions

A UCITS may enter into repurchase agreement transactions, being forward transactions at the maturity of which the UCITS has the obligation to repurchase the assets sold and the buyer has the obligation to return the assets received under the transaction.

Such transactions are subject to the following rules:

- ▶ The counterparty must be subject to prudential supervision rules considered by the CSSF to be equivalent to those prescribed by EU Law

CSSF's clarification: Counterparties to EPM techniques must be establishments:

- ▶ Authorized by a financial authority
- ▶ Subject to prudential supervision
- ▶ Either be located in the EEA or in a country belonging to the Group of Ten or have at least an investment grade rating
- ▶ Specialized in such transactions

If the counterparty does not fulfil any of the three first criteria, a UCITS has to demonstrate that the prudential rules applicable to such counterparty are equivalent to those laid down in EU Law.

- ▶ At the maturity of the agreement, the UCITS must have sufficient assets to enable it to settle the amount agreed with the counterparty, and continue to comply with the investment policy and restrictions
- ▶ The UCITS must ensure that the level of repurchase agreement transactions is kept at a level to enable it to meet all redemption obligations

(6) Limitation of counterparty risk and receipt of appropriate collateral

(a) Limitation of counterparty risk

To ensure that the counterparty risk linked to securities lending transactions is covered at all times, the UCITS must receive eligible collateral assets.

Such assets must, throughout the duration of the agreement, amount to at least 90% of the value of the global valuation of the securities lent (all rights included, i.e., interest, dividends).

UCITS may take into account collateral received in order to reduce the counterparty risk in sale with right of repurchase transactions and/or reverse repurchase and repurchase transactions.

The net exposures (i.e., the exposures of the UCITS less the collateral received by the UCITS) to a counterparty arising from securities lending transactions, reverse repurchase transactions, or repurchase agreement transactions must be taken into account in the calculation of the 20% limit within a single body (see also Section 4.2.2.8.1.1.(6)).



(b) Receipt of eligible assets as collateral

The following assets are considered as eligible collateral:

- ▶ Liquid assets, including:
  - ▶ Cash and short-term bank deposits
  - ▶ MMIs as defined in Section 4.2.2.7.5.1. (issued by an issuer not affiliated to the counterparty)
  - ▶ Letters of credit or guarantees on first demand issued by first class credit institutions not affiliated to the counterparty
- ▶ Bonds issued or guaranteed by:
  - ▶ An OECD Member State, their local authorities, or supranational bodies and organizations with community, regional, or worldwide character
  - ▶ First class issuers offering adequate liquidity
- ▶ Shares or units issued by any of the following:
  - ▶ Daily valued money market UCIs assigned a rating of AAA or equivalent
  - ▶ UCITS investing in bonds issued or guaranteed by first class issuers offering adequate liquidity which is not affiliated to the counterparty
  - ▶ UCITS investing in shares (providing that these shares are included in a main index) admitted to or dealt in on a regulated market of an EU Member State or listed on a stock exchange of an OECD Member State
- ▶ Shares (providing that these shares are included in a main index) that are either:
  - ▶ Admitted to or dealt in on a regulated market of an EU Member State
  - ▶ Listed on a stock exchange of an OECD Member State

If collateral is given in any form other than cash or shares or units of a UCITS or other UCI, it must be issued by an entity not affiliated to the counterparty.

On receipt of collateral, the UCITS must value the assets received on a daily basis. In addition, the lending agreement must include provisions which require the counterparty to give the UCITS additional collateral, at very short notice, if the value of the collateral initially given is insufficient in comparison with the amount to be covered. In addition, provisions should also provide for margins to take into consideration exchange risks or market risks inherent to the assets accepted as collateral.

The following considerations must be taken into account with respect to collateral:

- ▶ If cash has been received as collateral, the UCITS may be exposed to credit risk *vis-à-vis* the custodian of the collateral. If this risk exists, the UCITS must take the collateral into consideration for the purpose of the limits on deposits (Article 43 (1) of the 2010 Law, as amended - see Section 4.2.2.8.1.1.(4))
- ▶ Cash collateral must not be safekept by the counterparty except if the assets are legally protected from consequences of default of the counterparty
- ▶ Non-cash collateral must not be safekept by the counterparty except if it is adequately segregated from the counterparty's assets
- ▶ The collateral must, at all times, be available either:
  - ▶ Directly
  - ▶ Via a first class financial institution or a wholly-owned subsidiary thereof to enable the UCITS to seize or realize the collateral assets if the counterparty does not comply with its obligation to return the securities lent
- ▶ In case of a reorganization or liquidation, or similar, the UCITS must ensure (via its contractual terms) that it is able to discharge its obligation to return assets received as collateral if the securities cannot be returned under the initially agreed terms

Furthermore, the collateral:

- ▶ Must be received before or at the same time as the transfer of securities lent (see also (3))
- ▶ May not be sold or given as security or pledged by the UCITS, subject to the latter being otherwise covered
- ▶ May be returned at the same time as, or subsequent to, when the lent securities are being returned

According to ESMA's *Guidelines on ETFs and other UCITS issues*, all assets received by UCITS in the context of EPM techniques should be considered as collateral.

Where a UCITS enters into OTC FDI transactions and EPM techniques, all collateral used to reduce counterparty risk exposure should comply with the following criteria at all times:

- ▶ Liquidity - Any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing so that it can be sold quickly at a price that is close to pre-sale valuation. Collateral received should also comply with the requirements of Section 4.2.2.8.2.
- ▶ Valuation - Collateral received should be valued on at least a daily basis and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place
- ▶ Issuer credit quality - Collateral received should be of high quality

- ▶ Correlation - The collateral received by the UCITS should be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty
- ▶ Collateral diversification (asset concentration) - Collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of EPM and OTC FDI transactions a basket of collateral with a maximum exposure to a given issuer of 20% of its NAV. When UCITS are exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer

According to ESMA's *Guidelines on ETFs and other UCITS issues*, by way of derogation from the aforementioned diversification rules, a UCITS may be fully collateralized in different transferable securities and MMIs issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such a UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30% of the UCITS' NAV.

UCITS that intend to be fully collateralized in securities issued or guaranteed by a Member State, local authorities, third countries, or public international bodies should disclose this fact in the prospectus of the UCITS. UCITS should also identify the Member States, local authorities, third countries, or public international bodies issuing or guaranteeing securities from which they are able to accept as collateral for more than 20% of their NAV. This derogation does not affect the other criteria for collateral management as set out in the guidelines.

- ▶ Risks linked to the management of collateral, such as operational and legal risks, should be identified, managed, and mitigated by the risk management process
- ▶ Where there is a title transfer, the collateral received should be held by the depositary of the UCITS. For other types of collateral arrangement, the collateral can be held by a third-party custodian that is subject to prudential supervision and that is unrelated to the provider of the collateral
- ▶ Collateral received should be capable of being fully enforced by the UCITS at any time without reference to or approval from the counterparty

#### (7) Reinvestment of collateral

If collateral is received in the form of cash, the cash may be reinvested by the UCITS in the following:

- ▶ Shares or units of daily valued MMFs assigned a rating of AAA or equivalent

CSSF's clarification:

Only credit ratings issued or backed by credit rating agencies registered or certified in the EU may be used for regulatory purposes. An updated list is available on the ESMA's website.

- ▶ Short-term bank deposits
- ▶ MMIs as defined in Section 4.2.2.7.5.1.
- ▶ Short-term bonds issued or guaranteed by an EU Member State, Switzerland, Canada, Japan or the United States or by their local authorities or by supranational institutions and undertakings of a community, regional or worldwide nature
- ▶ Bonds issued or guaranteed by first class issuers offering adequate liquidity
- ▶ Reverse repurchase agreements eligible under CSSF Circular 08/356

If financial assets are purchased through the reinvestment of cash received as collateral, the purchased financial assets:

- ▶ If other than bank deposits and shares or units of UCIs, must be issued by an entity not affiliated to the counterparty
- ▶ If other than bank deposits, must not be safekept by the counterparty, except if they are segregated in an appropriate manner from the latter's own assets
- ▶ If bank deposits, must not be safekept by the counterparty unless they are legally protected from consequences of default of the counterparty
- ▶ May not be pledged or given as a guarantee except if the UCITS has sufficient liquidity to return the received collateral in the form of cash
- ▶ If short-term bank deposits, MMIs and bonds, must be core eligible investments in accordance with the 2010 Law

Exposures arising from the reinvestment of collateral received by the UCITS from securities lending transactions, sale with right of repurchase transactions, reverse repurchase agreement transactions, and repurchase agreement transactions must be taken into account within the diversification limits applicable under the 2010 Law (see Section 4.2.2.8.). The UCITS must also ensure that:

- ▶ If short-term bank assets are likely to expose the UCITS to credit risk *vis-à-vis* the custodian, the UCITS must take this into account when computing the deposit limits set out in Article 43(1) of the 2010 Law, as amended - see Section 4.2.2.8.1.I.(4)
- ▶ The reinvestment must be taken into account for the calculation of the global exposure of the UCITS in particular if it creates a leverage effect. Any reinvestment of cash collateral in financial assets providing a return in excess of the risk free rate is subject to this requirement
- ▶ Any collateral assets that have been reinvested must be specifically mentioned, with their values given, in an appendix to the financial reports of the UCITS

According to ESMA's *Guidelines on ETFs and other UCITS issues*:

- ▶ Non-cash collateral received should not be sold, reinvested, or pledged
- ▶ Cash collateral received should only be:
  - ▶ Placed on deposit with a credit institution that has its registered office in an EU Member State or, if located in a non-Member State, subject to equivalent prudential rules
  - ▶ Invested in high-quality government bonds
  - ▶ Used for the purpose of reverse repurchase transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on an accrued basis
  - ▶ Invested in short-term MMFs as defined in Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds, as amended (see Section 4.8.)
- ▶ Reinvested cash collateral should be diversified in accordance with the diversification requirements applicable to non-cash collateral

ESMA clarified that when a UCITS reinvests cash collateral in short-term MMFs, these short-term MMFs should not invest, according to their constitutional document, more than 10% of their net assets in other UCITS or UCIs.

### 4.2.3. Part II UCIs

Part II of the 2010 Law, as amended, contains no provisions regarding investment or borrowing rules for such UCIs. Such rules are specified in CSSF circulars or determined on a case-by-case basis by the CSSF.

The CSSF has issued rules or guidelines for 2010 Law Part II UCIs investing in the following activities:

- ▶ Transferable securities (see Section 4.2.3.1.)
- ▶ Alternative investments (i.e., hedge funds) (see Section 4.2.3.2.)
- ▶ Venture capital (see Section 4.2.3.3.); see also Section 4.7.1. on the investment restrictions applicable to qualifying EuVECAs
- ▶ Futures contracts and options (see Section 4.2.3.4.)
- ▶ Real estate (see Section 4.2.3.5.)

The rules applicable for UCIs employing certain techniques and instruments relating to transferable securities and MMIs set out in CSSF Circular 08/356 are also, in principle, applicable to 2010 Law Part II UCIs (see Sections 4.2.2.10.(2) to (7)); however, the requirements of ESMA's *Guidelines on ETFs and other UCITS issues* are, in principle, not applicable to 2010 Law Part II UCIs.

In addition to the general annual reporting requirements, specific requirements apply to these types of 2010 Law Part II UCIs (see Section 10.5.1.).

In addition, full AIFM regime 2010 Law Part II UCIs that:

- ▶ Invest in securitization positions are subject to the requirements outlined in Section 4.5.
- ▶ Acquire major holdings or control over non-listed companies are subject to the requirements outlined in Section 4.6.

#### 4.2.3.1. Part II UCIs investing in transferable securities

The following summarizes investment and borrowing restrictions as set out in Chapter G of Circular 91/75, as amended. Certain limits will not apply if they are not compatible with the investment policy of the UCI (e.g., UCIs whose investment policy provides for the investment of 20% or more of their net assets in venture capital or the permanent borrowing for investment purposes of at least 25% of their net assets).

*A. Unlisted securities*

- (1) No more than 10% of net assets may be invested in securities not quoted on a stock exchange or dealt in on another regulated market (see, however, Section 4.2.3.1.D.(1))

*B. Investment in any one security or issuer*

- (1) No more than 10% of net assets may be invested in securities issued by any one issuer (see, however, Section 4.2.3.1.D.(1))

*C. Significant influence over an issuer*

- (1) No more than 10% of securities issued by any one issuer may be acquired (see, however, Section 4.2.3.1.D.(1))
- (2) In the case of multiple compartment UCIs, the restriction in Section 4.2.3.1.C.(1) limiting the holding of securities of one issuer also applies to all compartments taken together

*D. Derogation*

- (1) Restrictions in Section 4.2.3.1.A.(1) to C.(1) are not applicable to securities issued or guaranteed by OECD Member States or their local authorities or public international bodies with EU, regional or worldwide scope

*E. Investment in other UCIs*

- (1) Restrictions in Section 4.2.3.1.A.(1) to C.(1) are applicable to the investment in other UCIs of the open-ended type where those UCIs are not subject to risk diversification requirements comparable to those in Section 4.2.3.1.A.(1) to D.(1). Investment in closed-ended UCIs is permitted and subject to the restrictions applicable to transferable securities. If investment is to be made in other UCIs (fund of funds), this must be expressly stated in the prospectus and, if such investment is to be in other UCIs of the same promoter, the prospectus must specify the nature of fees and expenses arising

*F. Investment in other compartments*

- (1) A compartment of a UCI may, subject to the conditions laid down in the constitutional document as well as in the prospectus, subscribe, acquire, and/or hold securities issued or to be issued by one or more compartments of the same UCI without that UCI, when it is formed as an investment company, being subject to the requirements of the 1915 Law with respect to the subscription, acquisition, and/or the holding by the company of its own shares, provided all the following conditions are met:
  - ▶ The target compartment does not, in turn, invest in the compartment invested in this target compartment
  - ▶ No more than 10% of the net assets of the target compartments, whose acquisition is contemplated, may be invested, pursuant to their constitutional document, in shares or units of other target compartments of the same UCI
  - ▶ Voting rights, if any, attaching to the relevant securities are suspended for as long as they are held by the compartment concerned
  - ▶ As long as these securities are held by the UCI, their value will not be taken into consideration for the calculation of the net assets of the UCI for the purposes of verifying the minimum threshold of the net assets imposed by the 2010 Law

*G. Borrowings*

- (1) Borrowings of up to 25% of net assets without any restriction are allowed. Leveraged UCIs are not subject to this restriction

**4.2.3.2. Alternative investments***A. Introduction*

UCIs that adopt alternative investment strategies were not specifically covered by the provisions of Circular 91/75, as amended. Therefore, the CSSF issued Circular 02/80, which specifically concerns UCIs whose investment objective is to adopt so-called alternative investment strategies, akin to those pursued by hedge funds.

The overall objective of the Circular is to clarify the legal and regulatory framework applicable to such products.

The Circular's purpose is to provide a formal framework for establishing regulated hedge fund products that had previously been approved on a case-by-case basis.

The CSSF may allow departures from the provisions set out in the Circular, where justified, or impose additional investment restrictions, where appropriate. This may include cases where the Circular is more restrictive than subsequent regulations.

## B. Short selling

Short selling may be carried out subject to the following rules:

- ▶ Aggregate commitment (i.e., unrealized losses) in terms of short selling may not exceed 50% of assets
- ▶ The short sales of transferable securities for which the UCI holds adequate coverage are not to be considered in the calculation of the total commitments referred to above. The granting by the UCI of a security, of whatever nature, on its assets to third parties in order to secure its obligations towards such third parties, is not to be considered as adequate coverage of the UCI's commitments
- ▶ In connection with short sales on transferable securities, UCIs are authorized to enter, as borrower, into securities lending transactions with first class professionals specialized in this type of transaction. The counterparty risk (i.e., the difference between the value of the securities pledged and the value of the securities borrowed) per lender may not exceed 20% of assets
- ▶ Up to 10% of assets may be invested in short positions of unlisted securities, provided such securities are liquid
- ▶ Not more than 10% of the same type of securities issued by the same issuer may be sold short
- ▶ Short positions on securities issued by the same body may not exceed 10% of assets and/or the commitment on such securities may not exceed 5% of assets
- ▶ If the UCI enters into short sale transactions, it must hold sufficient assets enabling it at any time to close the open positions resulting from such short sales

## C. Borrowing

Borrowing for investment purposes on a permanent basis from first class credit institutions who specialize in this type of transaction is permitted subject to the following:

- ▶ Borrowings may not exceed 200% of the net assets. Consequently, the value of the total assets may not exceed 300% of the value of net assets
- ▶ In cases where there is a high degree of correlation between long and short positions, borrowings may increase to 400% of net assets

Counterparty risk (defined under "short selling") cannot represent more than 20% of the UCI's assets per lender.

## D. Investments in other UCIs (fund of funds)

Investments in other UCIs are subject to the following provisions:

- ▶ Up to 20% of net assets may be invested in the securities of the same UCI. However, in applying this limit each compartment of a multiple compartment UCI will be considered as a separate UCI, provided that no cross-liability exists between the compartments
- ▶ Up to 100% of the shares issued by a multiple compartment UCI may be held, provided that the total investment in the UCI does not exceed 50% of net assets

These limits are not applicable to investments in open-ended regulated UCIs that apply a diversified investment policy. This derogation may not result in an excessive concentration of the investments of the UCI in one single target UCI provided that for the purpose of this limitation, each compartment of a target UCI with multiple compartments is to be considered as a distinct target UCI and that no cross-liability exists between the compartments.

UCIs that principally invest in other UCIs must make sure that their portfolio of target UCIs presents appropriate liquidity features to enable the UCIs to meet their obligation to redeem their shares. Their investment policies must include a description of how their portfolio of target UCIs presents appropriate liquidity features.

## E. Long positions

Long positions must meet the following criteria:

- ▶ No more than 10% of its assets may be invested in unlisted securities
- ▶ No more than 10% of the same type of securities issued by the same entity may be acquired
- ▶ Exposure to a single issuer may not exceed 20% of assets

These restrictions do not apply to investments in other UCIs and to securities issued or guaranteed by an OECD Member State or by its local authorities or by supranational bodies or organizations of an EU, regional or worldwide nature.

## F. Securities lending

In general, such UCIs may lend through a standard system organized by a recognized clearing institution or through a first class financial institution, subject to the following provisions:

- ▶ Collateral (in the case of a first class institution only) received must be at least equal to the value of securities lent
- ▶ Securities lent may not exceed 50% of the value of the UCI's portfolio unless the UCI has the right to cancel the contract at any time
- ▶ Lending contracts may not exceed 30 days unless the UCI has the right to cancel the contract at any time

### G. Financial derivative instruments (FDIs)

Such UCIs are authorized to use all types of exchange-traded/OTC FDIs such as options, forward or futures contracts, as well as swap contracts, provided that the following conditions are met:

- ▶ The UCI's total commitments arising from such instruments (exchange-traded and OTC) and short selling cannot exceed the value of the assets
- ▶ Total margin deposits (exchange-traded), commitments arising from FDIs (i.e., unrealized losses for OTC instruments), and premiums paid for the acquisition of options outstanding may not exceed 50% of the assets
- ▶ Sufficient liquid assets (for example, term deposits, Treasury bills, Treasury bonds, and MMIs) to finance margin calls must be maintained
- ▶ Borrowings may not be used to finance margin deposits
- ▶ Margin requirements or commitments on a single contract may not exceed 5% of the assets
- ▶ Premiums paid on options with identical characteristics may not exceed 5% of the assets
- ▶ The UCI may not invest directly in commodities, although it may hold commodity futures and hold precious metals dealt in on an organized market
- ▶ The UCI must ensure an adequate spread of investment risks by sufficient diversification
- ▶ The UCI margin requirements/commitments on a single commodity/class of financial futures may not exceed 20% of the assets

UCIs that use such techniques and instruments must include in their prospectus the maximum total leverage and a description of the risks inherent in such transactions.

### H. Repurchase and reverse repurchase agreements

The UCI may enter into sale with right of repurchase transactions which entail the purchase and sale of securities where the terms reserve the right to the seller to repurchase the securities from the buyer at a price and at a time agreed between the two parties at the time when the contract is entered into. The UCI can also enter into repurchase transactions which consist of transactions where, at maturity, the seller has the obligation to take back the asset sold whereas the original buyer either has a right or an obligation to return the asset sold.

The UCI can either act as buyer or as seller in the context of the aforementioned transactions.

The UCI may enter into such transactions provided that the following conditions are met:

- ▶ The transactions must be carried out with first class institutions
- ▶ During the duration of a sale with right of repurchase agreement where the UCI acts as purchaser, the UCI may not sell the securities that are the subject of the contract before the counterparty has exercised its right to repurchase the securities or until the deadline for the repurchase has expired, unless the UCI has other means of coverage. If the UCI is open for redemption, it must ensure that the value of such transactions is kept at a level such that it is at all times able to meet its redemption obligations. The same conditions are applicable in the case of a repurchase transaction on the basis of a purchase and firm resale agreement where the UCI acts as purchaser (transferee)
- ▶ Where the UCI acts as seller (transferor) in a repurchase transaction (repo), the UCI may not, during the whole duration of the repo, transfer the title to the security under the repo or pledge them to a third party, or repo them a second time, in whatever form. The UCI must, at the maturity of the repurchase transaction, hold sufficient assets to pay, if appropriate, the agreed repurchase price payable to the transferee

### I. Minimum entry investment

There is no minimum level of initial investment by investors.

### J. Breach of investment limits

Where an investment limit is breached due to passive reasons (market movements, etc.), the UCI must take corrective action in the best interests of the shareholders or unitholders.

The CSSF has clarified on numerous occasions that breaches of investment restrictions resulting from predictable events (cash inflows or outflows expected due to subscriptions, redemptions, reimbursements of bonds) should be considered as active breaches with the full application of CSSF Circular 02/77. Refer to Section 8.9.

### K. Prime broker

The use of a prime broker is subject to the counterparty risk limitation mentioned under Section 4.2.3.2.C. and the requirements outlined in Section 9.8.

#### 4.2.3.3. Venture capital UCIs

Investment in venture capital is defined as “investment in securities of unlisted companies because either these companies are recently formed, or they are still in the course of development and therefore have not yet obtained the stage of maturity required to have access to stock markets”. Venture capital UCIs invest in these higher risk companies with the intention of achieving a higher rate of return.

The principal regulations applicable to venture capital UCIs are stated in Chapter I.I. of Circular 91/75, as amended. The managers and investment advisors must be able to demonstrate their specific experience in venture capital.

##### A. Investment restrictions

Investments must be diversified in order to spread the risk and, in particular, no more than 20% of net assets may be invested in any one company.

#### 4.2.3.4. Futures contracts and/or options UCIs

The principal regulations applicable to UCIs investing in one or more of commodity futures, financial futures and options are stated in Chapter I.II. of Circular 91/75, as amended. The managers and investment advisors must be able to demonstrate their expertise in this field.

##### A. Investment restrictions

- (1) Margin deposits related to commitments on purchase and sale of futures contracts and call and put options may not exceed 70% of net assets, the balance of 30% representing a liquidity reserve
- (2) Futures contracts, including those underlying options, must be dealt in on an organized market
- (3) Contracts concerning commodities, other than commodity futures contracts, are not allowed. The acquisition of precious metals, negotiable on an organized market, for cash is permitted
- (4) Only call and put options dealt in on an organized market are permitted. Premiums paid for such options are included in the 70% limit in Section 4.2.3.4.A.(1)
- (5) Investments must be sufficiently diversified in order to spread risk
- (6) An open forward position may not be held in any one contract for which the margin requirement represents 5% or more of net assets. This also applies to open positions resulting from the sale of options
- (7) Premiums paid to acquire options having identical characteristics may not exceed 5% of net assets
- (8) Open positions in futures contracts concerning a single commodity or a single category of financial futures must be less than 20% of net assets. This also applies to open positions resulting from the sale of options

##### B. Borrowings

- (1) Borrowings of up to 10% of net assets are permitted but not for investment purposes

#### 4.2.3.5. Real estate UCIs

The CSSF defines real estate for the purposes of Circular 91/75, as amended, as:

- ▶ Property consisting of land and/or buildings registered in the name of the UCI
- ▶ Participations in real estate companies (as well as loans to such companies), the exclusive purpose and objects of which are the acquisition, development, and sale together with the letting and tenancing of real estate, assuming that such participations are at least as realizable as those real estate interests held directly by the UCI
- ▶ Various long-term real estate related interests such as rights to ground rents, long-term leases and option rights over real estate investments

The principal regulations applicable to real estate UCIs are stated in Chapter I.III. of Circular 91/75, as amended. The managers and investment advisors must have experience in real estate investment.

##### A. Investment restrictions

- (1) Investment in property must be sufficiently diversified in order to spread risk, and in any case no more than 20% of net assets may be invested in any one property. Property which has an economic life dependent on another property is not considered as a separate property. This 20% rule does not apply during a start-up period not exceeding four years

## B. Borrowings

- (1) Total borrowings may not exceed 50% of the value of all properties

## C. Valuations of properties

- (1) One or more experienced independent property valuers must be appointed
- (2) At the year end, all properties owned by the UCI or its affiliated real estate companies must be valued by the property valuers
- (3) Properties may not be acquired or sold without a valuation by the property valuers, although a new valuation is not required if the sale of a property occurs within six months of the last valuation
- (4) The purchase or sale price may not be appreciably higher or lower than the valuation, except under justifiable circumstances, which must be explained in the next financial report

### 4.2.3.6. Virtual assets UCIs

On 29 November 2021, the CSSF published its *FAQ Virtual Assets* which provides guidance on virtual assets and similar financial innovations. Virtual assets are defined in Article 1 (20b) of the Law of 12 November 2004 on the fight against money laundering and terrorist financing, as amended.

The CSSF indicated that entities under the prudential supervision of the CSSF must bear in mind that investing in virtual assets is not suitable for all kind of investors and/or all investment objectives.

Therefore, UCIs addressing non-professional customers and pension funds are not allowed to invest directly or indirectly in virtual assets.

Investments in virtual assets could be compatible with UCIs aimed at the professional investor, on condition that the investment by the UCI in virtual assets does not prevent the application of and compliance with existing regulatory requirements. In consequence, an AIF may invest directly (and indirectly) in virtual assets under the condition that its shares/units are marketed only to professional investors. Should such AIF be managed by a Luxembourg authorized AIFM, the latter must obtain an extension of authorization from the CSSF for this new investment strategy. Virtual assets present specificities such as their volatility, liquidity and technological risk which could significantly affect the risk profile of the investment vehicle. The CSSF drew attention to the integration phase of virtual assets in the investment policy and reiterated the importance of having adequate internal control functions and their key role in the approval of new products/investment strategies. Given the diverse range of virtual assets available, investment managers need to make a case-by-case assessment of the impact of these investments on the risk profile of the UCI. Investment managers have to ensure that investors are properly informed in a transparent and timely manner and that the relevant UCI documentation is updated.

The FAQ also specifies minimum internal governance arrangements to ensure a sound and prudent management of all activities of IFMs (and other entities) in this area. The management body is responsible for developing a business strategy with respect to activities involving virtual assets including a related risk strategy, including notably the definition of the risk appetite and the overall framework for risk-taking and risk management.

## 4.3. SIFs

SIFs are required to comply with general diversification and risk management requirements, but are not subject to detailed investment or borrowing rules. This section covers the diversification requirements; risk management requirements are covered in Section 7.4.

In addition, full AIFM regime SIFs that:

- ▶ Invest in securitization positions are subject to the requirements outlined in Section 4.5.
- ▶ Acquire major holdings or control over non-listed companies are subject to the requirements outlined in Section 4.6.

SIFs that are EuVECAs or EuSEFs are subject to the specific requirements on their investments set out in Section 4.7.

As regards investments by SIFs into virtual assets, please refer to the information/conditions mentioned in Section 4.2.3.6 above.



### 4.3.1. Diversification

The SIF Law states that a SIF should apply the principle of risk diversification. CSSF Circular 07/309 on risk-spreading in the context of specialized investment funds complemented the SIF Law and provided clarification on the investment restrictions that must be adhered to in order to ensure adequate risk diversification:

- (1) A SIF cannot, in principle, invest more than 30% of its assets or its commitments to subscribe to securities of the same nature issued by the same issuer. This restriction is not, however, applicable to investments in:
  - Securities issued or guaranteed by an OECD Member State or by its local authorities or by supranational bodies or organizations of an EU, regional, or worldwide nature
  - Target UCIs that are subject to risk diversification principles that are at least comparable to those relevant to SIFs (e.g., a feeder SIF investing in a master UCI). Each compartment of a target multiple compartment UCI may be considered as a distinct issuer provided that the segregation of assets and liabilities on a compartment by compartment basis is implemented
- (2) Short selling cannot, in principle, result in the SIF holding uncovered securities of the same nature issued by the same issuer representing more than 30% of its assets
- (3) When using FDIs, the SIF must ensure comparable risk diversification through appropriate diversification of the underlying assets. Counterparty risk of OTC operations must be limited according to the quality and qualification of the counterparty

The risk diversification requirements should, in practice, be complied with by each compartment of a multiple compartment SIF.

The CSSF may provide exemptions from the restrictions laid out in CSSF Circular 07/309 on a case-by-case basis - for example, exemptions may be granted, for a limited period, to real estate and private equity SIFs making their first investments. However, the CSSF may also request that additional restrictions are adhered to, in cases of funds with specific investment policies.

A compartment of a SIF may, subject to the conditions set out in the offering document, subscribe, acquire, and/or hold securities issued or to be issued by one or several other compartments of the same SIF, without this SIF, when it is formed as an investment company, being subject to the requirements regarding the subscription, acquisition, and/or holding by a company of its own shares set out in the 1915 Law, subject to the following conditions:

- The target compartment does not, in turn, invest in the compartment invested in this target compartment
- The voting rights, if any, which might be attached to the securities concerned will be suspended for as long as they are held by the relevant compartment and without prejudice to an appropriate treatment in accounting and in the periodical reports
- As long as these securities are held by the SIF, their value must not be taken into account for the calculation of the SIF's net assets for the calculation of the minimum threshold of net assets imposed by the SIF Law, as amended

Sufficient information and documentation must be provided to the CSSF to enable it to determine compliance with the investment restrictions.

Details of how the principle of risk diversification will be implemented, including quantifiable investment limits, must be disclosed in the offering document (see Section 10.3.5.).

## 4.4. RAIFs

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The RAIF regime is applicable to Luxembourg AIFs managed by an authorized AIFM:

- That invest in accordance with the principle of risk-spreading
- Whose securities or partnership interests are reserved for well-informed investors
- Whose constitutive documents provide that they are subject to the provisions of the RAIF Law

The RAIF Law, as amended, allows full flexibility with respect to the assets in which a RAIF may invest.

The RAIF regime is designed to accommodate AIFs that invest in any type of assets and which pursue both traditional and alternative investment strategies.

The RAIF Law does not provide for specific investment rules or restrictions. It only requires that RAIFs are subject to the principle of risk-spreading<sup>15</sup>.

It is the responsibility of the governing body of the RAIF to ensure that the minimum diversification rules implied by the RAIF Law are complied with.

As regards investments by RAIFs into virtual assets, please refer to information/conditions mentioned in Section 4.2.3.6 on the previous page.

<sup>15</sup> Unless the RAIF restricts itself to investment in risk capital to benefit from the same tax regime as that applicable to an investment company in risk capital (SICAR).

## 4.5. Investment in securitizations by self-managed UCITS, UCITS management companies or AIFMs managing and/or marketing alternative investment funds in the EU

The Securitization Regulation<sup>16</sup> came into effect on 1 January 2019. For the purposes of this Regulation, the following definitions apply:

A “securitization” means a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranching, having all of the following characteristics:

- (a) Payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures
- (b) The subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme
- (c) The transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013, as amended (i.e., specialized lending to finance or operate physical assets)

UCITS and AIFs may be able to invest in securitizations providing that eligible assets rules (for UCITS) (see Section 4.2.2.7.) and investment policies are adhered to.

### I. Due diligence requirements:

Self-managed UCITS, UCITS management companies and AIFMs managing and/or marketing alternative investment funds in the EU fall within the definition of “institutional investors” as defined in Regulation (EU) 2017/2402, as amended.

As such, prior to investing in a targeted securitization, self-managed UCITS, UCITS management companies and AIFMs managing and/or marketing alternative investment funds in the EU are required to perform due diligence ensuring that:

- ▶ The originator or original lender (except if EU credit institution or investment firm) grants all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply those criteria and processes
- ▶ The originator, sponsor or original lender complies with risk retention rules set out in the Regulation
- ▶ The originator, sponsor or securitization special purpose entity (SSPE) makes available required information with the frequency and modalities provided for in the Regulation

A self-managed UCITS, UCITS management companies or AIFMs managing and/or marketing alternative investment funds in the EU should also carry out a due diligence assessment enabling it to assess the risks involved covering at least the following:

- ▶ Risk characteristics of the individual securitization position and of the underlying exposures
- ▶ All the structural features of the securitization that can materially impact the performance of the securitization position, including the contractual priorities of payment and priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers and transaction-specific definitions of default

In addition, the self-managed UCITS, UCITS management companies and AIFMs managing and/or marketing alternative investment funds in the EU should on an ongoing basis:

- ▶ Establish appropriate written procedures that are proportionate to the risk profile of the securitization position and, where relevant, to the UCITS/AIFs trading and non-trading book, in order to monitor, on an ongoing basis, compliance by the originator, sponsor or original lender and the performance of the securitization position and of the underlying exposures
- ▶ Perform stress tests
- ▶ Ensure internal reporting to its management body so that the management body is aware of the material risks arising from the securitization position
- ▶ Be able to demonstrate to its competent authorities, upon request, that it has a comprehensive and thorough understanding of the securitization position and its underlying exposures and that it has implemented written policies and procedures for the risk management of the securitization position and for maintaining records of the verifications and due diligence

### II. Corrective action:

Where self-managed UCITS, UCITS management companies and AIFMs managing and/or marketing alternative investment funds in the EU are exposed to securitizations that no longer meet the requirements provided in Regulation (EU) 2017/2402, they should, in the best interest of the investors in the relevant AIFs or UCITS, act and take corrective action, if appropriate.

<sup>16</sup> Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, as amended.

## 4.6. Major holdings and control over portfolio companies and issuers

The AIFM Law sets down requirements on the acquisition of major holdings or control of non-listed companies and issuers by AIFs.

A “non-listed company” is defined as a company that has its registered office in the EU and the shares of which are not admitted to trading on a regulated market within the meaning of the MiFID II Directive<sup>17</sup>.

An “issuer” is defined as an issuer within the meaning of the Transparency Directive<sup>18</sup> where that issuer has its registered office in the EU and where its shares are admitted to trading on a regulated market within the meaning of the MiFID II Directive.

The provisions on acquisition of control apply to AIFMs acting individually, or cooperating with one or more other AIFMs on the basis of an agreement, managing one or more AIFs, which AIFs either individually or jointly with other AIFs on the basis of an agreement aimed at acquiring control, acquire control of a non-listed company, and, for certain limited provisions, an issuer. Control is defined as more than 50% of the voting rights for non-listed companies and by reference to Article 5(3) of the Takeover Bids Directive<sup>19</sup> for issuers.

The provisions are neither applicable to EU small- and medium-sized enterprises (SMEs<sup>20</sup>) nor to special purpose vehicles (SPVs) with the purpose of purchasing, holding, or administering real estate.

When an AIF acquires, sells, or holds shares of a non-listed company, the AIFM must notify the competent authority of its home Member State of the proportion of voting rights of the non-listed company held by the AIF whenever the proportion reaches, exceeds, or falls below any of the following thresholds: 10%, 20%, 30%, 50%, and 75%.

When an AIF acquires, individually or jointly, control over a non-listed company, the AIFM is required to:

- ▶ Notify, within 10 working days, the non-listed company, its shareholders, and its competent authority of the resulting situation in terms of voting rights and the conditions under which control has been reached, including information about the identity of the different shareholders involved
- ▶ Disclose to the non-listed company, its shareholders, and its competent authority:
  - ▶ The identity of the AIFM that, either individually or in agreement with other AIFMs, manage(s) the AIF(s) that has/have reached control
  - ▶ The policy for preventing and managing conflicts of interests
  - ▶ The policy for external and internal communication relating to the company, in particular as regards employees

These provisions also apply to issuers.

In addition, the AIFM must disclose:

- ▶ To the non-listed company and its shareholders: its intentions regarding the future business of the non-listed company and the likely repercussion on employment
- ▶ To its competent authority and the investors of the AIF: information on the financing of the acquisition

In the notification and disclosure to the non-listed company, the AIFM must request the board of directors of the company to inform the representatives of employees or the employees themselves of the acquisition of control by the AIF managed by the AIFM and provide the information notified and disclosed. This also applies to issuers.

The AIFM is required to ensure that information on the development of the non-listed company's business is disclosed to the investors in the AIF and make its best efforts to ensure that the information is made available to employees of the company. The AIFM may either:

- ▶ Request and use its best efforts to ensure that the annual report of the non-listed company is made available by the board of directors of the company to the employees' representatives or, where there are none, to the employees themselves within the period such annual report has to be drawn up in accordance with the applicable national law, and also make the information available to the investors of each such AIF at the latest when the annual report of the non-listed company is made available
- ▶ Include in the annual report of each such AIF (see also Section 10.5.2.) information relating to the relevant non-listed company, and also request and use its best efforts to ensure that the board of directors of the non-listed company makes available this information to the employees' representatives of the company concerned or, where there are none, to the employees themselves at the latest when the annual report of the AIF is made available

<sup>17</sup> Point (214) of Article 4(1) of Directive 2014/65/EU on markets in financial instruments, as amended.

<sup>18</sup> Point (d) of Article 2(1) of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, as amended.

<sup>19</sup> Directive 2004/25/EC on takeover bids, as amended.

<sup>20</sup> Micro-, small-, and medium-sized enterprises (SMEs) are enterprises that employ fewer than 250 persons and have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million.

The information to be included in the annual report of the non-listed company or the AIF must include at least a fair review of the development of the company's business representing the situation at the end of the period covered by the annual report and give an indication of:

- ▶ The company's likely future development
- ▶ The information concerning acquisitions of own shares

In the case of acquisition of control of a non-listed company or issuer by one or more AIF, the AIFM cannot, within 24 months of the acquisition of control of the company by the AIF, facilitate, support, or instruct any distribution, capital reduction, share redemption, and/or acquisition of own shares by the company or vote in favor of a distribution, capital reduction, share redemption, and/or acquisition of own shares by the company where:

- ▶ The portfolio company's net assets decreased below the subscribed capital plus legally non-distributable reserves
- ▶ Distribution would exceed the amount of available profit

The AIFM is required to make its best efforts to prevent distributions, capital reductions, share redemptions, and/or the acquisition of own shares by the company.

## 4.7. EuVECA and EuSEFs

The managers of qualifying European Venture Capital Funds (EuVECA) and of qualifying European Social Entrepreneurship Funds (EuSEFs) are required to comply with regulatory requirements which include investment restrictions.

The EuVECA and EuSEF regimes are introduced in Section 2.4.4.3.; the applicable investment restrictions and leverage provisions are outlined in this section.

### 4.7.1. Qualifying EuVECA

Qualifying EuVECA are UCIs that invest no more than 30% of their aggregate capital contributions and uncalled committed capital<sup>21</sup> in assets other than "qualifying investments".

"Qualifying investments" include:

- ▶ Equity and quasi-equity instruments<sup>22</sup> that are issued by:
  - ▶ A qualifying portfolio undertaking and acquired directly by the EuVECA from the qualifying portfolio undertaking
  - ▶ A qualifying portfolio undertaking in exchange for an equity security issued by a qualifying portfolio undertaking
  - ▶ An undertaking of which the qualifying portfolio undertaking is a majority-owned subsidiary and which is acquired by the EuVECA in exchange for an equity instrument issued by the qualifying portfolio undertaking
- ▶ Secured or unsecured loans granted by the EuVECA to a qualifying portfolio undertaking in which the EuVECA already holds qualifying investments, provided that no more than 30% of the aggregate capital contributions and uncalled committed capital in the qualifying venture capital fund is used for such loans
- ▶ Shares of a qualifying portfolio undertaking acquired from existing shareholders of that undertaking
- ▶ Shares or units of one or several other qualifying EuVECA, provided that those qualifying EuVECA have not themselves invested more than 10% of their aggregate capital contributions and uncalled committed capital in qualifying EuVECA

A "qualifying portfolio undertaking" must:

- ▶ Meet the criteria applicable to a small- and medium-sized enterprise (SME) - i.e., have less than 250 employees and must have either a turnover not exceeding EUR 50 million or an annual balance sheet not exceeding EUR 43 million
- ▶ Be established in an EEA Member State or a third country that:
  - ▶ Is not listed as a non-cooperative country and territory (NCCT) by the Financial Action Task Force (FATF)<sup>23</sup>
  - ▶ Has signed a compliant OECD Article 26 Model Tax Convention<sup>24</sup> with the home Member State of the manager of the EuVECA and each other Member State in which the shares or units of the EuVECA are intended to be marketed
- ▶ Not be listed at the time of investment

<sup>21</sup> After deduction of all relevant costs. Cash and cash equivalents are excluded from the calculation.

<sup>22</sup> Quasi-equity means any type of financing instrument that is a combination of equity and debt, where the return on the instrument is linked to the profit or loss of the qualifying portfolio undertaking and where the repayment of the instrument in the event of default is not fully secured.

<sup>23</sup> An intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.

<sup>24</sup> Article 26 of the OECD Model Tax Convention creates an obligation to exchange information that is foreseeably relevant to the correct application of a tax convention as well as for purposes of the administration and enforcement of domestic tax laws of the contracting states.

## 4.7.2. Qualifying EuSEFs

Qualifying EuSEFs are UCIs that invest no more than 30% of their aggregate capital contributions and uncalled committed capital in assets other than “qualifying investments”.

“Qualifying investments” include:

- ▶ Equity and quasi-equity instruments that are issued by:
  - ▶ A qualifying portfolio undertaking and acquired directly by the EuSEF from the qualifying portfolio undertaking
  - ▶ A qualifying portfolio undertaking in exchange for an equity security issued by a qualifying portfolio undertaking
  - ▶ An undertaking of which the qualifying portfolio undertaking is a majority-owned subsidiary and which is acquired by the EuSEF in exchange for an equity instrument issued by the qualifying portfolio undertaking
- ▶ Securitized or unsecuritized debt instruments issued by a qualifying portfolio undertaking
- ▶ Shares or units of one or several other qualifying EuSEFs, provided that those qualifying EuSEFs have not themselves invested more than 10% of their aggregate capital contributions and uncalled committed capital in qualifying EuSEFs
- ▶ Secured or unsecured loans granted by the EuSEF to a qualifying portfolio undertaking
- ▶ Any other type of participation in a qualifying portfolio undertaking

A “qualifying portfolio undertaking” must:

- ▶ Have the achievement of measurable, positive social impacts as a primary objective in accordance with its constitutional document, where the undertaking meets one of the following criteria:
  - ▶ Provides services or goods to vulnerable, marginalized, disadvantaged or excluded persons
  - ▶ Employs a method of production of goods or services that embodies its social objective
  - ▶ Provides financial support exclusively to such social undertakings
- ▶ Use its profits primarily to achieve its primary social objective
- ▶ Be managed in an accountable and transparent way, in particular by involving workers, customers and stakeholders affected by its business activities
- ▶ Be established in an EEA Member State or a third country that:
  - ▶ Is not listed as a non-cooperative country and territory (NCCT) by the FATF
  - ▶ Has signed a compliant OECD Article 26 Model Tax Convention with the home Member State of the manager of the EuSEF and each other Member State in which the shares or units of the EuSEF are intended to be marketed
- ▶ Not be listed at the time of investment

EuSEF managers must employ, for each EuSEF that they manage, clear and transparent procedures to measure the extent to which the qualifying portfolio undertakings in which the EuSEF invests achieve the positive social impact to which they are committed. Indicators may cover one or more of the following subjects:

- ▶ Employment and labor markets
- ▶ Standards and rights related to job quality
- ▶ Social inclusion and protection of particular groups
- ▶ Equal treatment, equal opportunities and non-discrimination
- ▶ Public health and safety
- ▶ Access to and effects on social protection and on health and educational systems

## 4.7.3. Use of leverage

The manager of the qualifying European fund must not employ any method to increase the exposure at the level of the qualifying fund beyond the level of its committed capital. It may borrow cash or securities, issue debt obligations or provide guarantees where such borrowings, debt obligations or guarantees are covered by uncalled commitments.

## 4.8. Money market funds (MMFs)

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On 30 June 2017, the final text of Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on *money market funds* was published in the Official Journal of the European Union. The Regulation, as amended, applies to funds and compartments that qualify as MMFs as per the definition set out in Article 1 of the Regulation.

### A. MMFs Eligible assets - summary

This section provides a high level overview of the eligible assets for investment by an MMF.

- a. An MMF must invest only in one or more of the following categories of financial assets and only under the conditions specified in the Regulation, as amended:
  - a) MMIs including financial instruments issued or guaranteed separately or jointly by the EU, the national, regional and local administrations of the Member States or their central banks, the European Central Bank, the European Investment Bank, the European Investment Fund, the European Stability Mechanism, the European Financial Stability Facility, a central authority or central bank of a third country, the International Monetary Fund, the International Bank for Reconstruction and Development, the Council of Europe Development Bank, the European Bank for Reconstruction and Development, the Bank for International Settlements or any other relevant international financial institution or organization to which one or more Member States belong
  - b) Eligible securitizations and asset-backed commercial papers (ABCPs)
  - c) Deposits with credit institutions
  - d) FDIs
  - e) Repurchase agreements
  - f) Reverse repurchase agreements
  - g) Units or shares of other MMFs
- b. An MMF must not undertake any of the following activities:
  - a) Investing in assets other than those referred to in subsection a. above
  - b) Short sale of any of the following instruments: MMIs, securitizations, ABCPs and units or shares of other MMFs
  - c) Taking direct or indirect exposure to equity or commodities, including via derivatives, certificates representing them, indices based on them, or any other means or instrument that would give an exposure to them
  - d) Entering into securities lending agreements or securities borrowing agreements, or any other agreement that would encumber the assets of the MMF
  - e) Borrowing and lending cash
- c. An MMF may hold ancillary liquid assets.

### B. Detailed rules regarding eligible assets for MMFs

#### a. Eligible MMIs

An MMI is eligible for investment by an MMF provided that it fulfils all of the following requirements:

- a) It meets the eligible asset requirement of MMIs for investment by UCITS (see Section 4.2.2.7.5.)
- b) It displays one of the following alternative characteristics:
  - i. It has a legal maturity at issuance of 397 days or less
  - ii. It has a residual maturity of 397 days or less
- c) The issuer of the MMI and the quality of the MMI have received a favorable assessment pursuant to the credit quality assessment (see Section 7.5.2.)
- d) Where an MMF invests in a securitization or ABCP, it is subject to the specific eligibility requirements applicable to these investments, set out in subsection b.

Notwithstanding point b) above, standard MMFs are also allowed to invest in MMIs with a residual maturity until the legal redemption date of less than or equal to two years, provided that the time remaining until the next interest rate reset date is 397 days or less. For that purpose, floating-rate MMIs and fixed-rate MMIs hedged by a swap arrangement must be reset to a money market rate or index.

Point c) above does not apply to MMIs issued or guaranteed by the EU, a central authority or central bank of a Member State, the European Central Bank, the European Investment Bank, the European Stability Mechanism or the European Financial Stability Facility.

b. Eligible securitizations and ABCPs

1. Both a securitization and an ABCP must be considered to be eligible for investment by an MMF provided that the securitization or ABCP is sufficiently liquid, has received a favorable credit quality assessment, and is any of the following:
  - a) A securitization referred to in Article 13 of the Commission Delegated Regulation (EU) 2015/61, as amended<sup>25</sup>
  - b) An ABCP issued by an ABCP program which:
    - i. Is fully supported by a regulated credit institution that covers all liquidity, credit and material dilution risks, as well as ongoing transaction costs and ongoing program-wide costs related to the ABCP, if necessary to guarantee the investor the full payment of any amount under the ABCP
    - ii. Is not a re-securitization and the exposures underlying the securitization at the level of each ABCP transaction do not include any securitization position
    - iii. Does not include a synthetic securitization as defined in point (11) of Article 242 of Regulation (EU) No 575/2013, as amended
  - c) A simple, transparent and standardized (STS) securitization, as determined in accordance with the criteria and conditions laid down in Articles 20, 21 and 22 of Regulation (EU) 2017/2402 of the European Parliament and of the Council, as amended<sup>26</sup>, or an STS ABCP, as determined in accordance with the criteria and conditions laid down in Articles 24, 25 and 26 of that Regulation
2. A short-term MMF may invest in the securitizations or ABCPs referred to in paragraph 1. provided any of the following conditions is fulfilled, as applicable:
  - a) The legal maturity at issuance of the securitizations referred to in point a) of paragraph 1. is two years or less and the time remaining until the next interest rate reset date is 397 days or less
  - b) The legal maturity at issuance or residual maturity of the securitizations or ABCPs referred to in points b) and c) of paragraph 1. is 397 days or less
  - c) The securitizations referred to in points a) and c) of paragraph 1. are amortizing instruments and have a weighted average life (WAL) of two years or less
3. A standard MMF may invest in the securitizations or ABCPs referred to in paragraph 1. provided any of the following conditions is fulfilled, as applicable:
  - a) The legal maturity at issuance or residual maturity of the securitizations and ABCPs referred to in points a), b) and c) of paragraph 1. is two years or less and the time remaining until the next interest rate reset date is 397 days or less
  - b) The securitizations referred to in points a) and c) of paragraph 1. are amortizing instruments and have a WAL of two years or less

c. Eligible deposits with credit institutions

A deposit with a credit institution is eligible for investment by an MMF provided that all of the following conditions are fulfilled:

- a) The deposit is repayable on demand or is able to be withdrawn at any time
- b) The deposit matures in no more than 12 months
- c) The credit institution has its registered office in a Member State or, where the credit institution has its registered office in a third country, it is subject to prudential rules considered equivalent to those laid down in EU Law in accordance with the procedure laid down in Article 107(4) of Regulation (EU) No 575/2013, as amended<sup>27</sup>

d. Eligible FDIs

An FDI is eligible for investment by an MMF provided it is dealt in on a regulated market or OTC and provided that all of the following conditions are fulfilled:

- a) The underlying of the derivative instrument consists of interest rates, foreign exchange rates, currencies or indices representing one of those categories
- b) The derivative instrument serves only the purpose of hedging the interest rate or exchange rate risks inherent in other investments of the MMF
- c) The counterparties to OTC derivative transactions are institutions subject to prudential regulation and supervision and belonging to the categories approved by the competent authority of the MMF
- d) The OTC derivatives are subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the MMF's initiative

e. Eligible repurchase agreements

A repurchase agreement is eligible to be entered into by an MMF provided that all of the following conditions are fulfilled:

- a) It is used on a temporary basis, for no more than seven working days, only for liquidity management purposes and not for investment purposes other than as referred to in point c)
- b) The counterparty receiving assets transferred by the MMF as collateral under the repurchase agreement is prohibited from selling, investing, pledging or otherwise transferring those assets without the MMF's prior consent

<sup>25</sup> Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for credit institutions, as amended.

<sup>26</sup> Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017, as amended, laying down a general framework for securitisation and creating a specific framework for STS securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

<sup>27</sup> Idem.

- c) The cash received by the MMF as part of the repurchase agreement is able to be:
  - i. Placed on deposits in accordance with the 2010 Law, or
  - ii. Invested in assets referred to here below in f. 6., but must not otherwise be invested in eligible assets for MMFs, transferred or otherwise reused
- d) The cash received by the MMF as part of the repurchase agreement does not exceed 10% of its assets
- e) The MMF has the right to terminate the agreement at any time upon giving prior notice of no more than two working days
- f. Eligible reverse repurchase agreements
  1. A reverse repurchase agreement is eligible to be entered into by an MMF provided that all of the following conditions are fulfilled:
    - a) The MMF has the right to terminate the agreement at any time upon giving prior notice of no more than two working days
    - b) The market value of the assets received as part of the reverse repurchase agreement is at all times at least equal to the value of the cash paid out
  2. The assets received by an MMF as part of a reverse repurchase agreement must be MMIs that fulfil the eligibility requirements indicated in a. above  
The assets received by an MMF as part of a reverse repurchase agreement must not be sold, reinvested, pledged or otherwise transferred
  3. Securitizations and ABCPs must not be received by an MMF as part of a reverse repurchase agreement
  4. The assets received by an MMF as part of a reverse repurchase agreement must be sufficiently diversified with a maximum exposure to a given issuer of 15% of the MMF's NAV, except where those assets take the form of MMIs that fulfil the requirements mentioned in Section 4.8.A.a.a). In addition, the assets received by an MMF as part of a reverse repurchase agreement must be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty
  5. An MMF that enters into a reverse repurchase agreement must ensure that it is able to recall the full amount of cash at any time on either an accrued basis or a mark-to-market basis. When the cash is recallable at any time on a mark-to-market basis, the mark-to-market value of the reverse repurchase agreement must be used for the calculation of the NAV of the MMF
  6. By way of derogation from Section 4.8.B.f.2., an MMF may receive as part of a reverse repurchase agreement liquid transferable securities or MMIs other than those that fulfil the eligibility requirements of MMIs provided that those assets comply with one of the following conditions:
    - a) They are issued or guaranteed by the EU, a central authority or central bank of a Member State, the European Central Bank, the European Investment Bank, the European Stability Mechanism or the European Financial Stability Facility provided that a favorable credit quality assessment has been received
    - b) They are issued or guaranteed by a central authority or central bank of a third country, provided that a favorable credit quality assessment has been received  
The assets received as part of a reverse repurchase agreement must be disclosed to MMF investors, in accordance with the Securities and Financing Transaction Regulation.  
The assets received as part of a reverse repurchase agreement must fulfil the requirements mentioned in Section 4.8.A.a.a).
  7. The Commission Delegated Regulation (EU) 2018/990 of 10 April 2018 specifies, *inter alia*, quantitative and qualitative liquidity requirements applicable to assets referred to in paragraph 6. and quantitative and qualitative credit quality requirements applicable to assets referred to in point a) above as follows:
    - i. Reverse repurchase agreements must meet established market standards and their terms and conditions must enable managers of MMFs to fully enforce their rights in case of default of the counterparty to such agreements, or their early termination and give managers of MMFs the unrestricted right to sell any assets received as collateral
    - ii. The assets referred to above must be subject to a haircut, that is equal to the volatility adjustment figures referred to in tables 1 and 2 of Article 224(1) of Regulation (EU) No 575/2013, as amended, for a given residual maturity, in respect of a five-day liquidation period and the highest assessment in terms of credit quality step
    - iii. Where necessary, managers of MMFs must apply an additional haircut to that referred to in paragraph ii. to assess whether such an additional haircut is necessary, they must take into account all of the following factors:
      - (a) The credit quality assessment of the counterparty to the reverse repurchase agreement
      - (b) The margin period of risk, as defined in Article 272(9) of Regulation (EU) No 575/2013, as amended
      - (c) The credit quality assessment of the issuer or of the asset that is used as collateral
      - (d) The remaining maturity of the assets used as collateral
      - (e) The volatility of the price of the assets used as collateral



- iv. For the purpose of paragraph iii., managers of MMFs must put in place a clear haircut policy adapted to each asset received as collateral. That policy must be documented and must substantiate each decision to apply a specific haircut to the value of an asset
- v. Managers of MMFs must regularly revise the haircut referred to in paragraph ii., taking into account changes in the residual maturity of the assets used as collateral. They must also revise the additional haircut referred to in paragraph iii., whenever the factors referred to in that paragraph change
- vi. Paragraphs i. to v. shall not apply if the counterparty to the reverse repurchase agreement is any of the following:
  - (a) A credit institution supervised under Directive 2013/36/EU of the European Parliament and of the Council<sup>28</sup>, or a credit institution authorized in a third country, provided that the prudential supervisory and regulatory requirements are equivalent to those applied in the EU
  - (b) An investment firm supervised under Directive 2014/65/EU of the European Parliament and of the Council<sup>29</sup>, or a third country investment firm, provided that the prudential supervisory and regulatory requirements are equivalent to those applied in the EU
  - (c) An insurance undertaking supervised under Directive 2009/138/EC of the European Parliament and of the Council<sup>30</sup>, or a third country insurance undertaking, provided that the prudential supervisory and regulatory requirements are equivalent to those applied in the EU
  - (d) A central counterparty authorized under Regulation (EU) No 648/2012 of the European Parliament and of the Council<sup>31</sup>
  - (e) The European Central Bank
  - (f) A national central bank
  - (g) A third country central bank, provided that the prudential supervisory and regulatory requirements applied in that country have been recognized as equivalent to those applied in the EU in accordance with Article 114(7) of Regulation (EU) No 575/2013<sup>32</sup>
- g. Eligible units or shares of MMFs
  - 1. An MMF may acquire the units or shares of any other MMF ("target MMF") provided that all of the following conditions are fulfilled:
    - a) No more than 10% of the assets of the target MMF are able, according to its fund rules or instruments of incorporation, to be invested in aggregate in units or shares of other MMFs
    - b) The target MMF does not hold units or shares in the acquiring MMF

An MMF whose units or shares have been acquired must not invest in the acquiring MMF during the period in which the acquiring MMF holds units or shares in it.
  - 2. An MMF may acquire the units or shares of other MMFs, provided that no more than 5% of its assets are invested in units or shares of a single MMF
  - 3. An MMF may, in aggregate, invest no more than 17.5% of its assets in units or shares of other MMFs
  - 4. Units or shares of other MMFs are eligible for investment by an MMF provided that all of the following conditions are fulfilled:
    - a) The target MMF is authorized under the MMF regulation
    - b) Where the target MMF is managed, whether directly or under a delegation, by the same manager as that of the acquiring MMF or by any other company to which the manager of the acquiring MMF is linked by common management or control, or by a substantial direct or indirect holding, the manager of the target MMF, or that other company, is prohibited from charging subscription or redemption fees on account of the investment by the acquiring MMF in the units or shares of the target MMF
    - c) Where an MMF invests 10% or more of its assets in units or shares of other MMFs:
      - i. The prospectus of that MMF must disclose the maximum level of the management fees that may be charged to the MMF itself and to the other MMFs in which it invests, and
      - ii. The annual report must indicate the maximum proportion of management fees charged to the MMF itself and to the other MMFs in which it invests
  - 5. Sections 4.8.B.g.2. and 3. above do not apply to an authorized MMF that is an AIF, if all of the following conditions are met:
    - a) The MMF is marketed solely through an employee savings scheme governed by national law and which has only natural persons as investors
    - b) The employee savings scheme referred to in point a) only allows investors to redeem their investment subject to restrictive redemption terms which are laid down in national law, whereby redemptions may only take place in certain circumstances that are not linked to market developments

<sup>28</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, as amended, on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

<sup>29</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014, as amended, on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

<sup>30</sup> Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009, as amended, on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

<sup>31</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, as amended.

<sup>32</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013, as amended, on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

By way of derogation from Sections 4.8.B.g.2. and 3. above, an authorized MMF that is a UCITS may acquire units or shares in other MMFs in accordance with Article 55 or 58 of Directive 2009/65/EC, as amended, under the following conditions:

- a) The MMF is marketed solely through an employee savings scheme governed by national law and which has only natural persons as investors
  - b) The employee savings scheme referred to in point a) only allows investors to redeem their investment subject to restrictive redemption terms which are laid down in national law, whereby redemptions may only take place in certain circumstances that are not linked to market developments
6. Short-term MMFs may only invest in units or shares of other short-term MMFs.
  7. Standard MMFs may invest in units or shares of short-term MMFs and standard MMFs.

### C. Provisions on investment policies

#### a. Diversification

1. An MMF must invest no more than:
  - a) 5% of its assets in MMIs, securitizations and ABCPs issued by the same body
  - b) 10% of its assets in deposits made with the same credit institution, unless the structure of the banking sector in the Member State in which the MMF is domiciled is such that there are insufficient viable credit institutions to meet that diversification requirement and it is not economically feasible for the MMF to make deposits in another Member State, in which case up to 15% of its assets may be deposited with the same credit institution

#### CSSF's clarification:

A Luxembourg MMF is not authorized to invest more than 10% of its net assets in deposits with the same credit institution as foreseen in the preceding paragraph as the CSSF considers that the conditions laid down in article 17(1)(b) of the MMF Regulation, as amended, are not met for Luxembourg domiciled MMFs because:

- There are sufficient viable credit institutions in Luxembourg
- It is economically feasible for the MMF to make deposits in another Member State

As ancillary liquid assets mentioned in Section 4.8.A.c. are limited to deposits at sight with banks, the 10% limit applicable to deposits also applies to ancillary liquid assets.

2. By way of derogation from Sections 4.8.C.a.1.a), a variable net asset value (VNAV) MMF may invest up to 10% of its assets in MMIs, securitizations and ABCPs issued by the same body provided that the total value of such MMIs, securitizations and ABCPs held by the VNAV MMF in each issuing body in which it invests more than 5% of its assets does not exceed 40% of the value of its assets
3. The aggregate of all of an MMF's exposures to securitizations and ABCPs must not exceed 20% of the assets of the MMF, whereby up to 15% of the assets of the MMF may be invested in securitizations and ABCPs that do not comply with the criteria for the identification of STS securitizations and ABCPs
4. The aggregate risk exposure to the same counterparty of an MMF stemming from OTC derivative transactions must not exceed 5% of the assets of the MMF
5. The aggregate amount of cash provided to the same counterparty of an MMF in reverse repurchase agreements must not exceed 15% of the assets of the MMF
6. Notwithstanding the individual limits laid down in point 1 and 4, an MMF must not combine, where to do so would result in an investment of more than 15% of its assets in a single body, any of the following:
  - a) Investments in MMIs, securitizations and ABCPs issued by that body
  - b) Deposits made with that body
  - c) OTC FDIs giving counterparty risk exposure to that body

By way of derogation from the diversification requirement provided for in the first subparagraph, where the structure of the financial market in the Member State in which the MMF is domiciled is such that there are insufficient viable financial institutions to meet that diversification requirement and it is not economically feasible for the MMF to use financial institutions in another Member State, the MMF may combine the types of investments referred to in points a) to c) up to a maximum investment of 20% of its assets in a single body.
7. By way of derogation from point a) of paragraph 1., the competent authority of an MMF may authorize an MMF to invest, in accordance with the principle of risk-spreading, up to 100% of its assets in different MMIs issued or guaranteed separately or jointly by the EU, the national, regional and local administrations of the Member States or their central banks, the European Central Bank, the European Investment Bank, the European Investment Fund, the European Stability Mechanism, the European Financial Stability Facility, a central authority or central bank of a third country, the International Monetary Fund, the International Bank for Reconstruction and Development, the Council of Europe Development Bank, the European Bank for Reconstruction and Development, the Bank for International Settlements, or any other relevant international financial institution or organization to which one or more Member States belong

The first subparagraph only applies where all of the following requirements are met:

- a) The MMF holds MMIs from at least six different issues by the issuer
  - b) The MMF limits the investment in MMIs from the same issue to a maximum of 30% of its assets
  - c) The MMF makes express reference, in its fund rules or instruments of incorporation, to all administrations, institutions or organizations referred to in the first subparagraph that issue or guarantee separately or jointly MMIs in which it intends to invest more than 5% of its assets
  - d) The MMF includes a prominent statement in its prospectus and marketing communications drawing attention to the use of the derogation and indicating all administrations, institutions or organizations referred to in the first subparagraph that issue or guarantee separately or jointly MMIs in which it intends to invest more than 5% of its assets
8. Notwithstanding the individual limits laid down in paragraph 1., an MMF may invest no more than 10% of its assets in bonds issued by a single credit institution that has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. In particular, sums deriving from the issue of those bonds must be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest
- Where an MMF invests more than 5% of its assets in the bonds referred to in the first subparagraph issued by a single issuer, the total value of those investments must not exceed 40% of the value of the assets of the MMF.
9. Notwithstanding the individual limits laid down in paragraph 1., an MMF may invest no more than 20% of its assets in bonds issued by a single credit institution where the requirements set out in point (f) of Article 10(1) or point (c) of Article 11(1) of Delegated Regulation (EU) 2015/61<sup>33</sup> are met, including any possible investment in assets referred to in paragraph 8. above
- Where an MMF invests more than 5% of its assets in the bonds referred to in the first subparagraph issued by a single issuer, the total value of those investments must not exceed 60% of the value of the assets of the MMF, including any possible investment in assets referred to in paragraph 8., respecting the limits set out therein.
10. Companies which are included in the same group for the purposes of consolidated accounts under Directive 2013/34/EU of the European Parliament and of the Council, as amended, or in accordance with recognized international accounting rules, must be regarded as a single body for the purpose of calculating the limits referred to in paragraphs 1. to 6. above

#### b. Concentration

1. An MMF must not hold more than 10% of the MMIs, securitizations and ABCPs issued by a single body.

CSSF's clarification:

The above-mentioned limitation applies at single issuer level and not on a consolidation basis.

2. This limit will not apply in respect of holdings of MMIs issued or guaranteed by the EU, national, regional and local administrations of the Member States or their central banks, the European Central Bank, the European Investment Bank, the European Investment Fund, the European Stability Mechanism, the European Financial Stability Facility, a central authority or central bank of a third country, the International Monetary Fund, the International Bank for Reconstruction and Development, the Council of Europe Development Bank, the European Bank for Reconstruction and Development, the Bank for International Settlements, or any other relevant international financial institution or organization to which one or more Member States belong

#### c. Portfolio rules

##### A. Short-term MMFs

1. A short-term MMF must comply on an ongoing basis with all of the following portfolio requirements:
  - a) Its portfolio is to have a WAM of no more than 60 days
  - b) Its portfolio is to have a WAL of no more than 120 days, subject to the second and third subparagraphs
  - c) For low volatility net asset value (LVNAV) MMFs and public debt constant net asset value (CNAV) MMFs, at least 10% of their assets are to comprise daily maturing assets, reverse repurchase agreements which are able to be terminated by giving prior notice of one working day or cash which is able to be withdrawn by giving prior notice of one working day. A LVNAV MMF or public debt CNAV MMF is not to acquire any asset other than a daily maturing asset when such acquisition would result in that MMF investing less than 10% of its portfolio in daily maturing assets
  - d) For a short-term VNAV MMF, at least 7.5% of its assets are to comprise daily maturing assets, reverse repurchase agreements which are able to be terminated by giving prior notice of one working day, or cash which is able to be withdrawn by giving prior notice of one working day. A short-term VNAV MMF is not to acquire any asset other than a daily maturing asset when such acquisition would result in that MMF investing less than 7.5% of its portfolio in daily maturing assets

<sup>33</sup> Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions, as amended.

**CSSF's clarification:**

Deposits with a one week or one month term can be considered as daily maturing assets when they can be withdrawn by giving prior notice of one working day. Reverse repos with a fixed term that can be terminated by giving prior notice of one working day can also be considered as daily maturing assets.

- e) For LVNAV MMFs and public debt CNAV MMFs, at least 30% of their assets are to comprise weekly maturing assets, reverse repurchase agreements which are able to be terminated by giving prior notice of five working days or cash which is able to be withdrawn by giving prior notice of five working days. A LVNAV MMF or public debt CNAV MMF is not to acquire any asset other than a weekly maturing asset when such acquisition would result in that MMF investing less than 30% of its portfolio in weekly maturing assets
- f) For a short-term VNAV MMF, at least 15% of its assets are to comprise weekly maturing assets, reverse repurchase agreements which are able to be terminated by giving prior notice of five working days, or cash which is able to be withdrawn by giving prior notice of five working days. A short-term VNAV MMF is not to acquire any asset other than a weekly maturing asset when such acquisition would result in that MMF investing less than 15% of its portfolio in weekly maturing assets
- g) For the purpose of the calculation referred to in point e), assets referred to in Section 4.8.C.a.7. which are highly liquid and can be redeemed and settled within one working day and have a residual maturity of up to 190 days may also be included within the weekly maturing assets of a LVNAV MMF and public debt CNAV MMF, up to a limit of 17.5% of its assets
- h) For the purpose of the calculation referred to in point f), MMIs or units or shares of other MMFs may be included within the weekly maturing assets of a short-term VNAV MMF up to a limit of 7.5% of its assets provided they are able to be redeemed and settled within five working days

For the purposes of point b) of the first subparagraph, when calculating the WAL for securities, including SFIs, a short-term MMF must base the maturity calculation on the residual maturity until the legal redemption of the instruments. However, in the event that a financial instrument embeds a put option, a short-term MMF may base the maturity calculation on the exercise date of the put option instead of the residual maturity, but only if all of the following conditions are fulfilled at all times:

- i. The put option is able to be freely exercised by the short-term MMF at its exercise date
- ii. The strike price of the put option remains close to the expected value of the instrument at the exercise date
- iii. The investment strategy of the short-term MMF implies that there is a high probability that the option will be exercised at the exercise date

By way of derogation from the second subparagraph, when calculating the WAL for securitizations and ABCPs, a short-term MMF may instead, in the case of amortizing instruments, base the maturity calculation on one of the following:

- i. The contractual amortization profile of such instruments
- ii. The amortization profile of the underlying assets from which the cash flows for the redemption of such instruments result

2. If the limits referred to in this section are exceeded for reasons beyond the control of an MMF, or as a result of the exercise of subscription or redemption rights, that MMF must correct the situation, taking due account of the interests of its unit holders or shareholders
3. All MMFs may take the form of a short-term MMF

**B. Standard MMFs**

1. A standard MMF must comply on an ongoing basis with all of the following requirements:
  - a) Its portfolio is to have at all times a WAM of no more than six months
  - b) Its portfolio is to have at all times a WAL of no more than 12 months, subject to the second and third subparagraphs
  - c) At least 7.5% of its assets are to comprise daily maturing assets, reverse repurchase agreements which can be terminated by giving prior notice of one working day or cash which can be withdrawn by giving prior notice of one working day. A standard MMF is not to acquire any asset other than a daily maturing asset when such acquisition would result in that MMF investing less than 7.5% of its portfolio in daily maturing assets
  - d) At least 15% of its assets are to comprise weekly maturing assets, reverse repurchase agreements which can be terminated by giving prior notice of five working days or cash which can be withdrawn by giving prior notice of five working days. A standard MMF is not to acquire any asset other than a weekly maturing asset when such acquisition would result in that MMF investing less than 15% of its portfolio in weekly maturing assets
  - e) For the purpose of the calculation referred to in point d), MMIs or units or shares of other MMFs may be included within the weekly maturing assets up to 7.5% of its assets provided they are able to be redeemed and settled within five working days

For the purposes of point b) of the first subparagraph, when calculating the WAL for securities, including SFIs, a standard MMF should base the maturity calculation on the residual maturity until the legal redemption of the instruments. However, in the event that a financial instrument embeds a put option, a standard MMF may base the maturity calculation on the exercise date of the put option instead of the residual maturity, but only if all of the following conditions are fulfilled at all times:

- i. The put option is able to be freely exercised by the standard MMF at its exercise date
- ii. The strike price of the put option remains close to the expected value of the instrument at the exercise date
- iii. The investment strategy of the standard MMF implies that there is a high probability that the option will be exercised at the exercise date

By way of derogation from the second subparagraph, when calculating the WAL for securitizations and ABCPs, a standard MMF may instead, in the case of amortizing instruments, base the maturity calculation on one of the following:

- (i) The contractual amortization profile of such instruments
  - (ii) The amortization profile of the underlying assets from which the cash flows for the redemption of such instruments result
2. If the limits referred to in this Section are exceeded for reasons beyond the control of a standard MMF or as a result of the exercise of subscription or redemption rights, that MMF must correct the situation, taking due account of the interests of its unitholders or shareholders
  3. A standard MMF may not take the form of a public debt CNAV MMF or a LVNAV MMF

## 4.9. European long-term investment funds (ELTIFs)

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The ELTIF regime and its upcoming reform are introduced in Section 2.4.5.; the applicable investment restrictions and diversification rules are outlined in this section.

### A. Eligible investments

Eligible investments of an ELTIF include:

- ▶ Eligible investment assets, being:
  - ▶ Equity or quasi-equity instruments
  - ▶ Debt instruments issued by a qualified portfolio undertaking<sup>34</sup>
  - ▶ Loans granted by the ELTIF to a qualifying portfolio undertaking<sup>35</sup> with a maturity no longer than the life of the ELTIF
  - ▶ Units or shares of one or several other ELTIFs, EuVECAs, and EuSEFs provided that those ELTIFs, EuVECAs, and EuSEFs have not themselves invested more than 10% of their capital in ELTIFs
  - ▶ Direct holdings or indirect holdings via qualified portfolio undertakings<sup>36</sup> of individual real assets with a value of at least EUR10,000,000 or its equivalent in the currency which, and at the time when, the expenditure is incurred
- ▶ Assets eligible for UCITS (see Section 4.2.2.3.)

An ELTIF is not permitted to:

- ▶ Short sell assets
- ▶ Take direct or indirect exposure to commodities
- ▶ Enter into securities lending, securities borrowing, repurchase transactions, or any other agreement that has an equivalent economic effect and poses similar risks, if thereby more than 10% of the assets of the ELTIF are affected
- ▶ Use FDIs, except for hedging purposes of the ELTIF's other investments

<sup>34</sup> A qualified portfolio undertaking is defined by Regulation (EU) 2015/760 as a portfolio undertaking other than a collective investment undertaking that fulfils the following requirements: (i) it is not a financial undertaking, (ii) it is an undertaking which is not admitted to trading on a regulated market or on a multilateral trading facility; or is admitted to trading on a regulated market or on a multilateral trading facility and at the same time has a market capitalization of no more than EUR 500 million and (iii) it is established in a Member State, or in a third country provided that the third country is not a high-risk and non-cooperative jurisdiction identified by the FATF and that the third country has signed an agreement with the home Member State of the manager of the ELTIF and with every other Member State in which the units or shares of the ELTIF are intended to be marketed to ensure that the third country fully complies with Article 26 of the OECD Model Tax Convention on Income and Capital and ensures effective exchange of information in tax matters, including any multilateral tax agreements.

<sup>35</sup> Idem.

<sup>36</sup> Idem.

Following ESMA's final report on draft technical standards under the ELTIF regulation of June 2016, Commission Delegated Regulation (EU) 2018/480 of 4 December 2017, entered into force on 12 April 2018, and supplemented Regulation (EU) 2015/760 with regard to regulatory technical standards on financial derivative instruments solely serving hedging purposes, sufficient length of the life of the European long-term investment funds, assessment criteria for the market for potential buyers and valuation of assets to be divested, and the types and characteristics of the facilities available to retail investors.

With respect to FDIs solely serving hedging purposes, the Regulation specifies that they qualify as hedging derivatives if they meet all of the following criteria:

- ▶ A financial derivative instrument should only be used for hedging risks arising from exposures to eligible asset investments. The purpose of hedging the risks arising from exposures to the assets should only be considered to be fulfilled where the use of that FDI results in a verifiable and objectively measurable reduction of those risks at the ELTIF level. Where FDIs to hedge the risks arising from the exposure to the assets are not available, FDIs with an underlying of the same asset class may be used
- ▶ The use of the FDIs aimed to provide a return for the ELTIF will not be deemed to serve the purpose of hedging the risks
- ▶ The manager of the ELTIF should take all reasonable steps to ensure that the FDIs used to hedge the risks inherent to other investments of the ELTIF reduce the risks at the ELTIF level in accordance with paragraph 1, including in stressed market conditions

#### B. Composition and diversification requirements

An ELTIF must comply with the following diversification requirements:

- ▶ An ELTIF must invest at least 70% of its capital in eligible investment assets
- ▶ An ELTIF should invest no more than:
  - ▶ 10% of its capital in instruments issued by, or loans granted to, any single qualifying portfolio undertaking
  - ▶ 10% of its capital directly or indirectly in a single real asset

An ELTIF may raise both of the above 10% limits to 20% provided that the aggregate value of the assets held by the ELTIF in qualifying portfolio undertakings and in individual real assets in which it invests more than 10% of its capital does not exceed 40% of the value of the capital of the ELTIF.

- ▶ 10% of its capital in units or shares of any single ELTIF, EuVECA, or EuSEF
- ▶ 5% of its capital in assets eligible to UCITS (see Section 4.2.2.3.)

An ELTIF may raise the 5% limit to 25% where bonds are issued by a credit institution that has its registered office in a Member State and is subject by law to special public supervision designed to protect bondholders.

- ▶ The aggregate value of units or shares of ELTIFs, EuVECAs, and EuSEFs in an ELTIF portfolio should not exceed 20% of the value of the capital of the ELTIF
- ▶ The aggregate risk exposure to a counterparty of the ELTIF from OTC derivative transactions, repurchase agreements, or reverse repurchase agreements should not exceed 5% of the value of the capital of the ELTIF
- ▶ Companies that are included in the same group for the purpose of consolidated accounts should be considered as a single qualifying portfolio undertaking or a single body for the purpose of calculating the diversification limits

#### C. Concentration requirements

An ELTIF cannot acquire more than 25% of the units or shares of a single ELTIF, EuVECA, or EuSEF.

An ELTIF should comply with the concentration limits set out in the last bullet point of Section 4.2.2.4. with respect to its holdings in assets eligible for UCITS.

#### D. Borrowing requirements

An ELTIF may borrow cash provided that such borrowing fulfils the following conditions:

- ▶ It represents no more than 30% of the value of the capital of the ELTIF
- ▶ It serves the purpose of investing in eligible investment assets, except for eligible loans (please refer to Section 4.9.A.), provided that the holdings in cash or cash equivalents of the ELTIF are not sufficient to make the investment concerned
- ▶ It is contracted in the same currency as the assets to be acquired with the borrowed cash
- ▶ It has a maturity no longer than the life of the ELTIF
- ▶ It encumbers assets that represent no more than 30% of the value of the capital of the ELTIF

# 05

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## GOVERNANCE AND LIABILITY

EY supports asset managers, traditional and alternative investment fund houses in defining and implementing governance models for investment funds and their managers, performing due diligence on delegates and service providers, and also offers technical training to members of governing bodies.



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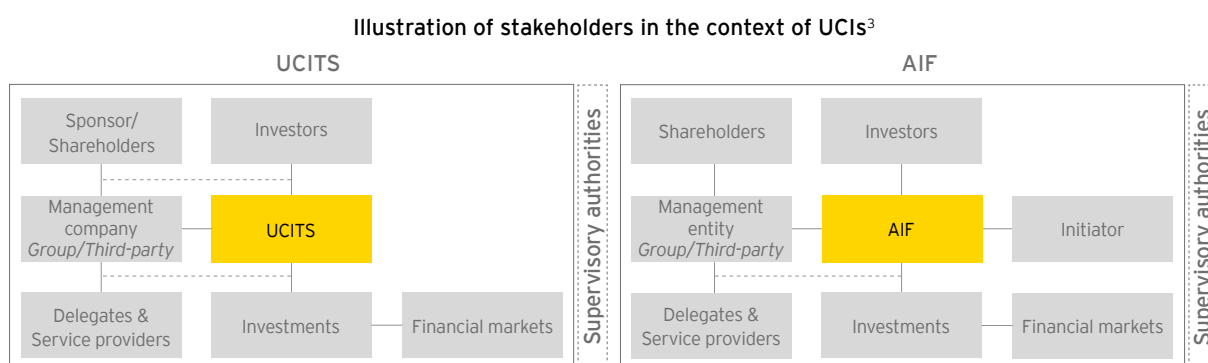
## 5.1. Governance

### 5.1.1. Introduction

“Governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”<sup>1</sup> Governance from a strategic perspective is covered in Section 5.1.2.

“Governance involves a set of relationships between a company’s management, its Board, its shareholders and other stakeholders.”<sup>2</sup>

In the context of UCIs, there are many types of direct and indirect relationships with stakeholders. They may be illustrated as follows:



The relationships between UCIs, their management entities (management companies and/or AIFMs), and other stakeholders are recurring themes throughout this chapter.

Governance in relation to investors, investments, and financial markets is covered in Section 5.1.3.

The impact of the structure and organization of a UCI on its governance is covered in Section 5.1.4.

Governance models in Luxembourg are covered in Section 5.1.5.

In the context of UCIs, a number of regulatory requirements cover:

- The role and responsibilities of governing bodies and senior management
- The qualifications of governing bodies and senior management
- Internal organization
- Delegation

Governance roles in the context of UCIs are covered in Section 5.1.6.

UCIs and management entities are required to comply with rules of conduct. Furthermore, UCIs and their management entities may voluntarily apply corporate governance principles including general corporate governance principles, such as the OECD’s *Principles of Corporate Governance*, as well as principles specific to UCIs, such as ALFI’s *Code of Conduct for Luxembourg Investment Funds*. Governance principles and rules of conduct are covered in Section 5.1.7.

The oversight of UCIs is covered in Section 5.1.8.

### 5.1.2. Governance from a strategic perspective

The role of the governing body of a management entity or a UCI can also be seen from a strategic perspective. It may be argued that the governing body is:

- Responsible for establishing and maintaining the vision, mission, and values
- Responsible for determining the strategy
- Responsible for overseeing the implementation of the strategy
- Accountable to unit/shareholders and responsible towards stakeholders

<sup>1</sup> Preamble to Principles of Corporate Governance, Organisation for Economic Co-operation and Development (OECD), 2004, as amended.

<sup>2</sup> Idem.

<sup>3</sup> In these illustrations, the UCI is managed by a management company or an AIFM. For a UCI that has not appointed a management company or AIFM, the illustration would be slightly different - see also Section 1.4.



#### A. Establish and maintain vision, mission and values

A key role of the governing body is to establish and maintain the vision, mission, and values:

- ▶ Vision indicates a view of the future
- ▶ Mission statement outlines what needs to be done to achieve the envisaged state
- ▶ Values are a set of principles and standards that drive decision making

#### B. Determine the strategy

The vision, mission, and values should be implemented by a strategy, which is approved by the governing body. This may include:

- ▶ Choice of organizational model for the UCI, its management, and service providers. Some of the organizational model choices are outlined in Section 1.4.
- ▶ Drawing up a program of activities: management entities and UCIs that have not appointed a management entity are required, in the application for authorization, to provide the CSSF with a program of activities, setting out, *inter alia*, the organizational structure of the entity, as described in Section 6.3.1.
- ▶ Determining the strategy to meet the investment policy of the UCI

#### C. Oversee the implementation of the strategy

Overseeing the implementation of the strategy includes, *inter alia*:

- ▶ Implementing the investment policy of the UCI, in compliance with investor disclosures and fund documentation, and the law
- ▶ Maintaining an appropriate governance structure and internal organization (see Section 5.1.6.)
- ▶ Complying with applicable values statements, governance principles, and rules of conduct (see Section 5.1.7.)
- ▶ Appointing and overseeing external delegates and other service providers (see Section 5.1.6.1.C.)
- ▶ Complying with contractual obligations

#### D. Accountable to unit/shareholders and responsible towards stakeholders

UCIs are required to demonstrate accountability to investors, making available:

- ▶ Initial disclosures: prospectus, key investor information document (KIID), or issuing document
- ▶ Annual/semi-annual reports
- ▶ Specific disclosures, *inter alia*, on:
  - ▶ Conflicts of interest
  - ▶ Policy and practice on exercise of voting rights and shareholder engagement
  - ▶ Any preferential treatment of certain investors
  - ▶ Remuneration policy and amounts of remuneration
  - ▶ Fees and inducements
  - ▶ Prime brokerage arrangements
  - ▶ Sustainability/environmental, social or governance (ESG) related disclosures (see Chapter 14)

The governing body, or governing bodies, is ultimately responsible for these disclosures, and will in some cases approve them. In many cases, these disclosures will be made public. They are covered in more detail in Chapter 10.

With respect to UCIs in corporate form, such as investment companies, the governing body will be responsible for convening shareholder meetings, including the annual general meeting (see Section 10.6.).

UCIs (except RAI Fs) and their management entities are subject to the ongoing supervision of the CSSF. They are required, *inter alia*, to:

- ▶ Provide the CSSF with updates to any information submitted in their application for authorization, as outlined in Section 3.4. for UCIs and Section 6.2.1. for management entities
- ▶ Submit to the CSSF information on their activities on a regular basis, as outlined in Section 3.5. for UCIs and Section 6.5.2. for management entities
- ▶ Promptly provide information requested by the CSSF

### 5.1.3. Governance in the wider context of UCIs

This section focuses on roles and responsibilities of the UCI and management entity in relation to stakeholders not covered in the previous sections.

Delegated acts amending the UCITS Delegated Directive<sup>4</sup> and AIFMD Delegated Regulation<sup>5</sup> require UCIs and IFMs to integrate sustainability risks in the management of UCIs as of 1 August 2022. The potential material negative impact that ESG events or conditions could cause, if they occur, on the value of the UCI should be positively embedded in the IFM's/UCI's governance, organization, conflicts of interest policies, investment due diligence as well as in their risk policies and procedures. For more information, see Sections 14.3. and 14.4.

#### A. Investors

The UCI or its management entity has a direct responsibility to investors, for example, in terms of implementing the investment policy with a view to generating returns, being transparent on costs and risks involved, acting in the best interests of the UCI and its investors and accountability.

However, it may also have an indirect responsibility to many more investors. Institutional investors, such as pension funds, funds of funds and nominee accounts may, in turn, represent thousands of individuals.

#### B. Investments

As an investor, the UCI directly or indirectly plays a role in society. The role of the UCI as an investor will depend on the type of investments. For example:

- ▶ An equity UCI, as a shareholder of a listed company, should exercise its voting rights in accordance with the Law and in line with its policy on the exercise of voting rights, and may exercise influence on the company in concert with other shareholders
- ▶ A fixed income UCI may play an important role in financing public bodies and companies
- ▶ Private equity UCIs will generally control non-listed companies, either acting individually or jointly. In relation to the investee company, the private equity UCI may play roles ranging from incubator to a pure investor role. The UCI can exert significant influence over the governing body and the management of a company
- ▶ A real estate UCI may invest in assets of significant importance for a community, such as residential properties, offices or shopping centers
- ▶ An infrastructure UCI may play an important role in developing and managing infrastructure in areas such as the environment, energy, healthcare, urban infrastructure, public and local utility facilities, telecommunications and transport

UCIs and their management entities are required to define and implement a policy on the exercise of voting rights in the portfolio of assets of the UCI.

The Luxembourg Law of 24 May 2011 on *the exercise of certain rights of shareholders in general meetings of listed companies*, as amended, requires IFMs/UCIs as shareholders in companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State to develop an engagement policy outlining how shareholder engagement is embedded in the fund investment strategy.

- ▶ Such policy must describe how IFMs monitor investee companies' strategies, financial and non-financial performance, risks, capital structures, ESG impacts and how they engage with these companies, exercise voting rights, communicate with stakeholders, cooperate with other shareholders and manage potential conflicts of interests related to their engagement
- ▶ IFMs should, on an annual basis, publicly disclose how their engagement policy has been implemented, including a general description of their voting behavior, an explanation of the most significant votes and the use of the services of proxy advisors. They must publicly disclose how they have cast votes in the general meeting of investee companies, at least when the subject matter of the vote or the size of their holding is significant

The above-mentioned disclosures must be made available free of charge on the asset manager's website.

Arrangements between IFMs and institutional investors should be publicly disclosed by institutional investors and should outline how the IFM is incentivized:

- ▶ To align its strategy and decisions with the profile and duration of the liabilities of the institutional investor
- ▶ To make investment decisions based on assessments about medium- and long-term financial and non-financial performance of the investee company
- ▶ To engage with these investee companies in order to improve their performance in the medium to long-term

Arrangements should indicate their duration, describe how remuneration and performance evaluation of the IFM are aligned with longer-term objectives of the institutional investors and how portfolio turnover costs are monitored.

Specific annual reports should be provided, publicly, or directly to those institutional investors, outlining how the investment strategy implementation complied with the arrangement, emphasizing longer-term risks, portfolio composition, portfolio turnover and turnover costs, policy on securities lending and how it has been applied to fulfill engagement activities.

<sup>4</sup> Commission Directive 2010/43 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organizational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company

<sup>5</sup> Commission Delegated Regulation 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision

On 11 May 2020, ALFI issued a Q&A on the Shareholder Rights Directive II (SRD II), including clarifications on SRD II obligations and timeline, engagement policy and implementation disclosures as well as transparency towards institutional investors.

IFMs are also required to consider principal adverse impacts (PAIs) of their investment decisions on sustainability factors or should disclose the clear reasons why they do not. If they intend to consider those PAIs in the future, they should be able to define when they intend to do so. See also Section 14.3.4.

### C. Financial Markets

UCIs and management entities are required to respect the integrity of the market. They are covered by securities laws, such as those on market abuse, and also reporting or clearing obligations in relation to derivatives. UCIs are also subject to specific investment rules (see Chapter 4).

UCIs and management entities are also required to provide regular information to the competent authorities, who use such information, *inter alia*, for the purposes of monitoring systemic risk (see Section 3.5. for UCIs and Section 6.5.2. for management entities).

## 5.1.4. The impact of the structure and organization of a UCI on its governance

The governance model of a UCI is driven by the basic structure of the UCI, and the organization of its management company and/or AIFM (except in the case of investment companies that have not appointed a management entity). The basic structures of UCIs are described in more detail in Section 2.3.1. The possible fund management models are illustrated in Section 6.1.4.

### A. Common funds

A common fund (FCP) has no legal personality and must be managed by an authorized management company.

A common fund is controlled by the management company and ultimately the governing body of the management company is in charge of the governance of the common fund, under the oversight of the depositary on certain matters, except in very specific circumstances.

Unitholders of a common fund generally have no control over the UCI. There is no requirement to hold unitholders' meetings.

### B. Investment companies

An investment company (SICAV or SICAF) has a legal personality. An investment company is controlled by its governing body (generally a Board of Directors). The shareholders of an investment company have ultimate control over the investment company. The governing body of the investment company is required to convene annual shareholders' meetings.

An investment company may either:

- ▶ Appoint an authorized management entity (a management company or AIFM)
- ▶ Manage itself (so called self-managed UCITS or internally managed AIF). In this case, the governing body of the UCI plays the role of the management entity

Where investment companies delegate management to a management entity, at least two governing bodies are involved:

- ▶ The governing body of the UCI
- ▶ The governing body of the management company or AIFM

Where multiple governing bodies are involved, a clear governance model is required to ensure that there are no overlaps or gaps. Cross-border management creates an additional level of complexity.

### C. Management companies managing AIFs

Under the AIFM Directive, management companies can manage AIFs in the following ways:

- ▶ Manage the AIFs itself, where the management company also has an AIFM authorization (see Section 6.2.1.), or where the AIFs under management fall below the *de minimis* thresholds (see Section 6.1.3.D.)
- ▶ Designate an authorized AIFM, in the case of a management company that is not authorized as an AIFM

The models are illustrated in Section 6.1.4.

Where the management company of a common fund in turn appoints an AIFM, two Boards are involved:

- The governing body of the management company
- The governing body of the AIFM

In this case, the governing body of the management company of a common fund plays a role comparable to that of the governing body of an investment company.

Where an investment company delegates management to a management entity, which in turn appoints an AIFM, three Boards are involved:

- The governing body of the UCI
- The governing body of the management company
- The governing body of the AIFM

#### D. Role of the management entity

The management company or AIFM is generally responsible for the key functions of:

- Portfolio management
- Risk management (see also Chapter 7)
- Administration (see also Chapter 8)
- Marketing/Distribution (see also Chapter 12)
- In the case of AIFMs, activities related to the assets of AIFs<sup>6</sup>

The entity is permitted to delegate some of its functions. Section 5.1.6.1.F. covers delegation from a governance perspective.

Responsibility for the appointment and oversight of other service providers, such as the depositary, the auditor<sup>7</sup>, and, where applicable, the management entity, also depends on the basic structure. In general, responsibility for the appointment and oversight of other service providers lies with:

- In the case of a common fund, the management company
- In the case of an investment company, the governing body of the UCI

The responsibilities of governing bodies on the appointment of delegates and service providers are illustrated in Section 6.3.1.B.

#### E. The organization of the UCI

Board Members must fully understand the UCI structures and their roles and duties with respect to the specificities of the structure.

It is good practice for Board Members to ensure that the UCI formalizes and maintains illustrations of its relationship with the management entity or asset management group/sponsor/initiator, covering, *inter alia*:

- The relationship between the UCI, the management entity and investors
- The internal organization of the management entity
- The relationship with group entities and third parties, covering, *inter alia*, responsibility for the due diligence, appointment, and ongoing monitoring of:
  - Delegates, such as portfolio managers, distributors and administrators (see also Section 5.1.6.1.F.)
  - Other service providers, such as depositaries, auditors and legal advisers
- The holding and investment structures of the UCI

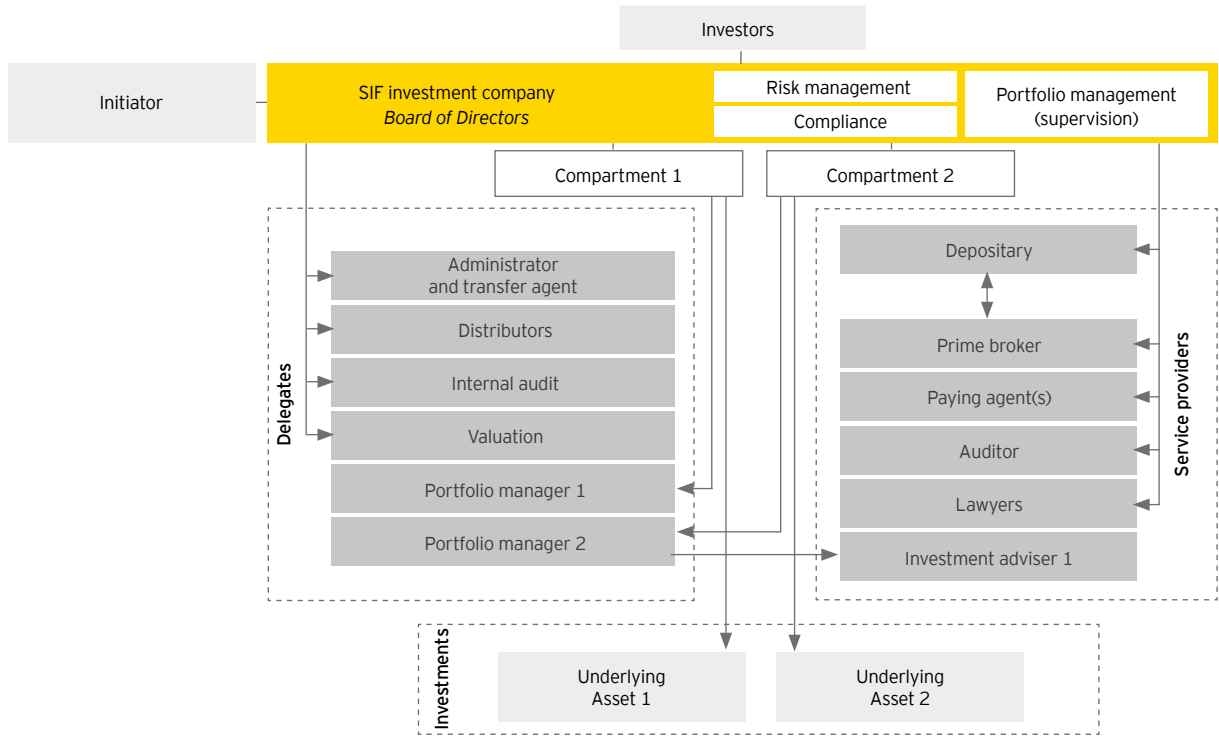
The following diagrams illustrate two typical Luxembourg UCI structures:

- Internally managed AIF - a Specialized Investment Fund (SIF)
- Super management company with multiple UCIs

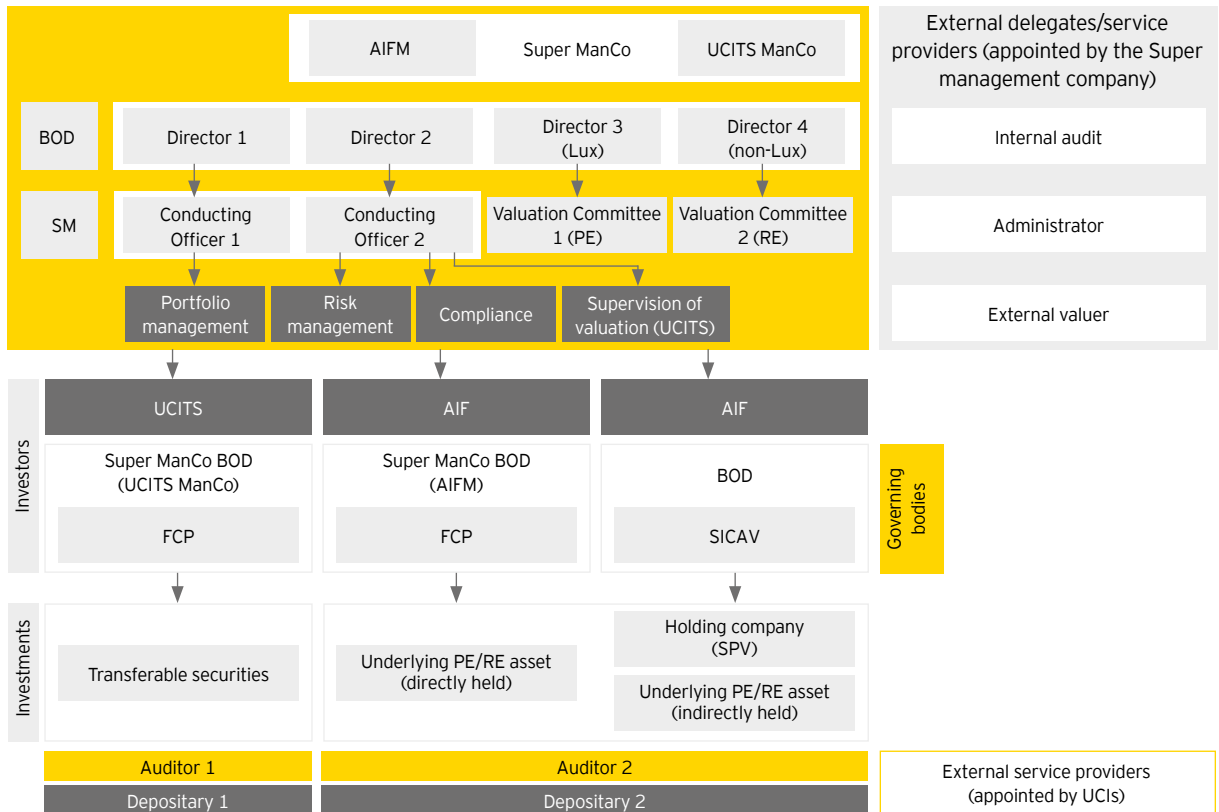
<sup>6</sup> See Section 6.2.1.

<sup>7</sup> For SICAVs, the annual general meeting of shareholders formally appoints the auditor.

### Internally managed AIF - a Specialized Investment Fund (SIF)



### Super ManCo with multiple UCIs



### 5.1.5. Governance models in Luxembourg

Luxembourg companies have the choice between two possible governance models:

- One tier
- Two tier

In a one tier governance model, the governing body (generally, the Board of Directors) plays the dual roles of ultimate decision-making body and the supervisory function.

In practice, day-to-day decisions are generally made by senior management in accordance with policies approved by the board.

In a two tier governance model, these roles are separated. The Management Board has the power to execute all activities necessary to achieve the company's objectives. The Supervisory Board, on the other hand, is in charge of the supervision of the company and cannot play a role in the day-to-day management of the company.

The following table illustrates how these two roles or governing bodies may typically be implemented in a one tier and two tier governance structure:

**Typical implementation of roles of governing in one tier and two tier governance models**

	One tier	Two tier
Ultimate decision making body	Board of Directors	Management Board
Supervisory function	Members of the Board of Directors responsible for the supervision of senior management	Supervisory Board

The one tier governance model is the most common in Luxembourg.

### 5.1.6. Governance roles in the context of UCIs

Governance is primarily the responsibility of the management company's governing body (in the case of common funds) or the UCI's governing body (in the case of investment companies), as described in Section 5.1.4.

The governance structure of a UCI or its management entity may be considered to be composed of:

- Board of Directors
- Senior management
- Internal organization

A key role of the governing body is overseeing internal and external delegates.

#### 5.1.6.1. Governing body

The governing body is generally a Board of Directors, but may also be the Board of Managers, depending, as the case may be, on the corporate form of the UCI and of the management company. Directors can be categorized as:

- Related to the promoter, initiator, or sponsor
- Related to the UCI's management company, related parties, or service providers
- Independent

CSSF Circular 18/698 on *Authorisation and organisation of investment fund managers incorporated under Luxembourg law - Specific provisions on the fight against money laundering and terrorist financing applicable to investment fund managers and entities carrying out the activity of registrar agent* was issued on 23 August 2018 and is applicable to Luxembourg IFMs which includes:

- Chapter 15 management companies
- AIFMs
- Self-managed UCITS
- Internally managed AIFs
- Luxembourg branches of IFMs set up under Chapter 17 of the 2010 Law

The remainder of Section 5.1. sets out principal provisions of the Circular relating to governance.

A. Governing body - Required skills, experience, reputation and composition of the management/governing body

The following table provides more precise definitions of governing bodies used in relation to Chapter 15 management companies and AIFMs:

**Definitions of governing bodies of Chapter 15 management companies and AIFMs**

	Chapter 15 management company	AIFM
Ultimate decision-making body	<p>“Board of Directors” means the Board of Directors of the management company</p> <p>The term “Board of Directors” does not comprise the Supervisory Board when management companies have a dual structure composed of a Board of Directors and a Supervisory Board</p>	<p>“Governing body” means the body with ultimate decision-making authority in an AIFM, comprising the supervisory and the managerial functions, or only the managerial function if the two functions are separate</p>
Supervisory function	<p>“Supervisory function” means the relevant persons or body or bodies responsible for the supervision of the senior management and for the assessment and periodical review of the adequacy and effectiveness of the risk management process and of the policies, arrangements, and procedures put in place to comply with the obligations under the 2010 Law</p>	<p>“Supervisory function” means the relevant persons or body or bodies responsible for the supervision of the AIFM’s senior management and for the assessment and periodical review of the adequacy and effectiveness of the risk management process and of the policies, arrangements, and procedures put in place to comply with the obligations under the AIFM Directive/AIFM Law</p>

CSSF Circular 18/698 requires an IFM governing body, in a one tier system, to have at least three members. In a two tier structure, the supervisory board must comprise at least three members and the management board at least two members.

Members of the management/governing body must:

- ▶ Possess sufficient skills and professional experience in relation to the relevant type(s) of UCI(s) as well as to the investment strategies of managed UCIs
- ▶ Have sufficient professional experience, having, for example, already performed similar activities to a high level of responsibility and autonomy
- ▶ Provide evidence of his/her professional reputation
- ▶ Taken as a whole, the management/governing body must be composed in a manner which allows the body to fully fulfill all of its responsibilities. This includes the professional skills as well as the personal qualities of the members, thus allowing the body to have a complete understanding of all the activities, risks incurred by the IFM and the UCIs managed, as well as the economic and regulatory environment in which the IFM develops. Each individual member must understand the internal governance system and their responsibilities within the IFM
- ▶ Each member must be able to carry out their mandate effectively, i.e., with the commitment, availability, objectivity, critical abilities and independence required. Consequently, the management/governing body cannot be composed of a majority of executive members (conducting officers or other employees of the IFM) unless adequately justified

Luxembourg UCIs increasingly appoint non-executive directors, *inter alia*, in order to enhance the level of independence, experience, and objectivity in the decision-making process.

- ▶ In cases such as a UCI set up in corporate form, i.e., a SICAV or SICAF, with a management entity, it is recommended that the managing/governing body of the management entity and that of the UCI are not predominantly composed of the same people
- ▶ If a member of the management/governing body is also part of senior management, i.e., a conducting officer, he/she may:
  - ▶ Combine the mandate of “member of management/governing body” with the role of Compliance Officer, the person responsible for monitoring compliance with the professional obligations with respect to AML/CFT or the person responsible for risk management
  - ▶ Combine the mandate of “member of the management/governing body” with the role of the person responsible for internal audit

Both the 2010 and SIF Laws require that Directors<sup>8</sup> be of sufficiently good repute and be sufficiently experienced in relation to the type of business carried out by the UCI.

The governing body is responsible for managing the business of the UCI in good faith, with reasonable care, in a competent, prudent, and active manner for the benefit of the UCI and its shareholders or unitholders.

<sup>8</sup> “Directors” means, in the case of public limited companies and in the case of cooperatives in the form of a public limited company, the members of the Board of Directors, in the case of partnerships, the managers or general partner, in the case of private limited liability companies, the manager(s) and in the case of common funds, the members of the Board of Directors or the managers of the management company.

The following table outlines the required minimum qualifications of governing bodies of management entities:

**Minimum qualifications of governing bodies of management entities**

	Chapter 15 management company	AIFM
<b>Knowledge, skills, and experience</b>	<p>Every member of the Board of Directors, or representative if a legal person has been appointed as Director, must be adequately skilled and experienced in relation to the type of UCIs concerned. Adequate professional experience must have been gained through having already performed similar activities to a high level of responsibility and autonomy.</p> <p>The members of the management body/governing body must ensure that their personal qualities enable them to properly perform their mandate as member of the management body/governing body, with the required commitment, availability, objectivity, critical thinking and independence.</p> <p>The members of the management body/governing body, as a collective body, must have a perfect understanding of all the activities, risks incurred by the Chapter 15 management company and the UCITS managed, as well as the economic and regulatory environment in which the management company operates.</p>	<p>The governing body of the AIFM must possess adequate collective knowledge, skills, and experience to be able to understand the AIFM's activities, in particular the main risks involved in those activities and the assets in which the AIF is invested.</p> <p>The members of the management body/governing body must ensure that their personal qualities enable them to properly perform their mandate as member of the management body/governing body, with the required commitment, availability, objectivity, critical thinking and independence.</p>
<b>Sufficient time</b>	<p>Every member of the Board of Directors must dedicate sufficient time and attention to his duties. He is required to limit the number of other professional engagements, in particular the mandates held in other companies, to the extent necessary in order to be able to perform his tasks correctly.</p> <p>As a result, every candidate for the position of member of the IFM's management body/governing body must ensure compliance with the following requirements:</p> <ul style="list-style-type: none"> <li>a) The number of hours spent fulfilling professional engagements cannot exceed 1,920 hours per year; and</li> <li>b) The number of mandates in regulated entities and in operating companies cannot exceed 20 mandates</li> </ul> <p>Thresholds are reduced when justified by nature, scale or complexity of the activities, or by reduction in the applicant's working time.</p> <p>Governing bodies meet at least once per quarter and must document the work in writing (agenda of meetings and minutes of meetings).</p>	<p>The members of the governing body must commit sufficient time to properly perform their functions in the AIFM, and must therefore limit the number of other professional engagements and mandates accordingly.</p> <p>As a result, every candidate for the position of member of the IFM's management body/governing body must ensure compliance with the following requirements:</p> <ul style="list-style-type: none"> <li>a) The number of hours spent fulfilling professional engagements cannot exceed 1,920 hours per year; and</li> <li>b) The number of mandates in regulated entities and in operating companies cannot exceed 20 mandates</li> </ul> <p>Thresholds are reduced when justified by nature, scale or complexity of the activities, or by reduction in the applicant's working time.</p> <p>Governing bodies meet at least once per quarter and must document the work in writing (agenda of meetings and minutes of meetings).</p>



	Chapter 15 management company	AIFM
Reputation <sup>9</sup> , integrity, independence	<p>Every member of the Board of Directors, or representative if a legal person has been appointed as Director, must be of sufficiently good repute.</p> <p>The composition of the Board of Directors of a Chapter 15 management company must not compromise its independence, for example:</p> <ul style="list-style-type: none"> <li>▶ When a depositary is a shareholder of the management company and also appointed as depositary of the UCITS managed by the management company, the Board of Directors of the management company must not be predominantly composed of representatives of the depositary</li> <li>▶ When a management company is appointed by an investment company, the Board of Directors of the two entities should not be predominantly composed of the same people</li> </ul>	<p>Each member of the governing body must act with honesty, integrity, and independence of mind.</p> <p>The composition of the governing body of an AIFM must not compromise its independence, for example:</p> <ul style="list-style-type: none"> <li>▶ An AIFM must ensure that no member of its governing body or any other management body is also a member of the management body or an employee of the depositary of UCIs it manages</li> <li>▶ Where a group link exists between the IFM and the depositary with which assets of AIFs managed by the AIFM are deposited, the AIFM must ensure the independence of the management bodies of the two entities and, where appropriate, of their supervisory function</li> </ul>
Training	The compliance function must raise awareness of the staff about the significance of compliance and related aspects and assist them in the daily activities relating to compliance. To this end, it must also develop an ongoing training program and ensure its implementation.	

### B. Number of hours and mandates

CSSF Circular 18/698 requires each member of the management/governing body to ensure that their mandate<sup>10</sup> is compatible with their other professional engagements in terms of required time and conflicts of interest.

The Circular limits the number of hours spent fulfilling professional engagements and number of mandates each member of the management/governing body of the IFM can have:

- ▶ 1,920 hours per year dedicated to professional engagements, and
- ▶ No more than 20 mandates in regulated entities and operational companies

Certain exceptions to the above limits may be accepted by the CSSF on a case-by-case basis, in situations such as:

- ▶ Multiple entities forming part of the same structure
- ▶ Mandates having the same promoter/sponsor

In such situations, applicants should attach to their application for authorization a description of the measures to be taken to ensure that the mandates will receive the time and attention required.

There must be at least three members of the management body/governing body. However, in case of a two tier system in which the supervisory and management functions are separated, the supervisory board must be composed of at least three members and the management board must be composed of at least two members.

For staff seconded/made available by an intra-group entity or a third party, the contract must be submitted to the CSSF.

### C. Tasks of the governing body

The tasks of the governing body include, *inter alia*:

- ▶ Ensuring that the UCI is managed in accordance with its strategy and objectives (investment strategy, realization of objectives in compliance with the applicable laws, regulations, CSSF Circulars, and prospectus)
- ▶ Convening annual and extraordinary general meetings
- ▶ Preparing management reports and financial statements

The Board may create dedicated committees (e.g., audit, investment, valuation, remuneration) for the fulfilment of its duties; this does not diminish in any way the Board's collective responsibility.

<sup>9</sup> The concept of good repute of members of the Board of Directors or of senior management does not seem to be clarified in the regulations in relation to management entities. However, the AIFM Directive Level 2 provides some clarifications with respect to the "good repute" of persons who effectively conduct the business of a delegate.

They shall not be deemed of sufficiently good repute if they have any negative records relevant both for the assessment of good repute and for the proper performance of the delegated tasks or if there is other relevant information that affects their good reputation. Such negative records shall include but shall not be limited to criminal offences, judicial proceedings, or administrative sanctions relevant for the performance of the delegated tasks. Special attention shall be given to any offences related to financial activities, including but not limited to obligations relating to the prevention of money laundering, dishonesty, fraud or financial crime, bankruptcy, or insolvency. Other relevant information shall include information indicating that the person is not trustworthy or honest. Furthermore, when the delegate is regulated in respect of its professional services within the EU, the persons who conduct the business may be deemed to be of "good repute" when the relevant supervisory authority has reviewed the criterion of "good repute" within the authorization procedure, unless there is evidence to the contrary.

<sup>10</sup> "Mandate" within CSSF Circular 18/698 is any role as a member of a management/governing body, or of a supervisory function or of conducting officer, in regulated or unregulated entities.

UCIs and their management entities can be configured in many different ways to deal with the specificities of different asset classes, geographies, frequently or infrequently traded assets, and the trend towards investor influence in the oversight of a UCI.

In these different configurations, there can be a range of governance and oversight bodies alongside the Boards, which, together, form the fabric of the governance structure.

The key oversight bodies of UCIs and their management entities may include a combination of the following:

- Board of UCI
- Board of management company
- Board of AIFM
- Board committees:
  - Investment committee (dedicated or not to a specific asset class)
  - Corporate governance committee
  - Appointment committee
  - Valuation committee
  - Audit committee
  - Remuneration committee
  - Shareholder/Unitholder/Investor Advisory Committee (with or without decision powers)
- Senior management
- Internal control functions:
  - Risk management
  - Compliance
  - Internal audit
- Boards of delegate portfolio manager, risk manager, other delegates, advisors, and service providers
- Boards of holding and investment structures

The roles of governing bodies of Chapter 15 management companies and AIFMs, as laid down in the regulations, include the following:

#### Roles and responsibilities of governing bodies of Chapter 15 management companies and AIFMs

	Chapter 15 management company	AIFM
Oversight of management entity's activities	The Management Board (the body composed of senior management) must regularly provide the Board of Directors of the management company with written complete information on the activities of the management company and the UCITS that it manages.	
Compliance	<p>Senior management and, when it exists, the supervisory function are responsible for the management company's compliance with its obligations under the 2010 Law.</p> <p>Senior management and, when appropriate, its governing body or supervisory function must:</p> <ul style="list-style-type: none"> <li>▸ Assess and periodically review the effectiveness of the policies, arrangements, and procedures put in place to comply with the obligations laid down in the 2010 Law</li> <li>▸ Take appropriate measures to address any deficiencies</li> </ul>	<p>The governing body, the senior management, and, when it exists, the supervisory function are responsible for the AIFM's compliance with its obligations under the AIFM Directive.</p> <p>Senior management and, when appropriate, its governing body or supervisory function must:</p> <ul style="list-style-type: none"> <li>▸ Assess and periodically review the effectiveness of the policies, arrangements, and procedures put in place to comply with the obligations laid down in the AIFM Directive</li> <li>▸ Take appropriate measures to address any deficiencies</li> </ul>
Internal controls (see also Section 6.3.2.)	The supervisory function, if any, must receive written reports on matters of compliance, internal audit, AML/CFT, and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.	The governing body or the supervisory function, if any, must receive on a regular basis written reports on matters of compliance, internal audit, AML/CFT, and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.

	Chapter 15 management company	AIFM
Risk management (see also Chapter 7)	<p>The management company's Board of Directors receives advice from the permanent risk management function as regards the identification of the risk profile of each managed UCITS.</p> <p>The management company's Board of Directors and, when it exists, its supervisory function, receives regular reports from the permanent risk management function on:</p> <ul style="list-style-type: none"> <li>▸ The consistency between the current levels of risk incurred by each managed UCITS and the risk profile agreed for that UCITS</li> <li>▸ The compliance of each managed UCITS with relevant risk limit systems</li> <li>▸ The adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies</li> </ul> <p>The risk management policy must state the terms, contents, and frequency of reporting of the risk management function to the Board of Directors and to senior management and, when appropriate, to the supervisory function.</p>	<p>The risk management function must be represented in the governing body or the supervisory function, when it has been established, at least with the same authority as the portfolio management function.</p> <p>The AIFM's governing body and, when it exists, its supervisory function:</p> <ul style="list-style-type: none"> <li>▸ Must be notified in a timely manner by the permanent risk management function when it considers the AIF's risk profile inconsistent with the risk limits or sees a material risk that the risk profile will become inconsistent with these limits</li> <li>▸ Receive regular updates from the permanent risk management function on: <ul style="list-style-type: none"> <li>▸ The consistency between and compliance with the risk limits and the risk profile of the AIF as disclosed to investors</li> <li>▸ The adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have been or will be taken in the event of any actual or anticipated deficiencies</li> </ul> </li> <li>▸ Review the functional and hierarchical separation of the risk management function (see Section 7.3.5.)</li> </ul>
Specific appointments	The Board of Directors has the obligation to designate Senior Management, including in particular an AML/CFT Compliance Officer and a Cloud Officer. It is also responsible for validating appointments of a functional manager as per applicable regulations.	
Conflicts of interest (see also Section 6.4.1.)	The governing body should approve the conflicts of interest policy and monitor its implementation.	The governing body of the AIFM and, when it exists, the supervisory function must establish the safeguards against conflicts of interest, regularly review their effectiveness, and take timely remedial action to address any deficiencies.
Remuneration (see also Section 6.4.3.)	<p>The Board of Directors is responsible for:</p> <ul style="list-style-type: none"> <li>▸ Determining the remuneration of the members of the Board of Directors and management bodies<sup>11</sup> of the management company</li> <li>▸ Approving/reviewing/updating the remuneration policy of the management company and supervising its implementation</li> </ul>	The management body of the AIFM, in its supervisory function, must adopt and periodically review the general principles of the remuneration policy and is responsible for its implementation
Internal Audit	<p>The management body/governing body and senior management of the IFM are assisted by internal audit; the latter enables them to optimize the control over their activities and the risks related thereto and thus to protect the IFM's organization and reputation.</p> <p>The internal audit function must be able to operate independently and must comply with the principle of segregation of duties in order to identify any risk of non-compliance of the IFM.</p>	
AML/CFT	The management/governing body of the IFM must validate the summary report on compliance with AML/CFT professional obligations, as prepared by the AML/CFT compliance officer at least once a year.	
Telework (see also Section 6.3.1)	The management/governing body of the IFM must organize telework, taking into account substance requirements, compliance with applicable legal and regulatory requirements and telework risk assessment. This must be documented in a telework policy and reflected in the IFM's internal organization and internal control framework.	

<sup>11</sup> | CSSF Circular 10/437.

On 29 November 2021, the CSSF published its *FAQ Virtual Assets* which provides guidance on virtual assets and similar financial innovations. The FAQ specifies, *inter alia*, minimum internal governance arrangements to ensure a sound and prudent management of all activities of IFMs (and other entities) in this area. The management body is responsible for developing a business strategy with respect to activities involving virtual assets including a related risk strategy, covering notably the definition of the risk appetite and the overall framework for risk-taking and risk management.

#### D. Independence requirements

The UCITS V Delegated Regulation sets out the following independence requirements with respect to the governing bodies of the self-managed investment company or management company and the depositary:

- (i) No person may, at the same time, be both a member of the management body of the management company, or self-managed investment company, and a member of the management body of the depositary
- (ii) No person may, at the same time, be both a member of the management body of the management company, or self-managed investment company, and an employee of the depositary
- (iii) No person may, at the same time, be both a member of the management body of the depositary and an employee of the management company or the self-managed investment company
- (iv) Where the management body of the management company, or self-managed investment company, is not in charge of the supervisory functions within the company, no more than one third of the members of its body in charge of the supervisory functions should consist of members who are, at the same time, members of the management body, the body in charge of the supervisory functions or employees of the depositary
- (v) Where the management body of the depositary is not in charge of the supervisory functions within the depositary, no more than one third of the members of its body in charge of the supervisory functions should consist of members who are at the same time members of the management body of the management company, or the body in charge of the supervisory functions of the management company or of the self-managed investment company or employees of the management company or of the investment company

In its *Frequently Asked Questions covering the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment*, the CSSF clarified that:

- ▶ When the depositary of a UCITS is a Luxembourg branch of an entity having its registered office in another EU Member State, the independence requirements should be assessed at the level of the Chapter 15 management company (or self-managed SICAV) established in Luxembourg with regard to the management body of the head office of the depositary and the employees of the depositary (both at the level of its head office and of the Luxembourg branch)
- ▶ When the management company of a UCITS is established as a Luxembourg branch of a management company having its registered office in another EU Member State, independence requirements are assessed at the level of the depositary established in Luxembourg with regard to the management body of the head office of the management company and the employees of the management company (both at the level of its head office and of the Luxembourg branch)

Where there is a group link between the management company or the self-managed investment company and the depositary, independent member of the bodies may be appointed as follows:

- (i) Where the management body of the management company and the management body of the depositary are also in charge of the supervisory functions within the respective companies, at least one third of the members, or two persons, whichever is lower, of each management body, must be independent
- (ii) Where the management body of the management company and the management body of the depositary are not in charge of the supervisory functions within the respective companies, at least one third of the members, or two persons, of the body in charge of the supervisory functions within the management company and within the depositary must be independent

In the above context, members are deemed to be independent if they are neither members of the management body or the body in charge of the supervisory functions nor employees of any of the other undertakings between which a group link exists and are free of any business, family or other relationship with the management company or the investment company, the depositary and any other undertaking within the group that gives rise to a conflict of interest such as to impair their judgment.

In most cases the supervisory functions are performed by members of the management body of the management company or the self-managed investment company.

In its *Frequently Asked Questions covering the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment*, the CSSF clarified that where there is a group link between the management company or the self-managed SICAV and the depositary, all 7 bullets above apply ((i) - (v) and (i)-(ii)).

The CSSF's *Frequently Asked Questions covering the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment* also clarified that:

- ▶ The minimum number of independent members of the Chapter 15 management body depends on the total number of members within the relevant body:
  - ▶ There must be a minimum of one independent member in bodies of four members or less
  - ▶ There must be a minimum of two independent members in bodies of five/six members
- ▶ Individuals previously involved with, or linked to, the Chapter 15 management company, the self-managed SICAV, or the depositary must respect a cooling-off period of twelve months

IFMs only authorized as AIFM should also comply with the above requirements to the extent applicable.

#### *E. Meetings of the governing body*

CSSF Circular 18/698 states that management/governing bodies must meet at least once per quarter to fulfill their responsibilities effectively, subject to nature, scale and complexity of the activities of the IFM.

Written documentation should be kept of these meetings, including agenda, minutes, ensuring documentation of decisions and measures taken by the management/governing body.

#### *F. Delegation*

In practice, the governing body generally delegates, wholly or partially, the performance of certain:

- ▶ Activities to service providers - refer to the list below
- ▶ Management activities to conducting officers (also known as senior management) - refer to Section 5.1.6.2. on the next page

In order to carry out its activities in a more efficient manner, each IFM may be authorized to delegate one or more of its functions to third parties. The Circular sets out the organization arrangements to be put in place in case of delegation of management functions.

In principle, an IFM may delegate the following activities:

- ▶ Portfolio management (only if risk management is not delegated)
- ▶ Risk management (only if portfolio management is not delegated)
- ▶ Valuation function
- ▶ Complaints handling
- ▶ Discretionary portfolio management
- ▶ Certain AML/CFT tasks

An IFM may also be authorized to delegate the following:

- ▶ Compliance function
- ▶ Internal audit function
- ▶ Operation of IT systems
- ▶ Accounting function
- ▶ Marketing function

The following tasks cannot be delegated:

- ▶ Determination of the general investment policy for each UCI that has not been established in the form of a company
- ▶ Determination of the risk profile of each managed UCI
- ▶ Interpretation of the risk management analyses
- ▶ Setting up and managing of the conflict of interest policy
- ▶ Setting up and monitoring of a best execution policy
- ▶ Determination of a probably realizable value of an investment in absence of a representative price
- ▶ The decision as to the choice of relevant delegate
- ▶ Monitoring and control of the delegated functions
- ▶ AIFMs must ensure the correct valuation of an AIF's assets as well as the calculation and publication of the AIF's net asset value
- ▶ The CSSF recommends that Chapter 15 management companies also ensure the correct valuation of a UCITS' assets as well as the calculation and publication of the UCITS' net asset value

CSSF Circular 18/698 sets out requirements which apply in case of delegation. When an IFM outsources Information and Communications Technologies (ICT) tasks or processes, CSSF Circular 18/698's baseline requirements are supplemented by governance framework requirements of Circular 22/806. Such requirements are set out in Section 6.3.3.

Delegation must always be reasonable, justified, in the interest of the UCI and its shareholders or unitholders, and under the supervision of the governing body. The governing body retains overall responsibility, including responsibility for performing due diligence on the delegate, making the decision to delegate, and monitoring the delegate.

It is possible for an IFM to delegate activities to third parties but not to the extent that the delegation results in the IFM becoming a "letter box entity". In practice, governing bodies in UCI structures have to meet regulatory and tax substance requirements (Board, senior management, control, professionals) at all levels (manager, fund, holding, and investment structures).

### 5.1.6.2. Senior management

Senior management (i.e., the conducting officers) and the supervisory function (if any) effectively conduct the business of the IFM.

The persons who effectively conduct the business of a Chapter 15 management company or an AIFM are referred to as "senior management" or, in Luxembourg, "conducting officers".

The conducting officers of a Chapter 15 management company collectively form a "Board of Management".

For staff seconded/made available by an intra-group entity or a third party, the contract must be submitted to the CSSF.

"Senior management" is defined slightly differently for Chapter 15 management companies and AIFMs:

#### Definitions of "senior management" of Chapter 15 management companies and AIFMs

Chapter 15 management company	AIFM
"Senior management" means the persons who effectively conduct the business of a management company.	"Senior management" means the person or persons who effectively conduct the business of an AIFM and, as the case may be, the executive member or members of the governing body.

While there are no explicit requirements on the senior management of a Chapter 16 management company, the management company must provide in its application for authorization to the CSSF information on the members of senior management (see Section 6.2.1.).

#### A. Number, location of conducting officers, and their relationship with the IFM

CSSF Circular 18/698 requires that a minimum of two conducting officers be appointed to carry out the day-to-day business of the IFMs, and they must permanently reside in Luxembourg, or be able to come to Luxembourg every day.

Two conducting officers must be employed in Luxembourg and must be allocated full-time to their tasks within the IFM. The CSSF may accept that one or more conducting officer(s) be available or seconded providing that contracts exist defining their rights and obligations, and reporting lines.

With respect to the number of mandates a conducting officer can perform, the Circular introduces a threshold of portfolios under management of the IFM of EUR 1.5 billion.

If the IFM manages less than EUR 1.5 billion, the conducting officers must not perform more than two mandates as conducting officers of IFMs. In such situations, the CSSF may accept that one conducting officer permanently resides in Luxembourg providing that the IFM employs sufficient competent staff to support the conducting officer who does not permanently reside in Luxembourg, and that the conducting officer is able to regularly visit Luxembourg.

If portfolios managed by the IFM exceed EUR 1.5 billion, the two appointed conducting officers must not perform any other conducting officer mandates and must permanently reside in Luxembourg. If the IFM appoints more than two conducting officers, one or more of the conducting officers may not permanently reside in Luxembourg and may not work full-time on the relevant conducting officer task, providing that the IFM employs enough people to support the relevant conducting officer and he/she is able to regularly visit Luxembourg.

People who perform more than one conducting officer mandate must be able to demonstrate to the CSSF that he/she has adequate time to dedicate to each mandate.

The CSSF must be able to contact the conducting officers directly and they must be able to provide the CSSF with all required information for its supervision.

B. Required skills, experience, and reputation of the conducting officers

CSSF Circular 18/698 requires conducting officers to possess the following:

- ▶ Sufficient skills and professional experience in relation to the relevant type(s) of UCI(s) as well as to the investment strategies of managed UCIs
- ▶ Adequate professional experience, having, for example, already performed similar activities to a high level of responsibility and autonomy
- ▶ Evidence of his/her professional reputation
- ▶ Both individually and jointly, they must have the necessary professional skills, reputation and personal qualities to fulfill their tasks, with a view to ensuring sound and prudent management of the IFM

**Qualifications of senior management of management entities**

	Chapter 15 management company	AIFM	Chapter 16 management company
Appropriate composition	The composition of the members of the management body/governing body as a whole must be appropriate so that the management body/governing body can fully meet its responsibilities. The appropriateness refers in particular to professional skills (knowledge, understanding and experience), as well as personal qualities of the members of the management body/governing body.		
Knowledge, skills, and experience	The persons who effectively conduct the business of a management company must be adequately experienced also in relation to the type of UCITS managed by the management company.  Members of senior management must have already acquired an adequate level of professional experience through the performance of similar activities at a senior level in terms of responsibility and independence.	The persons who effectively conduct the business of the AIFM must be adequately experienced also in relation to the investment strategies pursued by the AIF managed by the AIFM.	The persons who effectively conduct the business must have already acquired an adequate level of professional experience through the performance of similar activities at a senior level in terms of responsibility and independence.
Reputation, integrity, and independence of mind	The persons who effectively conduct the business of a management company must be of sufficiently good repute.  The principle of independence of the management company from the depositary of the UCITS under management implies that the conducting officers cannot be employees of the depositary.	The persons who effectively conduct the business of the AIFM must be of sufficiently good repute.	The persons who effectively conduct the business must prove their good repute.  The principle of independence of the management company from the depositary of the UCIs under management implies that the conducting officers cannot be employees of the depositary.

Following the publication of Delegated Acts amending the UCITS Directive<sup>12</sup> and AIFMD<sup>13</sup> in the EU Official Journal on 2 August 2021, IFMs will have to retain the necessary resources and expertise for the effective integration of sustainability risks as from 1 August 2022. See also Section 14.3.

<sup>12</sup> Commission Delegated Directive (EU) 2021/1270.

<sup>13</sup> Commission Delegated Regulation (EU) 2021/1255.

### C. Tasks of the conducting officers

The roles and responsibilities of senior management of Chapter 15 management companies and AIFMs, as laid down in the regulations and the Circular 18/698, include the following:

#### Roles and responsibilities of senior management of Chapter 15 management companies and AIFMs

	Chapter 15 management company	AIFM
Providing governing body with overview of management entity's activities	The executive committee regularly informs the management body/governing body, in an exhaustive manner and in writing, on the activities of the IFM and the UCIs it manages.	
Compliance	<p>The governing body, the senior management and, when it exists, the supervisory function are responsible for the UCI's compliance with its obligations under the Law and CSSF Circular 18/698.</p> <p>Senior management and, when appropriate, its governing body or supervisory function must:</p> <ul style="list-style-type: none"> <li>▸ Assess and periodically review the effectiveness of the policies, arrangements, and procedures put in place to comply with relevant regulatory framework</li> <li>▸ Create, maintain and implement a compliance charter</li> <li>▸ Take appropriate measures to address any deficiencies</li> </ul>	
Central administration (see also Section 6.3.2.3.)	<p>Senior management is responsible for the implementation of strategies and guiding principles for central administration and internal governance through specific written internal policies and procedures.</p> <p>The concept of "central administration" covers the management functions and the operational and control functions, which should enable the management company to control all of its activities.</p>	
Internal controls (see also Section 6.3.2.1.)	<p>Senior management is responsible for the implementation of adequate internal control mechanisms (permanent compliance, permanent risk management, permanent internal audit functions, and permanent IT and accounting support functions).</p> <p>Senior management is responsible for ensuring that the management company has a permanent and effective compliance function, even if this function is performed by a third party.</p> <p>Senior management must receive on a frequent basis, and at least annually, written reports on matters of compliance, internal audit, and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.</p> <p>Senior management is responsible for drafting and maintaining operating procedures and an internal audit charter.</p>	
Risk management (see also Chapter 7)	<p>Senior management must:</p> <ul style="list-style-type: none"> <li>▸ Approve and review on a periodic basis the risk management policy (RMP) and risk management procedure including arrangements, processes and techniques for implementing that policy, including the risk limit system for each managed UCI, and filing these for review</li> <li>▸ Ensure and verify on a periodic basis that the risk limits of each managed UCI are properly and effectively implemented and complied with, even if the risk management function is performed by third parties</li> <li>▸ Receive from the permanent risk management function regular reports outlining the current level of risk incurred by each managed UCI and any actual or foreseeable breaches to their limits, to ensure that prompt and appropriate action can be taken</li> </ul>	
Portfolio management	<p>Senior management:</p> <ul style="list-style-type: none"> <li>▸ Is responsible for the implementation of the general investment policy, as defined, when relevant, in the prospectus or the offering document and, if applicable, the UCITS KIID and/or PRIIPs KID as well as the constitutional document, for each managed UCI and a portfolio management procedure</li> <li>▸ Must oversee the approval of investment strategies for each managed UCI</li> <li>▸ Must ensure and verify on a periodic basis that the general investment policy and the investment strategies are properly and effectively implemented and complied with</li> <li>▸ Must approve and review on a periodic basis the adequacy of the internal procedures for undertaking investment decisions for each managed UCI to ensure that such decisions are consistent with the approved investment strategies</li> <li>▸ Must ensure the investment advisor is limited to an advisory role</li> <li>▸ Must define and implement a procedure describing the arrangements for the critical and independent analysis of the transactions proposed by the investment advisor. Mere verification by the IFM of the compliance of the transaction with the investment restrictions is not sufficient</li> <li>▸ Must perform prior analysis and validation of "white lists" and investment models by the IFM</li> </ul> <p>Adequate disclosure of the role of the IFM and the investment advisor is required in the prospectus.</p>	



	Chapter 15 management company	AIFM
Valuation (see also Section 7.6.)	<p>Senior management should ensure that valuation policies and procedures are established and implemented.</p> <p>Given that the Chapter 15 management company must also put in place appropriate procedures to ensure the accurate and precise valuation of assets and liabilities of UCITS pursuant to Article 9(3) of CSSF Regulation 10-4, the CSSF recommends that the Chapter 15 management company complies with the provisions as set for AIFMs.</p>	<p>Senior management is responsible for ensuring that the valuation policies and procedures are established and implemented and for approving any changes thereto.</p> <p>Senior management must also approve any model used to value the assets of the AIF.</p> <p>Policy/procedure should include:</p> <ul style="list-style-type: none"> <li>▸ Descriptions of the type of model and characteristics thereof (mere reference to standard model is not sufficient)</li> <li>▸ Name of person who has developed the model and name of person responsible for validating it</li> <li>▸ Process applied to modify existing models or to change a model (incl. name of person responsible for approving)</li> <li>▸ Arrangements for modifying a price which has been determined via models (incl. process for validation)</li> </ul> <p>Prior to the launch of a new investment strategy, the valuation policies and procedures must be re-examined by the AIFM then submitted to the CSSF with a view to obtaining authorization for the extension of the authorization to the new strategy in question.</p> <p>For complex and illiquid strategies, the separation of the risk and valuation function is recommended.</p> <p>The Valuation Committee (“VC”) is recommended to include senior management and staff of the AIFM located in Luxembourg or in proximity on a permanent basis as well as director responsible for valuation.</p> <p>Members composing the VC need to be independent of the process of investment management, including the selection of the investments.</p> <p>Work of the VC needs to be documented in writing, recording notably the analysis of risks linked to investment as well as decisions and measures taken.</p>
Conflicts of interest (see also Section 6.4.1.)	<p>Senior management must receive on a frequent basis, and at least annually, written reports on matters of compliance, internal audit, and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.</p>	<p>Senior management must receive on a frequent basis, and at least annually, written reports on monitoring of conflicts of interest.</p> <p>When the organizational or administrative arrangements made by the AIFM for the management of conflicts of interest are not adequate to ensure, with reasonable confidence, that risks of damage to the interests of the AIF or investors in the AIF are prevented, the senior management or other competent internal body of the AIFM must be promptly informed in order to take any necessary decision or action to ensure that the AIFM acts in the best interests of the AIF or the investors in that AIF.</p>
Distribution (see also Chapter 12)	<p>Senior management is responsible for implementing and monitoring the marketing activity and the oversight of the distribution network of the UCIs under management.</p>	
Prime brokers (see Section 6.3.5.2.)		<p>Senior management must approve the list of selected prime brokers.</p>

	Chapter 15 management company	AIFM
Remuneration (see also Section 6.4.3.)	Senior management is responsible for establishing and applying a remuneration policy that meets legal requirements applicable to IFMs.	Authorized management <sup>14</sup> is responsible for implementing the remuneration policy. It must elaborate procedures to this effect and submit them to the Board of Directors for approval. It must also inform the relevant personnel of the policies and procedures.
Resources	Senior management must ensure that the IFM has the technical infrastructure and human resources necessary to exercise its activity.	

#### D. Meeting obligations

Conducting officers must be in regular contact with each other and hold at least monthly meetings. The frequency should be determined based on the size and organization of the IFM, as well as the nature, scale and complexity of its activities. At its meetings, the Board of Management must, *inter alia*, discuss “Management Information” which must be a permanent item on its agenda.

Written minutes of these meetings should be maintained, documenting decisions and measures taken by the IFM.

#### E. Approval as members of managing/governing bodies and conducting officers

The CSSF must approve members of managing/governing bodies and conducting officers prior to appointment.

The notification sent to the CSSF must be accompanied by the following:

- ▶ Recent *curriculum vitae*, signed and dated
- ▶ Copy of passport/identity card
- ▶ Declaration of honor (may be downloaded from the CSSF's website)
- ▶ Recent extract of criminal record
- ▶ Table listing professional activities and mandates in regulated entities, or not, specifying the time devoted to each activity and mandate (“Time & Capacity Assessment”)

The IFM must send to the CSSF annually, within 5 months of its financial year end, an updated table listing the professional activities as well as mandates performed.

#### F. Independence from the depositary

A conducting officer of an IFM cannot be employed by the depositary of the UCI that the IFM manages.

The managing/governing body of a Chapter 15 management company cannot also be a member of the managing body or an employee of the depositary that it manages. It must ensure that none of its employees are also members of the management body of the depositary of the UCITS that it manages. If there is a group link between the management company and the depositary with which the assets of the UCITS are deposited, the management company must ensure independence of the management bodies of the two entities.

The CSSF recommends that AIFMs also comply with the provisions in the previous paragraph relating to Chapter 15 management companies.

#### G. Internal organization

The conducting officers of every IFM must be members of the management committee. The members of this committee work together in close partnership to take all actions falling within the scope of their responsibilities.

In the context of the operation of the executive committee and irrespective of the legal form or structure of the IFM, each conducting officer is assigned specific areas of responsibility, notably with regard to the following functions/activities:

- ▶ Investment management
- ▶ Risk management
- ▶ Administration of UCIs
- ▶ Marketing
- ▶ Compliance
- ▶ Internal audit
- ▶ Claim and complaint handling
- ▶ AML/CFT
- ▶ Valuation
- ▶ IT function
- ▶ Accounting function

The composition of the executive committee must be adapted to the size of the IFM as well as the nature, scale and complexity of its activities. Consequently, the IFM must assess the need to appoint more than two conducting officers. The allocation of tasks amongst the conducting officers must be organized to avoid conflicts of interest. The functions of risk-taking and independent control of these same risks cannot be assigned to the same conducting officer. As an example, the performance and/or control of the risk management function and that of the investment management function cannot be carried out by the same conducting officer.

<sup>14</sup> | This term is used in CSSF Circular 10/437.

## Functional and hierarchical separation of portfolio management and risk management at senior management levels

Chapter 15 management company	AIFM
<p>The permanent risk management function must be hierarchically and functionally independent from the operating units.</p> <p>A conducting officer cannot be responsible for both investment management and risk management (see also Section 7.2.5.).</p>	<p>The functional and hierarchical separation of the risk management function from the operating units, including the portfolio management function, must be ensured throughout the whole hierarchical structure of the AIFM, up to its governing body (see also Section 7.3.5.).</p>

The conducting officer in charge of the internal audit function cannot exercise the function of the Compliance Officer, of the AML/CFT Compliance Officer or of the person in charge of risk management and cannot be assigned to one of the above-mentioned functions or activities<sup>15</sup>. However, the conducting officer in charge of compliance may also be responsible for the risk management function.

The conducting officers of an IFM may also, on the basis of a service level agreement, make use of the expertise and/or technical means of other units within the group to which the management company belongs or a third party that has the competencies, quality, and authorizations necessary to provide the required support in a professional manner.

An IFM must meet requirements regarding organization and procedures:

- ▶ Establish management information and internal reporting systems allowing it to monitor its own activities and those of its delegates
- ▶ Establish, implement and maintain an adequate business continuity policy of its activities and services allowing for disaster recovery and periodic testing of back-up facilities
- ▶ Establish arrangements which allow it to identify and assess the risks of new business relationships and new products, including with respect to money laundering and terrorist financing, in particular regulatory and operational risks related to the launch of a UCI, a compartment or a new type of assets, the entering into of a new business relationship or in case of entry of the IFM in new markets or geographies
- ▶ Establish a clear and precise procedures manual which describes its internal functioning, the allocation of tasks amongst its staff as well as hierarchical lines
- ▶ Establish a written complaints handling policy which is made available to all relevant staff members
- ▶ Establish written procedures regarding personal transactions
- ▶ Manage conflicts of interest
  - ▶ Chapter 15 management companies should try to avoid conflicts of interest and, when they cannot be avoided, ensure that the UCITS it manages are fairly treated
  - ▶ AIFMs must take all reasonable steps to identify conflicts of interest and, when they cannot be avoided, to identify, handle, monitor and disclose those conflicts of interest in order to prevent them from affecting the interests of AIFs and their investors and to ensure that the AIFs they manage are fairly treated
  - ▶ Establish, implement and maintain an effective written conflicts of interest policy
  - ▶ Maintain a record of conflicts of interest
  - ▶ Inform investors of situations where the organization or administrative arrangements made by the IFM for handling conflicts of interest have not been sufficient to guarantee, with reasonable confidence, that the risk of damage to the interests of the UCI or of its investors will be prevented
- ▶ Establish rules of conduct including procedures, arrangements and policies to ensure that:
  - ▶ It executes the investment decisions taken for account of the UCIs managed in accordance with objectives, investment strategy and risk limits
  - ▶ It takes all reasonable steps to execute directly itself the orders to obtain the best possible result
  - ▶ It executes rapidly and equitably the orders on behalf of managed UCIs
- ▶ Implement a remuneration policy
- ▶ Develop an adequate and effective strategy for determining when and how voting rights attached to instruments held in managed portfolios are to be exercised so that these rights benefit exclusively the UCI concerned and its investors
- ▶ Establish procedures and arrangements to ensure that UCIs under management comply with the EMIR obligations, where applicable
- ▶ Implement procedures and arrangements to ensure compliance with the MMF Regulation, where applicable
- ▶ Implement procedures and arrangements to ensure compliance with the Sustainable Finance Disclosure Regulation<sup>16</sup> (see also Section 14.3.)

The principle of proportionality may apply: IFMs should take into account the nature, scale, and complexity of their activities, and the range of services performed.

The general organizational requirements applicable to management entities are covered in more detail in Section 6.3.1.

<sup>15</sup> In practice, the CSSF considers internal audit as a joint responsibility of all conducting officers, i.e., the management committee.

<sup>16</sup> Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector, as amended.

UCITS management companies and external AIFMs insofar as they are providing the investment services of individual portfolio management or non-core services and only in connection with the provision of these services will also have to comply with the ESMA's *Guidelines for the assessment of knowledge and competence of investment firms' personnel*.

In particular, staff giving information about investment products, investment services, and ancillary services should:

- ▶ Understand the key characteristics, risk, and features of those investment products available through the firm, including any general tax implications and costs to be incurred by the client in the context of transactions
- ▶ Understand the total amount of costs and charges to be incurred by the client in the context of transactions in an investment product, or investment services or ancillary services
- ▶ Understand the characteristics and scope of investment services or ancillary services
- ▶ Understand how financial markets function and how they affect the value and pricing of investment products on which they provide information to clients
- ▶ Understand the impact of economic figures, national/regional/global events on markets and on the value of investment products on which they provide information
- ▶ Understand issues relating to market abuse and anti-money laundering
- ▶ Assess data relevant to the investment products on which they provide information to clients such as the key investor information documents, prospectuses, financial statements, or financial data
- ▶ Understand specific market structures for the investment products on which they provide information to clients and, where relevant, their trading venues or the existence of any secondary markets
- ▶ Have a basic knowledge of valuation principles for the type of investment products in relation to which the information is provided
- ▶ Understand the difference between past performance and future performance scenarios as well as the limits of predictive forecasting

In addition to the above, according to the ESMA Guidelines, staff giving investment advice shall comply, *inter alia*, with the following criteria:

- ▶ Fulfil the obligations required by firms in relation to the suitability requirements including the obligations set out in the ESMA's *Guidelines on certain aspects of the MiFID suitability requirements*
- ▶ Understand how the type of investment product provided by the firm may not be suitable for the client, having assessed the relevant information provided by the client against potential changes that may have occurred since the relevant information was gathered
- ▶ Understand the fundamentals of managing a portfolio, including being able to understand the implications of diversification regarding individual investment alternatives

### 5.1.7. UCI governance

Governance is increasing in importance at international, European and local levels both individually in governance specific texts as well as part of the European Commission's sustainable action plan.

As a result, there are a number of governance principles that may be applied in the context of UCIs.

General governance principles include the OECD's *Principles of Corporate Governance*, the Luxembourg Stock Exchange's *Ten Principles of Corporate Governance* and INREV's *The Principles of Corporate Governance*.

On 27 November 2019, the European Parliament and the Council adopted the *Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector*, which contains a number of governance-related provisions applicable since 10 March 2021. Boards should make sure sustainability factors are embedded in IFMs and fund governance processes covering product development, portfolio management, risk management and reporting. Remuneration policies should reflect how meeting sustainability risk mitigation objectives will impact senior management bonuses. For more details, see Section 14.3.

The European Fund and Asset Management Association (EFAMA) issued its updated *Stewardship Code* in 2018, covering *Principles for asset managers' monitoring of, voting in, engagement with investee companies*. The adoption of this code by industry participants is voluntary, however, it aims to be a reference document for asset managers seeking to comply with SRD II. EFAMA believes that through stewardship, asset managers can encourage business and management practices on environmental, governance, human rights and social challenges thereby encouraging long-term value creation and economic stability. The Code's principles are:

- ▶ Asset managers should have an engagement policy available to the public on whether, and if so how, they exercise their stewardship responsibilities. Where asset managers decide not to develop an engagement policy, they should give a clear and reasoned explanation as to why this is the case
- ▶ Asset managers should monitor their investee companies, in accordance with their engagement policy
- ▶ Asset managers should establish clear guidelines on when and how they will escalate engagement with investee companies to protect and enhance value of their clients' investments
- ▶ Asset managers should consider acting with other investors, where appropriate, having due regard to applicable rules on acting in concert
- ▶ Asset managers should exercise their voting rights in a considered way
- ▶ Asset managers should disclose the implementation and results of their stewardship and voting activities

UCIs may also apply principles specific to UCIs. A key reference governance code in the context of Luxembourg UCIs is the Association of the Luxembourg Fund Industry's (ALFI) *Code of Conduct for Luxembourg Investment Funds* updated in 2022. The objective of the *Code of Conduct* is to provide Boards of Directors with a framework of high-level principles and best practice recommendations for the governance of Luxembourg investment funds and of management companies, where appropriate.

ALFI recommends that the *Code of Conduct* be applied by all UCIs - listed and unlisted - and by management companies in order to have a uniform and consistent approach in the marketplace.

Under the *Code of Conduct*, the Boards of Luxembourg UCIs should:

- ▶ Ensure that clear and transparent standards of corporate governance are applied at all times
- ▶ Have good professional standing and appropriate experience and use best efforts ensure that it is collectively competent to fulfill its responsibilities
- ▶ Act fairly and independently in the best interests of the investors
- ▶ Act with due care and diligence in the performance of its duties
- ▶ Ensure compliance with all applicable laws, regulations and with the fund's constitutional documents
- ▶ Ensure that investors are properly informed, are fairly and equitably treated and receive the benefits and services to which they are entitled
- ▶ Ensure that an effective risk management process and appropriate internal controls are in place
- ▶ Identify and manage fairly and effectively, to the best of its ability, any actual, potential, or apparent conflict of interest and ensure appropriate disclosure
- ▶ Ensure that shareholder rights are exercised in a considered way and in the best interests of the fund
- ▶ Ensure that the remuneration of the Board members is reasonable and fair and adequately disclosed
- ▶ Integrate as appropriate sustainability standards and objectives including environmental, social and governance (ESG) criteria in their business model and operations

ALFI and the *Institut Luxembourgeois des Administrateurs* (ILA) have developed guidance materials on topics included in the *Code of Conduct*, covering matters such as board member independence, board evaluations, board member time capacity, board member letter of appointment, board reports and conflicts of interest.

The Accounting Directive<sup>17</sup>, as amended, requires that Public Interest Entities (PIEs) include a corporate governance statement in their management report. That statement must be included as a specific section of the management report and must contain, *inter alia*, the following information:

- ▶ A reference to the following, where applicable:
  - ▶ The corporate governance code to which the undertaking is subject
  - ▶ The corporate governance code that the undertaking may have voluntarily decided to apply
  - ▶ All relevant information about the corporate governance practices applied over and above the requirements of national law
- ▶ Where an undertaking, in accordance with national law, departs from a corporate governance code referred above, an explanation by the undertaking as to which parts of the corporate governance code it departs from and the reasons for doing so; where the undertaking has decided not to refer to any provisions of a corporate governance code referred above, it shall explain its reasons for not doing so

<sup>17</sup> Directive 2013/34/EU of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.

- ▶ A description of the main features of the undertaking's internal control and risk management systems in relation to the financial reporting process
- ▶ The composition and operation of the administrative, management, and supervisory bodies and their committees

On 21 April 2021, the European Commission (EC) adopted a sustainable finance package which includes a proposal for a Directive amending the Accounting Directive as regards corporate sustainability reporting (the "CSRD"), which expands the applicability of the Accounting Directive to "large companies", other than PIEs with more than 500 employees. The CSRD would not only affect European companies, but companies headquartered in non-EU Member States as well, provided that they are publicly listed in EU countries. In addition, with the proposal of this Directive, the EC pushes for the consolidation of sustainability reporting, allowing parent companies to report at group level for the subsidiaries that would fall under the scope of CSRD.

The collective responsibility of the administrative, management and supervisory bodies of in-scope undertakings for ensuring that the (consolidated) annual financial statements, the (consolidated) management report and the (consolidated) corporate governance statement are drawn up and published in accordance with the requirements of the Accounting Directive should be extended to the digitalization requirements laid down in Delegated Regulation (EU) 2019/815, as amended, to the requirement to comply with European Union sustainability reporting standards and to the requirement to markup sustainability reporting.

The proposed Directive also foresees that undertakings with securities listed on regulated markets should always report on their gender diversity policies and the implementation thereof.

On 21 June 2022, a political agreement was reached between the European Parliament and the Council. See Section 14.2.4.B.

The financial reports of UCIs are covered in Section 10.5. and listed UCIs are covered in Chapter 13.

### 5.1.8. The oversight of UCIs

The governing body plays a key role in the oversight of UCIs. Other entities playing important roles in the ongoing oversight of UCIs include:

- ▶ The management company and delegates thereof: the senior management and control functions play key roles, but also all heads of units and each member of staff play a role (see Chapter 6)
- ▶ The depositary in the context of its oversight duties (see Chapter 9)
- ▶ The auditor (see Section 10.5.10.)
- ▶ The supervisory authorities (see Section 3.5.)

## 5.2. Criminal and civil liability

This section provides a brief overview of criminal and civil liability of entities and individuals in the context of Luxembourg UCIs.

Directive 2014/91/EU of 23 July 2014 on *UCITS as regards depositary functions, remuneration policies and sanctions* (the "UCITS V Directive") was published in the Official Journal of the European Union on 28 August 2014. On 12 May 2016, the Luxembourg law of 10 May 2016 (the "UCITS V Law"), transposing the UCITS V Directive and amending the 2010 Law, was published in the Luxembourg Mémorial A (Mémorial A 88 of 12 May 2016). One of the areas of focus of the UCITS V Directive is the harmonization of administrative sanctions.

Article 148 paragraph 4 of the 2010 Law, as amended, stipulates that the CSSF may impose the following penalties and other administrative measures:

- A public statement that identifies the person responsible for the infringement and the nature of the infringement
- An order requiring the person responsible to cease the conduct and to desist from the repetition of that conduct
- In the case of a UCI or a management company, suspension or withdrawal of the authorization of the UCI or the management company
- A temporary or, for repeated serious infringement of the law, a permanent ban against a member of the management body, of the management company or of the UCI or against any other natural person employed by the management company or the UCI which is held responsible, from exercising management functions in those or in such entities
- In the case of a legal person, a maximum fine of EUR 5 million or a maximum amount of 10% of the total annual turnover of the legal person according to the last available accounts approved by the management body
- In case of a natural person a maximum fine of EUR 5 million
- As an alternative to points e) and f), a maximum administrative fine of at least twice the amount of the benefit derived from the infringement of the law where that benefit can be determined, even if that exceeds the maximum amounts in points e) and f)

Article 149 of the 2010 Law, as amended, further provides that the CSSF shall publish on its website any decision against which there is no appeal imposing an administrative sanction or measure for infringements of the provisions of the 2010 Law without undue delay after the person on whom the sanction or measure was imposed has been informed of that decision. The publication should include at least information on the type and nature of the infringement and the identity of the persons responsible. This obligation does not apply to decisions imposing measures that are of an investigatory nature.

The Law of 23 July 2016 on the audit profession (the “Audit Profession Law”) transposing European Directive 2014/56/EU and implementing European Regulation 537/2014 deals with sanctions regime that is notably applicable to individual PIE audit committee members, directors, management, and the PIEs themselves in the event of non-compliance with the Audit Profession Law and EU regulation.

According to Article 43 of the audit profession law, the CSSF has the power to impose the following administrative measures and sanctions for breaches of the provisions of the audit profession law and, where applicable, of the EU Regulation:

- a) A notice requiring the natural or legal person responsible for the breach to cease the conduct and to abstain from any repetition of that conduct
- b) A public statement which indicates the person responsible and the nature of the breach, published on the CSSF’s website
- c) A temporary prohibition, of up to three years’ duration, banning the approved statutory auditor (*réviseur d’entreprises agréé*), the approved audit firm (*cabinet de révision agréé*) or the key audit partner from carrying out statutory audits and/or signing audit reports
- d) A declaration that the audit report does not meet the requirements of Article 35 of this law or, where applicable, Article 10 of Regulation (EU) No 537/2014
- e) In case of a legal person, an administrative fine of a maximum of EUR 1 million or a maximum of 5% of the total annual net turnover of the company as reflected in the latest accounts approved by the management board or supervisory board
- f) In case of a natural person, an administrative fine of up to EUR 500,000
- g) As an alternative to e) and f), an administrative fine of an amount equal to at least twice the benefit derived from the infringement, if it can be determined, even if that amount exceeds the maximum amounts referred to in points e) and f)
- h) The permanent deregistration from the public register and the permanent prohibition for the approved statutory auditor (*réviseur d’entreprises agréé*), the approved audit firm (*cabinet de révision agréé*) or the key audit partner to carry out statutory audits and/or sign audit reports
- i) A temporary prohibition, of up to three years’ duration, banning the statutory auditor (*réviseur d’entreprises*) or the audit firm (*cabinet de révision*) from carrying out the activities listed in letter (b) of the first subparagraph and in the second subparagraph of Article 1(34)
- j) A permanent prohibition banning the statutory auditor (*réviseur d’entreprises*) or the audit firm (*cabinet de révision*) from carrying out the activities listed in letter (b) of the first subparagraph and in the second subparagraph of Article 1(34)

The sanctions and administrative measures taken by the CSSF may be appealed pursuant to Article 46 of the audit profession law. The application of the penalty or administrative measure is suspended during the period for appeal and for the duration of the procedure.

## 5.2.1. Criminal liability

Both legal entities (including Luxembourg UCIs set up as investment companies and management companies) and individuals (including the directors and managers of such legal entities) can be held criminally liable for misdemeanors (minor offences) and crimes (serious offences).

While the criminal liability of directors and managers of Luxembourg UCIs as individual physical persons has always existed, criminal liability of UCIs as corporate entities was only implemented in Luxembourg law in 2010.

### 5.2.1.1. Criminal liability of directors and managers

Luxembourg law subjects all individuals holding a “*de jure*” or “*de facto*” management function with respect to a management company or investment company to criminal liability.

The criminal liability of physical persons prevents individuals from hiding behind a “*corporate veil*”.

Under Articles 1500-1 and 1500-2 of the Law of 10 August 1915 on commercial companies (“1915 Law”), any person who, purporting to be the owner of shares or bonds which do not belong to it, participates in a company constituted under the 1915 Law, in any vote in a general meeting of shareholders or bondholders and any person who has delivered shares or bonds so that they may be used for the purpose described above are punishable by a fine of EUR 500 to EUR 25,000.

The same penalty shall be imposed upon:

- 1) The persons who fail to include information on<sup>18</sup>, *inter alia*, the capital, denomination, registered office, corporate object, share classes, in the documentation published on the RCS or filed in accordance with the 2002 Law, in subscription forms, prospectuses, circulars, announcements and notices published in newspapers

<sup>18</sup> | Article 1500-2 1° refers specifically to the provisions of Articles 420-1, 420-15 and 420-19 of the 1915 Law.

- 2) The managers and directors who have failed to submit to the general meeting within six months after the end of the financial year, the annual accounts, the consolidated accounts, the management report, the certificate of the person entrusted with the audit as well as the managers and directors who have failed to publish such documentation in violation of the requirements of Articles 461-8, 710-23, 813-4 and 1770-1 of the 1915 Law and Article 79 of the 2002 Law
- 3) The managers and directors who have failed to publish the report on payments to governments or the consolidated report on payments to governments in violation of the requirements of Article 1760-4 of the 1915 Law and Article 72septies of the 2002 Law
- 4) The managers and directors who have failed to publish the non-financial statement or the corporate governance statement referred to in Article 1730-1 of the 1915 Law and Articles 68bis and 68ter of the 2002 Law
- 5) The directors, commissaires or liquidators who have failed to convene, within three weeks of being requested to do so, the general meeting provided for in Article 450-8 of the 1915 Law, second sub-paragraph
- 6) The persons who contravene the regulations adopted in implementation of Article 813-9 of the 1915 Law, first sub-paragraph, concerning the audit of *sociétés coopératives*
- 7) The managers of *sociétés à responsabilité limitée* and of civil companies and, in the latter, in the absence of managers, the members who have failed to publish changes of membership in accordance with Article 100-13, paragraph 2, point 3 of the 1915 Law
- 8) The managers who, directly or through intermediaries have opened a public subscription for corporate units or profit units of a *société à responsabilité limitée* as well as the executives of a *société par actions simplifiée* who opened a public subscription for shares
- 9) The directors of *sociétés anonymes* who fail to file the report referred to in Article 430-18 of the 1915 Law, paragraph 2, or who present a report not containing the minimum information prescribed thereby
- 10) The persons referred to in Article 1300-12 of the 1915 Law who have failed to carry out the publications provided for by Articles 1300-5 to 1300-7, 1300-9, 1300-10

According to Articles 1500-4 and 1500-5 of the 1915 Law, directors and/or managers can be sentenced to one month to two years in prison and/or fined EUR 5,000 to EUR 125,000 if they:

- 1) By fraudulent means, cause or attempt to cause the price of the UCI's shares, bonds, or other securities to rise or fall
- 2) Fraudulently provide incorrect information in the statement of bonds outstanding referred to in Article 470-12 of the 1915 Law
- 3) Fail, with fraudulent intent, to publish the annual accounts, the consolidated accounts, the management report, or the certificate of the person entrusted with the audit, as provided for by Articles 461-8, 813-4 and 1770-1 of the 1915 Law and Article 79 of the 2002 Law
- 4) Any director contravening Article 420-13 of the 1915 Law

The directors and/or managers can be jailed for five to ten years and fined EUR 5,000 to EUR 250,000 if they commit forgery, with fraudulent intent or the intent to cause damage, on the balance sheets or profit and loss statements of the UCI prescribed by law or the articles, by the various means mentioned in Article 1500-8 of the 1915 Law.

Moreover, the *de jure* and *de facto* directors/managers can be sanctioned by a prison term of one to five years and/or a fine of EUR 500 to EUR 25,000 if they in bad faith:

- 1) Used the UCI's assets or credit, knowing such use was contrary to the UCI's interests, for personal gain or for the benefit of another UCI or undertaking in which the director/manager has a direct or indirect stake
- 2) Used their power or votes, knowing such use was contrary to the UCI's interests, for personal gain, or for the benefit of another UCI or undertaking in which the director/manager has a direct or indirect stake

A shareholder, creditor, or any third party who is aware of a criminal offence and has suffered a loss may file a criminal complaint with an investigating judge (*juge d'instruction*) and start a civil action for damages. A complaint may also be filed with the police or the public prosecutor's office. If a civil action is not started at the same time, the public prosecutor will assess whether to appoint an investigating judge to conduct an independent criminal investigation.

Finally, delegation by the governing body of a Luxembourg management company or investment company to conducting officers and the chain of sub-delegation increases the number of individuals who can potentially incur the criminal liability of a management company or investment company, and who can be held liable as physical persons.

### 5.2.1.2. Criminal liability of Luxembourg legal entities

Any Luxembourg legal entity can be held criminally liable for misdemeanors and crimes, and may therefore be subject to the same criminal penalties as physical persons. Therefore, investment companies and management companies may be held criminally liable. Furthermore, criminal proceedings may also be brought against a foreign entity that has breached Luxembourg criminal law.



In order for a legal entity to be held criminally liable in Luxembourg, the misdemeanor or crime must meet all the following conditions:

- 1) Be the result of one or more of the actions/omissions of the “*de jure*” or “*de facto*” directors or managers
- 2) Have been committed both:
  - In the name of the company
  - For the benefit of the company (such benefit not necessarily being of financial nature)

Under Luxembourg law, the disappearance of the legal personality (e.g., through a dissolution or merger) results in the end of any pending criminal proceedings but does not remove the obligation of such legal entity to execute any penalty it was sentenced to prior to dissolution or merger. Public prosecution and investigating judges may also delay or prohibit dissolution or any transaction that could lead to it.

### 5.2.1.3. Punishable misdemeanors and crimes, and applicable penalties

Legal entities and physical persons may be held criminally responsible for all types of misdemeanors and crimes covered by the Luxembourg criminal code, as well as for those covered by specific laws, such as the 2010 Law, the SIF Law, the RAIF Law, the AIFM Law and the Law against Money Laundering and Terrorist Financing of 12 November 2004, as amended.

The most serious types of “general” crimes for which they may be held criminally liable include money laundering and concealment, acts of terrorism and financing of terrorism, misappropriation of public funds, embezzlement, active and passive corruption, and private corruption.

In addition, the 2010 Law and the SIF Law, as amended, provide for specific offences including, *inter alia*:

- 1) Where a person makes use of designations or descriptions giving the impression that the activities are subject to the 2010 Law or SIF Law without having obtained the relevant authorization from the CSSF
- 2) Where a person carries out, or directs the carrying out of, operations involving receipt of funds from investors if the relevant UCI is not duly authorized
- 3) Where a person has made loans or advances on units of a common fund using assets of the common fund, or has by any means at the expense of the common fund made payments in order to pay up units, or acknowledged payments to have been made that have not actually been so made
- 4) When the assets of the UCI fall below the minimum thresholds required by the applicable law (see Sections 2.5. and 3.10.1.) and:
  - In the case of a common fund, the CSSF is not informed without delay
  - In the case of an investment company, a general meeting is not convened
- 5) Where the issuance and redemption price of the shares or units of the UCI is not determined at the required specified intervals, where the share or unit issuance and redemption price is not determined, or the net asset value (NAV) is not calculated in accordance with the requirements of the law, or where, in the case of 2010 Law, such price is not made public (see also Sections 10.1.1. and 8.7.)

While the main sanctions applicable to physical persons are fines (up to EUR 50,000<sup>19</sup>) and imprisonment (up to two years<sup>20</sup>), the main penalties for legal entities are fines (up to EUR 750,000<sup>21</sup> for crimes and twice the amount of the fine applicable to individuals under the relevant law for misdemeanors) and dissolution (where the entity was created for the sole purpose of committing the crime or if its corporate object has been intentionally circumvented in order to commit the incriminated acts). Additional penalties for legal entities also include, for example, the seizure of assets.

<sup>19</sup> This maximum amount of fine may be increased up to EUR 125,000 in case of fraudulent intention.

<sup>20</sup> This may be increased up to ten years in case of fraudulent bankruptcy.

<sup>21</sup> This amount may be increased up to five times if the crime is made against the State or in case of money laundering, terrorist financing or any other case listed in Article 37 of the Luxembourg Criminal Code.

The AIFM Law subjects AIFMs, and their governing bodies or management, to administrative penalties for sanctionable behaviors as follows:

Sanctionable behavior	Possible penalties	Disclosure
<ul style="list-style-type: none"> <li>▶ Failing to comply with the obligations of the AIFM Law and the relevant implementing measures</li> <li>▶ Refusing to provide accounting documents or other requested information</li> <li>▶ Providing documents or other information that proves to be incomplete, inaccurate, or false</li> <li>▶ Contravening the rules governing the publication of balance sheets and accounts</li> </ul>	<ul style="list-style-type: none"> <li>▶ Warning</li> <li>▶ Reprimand</li> <li>▶ Fine of between EUR 250 and EUR 250,000</li> </ul>	The CSSF may publicly disclose the penalties imposed, unless such disclosure would seriously jeopardize the financial markets or cause disproportionate damage to the parties involved
<ul style="list-style-type: none"> <li>▶ Preventing the CSSF from exercising its powers of supervision, inspection, and investigation</li> <li>▶ Failing to act in response to orders of the CSSF</li> <li>▶ Behaving in a manner that risks jeopardizing the sound and prudent management of the institution concerned</li> </ul>	<ul style="list-style-type: none"> <li>▶ Temporary or definitive prohibition on carrying out operations or activities, as well as any other restrictions on the activity of the person or entity</li> <li>▶ Temporary or definitive prohibition on acting as directors, managers, or conducting persons of entities subject to the supervision of the CSSF</li> </ul>	

When imposing a penalty, the CSSF is required to take into account the nature, duration, and the severity of the infringement, the conduct and past record of the natural or legal person to be sanctioned, the damage caused to third parties, and the potential benefits or gain and/or those effectively deriving from the infringement.

Article 51 of the RAIF Law provides that a penalty of imprisonment of one month to one year and a fine of EUR 500 to EUR 25,000 or either of one of those penalties shall be imposed upon:

- a) Any person who has issued or redeemed or caused to be issued or redeemed units of a common fund in the cases referred to in Articles 10, paragraph 2 and 19, paragraph 3 of the RAIF Law
- b) Any person who has issued or redeemed units of a common fund at a price other than that obtained by application of the criteria provided for in Article 10, paragraph 1 of the RAIF Law
- c) Any person who, as director, manager, or auditor of the management company or the depositary, has made loans or advances on units of the common fund using assets of the said fund or who has by any means at the expense of the common fund made payments in order to pay up units or acknowledged payments to have been made that have not actually been made
- d) The directors or managers of the management company which have contravened Article 11 of the RAIF Law

## 5.2.2. Civil liability

The civil liability of the governing or managing body of a UCI and its members is mainly established by Luxembourg corporate, civil and contractual laws. Neither the 2010 Law, the SIF Law, the RAIF law nor the AIFM Law regulate the civil liability of the governing or managing body of a UCI, or its members. The civil liability of a management company of a common fund is mainly established by the Luxembourg Civil Code.

### 5.2.2.1. Civil liability of directors and managers of Luxembourg investment companies

UCIs are subject to specific laws, however, when these specific laws do not foresee a ruling, then for corporate forms, reference is made to the 1915 Law.

The main duty of the directors and/or managers is to act in the UCI's best interest, which means that they must place the company's interests before their own when taking decisions. All managerial decisions must be to the company's benefit. In defining corporate strategy, the directors and/or managers shall act as a reasonably prudent person (*bon père de famille*). Above all, when taking decisions, the directors/managers must respect the duties imposed by the 1915 Law and by the company's articles of association.

Directors and/or managers can incur civil liability on the basis of Article 441-9 of the 1915 Law for a public limited liability company (*société anonyme*), Article 710-16 of the 1915 Law for a private limited liability company (*société à responsabilité limitée*), or Articles 1382 and 1383 of the Luxembourg Civil Code. Pursuant to Articles 441-9 and 710-16 of the 1915 Law, a director and/or a manager can be held civilly liable to the company or its shareholders for negligence or misconduct committed during his or her term of office.

Moreover, directors and/or managers can also incur civil liability if they violate the 1915 Law or the company's articles of association and thereby cause damage to a third party. In this case, the company or any third party can hold the director and/or manager liable on the basis of Articles 1382 and 1383 of the Luxembourg Civil Code, provided the director and/or manager's act or omission caused direct, personal harm to the applicant.

The 1915 Law, as amended, provides that the directors/managers shall be jointly and severally liable to both the company and any third parties for damage resulting from a violation of the 1915 Law or the company's articles of association. They shall be released from liability if they were not a party to the violation in question, provided no misconduct can be attributed to them and they reported the violation at the first general meeting held after they gained knowledge thereof.

## Liability to the shareholders under Article 441-9 of the 1915 Law

Managers<sup>22</sup> and/or directors are liable not only for fraud but also for any misconduct in the management of the company's affairs.

Pursuant to applicable case law, misconduct does not imply a wrongful act on the part of the director and/or manager. Liability may also be incurred for omissions and negligence. Under normal circumstances, a manager is expected to behave as a reasonably prudent person who, when making a decision, benefits from the same knowledge and information as any other manager in the same circumstances. If a manager takes a decision on the basis of information that appears to be sufficient and trustworthy and that does not indicate that the decision, although it may entail a risk, is contrary to the UCI's interests, it should not be possible to hold the manager liable.

According to the majority view in the case law and literature, the general meeting of shareholders has the power to take legal action against a manager in connection with wrongful acts committed by that manager in the performance of his or her official duties.

Creditors of a company may, under certain circumstances, bring an action on behalf of the UCI if the latter fails to do so and if such failure harms their interests<sup>23</sup>. Since in this case the creditors are merely exercising a right on behalf of the debtor (the company), any proceeds from the action must be returned to the company.

A director and/or manager who is found liable must indemnify the company for any damage suffered, including indirect damage. It is however important to note that only reasonably foreseeable damage need be indemnified. Only in the case of fraud can a manager also be held liable for unforeseeable damage.

Directors and/or managers may not be held liable to the company for acts that appear in the company's books of account at the time discharge is granted to the board by the annual general meeting. This discharge is valid for the period covered by the accounts presented to and approved by the meeting, provided the accounts do not contain any errors, omissions, or false statements of a material fact.

## Liability to the Company and third parties under Article 441-9 of the 1915 Law

The second paragraph of Article 441-9 of the 1915 Law refers only to a violation of the 1915 Law or of the company's articles of association.

Liability can be incurred only as the result of a wrongdoing, which may be either an intentional act or negligence.

Both the company and third parties, i.e., any shareholder or creditor with a legitimate interest, can initiate proceedings. With respect to shareholders, they may only seek damages under this Article 441-9 for harm that is distinct from the company's collective harm, i.e., individual, personal damage.

The basis for liability is different, depending on whether proceedings are initiated by the company or by a third party. An action by the company will be based on contract, while third-party actions will be based on tort.

In the context of contract-based actions, only reasonably foreseeable damage must be repaired, except in the case of fraud. For liability in tort, however, damages can be sought for all actual harm caused by the tortious act.

The directors and/or managers are jointly liable with respect to any action brought under Article 441-9 of the 1915 Law. In order to avoid joint liability, the director and/or manager must be able to prove that she/he did not take part in the violation of the 1915 Law or the company's articles of association, that no misconduct can be attributed to her/him, and that she/he reported the breach to the first general meeting of shareholders held after gaining knowledge thereof.

A discharge by the general meeting of shareholders extinguishes liability to the company, as is the case under Article 441-9 of the 1915 Law. It is important to note that proceedings initiated by third parties are not affected by this discharge.

<sup>22</sup> Article 710-16 of the 1915 Law refers to Article 441-9 of the 1915 Law.

<sup>23</sup> Article 1166 of the Luxembourg Civil Code.

## Liability to the Company and third parties under Articles 1382 and 1383 of the Civil Code

The directors and/or managers may also be held liable in accordance with the general rules of civil liability<sup>24</sup> for cases not covered by Article 441-9 of the 1915 Law.

Under these provisions, liability can be incurred only as the result of a wrongdoing (an act, omission, or negligence) that caused damage to the company or a third party having dealings with the company. In this case, an action may be initiated by the company or the third party, provided the damage suffered does not result from managerial misconduct or a violation of the 1915 Law or the company's articles of association.

Third parties must prove that the manager's wrongdoing caused them personal, specific damage.

The statute of limitations for civil liability claims against the managers is five years from the date the act was committed, except in the case of fraud.

### 5.2.2.2. Civil liability of a Luxembourg management company

As an entity acting in the name and on behalf of a UCI, a management company of a common fund is liable to the unitholders for any loss resulting from the non-fulfillment or improper fulfillment of its obligations<sup>25</sup>. The management company is subject to civil law provisions governing its mandate and remains fully liable with respect to any delegated functions.

Directors and managers of the management company of a common fund are subject to the provisions of the 1915 Law and the Luxembourg Civil Code, and may only be held liable if a fault can be attributed to them.

The management company of an investment company, or a management company providing services to an investment company, is contractually liable towards the UCI. In such cases, individual shareholders of the investment company are not permitted to sue the management company. Unlike the Directors or managers of a UCI, the Directors of the management company cannot be discharged of their liability by the general meeting of shareholders of the UCI it manages or services.

<sup>24</sup> Articles 1382 and 1383 of the Luxembourg Civil Code.

<sup>25</sup> Article 15 of the 2010 Law.

# 06

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## MANAGEMENT OF UCIs:

### MANAGEMENT COMPANIES, AIFMs AND OTHER INVESTMENT FUND MANAGERS

EY supports Investment Fund Managers (IFMs), including asset managers, traditional and alternative investment fund houses in defining an efficient operating model and business plan, and in complying with the applicable regulatory and tax requirements, including:

- ▶ Drafting policies, procedures, and processes
- ▶ Application for authorization
- ▶ Tax management
- ▶ Review of fee structures
- ▶ Reporting on controls (e.g., ISAE 3402, US Attestation Standard AT-C section 320)



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## 6.1. Introduction

### 6.1.1. General Introduction

A management company or alternative investment fund manager (AIFM), referred to as Investment Fund Managers (IFMs) under CSSF Circular 18/698, is a legal entity that manages one or more undertakings for collective investment (UCI). For the purposes of this Chapter, these entities are collectively referred to as “management entities”.

Since it has no legal personality, a common fund (FCP) must always be managed by a management company. An investment company (SICAV or SICAF) must either appoint a management company or manage itself.

This Chapter:

- ▶ Outlines the scope of activities and key governance functions of management entities
- ▶ Lists the key regulations applicable to Luxembourg management entities
- ▶ Summarizes requirements applicable to the setting up and operation of Luxembourg management entities and investment companies that manage themselves (self-managed UCITS and internally managed AIF)
- ▶ Outlines the management passports
- ▶ Summarizes the expenses and taxation of management entities

In much of this Chapter, we outline the regulatory requirements applicable to IFMs - in particular, UCITS management companies and AIFMs. We also indicate the type of entity to which the regulatory requirements apply.

The remainder of the introduction to this Chapter provides a brief summary of:

- ▶ The scope of activities of management entities
- ▶ The basic fund management models
- ▶ The responsibilities of management entities in relation to the appointment and oversight of service providers
- ▶ Key limitations on delegation by management entities
- ▶ Services that management entities may provide as delegates
- ▶ The relationship between management entities and other regulated entities
- ▶ Regulatory reporting duties and required communication with the CSSF

On 25 November 2021, the European Commission (EC) issued a draft directive to amend the AIFMD and the UCITS Directive. On 16 May 2022, the rapporteur of the ECON Committee of the European Parliament (EP) published its report to the EC Commission proposing a number of changes to the first draft.

The key areas covered by the reform concern:

- ▶ The extension of the list of ancillary services an AIFM can perform to include, *inter alia*, credit servicing and benchmark administration
- ▶ Increased powers granted to ESMA in relation to cross-border cases harmful for investor protection or financial stability. The proposal also foresees to grant to host national competent authorities (NCAs) a power to address a reasoned request to a home NCA to take supervisory action in certain circumstances
- ▶ *Delegation rules and substance requirements:*
  - ▶ The application of delegation rules to all activities including ancillary services
  - ▶ The obligation to retain at least two senior managers resident in the European Union (EU) on full-time basis
  - ▶ The obligation for NCAs to notify the European Securities and Markets Authority (ESMA) in case of substantial delegation of portfolio management/risk management outside the EU
  - ▶ The obligation for ESMA to conduct peer reviews on letter-box entities and report on market practices with review clause to ensure effectiveness of delegation rules
- ▶ *Liquidity management tools:*
  - ▶ Ensure availability of liquidity management tools (LMTs) across the EU
  - ▶ Require at least one LMT for open-ended AIFs
  - ▶ Obligation to have (de-)activation policies
  - ▶ Obligation to notify NCA notification
  - ▶ Delineation of NCA powers

- ▶ *Regulatory reporting:*
  - ▶ Remove duplicate reporting and standardization of reports
  - ▶ Remove limitation on data which can be requested by NCAs
- ▶ *Disclosures to investors on:*
  - ▶ Conditions for using LMTs
  - ▶ Fees borne by the AIFM
  - ▶ All direct/indirect fees charges to the AIF or to any of its investments
- ▶ *Depositary regime:*
  - ▶ Possibility for an NCA to allow the use by UCITS/AIFs of a foreign EU depositary
  - ▶ Inclusion of investor central securities depositary in the custody chain when they provide custody services to AIFs/UCITS
- ▶ *Third country entities:*
  - ▶ Access to EU market tied to EU anti-money laundering (AML) rules
  - ▶ Access ban for AIFs, AIFMs and depositaries from non-cooperative jurisdictions for tax purposes

At the time of writing, ongoing discussions continue at the level of the Council and the European Parliament to reach a compromise.

## 6.1.2. Scope of activities of management entities

“Management” includes, in general, investment management, administration, and marketing. In practice, many management entities delegate some of these functions. The management entity remains responsible for overseeing and supervising all delegated functions.

Management entities may combine authorizations as summarized in Section 6.2.1.B. The following table outlines the permitted activities of management entities:

**Scope of activities of management entities**

	Chapter 15 management company	AIFM	Chapter 16 management company not authorized as AIFM
Scope of UCIs that may be managed	UCITS and other UCIs for which the management company is subject to prudential supervision	AIFs	Non-UCITS AIFs below <i>de minimis</i> threshold
Scope of management activity	Management of UCITS includes: <ul style="list-style-type: none"> <li>▶ Portfolio management</li> <li>▶ Risk management (see Chapter 7)<sup>1</sup></li> <li>▶ Administration (see Chapter 8)</li> <li>▶ Marketing (see Chapter 12)</li> </ul>	Managing AIFs means performing, for one or more AIFs, at least the investment management functions relating to: <ul style="list-style-type: none"> <li>▶ Portfolio management</li> <li>▶ Risk management (see Chapter 7)</li> </ul> AIFMs may also provide the services of: <ul style="list-style-type: none"> <li>▶ Administration (see Chapter 8)</li> <li>▶ Marketing (see Chapter 12)</li> <li>▶ Activities related to the assets of AIFs<sup>2</sup></li> </ul>	Either of the following: <ul style="list-style-type: none"> <li>▶ Management company that designates an AIFM for the AIFs it manages</li> <li>▶ Managing AIFs itself, when assets of the AIFs under management do not exceed the threshold above which authorization as AIFM is required<sup>3</sup></li> </ul>

<sup>1</sup> Not explicitly mentioned as a function included in the activity of collective portfolio management in the Annexes to the 2010 Law and the UCITS Directive.

<sup>2</sup> Such activities include:

- ▶ Services necessary to meet the fiduciary duties of the AIFM
- ▶ Facilities management
- ▶ Real estate administration activities
- ▶ Advice to undertakings on capital structure
- ▶ Advice to undertakings on industrial strategy and related matters
- ▶ Advice and services relating to mergers and the purchase of undertakings
- ▶ Other services connected to the management of the AIF and the companies and other assets it has invested in

<sup>3</sup> See Section 6.1.3.C.

	Chapter 15 management company	AIFM	Chapter 16 management company not authorized as AIFM
Passport for management activity	Yes, for management of UCITS	Yes, for management of AIFs	None
Additional activities	<p>Discretionary portfolio management: management of portfolios of investments, including those owned by pension funds, on a discretionary client-by-client basis, when such portfolios include one or more financial instruments<sup>4</sup>.</p> <p>As non-core services:</p> <ul style="list-style-type: none"> <li>▸ Investment advice concerning one or more financial instruments</li> <li>▸ Safekeeping and administration in relation to shares or units of UCIs</li> </ul>	<p>Discretionary portfolio management: management of portfolios of investments, including those of pension funds and institutions for occupational retirement provision, on a discretionary, client-by-client basis.</p> <p>As non-core services:</p> <ul style="list-style-type: none"> <li>▸ Investment advice</li> <li>▸ Safekeeping and administration in relation to shares or units of UCIs</li> <li>▸ Reception and transmission of orders in relation to one or more financial instruments</li> </ul>	<p>Managing investment vehicles other than AIFs, as defined by the AIFM Directive<sup>5</sup>.</p> <p>Such entities may, for example, include holding companies and joint ventures.</p> <p>This activity cannot be the sole activity of the management company.</p>
Passport for additional activities	Yes	Yet to be phased in <sup>6</sup>	No
Specific requirements applicable to the provision of additional services	<p>Neither Chapter 15 management companies nor AIFMs can be authorized to provide only discretionary portfolio management services and non-core services, or to provide non-core services without being authorized to provide discretionary portfolio management services.</p> <p>The provision of such additional services is subject to conduct of business obligations and organizational requirements (see Section 6.2.1.D.).</p>		This activity cannot be the sole activity of the management company.

<sup>4</sup> Financial instruments are listed in Section B of Annex II to the Law of 5 April 1993 on the financial sector, as amended (the 1993 Law). They include:

- Transferable securities
- Money market instruments
- Units in collective investment undertakings
- Options, futures, swaps, forward rate agreements, and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices, or financial measures that may be settled physically or in cash
- Options, futures, swaps, forward rate agreements, and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (other than by reason of a default or other termination event)
- Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market or a multilateral trading facility (MTF)
- Options, futures, swaps, forwards, and any other derivative contracts relating to commodities that can be physically settled but not otherwise mentioned in the previous bullet point, and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, *inter alia*, they are cleared and settled through recognized clearing houses or are subject to regular margin calls
- Derivative instruments for the transfer of credit risk
- Options, futures, swaps, forward rate agreements, and any other derivative contracts relating to climatic variables, freight rates, emission allowances, or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (other than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices, and measures that have the characteristics of other derivative financial instruments, having regard to whether, *inter alia*, they are traded on a regulated market or an MTF, are cleared and settled through recognized clearing houses, or are subject to regular margin calls

<sup>5</sup> The law explicitly states that a Chapter 16 management company may perform the administration of its own assets as an ancillary activity.

<sup>6</sup> The AIFM Directive permits an AIFM to manage AIFs on a cross-border basis, but does not explicitly permit the AIFM to provide additional services for which it has been authorized, including portfolio management and investment advice, on a cross-border basis. However, the recast MiFID Directive (MiFID II), *inter alia*, modifies the AIFM Directive to permit an AIFM to provide on a cross-border basis additional services for which it has been authorized.



	Chapter 15 management company	AIFM	Chapter 16 management company not authorized as AIFM
Provision of domiciliary services	Management entities are permitted to provide domiciliation services <sup>7</sup> to:		
	<ul style="list-style-type: none"> <li>▶ The UCIs they manage</li> <li>▶ Subsidiaries of the UCIs they manage</li> </ul>		

- ▶ Self-managed UCITS and internally managed AIFs are subject to almost all of the same requirements applicable to management companies and AIFMs (see Section 6.2.1.C.)
- ▶ It is necessary to distinguish between authorized AIFMs, which are required to comply fully with the AIFM Law or AIFM Directive requirements, and “simplified registration regime AIFMs”<sup>8</sup>, whose assets under management (AUM) are below the *de minimis*<sup>9</sup> thresholds
- ▶ In this Chapter, “AIFM” means “authorized AIFM”, unless otherwise specified

### 6.1.3. Requirement for an authorized management entity

This section provides an overview of key factors to be taken into account when determining whether an authorized management entity is required. The choice of organizational model is covered in Section 1.4.3.

#### A. Basic structure of the UCI

A common fund must always be managed by a management company.

An investment company (or in the case of a limited partnership or a partnership limited by shares, the managing general partner or the manager) must either appoint a management company or manage itself.

For further information, see Section 2.3.1.

#### B. Managing UCITS

A UCITS must either be managed by a UCITS management company or designate itself as self-managed. Only investment companies can be self-managed. Self-managed UCITS are subject to most of the requirements applicable to management companies (see Section 6.2.1.C.).

#### C. Managing AIFs

Each AIF is required to have a single AIFM, which is responsible for ensuring compliance with the requirements of the AIFM Directive, which is implemented in Luxembourg by the AIFM Law.

An AIFM is any legal person whose regular business is managing one or more AIF(s). The AIFM may be an external manager, or the AIF itself (internally managed AIF<sup>10</sup>) when the AIF’s governing body chooses not to appoint an external AIFM and such is permitted by the corporate structure of the AIF.

Managing AIFs means performing, for one or more AIF(s), at least the following investment management functions of:

- ▶ Portfolio management
- ▶ Risk management

In order to be considered the AIFM of an AIF, the AIFM must be appointed to perform the portfolio management and risk management of the AIF (although it may wholly or partially delegate at least one of these functions – see Section 6.3.3.I.), i.e., the AIFM must be responsible for both portfolio management and risk management.

<sup>7</sup> The domiciliation of companies is, in general, subject to the Law of 31 May 1999 governing the domiciliation of companies, as amended. However, the Law provides four exemptions in relation to:

- ▶ The domiciliation of a company with a natural person who is him/herself a direct or indirect partner exerting a significant influence over the conduct of the company’s affairs
- ▶ The domiciliation of an investment company or of any other undertaking for collective investment having the legal form of a commercial company, with a management company of undertakings for collective investment
- ▶ The domiciliation of a management company of undertakings for collective investment or an advisory company of undertakings for collective investment with another management company of undertakings for collective investment
- ▶ The domiciliation of a company with a company belonging to the same group

Management entities are not authorized to provide domiciliation services to entities other than the aforementioned entities. Credit institutions and certain financial sector professionals (PSFs) are authorized to provide corporate domiciliation services; they are subject to the supervision of the CSSF. On 23 November 2021, the CSSF issued the communication *Domiciliation activity exercised when operating a business center or a co-working space*, clarifying that any domiciliation activity exercised outside their main activity, such as operating a business center or a co-working space, requires prior authorization from the CSSF as specialized PFS according to Article 28-9 of the 1993 Law. The administrator of the UCI may also provide domiciliation services to UCIs – see Section 8.2.1.

<sup>8</sup> “Simplified registration regime AIFMs” are covered in Section 6.2.1.E.

<sup>9</sup> See Section 6.1.3.E.

<sup>10</sup> A RAIF cannot be internally managed. It must be managed by an authorized AIFM.

The AIFM may also be appointed to perform activities including administration and marketing, but this is not required.

An AIF is any UCI<sup>11</sup>, including investment compartments thereof, that raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and is not a UCITS.

An undertaking as a whole should be considered as an AIF when a compartment of the undertaking exhibits all the elements in the definition of an AIF.

An undertaking that exhibits all the following characteristics should be considered as a UCI:

- It does not have a general commercial or industrial purpose
- It pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors

The unitholders or shareholders of the undertaking, as a collective group, have no discretion or control, beyond that normally exercised through shareholder meetings, over operational matters relating to the daily management of the undertakings' assets. "Raising capital" means taking direct or indirect steps by the undertaking, the AIFM, or another entity acting on its behalf to procure the transfer or commitment of capital by one or more investor(s) to the undertaking for the purpose of investment in accordance with a defined investment policy. Such activity may:

- Take place once, on several occasions, or on an ongoing basis
- Be in the form of cash subscriptions or subscriptions in kind

When capital is raised from a pre-existing group for the investment of whose wealth the undertaking has been exclusively established, this is not likely to be within the scope of raising capital. A pre-existing group is a group of family members whose existence pre-dates the establishment of the undertaking.

A family office vehicle that invests the private wealth of investors without raising external capital should not be considered an AIF.

When a UCI is not prevented by national law, the constitutional document, or a provision or arrangement with binding effect from raising capital from more than one investor, it should be considered as a collective investment undertaking that raises capital from a "number of investors" even if it has:

- Only one investor
- A sole investor, which invests funds raised from more than one legal or natural person for the benefit of those persons or consists of an arrangement or structure with in total more than one investor (e.g., feeder structures or fund of fund structures and certain nominee arrangements)

A "defined investment policy" is a policy about how the pooled capital in the undertaking is to be managed to generate a pooled return for the investors. The factors that may indicate the existence of such a policy include:

- The investment policy is determined and fixed, at the latest by the time investors' commitments to the undertaking become binding on them
- The investment policy is set out in a document that becomes part of, or is referenced in, the constitutional document of the undertaking
- The undertaking, or the entity managing it, has an obligation to investors, which is legally enforceable by them, to follow the investment policy
- The investment policy specifies investment guidelines in relation to pursuit of certain strategies, investment in certain categories of asset or geographical regions, or conformity to restrictions, for example, on leverage, holding periods, or risk diversification

All AIFs are covered by the AIFM Directive, independent of their open-ended or closed-ended nature (see also Section 6.1.3.D.), legal form, and structure.

#### D. AIFM authorization

An AIFM may be either an:

- External AIFM: External AIFMs are separate legal entities that can manage one or more AIF(s)
- The AIF itself - an internally managed AIF<sup>12</sup>: The activities of internally managed AIFs are limited to the management of the assets of the AIF itself. Only AIFs in corporate form can be internally managed. Internally managed AIFs are subject to almost all the same requirements as AIFMs (see Section 6.1.3.C.)

An AIFM authorization is required when the AIF assets managed by the management entity are above the AIFM Law *de minimis* thresholds:

- AIFMs that manage portfolios of AIFs whose AUM, including any assets acquired through use of leverage, in total, do not exceed a threshold of EUR 100 million
- AIFMs that manage portfolios of AIFs whose AUM, in total, do not exceed a threshold of EUR 500 million when the portfolio of AIFs consists of AIFs that are not leveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF

<sup>11</sup> The AIFM Directive refers to "collective investment undertakings" (CIUs).

<sup>12</sup> A RAIF cannot be internally managed. It must be managed by an authorized AIFM.

An AIFM may be either or both of the following:

- An AIFM of open-ended AIFs
- An AIFM of closed-ended AIFs

An AIFM of an open-ended AIF is an AIFM that manages an AIF whose shares or units are, at the request of any of its shareholders or unitholders, repurchased or redeemed prior to the commencement of its liquidation phase or wind-down, directly or indirectly, out of the assets of the AIF and in accordance with the procedures and frequency set out in its rules or instruments of incorporation, prospectus, or offering documents.

A decrease in the capital of the AIF in connection with distributions according to the rules or instruments of incorporation of the AIF, its prospectus, or offering documents, including one that has been authorized by a resolution of the shareholders passed in accordance with those rules or instruments of incorporation, prospectus, or offering documents, is not taken into account for the purpose of determining whether or not the AIF is an open-ended AIF.

An AIF's shares or units that can be negotiated on the secondary market and are not repurchased or redeemed by the AIF are not taken into account for the purpose of determining whether or not the AIF is an open-ended AIF.

An AIFM of a closed-ended AIF is an AIFM that manages an AIF other than an open-ended AIF. AIFMs of closed-ended AIFs may benefit from certain grandfathering provisions (see Section 6.1.3.G.) or certain exemptions in relation to liquidity management (see Section 7.3.6.C.) and valuation (see Section 7.6.).

#### E. Simplified registration regime AIFMs

AIFMs that are below the *de minimis* thresholds (e.g., Chapter 16 management companies, internally managed 2010 Law Part II investment companies, and internally managed SIF investment companies, whose AUM, in each case, fall below the *de minimis* thresholds) are required to monitor their AUM and are subject to certain limited registration and regulatory reporting requirements.

Such AIFMs may choose to "opt-in" under the AIFM Law in order to benefit from the rights granted to AIFMs (in particular, passports); in this case, they must comply with all the provisions of the AIFM Law.

A specific European regime exists for the managers of qualifying European Venture Capital Funds (EuVECA) and of qualifying European Social Entrepreneurship Funds (EuSEFs). The EuVECA and EuSEF regimes are initially applicable to managers who manage portfolios of AIFs whose AUM, in total, do not exceed a threshold of EUR 500 million when the portfolio of AIFs consists of AIFs that are not leveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF.

#### F. Management companies managing AIFs

Management companies that manage AIFs have the following options:

- To become fully AIFM compliant:
  - Luxembourg UCITS management companies (Chapter 15 management companies) may choose to obtain an additional authorization as an AIFM; thus management companies can benefit from dual UCITS management company and AIFM authorizations
  - Luxembourg management companies of non-UCITS (Chapter 16 management companies) may choose to obtain authorization as an AIFM
- Not to become fully AIFM compliant: Both Chapter 15 and Chapter 16 management companies may also continue to perform management company functions for AIFs, without obtaining authorization as AIFMs. In this case, the following restrictions apply to the activities they can perform:
  - When AIF AUM of the management company do not exceed the threshold above which authorization as AIFM is required, they may manage the AIFs themselves as simplified registration regime AIFMs (see Section 6.1.3.E.)
  - When AIF AUM of the management company exceed the threshold above which authorization as AIFM is required, they must designate another authorized entity as AIFM of the AIFs they manage. The AIFM may be in Luxembourg or in another EU/European Economic Area (EEA) Member State. It must perform at least the portfolio management and the risk management of the AIFs. The management company has the choice between performing the functions of administration and/or marketing itself, delegating one or both of the functions to the AIFM, and/or delegating one or both of the functions to another third party

## G. Grandfathering and exemptions

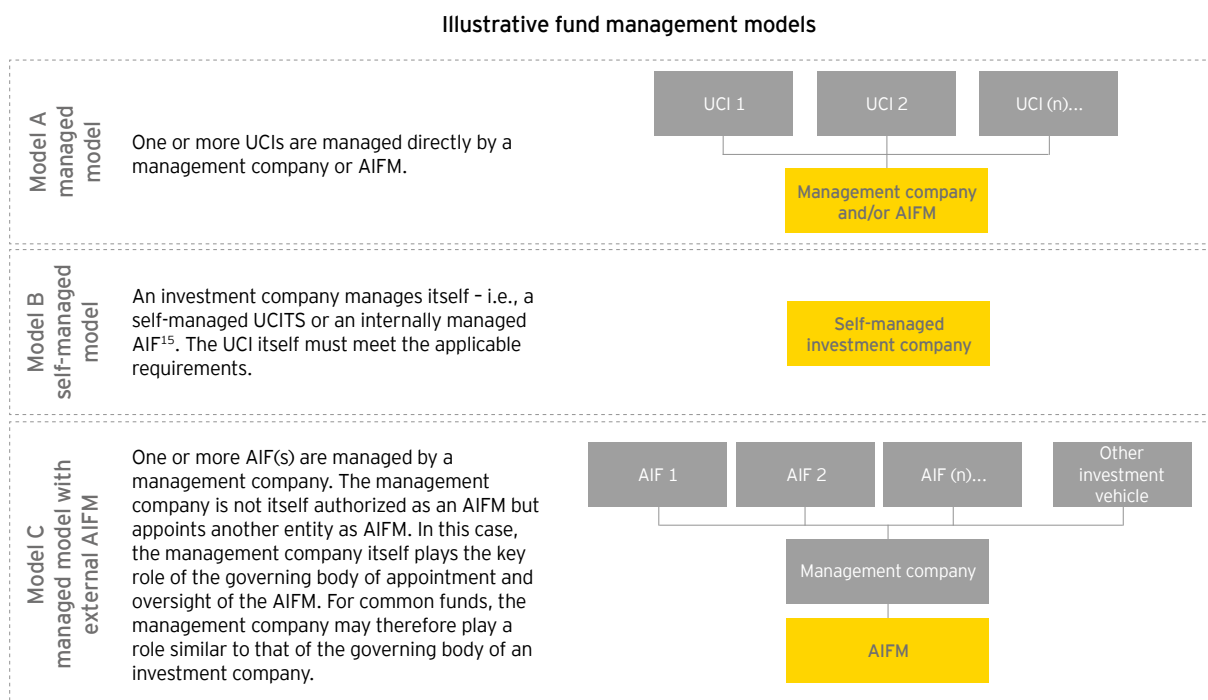
Managers of some closed-ended AIFs existing at the final date of transposition may benefit from grandfathering clauses, namely:

- Managers of closed-ended AIFs “which do not make any additional investments” after 22 July 2013 may continue to manage such AIFs without authorization under the AIFM Directive

The AIFM Law, as amended, provides for several exemptions from the Directive’s provisions. Full exemptions apply to holding companies as defined in the Directive<sup>13</sup>, securitization special purpose entities, institutions for occupational retirement provision (IORP), and their managers insofar as they do not manage AIFs, and to certain group AIFM entities<sup>14</sup>.

### 6.1.4. Fund management models

The following figure illustrates the typical management models for UCIs:



Group management models are covered in Section 1.4.3.4.

### 6.1.5. Relationship between management entities and other regulated entities

Management entities are not permitted to obtain authorization as another type of financial sector entity, such as a credit institution, an investment firm, or another type of professional of the financial sector (PSF).

Other financial sector entities are not permitted to obtain authorization as a management entity.

Management entities, credit institutions, and investment firms may delegate certain activities to each other, such as portfolio management or investment advice, subject to the applicable requirements, such as those on delegation and on conflicts of interest.

<sup>13</sup> Under the Directive, (2011/61/EU, as amended), a “holding company” is a company with shareholdings in one or more other companies, the commercial purpose of which is to carry out a business strategy or strategies through its subsidiaries, associated companies, or participations in order to contribute to their long-term value, and that is either:

- A company operating on its own account and whose shares are admitted to trading on a regulated market in the EU
- A company not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies, as evidenced in its annual report or other official documents

<sup>14</sup> AIFMs insofar as they manage one or more AIF(s) whose only investors are the AIFM or the parent undertakings or the subsidiaries of the AIFM or other subsidiaries of those parent undertakings, provided that none of those investors itself is an AIF.

<sup>15</sup> A RAIF cannot be internally managed. It must be managed by an authorized AIFM.

There is some overlap between the permitted activities of management entities, credit institutions, and investment firms. Certain services may be offered by both types of entity:

#### Areas of overlap between services that may be offered by management entities and MiFID<sup>16</sup> firms

Services offered by credit institutions and investment firms	UCITS management company	AIFM
Investment services and activities	<ul style="list-style-type: none"> <li>▸ Portfolio management</li> <li>▸ Investment advice</li> </ul>	<ul style="list-style-type: none"> <li>▸ Portfolio management</li> <li>▸ Investment advice</li> <li>▸ Reception and transmission of orders in relation to one or more financial instruments</li> </ul>
Ancillary services	<ul style="list-style-type: none"> <li>▸ In relation to shares or units of UCIs: Safekeeping and administration</li> </ul>	<ul style="list-style-type: none"> <li>▸ In relation to shares or units of UCIs: Safekeeping and administration</li> <li>▸ In relation to the assets of AIFs: Advice to undertakings on capital structure, industrial strategy, and related matters, and advice and services on mergers and the purchase of undertakings</li> </ul>

## 6.2. Establishment of a management entity

This Section summarizes the requirements applicable to the set up and operation of a management entity covering:

#### Scope of applicability of provisions covered in this Section

	Chapter 15 management company and self-managed UCITS <sup>17</sup>	AIFM and internally managed AIFs	Chapter 16 management company
<b>Corporate information</b>			
Authorization	✓	✓	✓
Legal form and office	✓		✓
Shareholders, sponsor, and related parties	✓	✓	✓
Own funds and professional liability cover	✓	✓	✓
<b>Governance</b>			
General organizational requirements	✓	✓	✓
Governing bodies	✓	✓	✓
Senior management	✓	✓	✓
Central administration	✓	✓	
Accounting function	✓	✓	
Human resources	✓	✓	
Technical resources	✓	✓	
Rules of conduct	✓	✓	
Delegation framework	✓	✓	
Depository appointment	✓	✓	
Prime brokers and counterparties		✓	
Conflicts of interest	✓	✓	✓
Complaints handling	✓	✓	
Remuneration policy	✓	✓	✓
Reporting to the CSSF	✓	✓	✓

<sup>16</sup> Markets in Financial Instruments Directive (MiFID II), Directive 2014/65/EU, as amended.

<sup>17</sup> When applicable. The provisions applicable to self-managed UCITS investment companies are listed in Section 6.2.1.C.

	Chapter 15 management company and self- managed UCITS <sup>17</sup>	AIFM and internally managed AIFs	Chapter 16 management company
Annual accounts	✓	✓	✓
Requirements applicable to management entities providing additional services (when relevant)	✓	✓	
Requirements applicable to simplified registration regime AIFM (when relevant)		✓	✓
Requirements applicable to managers of EuVECAs and EuSEFs (when relevant)			✓
Liquidation and insolvency	✓	✓	✓
<b>Internal control</b>			
Internal control framework	✓	✓	
Internal control and risk functions	✓	✓	
Compliance	✓	✓	✓
Accounting function	✓	✓	✓
AML/CTF & KYC	✓	✓	✓
IT function	✓	✓	✓
<b>Business functions</b>			
Portfolio management	✓	✓	✓
Valuation	✓	✓	✓
Distribution	✓	✓	✓

The “proportionality” principle may be invoked by management entities in relation to the application of certain provisions<sup>18</sup>. In general, this means that the CSSF will take into account the nature, scale, and complexity of the activities of the management entity when considering whether the management entity complies with certain requirements.

For Chapter 15 management companies, the CSSF has clarified that, in its assessment of proportionality, it will take into account, *inter alia*, the following factors: the number of UCITS and other UCIs managed by the management company, the total AUM, investment into assets that are considered to be riskier, the extent of the delegated functions, and specific intra-group expertise.

## 6.2.1. Authorization

Management entities must obtain authorization from the CSSF prior to incorporation and commencing business.

### A. Application for authorization

The main objective of the application for authorization is to demonstrate to the CSSF how the management entity will comply with the applicable legal requirements.

In summary, the application for authorization must contain, *inter alia*, the information on:

#### Corporate information

- ▶ The applicant
- ▶ Shareholding structure
- ▶ Own funds, professional liability cover and budget forecast

#### Governance

- ▶ Governing bodies and senior management
- ▶ Program of activities, in particular arrangements regarding the central administration and internal governance
- ▶ Organization and infrastructure

<sup>18</sup> | We have, in general, indicated when the proportionality principle applies in the following sections.

### Internal control

- Internal control and risk management
- Organization of the fight against money laundering and terrorist financing (AML/CTF)
- IT
- Accounting
- Information exchange between the IFM and the depositary
- Requirements with respect to organization and procedures, including:
  - Management information and internal reporting systems
  - Business continuity
  - Approval of new business relationships and new products
  - Manual of procedures
  - Claim and complaints handling
  - Personal transactions
  - Management of conflicts of interest
  - Rules of conduct
  - Remuneration policy
  - Exercise of voting rights
  - Monitoring of compliance with the obligations under EMIR<sup>19</sup> and MMF<sup>20</sup> Regulation

### Core and business functions, as per their Delegation status

- Specific organizational arrangements covering Delegation of (if applicable and subject to CSSF notification):
  - Collective portfolio management
  - Risk management
  - Valuation
  - Administration of UCIs
  - Complaints handling
  - Discretionary portfolio management (DPM) and ancillary services
- Specific organizational arrangements covering Delegation of (if applicable and subject to CSSF authorization):
  - Compliance
  - Internal audit
  - IT
  - Accounting
- Additional information for management entities providing additional services such as Discretionary Portfolio Management, investment advice and ancillary services
- External audit

The CSSF may request additional information necessary to complete the assessment of the application for authorization.

The detailed list of information to be included in the application for authorization of a management company or AIFM is available on the CSSF website.

<sup>19</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, as amended.

<sup>20</sup> Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds, as amended.

The following pages provide more details on the information to be provided in the application for authorization.

**Information to be provided in the application for authorization**

	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
<b>Corporate information</b>			
<b>Information on the applicant</b>	<ul style="list-style-type: none"> <li>▶ Presentation of the management company (denomination, legal form, initial capital)</li> <li>▶ Contact person in Luxembourg</li> <li>▶ Draft constitutional document</li> <li>▶ Reasons for establishing business in Luxembourg</li> </ul>	<ul style="list-style-type: none"> <li>▶ Name, registered office, head office, and legal form</li> <li>▶ Contact person in Luxembourg</li> <li>▶ Draft constitutional document or updated constitutional document</li> <li>▶ For existing regulated entities - confirmation, when applicable, that there have not been any changes since the last filing with the CSSF in relation to:               <ul style="list-style-type: none"> <li>▶ Governing bodies and senior management</li> <li>▶ Shareholding structure</li> <li>▶ Program of activity</li> <li>▶ Organizational requirements</li> </ul> </li> <li>▶ In addition, for existing unregulated entities:               <ul style="list-style-type: none"> <li>▶ Information on any branches</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▶ Presentation of the management company (denomination, legal form, initial capital)</li> <li>▶ Contact person in Luxembourg</li> <li>▶ Draft constitutional document</li> <li>▶ Reasons for establishing business in Luxembourg</li> </ul>
<b>Shareholding structure (direct or indirect qualifying shareholders - see also Section 6.2.3.1.)</b>	<ul style="list-style-type: none"> <li>▶ Legal entities:               <ul style="list-style-type: none"> <li>▶ Description of the group</li> <li>▶ Organization chart of the direct and indirect shareholding structure, highlighting entities subject to prudential supervision and their respective supervisory authorities</li> </ul> </li> <li>▶ Identification of the beneficial owners</li> <li>▶ Denomination of the shareholders, with an indication of the number of shares held</li> <li>▶ Annual reports including audited financial statements for the last three years</li> <li>▶ The constitutional document</li> <li>▶ Information on any consolidated supervision of the group to which the shareholder belongs</li> <li>▶ Confirmation that the initial capital has not been sourced from a loan or other cash advance and that the shares of the management company are unsecured</li> <li>▶ Declaration of honor signed by the natural person acting as the legal representative of the legal person</li> <li>▶ The jurisdiction in which it is established, the existence of prudential supervision and the nature of authorization(s) granted to the entities concerned</li> </ul>	<ul style="list-style-type: none"> <li>▶ Organization chart of the direct and indirect ownership structure</li> <li>▶ Identification of all direct and indirect shareholders or members, including nationality, supervisory authority (if applicable), direct or indirect nature of holding, and amount of holding</li> <li>▶ Qualifying holdings: Information listed in the Appendix to the <i>Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector</i> (see Section 6.2.3.1.A.), in order for the CSSF to be able to evaluate the sound and prudent management of the proposed shareholders</li> <li>▶ Relationship with other financial institutions (AIFM, UCITS management company, investment firm, or credit institution); name and supervisory authority of:               <ul style="list-style-type: none"> <li>▶ Any financial institution of which the AIFM is a subsidiary</li> <li>▶ Any parent entity that controls another financial institution</li> </ul> </li> <li>▶ Information on any consolidated supervision of the group to which the shareholder belongs</li> <li>▶ Information on any "close links" (see Section 6.2.3.1.C.)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Information on the shareholding structure (direct or indirect), and when applicable, organization chart of the group</li> </ul>

<sup>21</sup> | New AIFMs, existing management companies requesting authorization as AIFM, and internally managed AIFs.



**Corporate information**

Shareholding structure (direct or indirect qualifying shareholders - see also Section 6.2.3.1.)

- ▶ Any additional information listed in the Appendix to the *Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector* (see Section 6.2.3.1.A.), in order for the CSSF to be able to evaluate the quality and financial strength of the proposed shareholders
- ▶ Natural persons:
  - ▶ Proof of fulfillment of the conditions of good repute and required skills, including: Signed and dated *curriculum vitae*, extract of recent criminal record or affidavit, declaration of honor, and copy of their identity card or passport
  - ▶ Evidence that the shareholder has sufficient financial resources to ensure the sound and prudent management of the management company
  - ▶ Confirmation that the initial capital has not been sourced from a loan or other cash advance and that the shares of the management company are unsecured
  - ▶ Confirmation that the shareholder holds the shares for their own account
  - ▶ Indication of beneficial owners
  - ▶ Indication of whether the shareholder is subject to regulation by a supervisory authority
- ▶ Qualifying holdings: Any additional information listed in the Appendix to the *Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector* (see Section 6.2.3.1.A.), in order for the CSSF to be able to evaluate the sound and prudent management of the proposed shareholders

**Corporate information**

- Own funds, professional liability cover (see Section 6.2.3.2.), and budget forecast
- ▶ Own funds:
    - ▶ Initial capital
    - ▶ Details of the investment policy in relation to the initial capital, indicating when applicable, the name of the financial institution at which the initial capital is deposited
    - ▶ When relevant, the draft guarantee agreement provided by a credit institution or insurance undertaking in relation to any additional amount of own funds
    - ▶ Provisional three-year budget forecast
  - ▶ Own funds:
    - ▶ Initial capital
    - ▶ Value of portfolios of AIFs managed
    - ▶ Amount of own funds
    - ▶ When relevant, information on any guarantee agreement provided by a credit institution or insurance undertaking in relation to any additional amount of own funds
    - ▶ Type of assets in which own funds will be invested
  - ▶ Professional liability cover, either:
    - ▶ Additional own funds: Amount as a percentage of portfolios managed, breakdown of the calculation, date of annual recalculation, and confirmation that additional own funds amount to at least 0.01% of the value of the portfolios managed
    - ▶ Professional indemnity insurance: Information on issuer and its supervisory authority, information on insurance issuance date, term, excess, and cancellation, persons and liability risks covered, any excess covered by professional own funds and amount, and confirmation of the coverage of individual claims and aggregate claims per year
    - ▶ Evolution of the business, covering the AIFs managed or intended to be managed, total AUM, and forecast financial statements for a three-year period
  - ▶ Own funds

	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
	<b>Governance</b>		
<p>Governing bodies and senior management (see also Sections 5.1.6.1. and 5.1.6.2)</p>	<ul style="list-style-type: none"> <li>▶ Governing bodies (including board of directors, supervisory bodies (if any)), and senior management: <i>Curriculum vitae</i>, extract of criminal record or affidavit, declaration of honor, and copy of identity card or passport</li> <li>▶ Senior management (often referred to as conducting officers): <ul style="list-style-type: none"> <li>▶ Areas of responsibility, and relevant experience in these areas</li> <li>▶ Employment contract, or convention regulating the availability of senior management</li> </ul> </li> <li>▶ In case the members of senior management work for several companies, evidence that they are able to fulfill at all times the tasks for which they are responsible</li> <li>▶ Any request for derogation from the requirement that at least two conducting officers permanently reside in Luxembourg, or a country permitting them to come to Luxembourg on a daily basis</li> <li>▶ Description of the method of operation of the board of management</li> </ul>	<ul style="list-style-type: none"> <li>▶ Governing bodies and senior management: <ul style="list-style-type: none"> <li>▶ <i>Curriculum vitae</i>, extract of criminal record, declaration of honor, and copy of identity card or passport</li> <li>▶ Any "close links" (see also Section 6.2.3.1.C.)</li> </ul> </li> <li>▶ Governing bodies: <ul style="list-style-type: none"> <li>▶ Justification of adequate collective knowledge, skills, and experience</li> <li>▶ Demonstration that each member can dedicate the required time and attention</li> <li>▶ Types of training foreseen</li> </ul> </li> <li>▶ Senior management: <ul style="list-style-type: none"> <li>▶ Contact details</li> <li>▶ Nature and date of contractual agreement</li> <li>▶ Justification of experience in relation to the AIFs' investment strategies</li> <li>▶ List of other mandates with other AIFMs, and demonstration of sufficient time and resources to fulfill duties</li> </ul> </li> <li>▶ Any request for derogation from the requirement that at least two conducting officers permanently work in Luxembourg</li> </ul>	<ul style="list-style-type: none"> <li>▶ Information on senior management: <i>Curriculum vitae</i>, extract of criminal record, declaration of honor, and copy of their identity card or passport</li> </ul>

	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
<b>Program of activities</b>	<b>Governance</b>		
	<ul style="list-style-type: none"> <li>▶ Scope of activities and services for which authorization is sought (see also Section 6.1.2.)</li> <li>▶ Information on the UCIs to be managed directly or as a delegate for the next three financial years, including, number and net assets, covering UCIs that are created at the initiative of the group to which the management company belongs and those created at the initiative of other groups</li> <li>▶ The investment policies of the UCIs and financial instruments and markets in which they are to invest</li> <li>▶ Additional information in relation to UCIs managed: <ul style="list-style-type: none"> <li>▶ Information on the initiators of the UCIs managed by the management company</li> <li>▶ When the management company intends to manage UCIs under foreign law, the country of origin of the UCIs, their investment policies, and services offered</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▶ Scope of activities and services for which authorization is sought (see also Section 6.1.2.)</li> <li>▶ Information on the AIF it intends to manage, including: <ul style="list-style-type: none"> <li>▶ Information about the investment strategies, including the types of underlying funds if the AIF is a fund of funds, the AIFM's policy as regards the use of leverage, risk profiles, and other characteristics of the AIF it manages or intends to manage</li> <li>▶ The EU or third-country domiciles and countries where the AIF is marketed</li> <li>▶ Information on where the master AIF is established if the AIF is a feeder AIF</li> <li>▶ The constitutional documents of each AIF it intends to manage*</li> <li>▶ Evidence of how the AIFM will ensure that a depositary will be appointed for each AIF the AIFM intends to manage and details of the depositary for each AIF, including draft depositary contracts or current status of depositary negotiations, confirmation that the contract meets the minimum requirements (see Section 6.3.5.1.), confirmation that portfolio management or risk management are not delegated to the depositary, and confirmation in relation to asset segregation by the depositary and any sub-custodians (see Sections 9.4.2.1.A.2. and 9.7.3.)</li> <li>▶ Appointment of prime broker (where appropriate)</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▶ Program of activity, including information on the UCIs to be managed for the next three financial years</li> </ul>

	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
	<b>Governance</b>		
<b>Organization and infrastructure</b>	<ul style="list-style-type: none"> <li>▶ Functional organization chart, number of persons working for the management company, and, when possible, their names (see also Section 6.3.2.2.C.)</li> <li>▶ Confirmation of the existence of a procedures manual, which details its internal functioning, the allocation of tasks to staff, reporting lines, and, when relevant, the information exchange procedures with and the controls performed on delegates (see Sections 6.3.2.3. and 6.3.2.2.C.)</li> <li>▶ Description of the administrative, accounting, and IT infrastructure (including hardware, software and information sources) (see Section 6.3.2.2.A.)</li> <li>▶ Designation of a person responsible for the provision of information on the financial situation of the management company</li> </ul>	<ul style="list-style-type: none"> <li>▶ Functional organization chart, number of employees, details of any secondments from other companies (see Section 6.3.2.2.C.)</li> <li>▶ Evidence that the AIFM complies with the organizational requirements (see Section 6.3.1.)</li> <li>▶ Evidence that the AIFM has: <ul style="list-style-type: none"> <li>▶ Sound administrative and accounting procedures (see Section 6.3.2.2.B.)</li> <li>▶ Control and safeguard arrangements for electronic data processing (see Section 6.3.2.2.A.)</li> </ul> </li> <li>▶ Adequate internal control mechanisms, including: Rules for personal transactions by its employees, rules for the holding or management of investments to invest on its own account, rules to ensure that each transaction involving AIFs may be reconstructed, rules to ensure that the assets of AIFs managed by the AIFM are invested in accordance with the AIF's constitutional document and legal provisions in force (see Section 6.3.2.2.C.)</li> <li>▶ Details of the AIFM's technical infrastructure, including business continuity plan and back-up solutions (see Section 6.3.2.2.A.)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Description of the organizational structure (human and technical resources)</li> </ul>

	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
Internal control (see Section 6.3.2.) and risk management (see Chapter 7)	<b>Internal control</b>		
	<ul style="list-style-type: none"> <li>▶ Information, including <i>curriculum vitae</i>, on the persons in charge of: <ul style="list-style-type: none"> <li>▶ Compliance</li> <li>▶ Internal audit</li> <li>▶ Risk management</li> </ul> </li> <li>▶ Risk management process (see Section 7.2.)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Name and brief description of relevant professional experience of: <ul style="list-style-type: none"> <li>▶ Compliance officer</li> <li>▶ Internal auditor</li> <li>▶ Risk manager</li> </ul> </li> <li>▶ Risk management (see Section 7.3.): <ul style="list-style-type: none"> <li>▶ Risk management process including description of delegates and a description of the investment due diligence procedure</li> <li>▶ Qualitative and quantitative risk limits for each AIF, for at least market, credit, liquidity, counterparty, and operational risk</li> <li>▶ Comprehensive description of permanent risk management function and evidence that the function is functionally and hierarchically independent from the operating units, including portfolio management (see Section 6.3.2.1.)</li> <li>▶ Leverage and reuse of collateral: For each AIF, maximum leverage calculated according to gross and commitment methods and right of reuse of collateral or guarantee granted under a leveraging arrangement (see Section 7.3.)</li> <li>▶ Description of the liquidity management system (see Section 7.3.)</li> </ul> </li> </ul>	
Organization of the fight against money laundering and terrorist financing	<ul style="list-style-type: none"> <li>▶ The CSSF Circular 18/698 sets out the general framework and obligations applicable to IFMs and registrar agents</li> <li>▶ It sets out four scenarios, linked to the respective IFM obligations depending on the manner in which the relationships with the marketing intermediaries and the registrar agent are organized</li> <li>▶ Standardized key information is collected in a market entry form which must include: <ul style="list-style-type: none"> <li>▶ General information</li> <li>▶ Shareholder(s) and beneficial owner(s)</li> <li>▶ Identity of directors, shareholder(s) and beneficial owner(s) of legal persons acting as director of the IFM</li> <li>▶ Information on portfolio manager and/or advisor</li> <li>▶ Business model</li> <li>▶ AML/CFT Procedures</li> </ul> </li> <li>▶ Appointment of the person or collegial body, at governing body level, responsible for compliance with AML/CFT requirements</li> <li>▶ Appointment of the person responsible for the control of AML/CFT requirements: this is the AML/CTF compliance officer at the management level, also named the Money Laundering Reporting Officer (MLRO)</li> <li>▶ Definition of policy/procedure including: <ul style="list-style-type: none"> <li>▶ Definition of a Risk-Based Approach (RBA)</li> <li>▶ Tax offense/Tax fraud - Ongoing oversight</li> <li>▶ Risk score - Expected documentation of the scoring</li> <li>▶ Oversight over the Transfer and Domiciliary Agent</li> <li>▶ On-boarding AML/CFT process including the treatment of politically exposed persons (PEPs)</li> </ul> </li> </ul>		

	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
<b>Internal control</b>			
<b>IT</b>	<ul style="list-style-type: none"> <li>▶ IT function is considered as a support function and integrated into the second line of defense</li> <li>▶ Appoint a DPO (Data Protection Officer) and Cloud Officer if applicable</li> <li>▶ Requirement to have internally established IT system and procedures</li> <li>▶ Establishment of a business continuity plan to work in case of IT disruption</li> </ul>		
<b>Accounting</b>	<ul style="list-style-type: none"> <li>▶ Accounting function is considered as a support function and integrated into the second line of defense</li> <li>▶ Requirement to have an internally established accounting function and a person responsible for it (notify the CSSF)</li> <li>▶ The IFM must appoint from among its staff a person responsible for the accounting administration of UCIs. This function may be combined with other functions</li> <li>▶ Description of the accounting organization and procedures in an accounting procedures manual which complies with the relevant accounting rules in order to keep the accounts of the UCI and its compartments and ensure an effective calculation of the net asset value (NAV) and execution of subscriptions and redemptions</li> </ul>		
<b>Information exchange between the IFM and the depositary</b>	<ul style="list-style-type: none"> <li>▶ The IFM must ensure that the depositary receives, upon commencement of its duties and on an ongoing basis thereafter, all the relevant information it needs to perform its functions for the UCI for which it has been designated as depositary, so that the depositary may comply with its obligations in accordance with the applicable legal and regulatory provisions</li> <li>▶ Procedure describing: <ul style="list-style-type: none"> <li>▶ Information that must be provided in this context to the depositary of the managed UCITS</li> <li>▶ Nature of the information for which the IFM should play a centralized role in order to facilitate the flow of information</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▶ The IFM must ensure that the depositary receives, upon commencement of its duties and on an ongoing basis thereafter, all the relevant information it needs to perform its functions for the UCI for which it has been designated as depositary, so that the depositary may comply with its obligations in accordance with the applicable legal and regulatory provisions</li> <li>▶ Procedure describing: <ul style="list-style-type: none"> <li>▶ Information that must be provided in this context to the depositary of the managed AIFs</li> <li>▶ Nature of the information for which the IFM should play a centralized role to facilitate the flow of information</li> </ul> </li> <li>▶ When a prime broker is appointed, name and details of the interactions between the prime broker, the AIFM, and related parties, and draft agreement (see Section 6.3.5.2.)</li> </ul>	<ul style="list-style-type: none"> <li>▶ The IFM must ensure that the depositary receives, upon commencement of its duties and on an ongoing basis thereafter, all the relevant information it needs to perform its functions for the UCI for which it has been designated as depositary, so that the depositary may comply with its obligations in accordance with the applicable legal and regulatory provisions</li> <li>▶ Procedure describing <ul style="list-style-type: none"> <li>▶ Information that must be provided in this context to the depositary of the managed UCIs</li> <li>▶ Nature of information for which the IFM should play a centralized role in order to facilitate the flow of information</li> </ul> </li> </ul>

	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
<b>Internal control</b>  <b>Requirements with respect to organization and procedures: Focus on rules of conduct (see Section 6.4.2.), conflicts of interest (see Section 6.4.1.), and remuneration (see Section 6.4.3.)</b>	<ul style="list-style-type: none"> <li>▶ Confirmation regarding compliance with the requirements on rules of conduct and conflicts of interest policy</li> <li>▶ Description of the remuneration policy</li> <li>▶ Information on the person responsible for complaints handling and a description of the complaint handling procedures (see Section 6.4.4.)</li> <li>▶ Draft anti-money laundering and counter-terrorist financing procedures (see Section 8.8.4.)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Evidence that the AIFM has procedures:               <ul style="list-style-type: none"> <li>▶ To ensure that the assets of the AIF are invested in accordance with the applicable requirements and on the basis of appropriate due diligence</li> <li>▶ On order handling, best execution and recording of transactions (see Section 8.6.1.)</li> <li>▶ On recording and reporting of subscription and redemption orders (see Section 8.8.3.)</li> <li>▶ On fair treatment of investors, inducements, personal transactions by its employees (see Section 6.4.2.)</li> <li>▶ On the selection and appointment of counterparties and prime brokers (see Section 6.3.5.2.)</li> </ul> </li> <li>▶ When the AIF invests in securitization positions, basis of such exposures (e.g., main investment strategy, ancillary basis) and associated risk mitigation (see Section 4.5.)</li> <li>▶ Confirmation that the AIFM has established an adequate and effective strategy for the exercise of voting rights</li> <li>▶ Confirmation that the AIFM has established and maintained an effective conflicts of interest policy, covering, <i>inter alia</i>, the investments on its own account</li> <li>▶ Description of the remuneration policy, demonstrating compliance with remuneration requirements</li> </ul>	<ul style="list-style-type: none"> <li>▶ Description of management of potential conflicts of interest</li> <li>▶ Description of the remuneration policy</li> </ul>



	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
	<b>Core and business functions, as per their Delegation status</b>		
Delegation (see also Section 6.3.3.) and service providers	<ul style="list-style-type: none"> <li>▶ Detailed description of insourced and delegated activities, including information on delegates</li> <li>▶ Draft contracts with delegates</li> <li>▶ Detailed description of due diligence carried out by the management company on delegates with Risk Based Approach (RBA)</li> <li>▶ Information on the person or company responsible for the accounting of the management company, and, when relevant, the company responsible for maintaining the management company's accounting records (see Section 6.3.2.2.B.)</li> <li>▶ Information on the person responsible for accounting administration of the UCIs at the management company (see also Chapter 8)</li> <li>▶ In case the management company intends to act as administrator, required additional information (see also Section 8.2.1.)</li> <li>▶ Name of auditor (see Section 6.5.2.)</li> <li>▶ Information on the distribution network, including countries of distribution, intermediaries, and target clients (see also Chapter 12)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Information on arrangements made for full or partial delegation and sub-delegation to third parties covering: <ul style="list-style-type: none"> <li>▶ Delegated functions: portfolio management, risk management, administration, marketing, and activities related to the assets of AIFs</li> <li>▶ Name of the delegate, country, authorization(s), issuing authorities, full or partial delegation (indicating activities delegated vs. those retained)</li> <li>▶ Delegation to group vs. other entities</li> <li>▶ Copy of each delegation agreement</li> <li>▶ Objective reasons for delegation</li> <li>▶ Evidence that AIFM effectively supervises the delegate</li> <li>▶ Initial and ongoing due diligence on delegate with Risk Based Approach (RBA)</li> </ul> </li> <li>▶ Delegation of compliance and internal audit: Information on the entity to which the function is delegated and the name of the person within the AIFM responsible for monitoring the delegated function</li> <li>▶ Valuation (see Section 7.6.), including information on: <ul style="list-style-type: none"> <li>▶ Function: External valuer (indicating professional registration and supervisory authority), AIFM itself (including evidence of functional independence and conflicts of interest mitigation), or depository (including evidence of functional and hierarchical separation, conflicts of interest management, and due diligence)</li> <li>▶ Valuation models and validation thereof</li> <li>▶ Policies and procedures</li> </ul> </li> <li>▶ Person in charge of the accounting function of the AIFM (see Section 6.3.2.2.B.)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Detailed description of insourced and delegated activities, including information on delegates</li> <li>▶ Draft contracts with delegates</li> <li>▶ Detailed description of due diligence carried out by the management company on delegates with Risk Based Approach (RBA). In case the management company intends to act as an administrator, additional information required (see also Section 8.2.1.)</li> <li>▶ Name of auditor (see Section 6.5.2.) and accountant, if applicable</li> <li>▶ Information on the distribution network, including countries of distribution, intermediaries, and target clients (see also Chapter 12)</li> </ul>

	Chapter 15 management company	AIFM <sup>21</sup>	Chapter 16 management company
<b>Core and business functions, as per their Delegation status</b>			
Additional information for management entities providing additional services (see Section 6.2.1.D.)	<ul style="list-style-type: none"> <li>▶ Additional information to be included in the program of activities:               <ul style="list-style-type: none"> <li>▶ Discretionary portfolio management: Number of private, institutional, and pension fund clients, AUM by client type, financial instruments, and markets</li> <li>▶ The credit institutions at which the client assets will be deposited</li> <li>▶ The risk management policy applied in relation to discretionary portfolio management</li> <li>▶ When relevant, the non-core services offered</li> </ul> </li> <li>▶ Template of the discretionary management contracts and, if relevant, investment advisory services contracts, which the management company intends to request its clients to sign</li> <li>▶ Confirmation of Deposit Guarantee Association, Luxembourg (FGDL) membership</li> <li>▶ Confirmation of compliance with the additional requirements of the MiFID Directive<sup>22</sup></li> </ul>	<ul style="list-style-type: none"> <li>▶ Additional information to be included in the program of activities:               <ul style="list-style-type: none"> <li>▶ Discretionary portfolio management: Number of private, institutional, and pension fund clients, AUM by client type, financial instruments, and markets</li> <li>▶ The credit institutions at which the client assets will be deposited</li> <li>▶ The risk management policy applied in relation to discretionary portfolio management</li> </ul> </li> <li>▶ Staff involved in the provision of additional services</li> <li>▶ Technical infrastructure to provide additional services</li> <li>▶ Template of the discretionary management contracts and, if relevant, investment advisory service contracts, which the management company intends to request its clients to sign</li> <li>▶ For AIFMs intending to provide discretionary portfolio management services, confirmation of commitment to adhere to investor compensation scheme</li> <li>▶ Confirmation of compliance with the additional requirements of the MiFID Directive<sup>23</sup></li> </ul>	
External Audit	<ul style="list-style-type: none"> <li>▶ In accordance with Article 104 of the 2010 Law, as amended, and Article 7a of the 2013 Law, as amended, every IFM must entrust the audit of its annual accounting documents to one or more <i>réviseurs d'entreprises agréés</i> (approved statutory auditors) who can prove that they have adequate professional experience (see Section 6.5.2.)</li> </ul>		

\* Information marked with an asterisk (\*) may be provided up to one month before commencing business

### B. Dual authorization

Management entities may combine authorizations as follows:

- ▶ Chapter 15 management company/AIFM: With this “dual” authorization, a management entity is authorized to manage both UCITS and AIFs and benefits from the “management” passport to perform in other EU/EEA Member States the activities for which it has been authorized and “product” passports to market the UCITS products it manages to any type of investor and the AIF products it manages to professional investors in all EU/EEA Member States
- ▶ Chapter 16 management company/AIFM: With this “dual” authorization, a management entity is authorized to manage AIFs - both AIF common funds (for which a Luxembourg management company is required) and investment companies - and benefits from the “management” passport to manage AIFs in other EU/EEA Member States and “product” passports to market the AIF products it manages to professional investors in all EU/EEA Member States

<sup>22</sup> Markets in Financial Instruments Directive (MiFID II), Directive 2014/65/EU, as amended.

<sup>23</sup> Idem.

The following management entity authorizations may be combined:

#### Combined authorizations of management entities

	Chapter 15 management company	AIFM
AIFM	✓	N/A
Chapter 16 management company	X	✓

#### C. Investment companies which have not appointed a management entity

A self-managed UCITS investment company is required to comply with prudential requirements. It is required to have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing, and adequate internal control mechanisms.

A self-managed UCITS must have its registered office and decision-making center and administrative center in Luxembourg (see Section 6.3.2.3.). It may delegate administration to a Luxembourg administrator - i.e., a service provider in Luxembourg that is authorized to provide administration to UCIs (see Chapter 8).

It is required to comply, *inter alia*, with requirements on:

- ▶ Capital and business plan (see Section 2.4.1.5.)
- ▶ Sponsor (see Section 6.2.2.B.)
- ▶ Governing bodies and senior management (see Sections 5.1.6.1. and 5.1.6.2.)
- ▶ The portfolio management function and, when applicable, delegation thereof
- ▶ Permanent risk management function and risk management process (see Chapter 7)
- ▶ Delegation of functions (see Section 6.3.3.)
- ▶ Conflicts of interest (see Section 6.4.1.)
- ▶ Rules of conduct (see Section 6.4.2.)
- ▶ Remuneration policy (see Section 6.4.3.)
- ▶ Complaints handling (see Section 6.4.4.)
- ▶ Reporting to the CSSF (see Section 6.5.1.)
- ▶ Securities and instruments regulatory requirements
- ▶ External audit (see Section 10.5.10.)

A full AIFM regime internally managed AIF<sup>24</sup> is subject to the same requirements as an AIFM, except the capital requirements. An internally managed AIF is subject to initial capital requirements applicable to UCIs of EUR 300,000 (see also Section 2.5.) and to professional liability cover requirements (see Section 6.2.3.2.D.). An internally managed AIF can only manage assets of its own portfolio. It cannot under any circumstances provide services to third parties.

#### D. Management entities providing additional services

The additional services that may be provided by management entities are discretionary portfolio management and non-core services including investment advice (see Section 6.1.2.). The provision of such additional services is subject to prior authorization (see Section 6.2.1.).

The provision of discretionary portfolio management or non-core services by UCITS management companies and AIFMs is also subject to:

- ▶ The conduct of business obligations of Article 37-3 of the 1993 Law, as amended, when providing investment services to clients
- ▶ The organizational requirements of Article 37-1 of the 1993 Law, as amended

The provision of such services is also subject to most of the organizational requirements and operating conditions for investment firms laid down in *Commission Delegated Regulation (EU) 2017/565*, as amended, and the relevant MiFID rules of conduct in the financial sector laid down in *CSSF Circular 07/307*, as amended.

Neither management companies nor AIFMs that are authorized to provide discretionary portfolio management services may invest on behalf of their discretionary portfolio management clients in shares or units of UCIs they manage without prior general approval of the client.

The risk management policy applied to discretionary portfolio management must be submitted to the CSSF in the application for authorization.

Management companies that are authorized to provide discretionary portfolio management services must join the Deposit Guarantee Fund, Luxembourg (*Fonds de Garantie des Dépôts, Luxembourg* - FGDL).

<sup>24</sup> | A RAIF cannot be internally managed. It must be managed by an authorized AIFM.

By 31 March each year, FGDL members are required to provide the FGDL with figures at 31 December of the previous year, on

- Deposits
- Claims (instruments and monies)

In practice, this information is collected by the CSSF.

#### E. Simplified registration regime AIFMs

Simplified registration regime AIFMs are subject to registration with the CSSF. They are required to provide the following information:

- Identity
- Identity of the AIF that they manage, including the total value of AUM
- For each AIF, the offering document or a relevant extract from the offering document or a general description of the investment strategy, including at least:
  - The main categories of assets in which the AIF may invest
  - Any industrial, geographic, or other market sectors or specific classes of assets that are the focus of the investment strategy
  - A description of the AIF's borrowing or leverage policy

Simplified registration regime AIFMs are required to monitor their AUM at least annually. This implies, *inter alia*:

- Identifying all AIFs for which it is appointed as the external AIFM or the AIFs for which it is the AIFM, when the legal form of the AIF permits internal management
- Identifying for each managed AIF the portfolio of assets and determining the corresponding value of AUM, including all assets acquired through use of leverage
- Aggregating the determined values of AUM for all AIFs managed. Derivative instruments must be converted into their equivalent position in the underlying assets (see Section 7.3.6.A.)
- Comparing the resulting total value of AUM to the relevant *de minimis* threshold (see Section 6.1.3.E.)

Simplified registration regime AIFMs are required to monitor the AUM on an ongoing basis.

Simplified registration regime AIFMs must notify the CSSF in the event that they exceed the AIFM Law *de minimis* threshold. When the AUM exceeds the relevant *de minimis* threshold on more than a temporary basis (i.e., it is likely to continue for more than three months), the AIFM has 30 days to apply for AIFM authorization.

Simplified registration regime AIFMs must report to the CSSF annually on the main instruments in which they are trading and on the principal exposures and most important concentrations of the AIFs that they manage in order to enable the competent authorities to monitor systemic risk effectively (see Section 6.5.1.B.).

#### F. IFMs managing AIFs investing in virtual assets

As the AIFMD does not provide for a list of eligible or non-eligible assets, AIFs may in principle invest in any traditional or alternative assets as long as the AIFM can ensure compliance with the AIFMD. However, ESMA emphasizes that more specific investment and risk diversification requirements for AIFs investing in crypto-assets as well as limitations regarding the target investors of such AIFs may exist at national level (see Chapter 4).

Each authorized IFM which intends to manage an AIF, regulated or not, investing in virtual assets, needs to obtain prior authorization from the CSSF for the strategy "Other-Other Fund-Virtual assets".

In this context, the CSSF expects to receive, *inter alia*, the following information/documents:

- Description of the project and of the different service providers/delegates involved
- Information on whether or not the investments in virtual assets will be made directly or indirectly (e.g., by the means of derivatives)
- An updated risk management policy including in particular how the risks in relation to the virtual assets are managed
- An updated valuation policy including the rules as to how the value of the virtual assets will be determined
- Description regarding the experience of the portfolio manager (and other involved entities in the investment management process) in virtual assets
- Description of how the custody of the assets will be organized by the depositary
- Information regarding the targeted investors, as well as any information on the distribution channels of the AIF
- The IFM's AML/CTF analysis on the assets side

In addition, the CSSF expects that each initiator of an AIF which intends to invest in virtual assets should present its project beforehand to the CSSF. A particular emphasis should be put on assessing the conditions under which the IFM (or any participant in the AIF's business operations) is involved in the control of the virtual assets by means of access to/control over the cryptographic keys.

In general, an analysis of the services performed needs to be conducted in light of the activities listed under Article 1 (20c) of the AML/CTF Law. Should the IFM (or any other participant) provide these virtual asset services, a complete application file for registration as a virtual asset service provider (VASP) needs to be submitted to the CSSF before commencing the activity.

Further details with respect to the VASP registration procedures can be found on the CSSF website (Registration of a virtual asset service provider (VASP)).

#### G. Managers of EuVECAs and EuSEFs

The managers of qualifying EuVECAs and of qualifying EuSEFs must be legal persons whose regular business includes managing at least one qualifying European fund and they must be established in the EU/EEA. The manager benefits from the AIFM Directive exemption applicable to managers who manage portfolios of AIFs whose AUM, in total, does not exceed a threshold of EUR 500 million when the portfolio of AIFs consists of AIFs that are not leveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF. Such managers are subject to certain registration and regulatory reporting requirements under the AIFM Directive. They may also manage other types of UCIs.

When the total AUM subsequently exceeds the AIFM Directive threshold of EUR 500 million, the manager (who must obtain authorization under the AIFM Directive) may continue to use the qualifying European fund designations provided it continues to meet requirements of the qualifying European fund regime.

The managers of qualifying European funds are required to meet conduct of business requirements including:

- ▶ Act honestly, fairly, and with due skill, care, and diligence in conducting their activities
- ▶ Apply appropriate policies and procedures for preventing malpractices
- ▶ Conduct their business activities so as to promote:
  - ▶ The best interests of the qualifying European funds they manage, the investors in those qualifying European funds, and the integrity of the market
  - ▶ In the case of EuSEFs, the positive social impact of the qualifying portfolio undertakings
- ▶ Apply a high level of diligence in the selection and ongoing monitoring of investments in qualifying portfolio undertakings and, in the case of EuSEFs, the positive social impact of those undertakings
- ▶ Possess adequate knowledge and understanding of the qualifying portfolio undertakings in which they invest
- ▶ Treat investors fairly
- ▶ Ensure that no investor obtains preferential treatment, unless such preferential treatment is disclosed in the constitutional document of the qualifying fund

The manager of a qualifying European fund may delegate functions to third parties. The delegation must not prevent that manager from acting, or the qualifying venture capital fund from being managed, in the best interests of the investors therein. The manager's liability towards the qualifying European fund or the investors therein is not affected by the delegation. The manager cannot delegate functions to the extent that it becomes a letter-box entity.

The managers of qualifying European funds are required to identify and avoid conflicts of interest and, when they cannot be avoided, manage, monitor, and disclose those conflicts of interest in order to prevent them from adversely affecting the interests of the qualifying European funds and their investors and to ensure that the qualifying European funds they manage and their investors are fairly treated.

The manager of a qualifying European fund must have sufficient own funds and employ adequate and appropriate human and technical resources.

In February 2022, ALFI issued *considerations on requirements applicable to Luxembourg EuVECA managers* presenting a practical interpretation of applicable regulatory requirements.

The EuVECA and EuSEF regimes are introduced in Section 2.4.4.3.

#### H. Granting authorization

Following submission of a complete application, the CSSF will inform the management entity whether or not authorization has been granted within a period of six months in the case of a management company and three months (extendable) in the case of an AIFM. The management entity may commence business following approval of the application.

CSSF Circular 18/698 provides clarification and guidance on all matters pertaining to the organization of Luxembourg management companies and self-managed investment companies. It outlines, in particular, the CSSF's expectations in terms of substance, reporting duties and key functions (such as AML/CFT, risk management, marketing), internal corporate governance and sets out requirements for the key policies and procedures. With a dedicated section covering delegation oversight, the Circular also addresses the requirements for external governance.

#### Time to approval of a management entity

	Chapter 15 management company	AIFM <sup>25</sup>	Chapter 16 management company
Time to approval	Six months	Three months <sup>26</sup> The CSSF may extend this period for up to three additional months, when they consider it necessary due to the specific circumstances of the case and after having notified the AIFM accordingly.	Six months

If the CSSF refuses the application, the CSSF will outline the reasons for the refusal. See also Section 6.2.1.K.

Authorized management companies are entered by the CSSF on a list, which it publishes. Entry onto the list is equivalent to authorization and is notified by the CSSF to the concerned management company. This list and any modifications made thereto are also published in the Official Gazette (*the Mémorial*).

#### I. Restrictions on activities

The CSSF may restrict the scope of the authorization of a management entity, in relation to:

- ▶ The types of UCITS that a Chapter 15 management company is authorized to manage
- ▶ The investment strategies of AIFs that an AIFM is allowed to manage

#### J. Updates to authorization

The management entity must, on its own initiative and before implementation, inform the CSSF of any material changes to the conditions for initial authorization.

#### K. Withdrawal of authorization

The CSSF can withdraw authorization of the management entity when such entity:

- ▶ Does not make use of the authorization within 12 months, expressly renounces the authorization, or has ceased the activity covered by the authorization for the preceding six months
- ▶ No longer meets the conditions under which authorization was granted
- ▶ Has seriously or systematically infringed the provisions of the Law
- ▶ Has obtained the authorization by making false statements

## 6.2.2. Incorporating the management company

### A. Legal form and office

Management companies may be set up under any of the following forms:

- ▶ Public limited company (*société anonyme* – S.A.)
- ▶ Private limited company (*société à responsabilité limitée* – S.à r.l.)
- ▶ Cooperative company (*société cooperative*)
- ▶ Cooperative company organized as a public limited company (*société coopérative organisée sous forme de société anonyme* – S.Co S.A.)
- ▶ Corporate limited partnership (*société en commandite par actions* – S.C.A.)

Any legal person whose regular business is to manage one or more AIFs can apply for authorization as an AIFM.

Both the head office and registered office of a management entity must be in Luxembourg.

<sup>25</sup> New AIFMs, existing management companies requesting authorization as AIFMs, and internally managed AIFs.

<sup>26</sup> In practice, the three-month period is very often extended to six months in total.

## B. Sponsor

The CSSF may request a letter of assurance from a “sponsor”. In the letter of sponsorship, the sponsor makes a commitment to the CSSF that the management company respects/will respect the applicable prudential requirements, in particular, the own funds of the management company. Such a letter may be requested:

- ▶ At the time of authorization
- ▶ When there is a change of shareholders
- ▶ When the financial capacity of one or more of the shareholders of the management company or of the management company itself is no longer certain

In practice, the “sponsor” will generally be the main shareholder at incorporation of the management company, or a group entity to which the main shareholder belongs (see also Section 6.2.3.1.).

The role of “sponsor” of a Chapter 15 management company replaces the role of “promoter” of a UCI managed by a Chapter 15 management company (see Section 1.4.2.A.).

## 6.2.3. Funding the management company

### 6.2.3.1. Shareholders and related parties

#### A. Shareholders and their suitability

The CSSF must be informed of the identity of the direct and indirect shareholders (or members) of the management entity that have qualifying holdings, and the amounts of those holdings. The shareholders may be individuals or legal persons.

The CSSF will need to be satisfied as to the reputation and suitability of such shareholders or members.

The ownership structure of the management entity must be transparent and organized in a way that permits prudential supervision to be exercised effectively (see Section 6.2.3.1.C.).

The CSSF has outlined in more detail the requirements applicable to the shareholders or members of a Chapter 15 management company and AIFM. The CSSF requires that:

- ▶ Each individual acquiring, directly or indirectly, a qualifying holding in a Chapter 15 management company or AIFM must be suitable to ensure sound and prudent management of the company. The criteria for evaluating suitability include:
  - ▶ Reputation of the proposed acquirer
  - ▶ Reputation and experience of those who will direct the business
  - ▶ Financial soundness of the proposed acquirer
  - ▶ Compliance with the prudential requirements at group level
  - ▶ AML/CFT (see also Section 8.8.4.)

Each company entering into a direct shareholding structure of a management company must, in principle, dispose of own funds at least equivalent to the amount it intends to invest in the capital of the management company, after deduction, when appropriate, of other holdings held (see also Section 6.2.3.2.B.).

- ▶ Shareholder(s) contribution should, in principle, be carried out on the shareholder’s own account and not on behalf of third parties. Shares in the IFM cannot be pledged
- ▶ Where the appointed depository holds a direct or indirect qualifying holding in the IFM, the IFM is required to identify potential conflicts of interest and seek to avoid them in accordance with the procedures set out in the conflict of interest management policy of the IFM

Qualifying holdings are deemed to be holdings of 10% or more of the capital or of the voting rights, whether direct or indirect, or when it is possible to exercise significant influence.

#### B. Consultation with other Member States

The authorities of other Member States will be consulted prior to authorization when the management company is:

- ▶ A subsidiary of an entity authorized in another Member State
- ▶ A subsidiary of the parent undertaking of another entity authorized in another Member State
- ▶ Controlled by the same persons/entity that control other entities authorized in another Member State

#### C. Close links

The CSSF will refuse authorization of the management entity when the effective exercise of its supervisory functions is prevented by any of the following:

- ▶ “Close links” between the management entity and other natural or legal persons
- ▶ The laws, regulations, or administrative provisions of a third country governing natural or legal persons with which the management entity has close links
- ▶ Difficulties involved in the enforcement of those laws, regulations, and administrative provisions

“Close links” means a situation in which two or more individuals or legal persons are linked by ownership, directly or by way of “control”, of 20% or more of the voting rights or capital of an undertaking. “Control” refers to the relationship between a parent undertaking and a subsidiary or a similar relationship.

### 6.2.3.2. Minimum capital requirements, own funds and professional liability cover

#### A. Summary

Chapter 15 management companies and AIFMs are, respectively, covered by the 2010 Law and AIFM Law “own funds” requirements for their collective portfolio management activities (covering the portfolios of common funds and investment companies, but excluding portfolios managed under delegation).

They are also covered by capital adequacy requirements in the same way as investment firms under MiFID when they perform discretionary portfolio management services. These requirements only cover the individual discretionary portfolio management activities of management companies, not collective portfolio management.

#### B. Minimum initial capital and own funds

	Capital requirements of a management entity		
	Chapter 15 management company	AIFM	Chapter 16 management company
Initial capital	EUR 125,000	EUR 125,000	EUR 125,000
Additional own funds	Additional own funds <sup>27</sup> of 0.02% of the amount of the portfolios <sup>28</sup> that exceeds EUR 250 million.  Maximum total required capital, however, is EUR 10 million, unless the minimum amount of “own funds”, defined below, is higher.  Up to 50% of the additional own funds may be provided by means of a guarantee given by a credit institution or an insurance undertaking established in the EU or in a non-EU country subject to prudential rules considered by the CSSF as equivalent to those laid down in EU law.		N/A
Minimum amount of “own funds” (floor)	One quarter of their preceding year’s fixed overheads <sup>29</sup> (the amount prescribed in Article 13 of Regulation No 2019/2033) or, in the case of new management entities, of the fixed overheads projected in the business plan.		N/A

An AIFM is required to maintain financial resources adequate to its assessed risk profile (see also Section 7.3.6.B.).

Self-managed UCITS and internally managed AIFs are subject to initial capital requirements of EUR 300,000 (see also Section 2.5.).

<sup>27</sup> The definition of own funds for management companies and AIFMs, under both the 2010 Law and the AIFM Law, refers to the definition of own funds applicable to investment firms.

The Investment Firm Regulation (IFR - Regulation No 2019/2033 on prudential requirements for investment firms) defines own funds for investment firms. Under the IFR, own funds include, *inter alia*:

- ▶ Capital instruments which meet specific requirements
- ▶ Share premium accounts related to capital instruments
- ▶ Retained earnings
- ▶ Accumulated other comprehensive income
- ▶ Other reserves

<sup>28</sup> For capital requirements purposes, portfolios are deemed to be UCIs managed by the management entity, including portfolios for which it has delegated the management function, but excluding portfolios that it is managing under delegation.

<sup>29</sup> Overheads include the costs for staff and administrative bodies, as well as operating costs.

For investment firms, the European Banking Authority (EBA) draft Regulatory Technical Standards (RTS) on own funds requirements for investment firms based on fixed overheads lays down the methodology for calculating fixed overheads. In summary, investment firms should calculate the fixed overheads of the preceding year by using figures resulting from the applicable accounting framework by subtracting the following items from the total expenses after the distribution of profits in their most recent audited annual financial statements:

- ▶ Staff bonuses and other remuneration, to the extent that they depend on the net profits of the investment firm in the respective year
- ▶ Employees’, directors’, and partners’ shares in profits
- ▶ Other appropriations of profits and other variable remuneration, to the extent that they are fully discretionary
- ▶ Shared commission and fees payable that are directly related to commission and fees receivable, which are included within total revenue, and when the payment of the commission and fees payable is contingent upon the actual receipt of the commission and fees receivable
- ▶ Fees, brokerage, and other charges paid to central counterparties, exchanges and other trading venues and intermediate brokers for the purposes of executing, registering or clearing transactions
- ▶ Fees to tied agents
- ▶ Interest paid to customers on client money
- ▶ Non-recurring expenses from non-ordinary activities
- ▶ Expenditures from taxes where they fall due in relation to the annual profits of the investment firms
- ▶ Losses from trading on own account in financial instruments
- ▶ Payments related to contract-based profit and loss transfer agreements according to which the firm is obliged to transfer, following the preparation of its annual financial statements, its annual result to the parent undertaking
- ▶ Payments into a fund for general banking risk

A tied agent is a natural or legal person who, under the full and unconditional responsibility of only one investment firm on whose behalf it acts, promotes investment and/or ancillary services to clients or prospective clients, receives and transmits instructions or orders from the client regarding investment services or financial instruments, places financial instruments, and/or provides advice to clients or prospective clients regarding those financial instruments or services. A total of 35% of all the fees related to tied agents should be added to the result to obtain the fixed overheads.



C. Requirements in relation to minimum amount of “own funds”<sup>30</sup>

The capital of the management entity must be represented by registered shares.

The own funds must consist of liquid assets or assets easily convertible into liquid short-term assets. The CSSF does not, in principle, accept contributions in kind, such as debt contributions, either at the time of incorporation or in case of a capital increase.

The legally required minimum amount of own funds must be permanently available to the management entity and invested in its own interests. Subject to the principle of prudence, the own funds may be invested to finance the management company’s operating costs.

The own funds cannot be invested in or loaned to the shareholder. Funds can be invested in liquid assets or assets readily convertible to cash in the short term, but must not contain speculative positions.

Every holding of the management entity in another company must be notified to the CSSF and financed exclusively by surplus own funds above the legally required minimum amount. The activity of a subsidiary must be aligned with the activities of the management entity.

Surplus own funds may be invested in non-liquid assets according to CSSF Circular 18/698.

D. Professional liability cover

To cover potential professional liability risks, AIFMs must either have additional own funds or hold professional indemnity insurance.

The amount of additional own funds or professional indemnity insurance depends on the value of the “portfolios of AIFs managed”. The “portfolios of AIFs managed” is defined as the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through the use of leverage, whereby derivative instruments are valued at their market value.

**Methods to cover professional liability**

Additional own funds	Professional indemnity insurance
<p>The additional own funds should at least be equal to 0.01% of the value of the portfolios of AIFs managed. However, the CSSF may, on the basis of a three-year historical loss assessment, authorize the AIFM to hold a lower amount of additional own funds of not less than 0.008% of the value of the portfolios of AIFs managed by the AIFM.</p> <p>This additional own funds requirement must be recalculated at the end of each financial year or when the value of the portfolios of AIFs managed increases significantly, and the amount of additional own funds adjusted accordingly.</p>	<p>The coverage of the insurance for an individual claim must be equal to at least 0.7% of the value of the portfolios of AIFs managed by the AIFM.</p> <p>The coverage of the insurance for claims in aggregate per year must be equal to at least 0.9% of the value of the portfolios of AIFs managed by the AIFM.</p> <p>The professional liability insurance must:</p> <ul style="list-style-type: none"><li>▶ Have an initial term of no less than one year</li><li>▶ Have a notice period for cancellation of at least 90 days</li><li>▶ Cover professional liability risks</li><li>▶ Be taken out from an EU or non-EU undertaking authorized to provide professional indemnity insurance in accordance with EU law or national law</li><li>▶ Be provided by a third-party entity</li></ul>

Operational management requirements, including the scope of professional liability risks and the requirement to set up a historical loss database, are covered in Section 7.3.6.B.

E. Additional requirements applicable to management entities that provide discretionary portfolio management services

When a Chapter 15 management company or an AIFM is also engaged in the management of portfolios of investments that include financial instruments on a discretionary and individual basis (see Section 6.1.2.), it must respect specific own funds requirements regarding these discretionary portfolio management activities.

CSSF Circular 07/290, as amended, covers the definition of capital ratios pursuant to the Law of 5 April 1993 on the financial sector, as amended (the 1993 Law).

<sup>30</sup> This Section consolidates and summarizes the CSSF’s expectations in relation to own funds. The reference sources include:

- ▶ The 2010 Law and the AIFM Law
- ▶ CSSF Circular 18/698
- ▶ The CSSF’s explanations concerning the authorization procedure of Chapter 15 and Chapter 16 management companies (available on the CSSF’s website)

The Circular defines a capital adequacy ratio designed to ensure that investment undertakings, such as management companies, set aside sufficient own funds to cover their exposures to risks. The capital adequacy ratio compares eligible own funds to the overall capital requirement for the risks concerned.

The Circular, as amended, covers, *inter alia*:

- ▶ Definition of own funds
- ▶ Coverage of risks: General principles and coverage on a consolidated basis
- ▶ Minimum capital requirements for credit risk, settlement risk, counterparty credit risk, recognition of credit risk mitigation techniques, coverage of credit risks associated with securitization, position risk, foreign exchange risk, commodities risk, operational risk, and large “exposures”

The Investment Firm Directive (EU) 2019/2034 indirectly impacts AIFMs and Chapter 15 management companies providing MiFID II services. Depending of the type of investment service activities, the initial capital should be EUR 75,000, EUR 150,000 or EUR 750,000.

## 6.2.4. Liquidation and insolvency

In the event of a voluntary liquidation of a management company, the liquidator(s) must be approved by the CSSF. The liquidator(s) must provide all guarantees of honorability and professional skills.

The assets of the UCIs under management do not form part of the estate in case of insolvency of the management company and cannot be claimed by the creditors of the management company.

## 6.3. Organization and function of a management entity

### 6.3.1. Organizational requirements

#### A. Internal organizational requirements

Management companies and AIFMs are required to comply with general organizational requirements including the following:

- ▶ Establish, implement, and maintain decision-making procedures and an organizational structure that specifies reporting lines and allocates functions and responsibilities clearly and in a documented manner (see Sections 6.3.2.3. and 6.3.2.2.C.)
- ▶ Ensure that the staff is aware of the procedures to be followed for the proper discharge of their responsibilities (see Section 6.3.2.2.C.)
- ▶ Establish, implement, and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the management entity (see Section 6.3.2.1.)
- ▶ Establish, implement, and maintain effective internal reporting and communication of information at all relevant levels of the management entity (see Section 6.3.2.3.) and effective information flows with any third party involved (see Section 6.3.3.)
- ▶ Maintain adequate and orderly records of their business and internal organization (see Section 6.3.2.3.)
- ▶ Establish, implement, and maintain systems and procedures that are adequate to safeguard the security, integrity, and confidentiality of information, taking into account the nature of the information in question (see Section 6.3.2.2.A.)
- ▶ Establish, implement, and maintain an adequate business continuity policy aimed at ensuring, in the event of an interruption to their systems and procedures, the preservation of essential data and functions and the maintenance of services and activities or, when that is not possible, the timely recovery of such data and functions and the timely resumption of their services and activities (see Section 6.3.2.2.A.)
- ▶ Establish, implement, and maintain accounting policies and procedures and valuation rules that enable them, at the request of the CSSF, to deliver in a timely manner to the CSSF financial reports that reflect a true and fair view of their financial position and comply with all applicable accounting standards and rules (see also Section 6.3.2.2.B., 6.5.1. and 6.5.2.)
- ▶ Monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems, internal control mechanisms, and arrangements and take appropriate measures to address any deficiencies (see also Section 5.1.6. and 6.3.2.1.)

The roles, responsibilities of the governing bodies and senior management, as well as the applicable requirements are covered in more detail in Section 5.1.6.

On 9 April 2021, the CSSF issued Circular 21/769 *on governance and security requirements for supervised entities (“entities”) to perform tasks or activities through Telework (“the Circular”)*. It is worthwhile mentioning that the Circular applies under normal working conditions and does not apply under pandemic situations or in other exceptional circumstances having a comparable impact on working conditions.

The Circular provides criteria, both of which must be met to qualify a work relationship as telework:

- Work must be delivered by means of information and communication technologies (ICT) based on previous approval by the employer
- Work must be performed on a regular or occasional and voluntary basis and within the defined working hours at a predetermined place that is different from the employer's premises

The Circular provides a framework for governance and security arrangements to be implemented by entities employing telework. No CSSF approval is required for implementation, maintenance or extension of telework solutions but the CSSF will monitor compliance of entities with the Circular.

#### *Timeline and scope*

The Circular was applicable from 30 September 2021 to all entities supervised by the CSSF, branches of non-EEA<sup>31</sup> entities and branches of EU entities in addition to the rules applicable in the home Member State.

However, the Circular does not regulate contractual relations with employees and does not interfere with the Luxembourg Labour Code or create any precedence for rights/obligations on whether telework may be implemented by entities under the supervision of the CSSF.

For the purpose of the Circular, persons put at the disposal of a supervised entity through a contract by a third-party employer should also be considered as staff members.

#### *Key points*

##### 1. Board responsibility

Telework must be organized under the responsibility of the board of directors of the entity or any body that represents the entity, by virtue of the law and of the instruments of incorporation.

##### 2. Substance

Head office should be able to demonstrate that it remains at all times the decision-making center. Sufficient substance should be retained on the premises in order to allow entities to handle emergencies and time-critical issues and staff should be able to return to the premises on short notice.

The following minimum criteria should be used when implementing telework:

- The number of staff who may telework must comply with central administration requirements
- The amount of telework allowed for each staff member should be limited
- At least one authorized manager should be on-site at all times
- Key functions should be sufficiently represented every day to permanently guarantee functioning of activities, control and decision-taking, in a manner proportionate to the organization and the nature, scale and complexity of activities
- There should be sufficiently skilled and responsible staff on-site to guarantee adequate functioning of activities and controls during business hours
- There should be no substantial impact on activities in case of connection disruptions

##### 3. Compliance with applicable legal and regulatory requirements

Entities must ensure continuous compliance with the Luxembourg Labour Code, tax and company laws, professional secrecy, data protection and social security requirements.

##### 4. Telework risk assessment

A formalized risk analysis should identify risks inherent to teleworking as well as mitigating controls and measures. Such risk assessment should be reviewed on a regular basis and at least annually by the board to consider lessons learnt, organizational/environmental changes and emerging threats. Special attention should be paid to the risks associated with telework of privileged users and appropriate controls and measures should be implemented to log their actions.

##### 5. Telework policy

Entities must have documented rules either as part of the general security policy document or in a dedicated telework policy. The latest rules should be adapted to the nature, scale and complexity of the activities of the entity (principle of proportionality) and clearly define:

- To what extent telework is allowed, considering risks and defining limits
- From where telework is allowed

The telework policy should notably formalize:

- Which units/departments/functions/activities may be performed via in telework
- Minimum staff on-site at entity/department level and working hours allowed via telework
- Control procedures to monitor work performed via telework
- Minimum physical meetings in Luxembourg
- Measures to be taken to ensure compliance with confidentiality/data protection regulations

<sup>31</sup> | EEA, i.e., EU countries and Iceland, Liechtenstein and Norway.

## 6. Internal organization and internal control framework

- ▶ Monitoring requirements  
Name, function and department of staff teleworking should be recorded in a commonly used database format and provided to the CSSF upon request
- ▶ Controls by internal control functions over telework  
Internal control functions (compliance, risk incl. information security, internal audit) should review the telework policy, process and compliance as part of their pluriannual work program and report any issues or findings in their respective annual summary report to the CSSF

## 7. Detailed requirements related to ICT and security risks

Entities should implement these requirements in a manner which is proportionate to the nature, scale and complexity of their activities and commensurate to the risks they are exposed to.

- ▶ A telework security policy should set principles and rules applicable in the context of telework, to protect the confidentiality, integrity and availability of the entity's data, information and ICT systems. The telework security policy, a subset of the general security policy or the telework policy, should be aligned with the risk assessment's results, approved by the board, and complemented by operational procedures
- ▶ Entities should ensure their staff members are aware of risks, best practices and their duties and responsibilities in line with the relevant security policies to reduce human error, theft, misuse or loss. Procedures should cover organizational and technical risks (social engineering, phishing attacks, etc.) and the appropriate behaviours to be adopted by the teleworkers
- ▶ Access rights should be established and granted based on the "need-to-know" principle while maintaining a segregation of duties. Additionally, access rights must be reviewed at least annually for normal users and at least bi-annually for privileged users
- ▶ The use of corporate own devices should be encouraged as well as the use of virtual desktop infrastructures or controlled professional environments (containers) on private devices. Private devices should not be used for critical activities or ICT administration and, where permitted, should be subject to a specific risk analysis and controls
- ▶ Entities should ensure at all times that telework infrastructure components are functioning properly, are secured correctly and closely monitored
- ▶ Mechanisms should be in place to detect abnormal connections and block/alert them, based on security and non-security criteria such as, *inter alia*:
  - ▶ Correct authentication of the teleworker
  - ▶ Correct identification and authentication of the device
  - ▶ Correct identification of the remote location of the teleworker
  - ▶ Connection time within the defined working hours
  - ▶ Security components and mechanisms are not modified or bypassed by the telework or an attacker, are up-to-date and running
- ▶ Robust change management should be in place, ensuring that changes do not jeopardize the infrastructure and security level
- ▶ Data in transit must be secured, i.e., encrypted in accordance with the data classification current leading practice (encryption protocols, key size, algorithms)
- ▶ Two-factor authentication (2FA) may be adapted to the type of operation and the user profile. For critical activities, strong 2FA is required with one of the factors being dynamic (e.g., OTP)
- ▶ The effectiveness of security measures should be reviewed by an independent security control function (information security officer, internal audit or specialized external third party) before the go-live and on a regular basis. Vulnerability scans/penetration tests should be conducted on a regular basis, commensurate with the level of identified risk
- ▶ Technology risk watch should allow entities to detect timely new vulnerabilities, with particular attention to risks related to the use of private devices, where they are allowed
- ▶ A sound logging process should be implemented for security monitoring purposes. Access logs should be secured. The proportionality principle applies for the granularity of logged information and the log retention period without prejudice to the requirements set out in EU (General Data Protection Regulation (GDPR)) and national law

## B. Appointment and oversight of service providers

The responsibilities of the management entity depend on the basic structure of the investment fund:

- ▶ A common fund has no legal personality; it is created and managed by a management company. The management company may delegate certain of its collective management functions; it must monitor the activities of its delegates. It must also appoint the other required service providers
- ▶ An investment company is a legal entity with a governing body; it can appoint a management entity or manage itself:
  - ▶ Investment company managed by a management entity: One of the main responsibilities of the governing body is the appointment and monitoring of the management entity. The management entity may, itself, delegate certain of its collective management functions; it must monitor the activities of its delegates. The governing body is also responsible for the appointment and oversight of other service providers
  - ▶ Investment company manages itself (a self-managed UCITS or an internally managed AIF<sup>32</sup>): The governing body is responsible for the appointment and oversight of all the service providers

Collective management delegated functions may include, for example, portfolio management, administration, risk management, and marketing. Delegation is summarized in Section 6.3.3.

The other service providers include, *inter alia*, the depositary (see Chapter 9), paying agent (see Section 1.4.2.M.), and auditor (see Section 10.5.10.).

The following illustrates the typical responsibilities in relation to the appointment and monitoring of service providers:

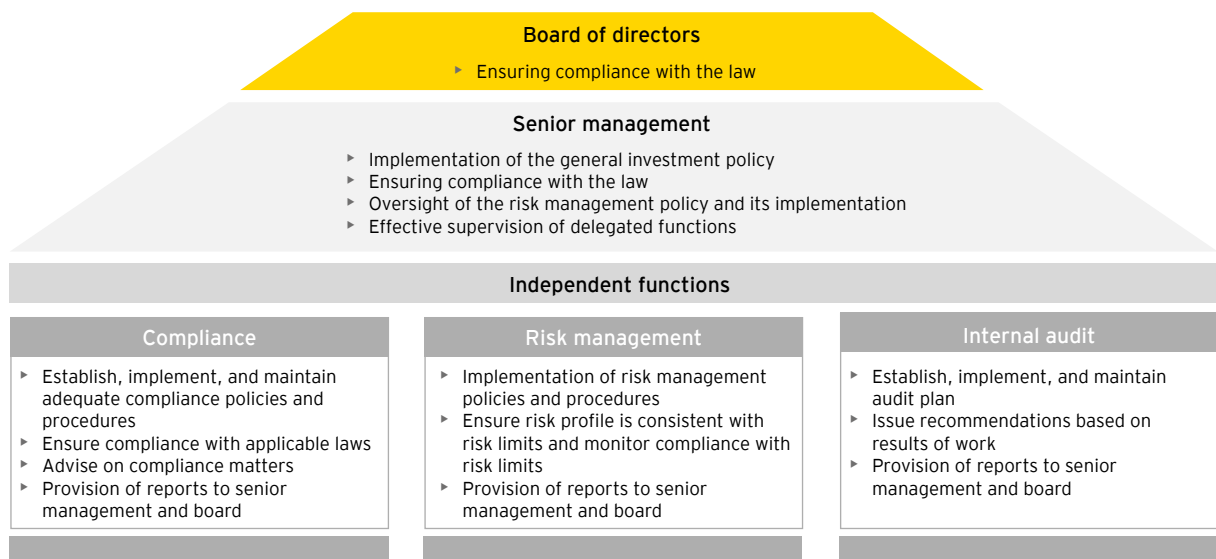
### Who usually appoints and monitors the service providers?

	Management entity	Collective management delegates (e.g., portfolio manager, risk management function service provider, administrator, or distributor)	Other service providers (e.g., depositary, auditor, legal advisor)
Common fund	N/A Management company creates the common fund - it is not appointed	Management company	Management company
Investment company:			
Externally managed	Governing body of investment company	Management entity	Governing body of investment company <sup>33</sup>
Self-managed or internally managed <sup>34</sup>	N/A	Governing body of investment company	Governing body of investment company <sup>35</sup>

## 6.3.2. Internal control framework

The following diagram illustrates a possible internal control framework of a management entity:

### Structure of possible internal control structure



<sup>32</sup> A RAIF cannot be internally managed. It must be managed by an authorized AIFM.

<sup>33</sup> The annual general meeting of shareholders formally appoints the auditor.

<sup>34</sup> A RAIF cannot be internally managed. It must be managed by an authorized AIFM.

<sup>35</sup> The annual general meeting of shareholders formally appoints the auditor.

IFMs must set up an internal governance system that complies with the “three-lines-of-defence model” concept.

The first line of defense consists of the business units that take care of, or acquire, risks under a predefined policy and limit and carry out controls.

The second line of defense consists of the permanent risk management and compliance functions that contribute to independent risk control, as well as of the support functions, including the IT function and the accounting function.

The third line of defense consists of the internal audit function which carries out an independent, objective and critical evaluation of the first two lines of defense.

### 6.3.2.1. Internal control functions

The internal control functions of a management entity are compliance, risk management, which form part of the second line of defense, and internal audit, which forms part of the third line of defense. Pursuant to CSSF Circular 18/698, supporting functions such as IT and accounting are also part of the second line of defense.

Chapter 15 management companies and AIFMs are required to establish and maintain operational permanent compliance, risk management, and, subject to proportionality considerations, internal audit functions.

The internal control functions must:

- Be permanent and independent
- Have sufficient authority and access to the governing body/management body, auditor and CSSF
- Work objectively: Must possess independence from operating units they control
- Have high professional competences and up to date knowledge
- Have the necessary HR/infrastructure/budgets
- Have a remuneration not linked to performance of the funds
- Document the work carried out in order to enable the interventions and the conclusions to be traced
- Verify that a follow-up is effectively carried out of the recommendations
- Inform senior management and the governing/management body where required

Each head of internal control function should be appointed and dismissed in line with a written procedure. Appointments and dismissals must be approved by the managing body/governing body and their names communicated to the CSSF. Heads of internal control functions who are entering such a position for the first time must demonstrate extensive professional experience and sufficient theoretical knowledge.

They must provide the senior management and the managing body/governing body with the advice and guidance they deem appropriate to improve the central administration and the internal governance of the IFM. They should communicate as soon as feasible with the senior management and the managing/governing bodies to reply to their requests for advice or to inform them when they consider that the effective, sound or prudent management of the activities is compromised.

Senior management must receive on a frequent basis, and at least annually, written reports on matters covered by internal control functions indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.

The CSSF has clarified that, in a Chapter 15 management company, the risk management and/or compliance function cannot be combined with the internal audit function, but risk management and compliance may be combined. Neither the compliance officer, the head of risk management, nor the internal auditor can be a member of the board of directors of the management company. A conducting officer may be responsible for the permanent risk management function provided the officer has the relevant qualifications, knowledge, and experience. When the compliance and internal audit functions have been delegated, the monitoring of these functions cannot be carried out by the same individual.

A Chapter 15 management company must promote an internal culture of control and monitoring of risk, which aims to ensure that all members of staff actively participate in the detection, declaration, and control of risks incurred by the management company. Continuous and updated training must be organized for each employee of the internal control functions.

The internal control functions must cover the activities of branches, representative offices, agencies and subsidiaries of an IFM.

AML/CTF internal control requirements are covered in Section 8.8.4.

Management entities are required to submit to the CSSF on an annual basis a written report of the management on the state of the internal controls. The report must address the realization of the internal control objectives, describe the means implemented, and summarize the main observations made and deficiencies observed by the internal control functions, the corrective measures taken, and the effective follow-up of these measures. It should include a copy of the summary report on the controls carried out by the internal audit during the previous financial year.

## A. Compliance

Chapter 15 management companies and AIFMs are required to establish, implement, and maintain adequate policies and procedures, including a compliance charter designed to detect any risk of failure to comply with its obligations under the law, and the associated risks, and put in place adequate measures and procedures designed to minimize such risk.

The management entity should take into account the nature, scale, and complexity of its business and the nature and range of services and activities undertaken in the course of that business.

Chapter 15 management companies and AIFMs are required to establish and maintain a permanent and effective compliance function, responsible for:

- ▶ Monitoring of adequacy and effectiveness of measures, policies, and procedures put in place to detect any risk of failure by the management entity to comply with its obligations under the law, as well as the associated risks and the actions taken to address any deficiencies in the management entity's compliance with its obligations
- ▶ Advising and assisting relevant persons responsible for carrying out services and activities on matters of compliance with the law

The management entity must ensure that:

- ▶ The compliance function has the necessary authority, resources, expertise, and access to all relevant information
- ▶ A compliance officer is appointed. The compliance officer is responsible for:
  - ▶ The compliance function
  - ▶ Reporting on a frequent basis, and at least annually, to senior management on matters of compliance, indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies
- ▶ Persons in the compliance function are not involved in the performance of services or activities they monitor
- ▶ The method of determining the remuneration of a compliance officer and other persons in the compliance function does not affect their objectivity and is not likely to do so (see also Section 6.4.3.)

A management entity is not required to comply with either of the last two bullet points when it is able to demonstrate that, in view of the nature, scale, and complexity of its business and the nature and range of its services, those requirements are not proportionate and that its compliance function continues to be effective.

The compliance function should not be outsourced to third parties. This principle shall not preclude the possibility to use the expertise or technical means of third parties or the possibility to establish, where applicable, a functional link with the group compliance function. In particular, a management company providing additional services (see Section 6.1.2.) is not permitted to delegate the compliance function.

The operational arrangements of the compliance function in terms of objectives, responsibilities and powers must be laid down in a compliance charter drawn up by the compliance function and approved by the senior management and ultimately by the management body/governing body.

The compliance function must raise awareness of the staff about the significance of compliance and related aspects and assist them in the daily activities relating to compliance. To this end, it must also develop an ongoing training program and ensure its implementation.

ESMA's *Guidelines on certain aspects of the MiFID compliance function requirements*, initially published in July 2012 and subsequently updated, provide additional insight into the responsibilities and organization of the compliance function in the context of MiFID. The Guidelines are not applicable to most management entities.

On the responsibilities of the compliance function, the Guidelines cover:

- ▶ Compliance risk assessment: risk-based approach
- ▶ Monitoring obligations: compliance monitoring program, the priorities of which should be determined by the compliance risk assessment
- ▶ Reporting obligations: regular reporting to senior management and when there are significant findings
- ▶ Advisory obligations including: support for staff training, day-to-day assistance for staff, and participation in the establishment of new policies and procedures within the investment firm

On the organizational requirements for the compliance function, the Guidelines cover:

- ▶ Effectiveness: appropriate human and other resources, authority, information, and knowledge, experience, and expertise of the compliance officer
- ▶ Skills, knowledge, expertise and authority of the compliance function
- ▶ Permanence: performance of the responsibilities of the compliance function on an ongoing basis
- ▶ Independence: ensuring that the compliance staff act independently when performing their tasks and appointment
- ▶ Proportionality with regard to the effectiveness of the compliance function
- ▶ Combining compliance with other functions
- ▶ Outsourcing of the compliance function

The Guidelines are applicable to investment firms, including credit institutions that provide investment services and UCITS management companies that provide the investment services of individual portfolio management or investment advice.

The IFM should monitor compliance with EMIR for each UCI it manages and which enter into derivative contracts. In particular, the IFM must have procedures and arrangements in place to:

- ▶ Monitor the month-end notional aggregate amount (AANA) for each UCI or UCI compartment and comply with the obligation to notify the CSSF when the threshold is breached or when the UCI chooses to not calculate AANA
- ▶ Ensure that new or novated over-the-counter (OTC) derivatives pertaining to a product class which has been declared subject to the clearing obligation are cleared within four months of the notification to the CSSF
- ▶ Ensure the information on all derivative contracts is adequately reported in a timely manner
- ▶ Measure, monitor and mitigate operational risk and counterparty credit risk for OTC derivatives contracts not cleared by a contract clearing counterparty, including:
  - ▶ Ensure the timely confirmation of the terms of the OTC derivative contract
  - ▶ Implement formalized, robust, resilient and auditable procedures to reconcile portfolios, to manage associated risk, to anticipate potential disputes between parties, resolve them and to monitor the value of the outstanding contracts
  - ▶ Ensure the mark-to-market valuation on a daily basis or, when market conditions prevent reliable marking-to-market, reliable and prudent marking-to-model
  - ▶ Ensure the timely, accurate and appropriate segregation of exchange of collateral with respect to outstanding contracts in scope of margin requirements

In the event of delegation, the IFMs must also comply with the rules on delegates oversight. See Section 6.3.3.

The head of the compliance function is required to prepare a summary report on its activities and operations once a year. See Section 6.5.1.

## B. Risk management

The risk management function is covered in Chapter 7.

## C. Internal audit

Chapter 15 management companies and AIFMs are required to establish and maintain an internal audit function, when this is appropriate to the nature, scale, and complexity of the business as well as the nature and range of collective portfolio management activities undertaken.

The internal audit function is responsible for:

- ▶ Establishing, implementing, and maintaining an internal audit plan to examine and evaluate the adequacy of the management entity's systems, internal control mechanisms, and arrangements
- ▶ Issuing recommendations based on the work carried out
- ▶ Verifying compliance with the recommendations issued
- ▶ Issuing internal audit reports, at least annually



The operational arrangements of the internal audit function in terms of objectives, responsibilities and powers must be laid down in an internal audit charter drawn up by the internal audit function and approved by the senior management, confirmed, where appropriate, by the audit committee and ultimately approved by the management body/governing body of the IFM.

The internal audit function must be independent from the other internal control functions which it audits. Consequently, the risk management function or the compliance function cannot be performed by the person responsible for the internal audit function of the IFM. However, these functions may take into account the internal audit work as regards the verification of the correct application of the standards in force to the exercise of the activities by the IFM.

### 6.3.2.2. Support functions

#### A. IT

Pursuant to CSSF Circular 18/698, IFMs are required to have internally established IT systems and procedures to safeguard the security, integrity and confidentiality of information but also IT risks. The IT function is integrated in the second line of defense.

Each IFM must comply with the provisions of CSSF Circular 11/504 concerning fraud and incidents due to external computer attacks.

In case of use of third-party services, IFMs must:

- ▶ Obtain service agreements, perform initial due diligence and notify the CSSF
- ▶ Ensure the rapid and unrestricted access to data

CSSF Circular 22/805 has repealed CSSF Circular 19/714 on IT outsourcing relying on a cloud computing infrastructure. CSSF Circular 22/806, issued on 22 April 2022, integrates into the Luxembourg regulatory framework the revised Guidelines on outsourcing arrangements issued by the EBA on 25 February 2019, extending the scope of these Guidelines to all IFMs subject to CSSF Circular 16/698.

This Circular applies to IFMs only in case of ICT outsourcing. In such situations, the general organization principles of CSSF Circular 18/698 apply as a baseline and are supplemented by the governance requirements of Circular 22/806. With regard to the technical infrastructure, IT and business continuity, CSSF Circular 22/806 overrides the corresponding requirements in CSSF Circular 18/698.

It is worthwhile to mention that Chapter 16 management companies which are not authorized as AIFMs are not expected to comply with the CSSF Circular 22/806.

The Circular clarifies, *inter alia*:

- ▶ The responsibility of the management body which can never be outsourced: management should clearly assign the responsibilities related to outsourcing, allocate sufficient skills, and establish an outsourcing function or designate a sufficiently senior staff member
- ▶ The unacceptable consequences brought by outsourcing (undue operational risks, breach of regulation, quality and independence of internal controls or oversight)
- ▶ The conditions for intragroup outsourcing
- ▶ The requirements related to the governance of outsourcing arrangements where:
  - ▶ Appropriate monitoring and oversight should be formalized, operational and performed
  - ▶ Outsourcing policy, pre-outsourcing assessments, register of outsourcing arrangements, exit plans or business continuity plans should be documented, maintained and reviewed on a regular basis
  - ▶ The supervised entities should receive sufficient information/reports to determine their continuous compliance with the provisions of the Circular and other applicable requirements on internal governance and on risk management
  - ▶ Written contracts should be set to define the supervised entities and the service provider rights and obligations, including, in particular, the conditions to access the information related to the outsourced functions, the audit rights and the termination rights
  - ▶ The protection of personal data should be ensured contractually, in particular when outsourcing to third countries, to guarantee that the service provider is bound to respect all legal requirements applicable to the supervised entity. Where outsourcing ICT services other than ICT system management/operations services and where the service provider is not allowed to access data subject to professional secrecy, the service provider may access this data only if it is overseen by a person of the supervised entity in charge of ICT
- ▶ The independence of the service provider from the independent auditor in charge of the statutory audit of the in-scope entity and from the group to which the independent auditor belongs
- ▶ The supervisory conditions applicable for outsourcing and notably:
  - ▶ The notification of the intention to outsource critical or important functions to the competent authority
  - ▶ The requirements applicable to outsourcing to:
    - ▶ Luxembourg service providers
    - ▶ Other EU Member States' service providers
    - ▶ Third-country service providers

- ▶ The application of the “need to know” and “least privilege” to ensure proper control over the confidentiality and integrity of data and systems
- ▶ The obligation for the service provider to erase data and systems of the supervised entity within a reasonable timeframe upon termination of contract
- ▶ The access, information and rights of the independent auditor and the competent authority

Prior notification to the CSSF should be performed one month (when outsourcing to a Luxembourg support PFS governed by Article 29-1 to 29-6 of the Law of 5 April 1993 on the financial sector, as amended) or three months (in any other case) before the implementation of the outsourcing arrangement, when there are:

- ▶ Planned, new critical or important outsourcing arrangements
- ▶ Material changes to existing critical or important outsourcing arrangements
- ▶ Changes to outsourcing arrangements that lead to an outsourced function becoming critical or important

Entities do not have to wait for the approval as long as potential concerns expressed by the relevant competent authority are considered.

On 10 May 2021, ESMA published *Guidelines on outsourcing to cloud service providers (CSPs)* applicable, *inter alia*, to all cloud outsourcing arrangements entered into, renewed or amended by AIFMs, UCITS management companies, self-managed UCITS and internally managed AIFs after 31 July 2021.

The Guidelines should be used by firms to identify, address and monitor the risks arising from cloud outsourcing arrangements. They provide guidance to firms on:

- ▶ The risk assessment and due diligence that they should undertake on their CSPs
- ▶ The governance, organizational and control frameworks that they should put in place to monitor the performance of their CSPs and how to exit their cloud outsourcing arrangements without undue disruption to their business
- ▶ The contractual elements that their cloud outsourcing agreement should include
- ▶ The information to be notified to competent authorities

A business continuity plan should be established to work in case of IT disruption.

The CSSF has clarified that every IFM has the following options relating to its IT infrastructure:

- ▶ Implement its own IT infrastructure, including its own computers and duly documented programs at its premises in Luxembourg. This IT infrastructure should be supported by the IFM's own IT department, organized and surrounded by an internal control system determined by the management authority. The IFM may use the services of a third party, including advice, programming, and maintenance, under a formalized agreement
- ▶ Be connected via a link to a data processing center at its parent company or a subsidiary thereof. In this case, the IFM must verify that the parent company or subsidiary is qualified and capable of providing the service in question. It must have quick and unlimited access to its data. The system must ensure security of communication and confidentiality of client information

The electronic data systems, accounting, recording of portfolio transactions and of subscription and redemption orders, and record-keeping requirements are covered in Chapter 8.

Chapter 15 management companies and AIFMs are required to establish, implement, and maintain systems and procedures that are adequate to safeguard the security, integrity, and confidentiality of information, taking into account the nature of the information in question.

In case of data transfer from the depositary or the central administration to a third party (outsourcing), UCIs/IFMs need to ensure the application form and prospectus are updated prior to the transfer and notify the investors of the documentation update.

Chapter 15 management companies and AIFMs are required to monitor and, on a regular basis, evaluate the adequacy and effectiveness of their systems and take appropriate measures to address any deficiencies.

Chapter 15 management companies and AIFMs are required to establish, implement, and maintain an adequate business and service continuity policy aimed at ensuring, in the event of an interruption to their systems and procedures, the preservation of essential data and functions and the maintenance of services and activities, or, when that is not possible, the timely recovery of such data and functions and the timely resumption of their services and activities.

The CSSF has clarified that the IFM must establish, implement, and maintain a business continuity plan permitting it to resume its activity after a disaster and foreseeing regular verification of the backup capacity. When the IFM delegates, in whole or in part, one or more of its collective portfolio management activities, including risk management, it must ensure that the service provider has implemented an adequate business continuity plan.

## B. Accounting

Pursuant to CSSF Circular 18/698, IFMs are required to have an internally established accounting function and a person responsible for it. The accounting function is integrated in the second line of defense.

A Chapter 15 management company or AIFM can either put in place its own accounting function or use, under its responsibility, and subject to prior CSSF notification, the expertise of a third party specialized in the area of accounting.

In case of use of third-party services, IFMs must obtain a service agreement, perform initial due diligence and ongoing monitoring. Independent of the organization of the accounting function (see Section 8.4.), the accounting records on the activity of a Chapter 15 management company must be available at, or electronically accessible from, the headquarters of the management company in Luxembourg.

Every Chapter 15 management company and AIFM must communicate to the CSSF the name of the person responsible within the management company who can provide information on the financial information of the management company.

The entire accounting organization and procedures must be described in a manual of accounting procedures that provide for:

- Identification and recording of all transactions undertaken by the IFM
- Explanation of changes in accounting balances from one accounting period to the next by retaining movements affecting accounting items
- Safekeeping of all accounting documents in accordance with the applicable legal requirements
- The performance of reconciliations between accounts and accounting entries
- Ensuring the reliability of financial reporting

While defining and implementing these procedures, the IFM must ensure compliance with the principle of integrity in order to avoid, in particular, that the accounting system is used for fraudulent purposes.

## C. Human resources

An organization chart and job description must be drawn up on the basis of the principle of segregation of duties (to be provided to the CSSF upon request); staff are, in principle, employees of the IFM (employment contract).

Management companies and AIFMs are required to establish, implement, and maintain decision-making procedures and an organizational structure that specifies reporting lines and allocates functions and responsibilities clearly and in a documented manner.

Chapter 15 management companies and AIFMs are required to employ personnel with the skills, knowledge, and expertise, both individually and collectively, necessary for the discharge of the responsibilities allocated to them, taking into account the nature, scale, and complexity of their business and the nature and range of services and activities undertaken in the course of that business.

The CSSF may, however, grant a derogation from this requirement and allow some or all of the personnel to be seconded or temporarily assigned from an entity belonging to the same group or from a third-party entity. In such cases, the agreement covering such arrangements must be submitted to the CSSF. In addition, this agreement must deal with the conflicts of interest between the personnel concerned and the entity, if it belongs to the same group. The staff seconded or assigned must be available in Luxembourg during normal business hours.

Chapter 15 management companies and AIFMs must ensure that the performance of multiple functions by relevant persons does not, and is not likely, to prevent those relevant persons from discharging any particular function soundly, honestly, and professionally.

Every IFM must employ at least three full-time equivalent (FTE) people at the head office in Luxembourg who perform key functions. Depending on the nature and complexity of its activity, the IFM must adapt the size of the teams performing key functions and employ more people with the necessary skills, knowledge and expertise in order to perform key functions. Long-term absences or resignations must not prevent the well-functioning of the Chapter 15 management company and AIFM.

In its application for authorization, an AIFM must provide:

- A detailed organization chart of the applicant AIFM, showing the names and positions of all managers, and the names of the departments for which they are responsible
- Indicate the number of employees and give details of any employees that are seconded from other companies

Chapter 15 management companies and AIFMs are required to ensure that the staff is aware of the procedures to be followed for the proper discharge of their responsibilities.

### 6.3.2.3. Central administration

Chapter 15 management companies and AIFMs are required to have and employ the human and technical resources and procedures that are necessary for the proper performance of their business activities.

The letter-box entity concept is assessed in terms of size of the teams dedicated to key functions, volumes under management, complexity and number of UCIs managed by the IFM.

The CSSF has clarified the concept of “central administration”, which must be at the head office of the management company. The “central administration” consists of two key elements:

- ▶ A decision-making center: senior management and the heads of the administrative and control functions, or the different departments or professionals existing within the management company
- ▶ An administrative center: human and technical resources including a sound administrative and accounting organization permitting adequate execution of operations, correct and complete recording of operations, the timely production of reliable management information, the oversight over delegated activities, the management of conflicts of interest, and the respect of the applicable rules of conduct

Central administration of the IFM, which comprises the functions of direction and management, execution and control, must permit the IFM to have control of all of its activities.

Chapter 15 management companies and AIFMs must establish a precise and clear procedures manual describing its internal functioning, the allocation of tasks among its staff, hierarchical lines, and, when applicable, the procedures for exchanging information with and controls undertaken on delegates. The manual has to be available at the registered office of the IFM, accessible to its staff, and kept up to date, taking into account the evolution of the management company’s activity.

Chapter 15 management companies and AIFMs are required to elaborate a number of procedures, and regularly update them. The management company must confirm the existence of such procedures to the CSSF in its application for authorization. The CSSF may request a copy of the relevant procedure at any time. The procedures should include, *inter alia*:

- ▶ Personal transactions (see Section 6.4.2.)
- ▶ Conflicts of interest (see Section 6.4.1.)
- ▶ Rules of conduct (see Section 6.4.2.)
- ▶ Strategy for the exercise of voting rights
- ▶ Remuneration (see Section 6.4.3.)

Chapter 15 management companies and AIFMs should generate “management information” on their activities, and those of its delegates. The management information should cover, *inter alia*:

- ▶ Results of controls performed on the activities of delegates
- ▶ Risk management analysis
- ▶ Incidents related to collective management (e.g., NAV calculation errors, breaches of investment limits, valuation issues, reconciliation issues, situations giving rise to conflicts of interest)
- ▶ Best execution policy
- ▶ Complaints
- ▶ Minutes of previous meetings

Chapter 15 management companies and AIFMs should maintain adequate and orderly records of its business and internal organization.

Chapter 15 management companies and AIFMs must at all times have the necessary expertise and resources to effectively monitor the activities carried out by delegates on the basis of an arrangement with the management company, especially with regard to the management of the risk associated with the delegation. Chapter 15 management companies and AIFMs should ensure that they receive all the information they require from delegates in order to effectively oversee their activities and, in the case of Chapter 15 management companies, in order to be able to generate management information (see also Section 6.3.3.).

Management information must be available in Luxembourg and preferably saved in a central database available at any time in Luxembourg.

The administration function is covered in Chapter 8.

## 6.3.3. Rules on delegation

### 6.3.3.1. Delegation by management entities

A management entity is permitted to delegate some of its tasks, generally in order to achieve a more efficient conduct of its business. However, a management entity should not delegate its tasks to the extent that it becomes a letter-box entity. The following table provides a summary of some of the key limitations on delegation:

Overview of key limitations on delegation of activities by management entities

	Activities that may be delegated <sup>36</sup>	Activities that cannot be delegated
Chapter 15 management companies	<p>The management functions of collective portfolio management:</p> <ul style="list-style-type: none"> <li>▶ Portfolio management</li> <li>▶ Valuation</li> <li>▶ Administration</li> <li>▶ Marketing</li> <li>▶ Risk management</li> <li>▶ Complaints handling</li> <li>▶ Outsourcing of specific tasks pertaining to the compliance function</li> <li>▶ Outsourcing of specific tasks pertaining to the AML/CFT function</li> <li>▶ Internal audit function (in principle if no management company branches are set-up)</li> <li>▶ Operation of the IT system</li> <li>▶ Accounting</li> <li>▶ Other specific non-core services</li> </ul>	<ul style="list-style-type: none"> <li>▶ Definition of the general investment policy of a common fund</li> <li>▶ Definition of the risk profile of each UCITS</li> <li>▶ Interpretation of the risk management analysis, including any corrective measures</li> <li>▶ Implementing the conflicts of interest policy, and its monitoring</li> <li>▶ Implementing the best execution policy, and its monitoring</li> <li>▶ When a representative price is not available, ensuring that senior management has taken a decision on the determination of a probable fair value or have all the necessary supporting information to take such a decision</li> <li>▶ Choice of service provider</li> <li>▶ Monitoring and control of delegated functions</li> </ul>
AIFM	<p>The AIFM is not permitted to delegate activities to the extent that the AIFM:</p> <ul style="list-style-type: none"> <li>▶ No longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation</li> <li>▶ No longer has the power to take decisions in key areas that fall under the responsibility of senior management or no longer has the power to perform senior management functions, in particular the implementation of the general investment policy and investment strategies</li> <li>▶ Loses its contractual rights to inquire, inspect, have access, or give instructions to its delegates or the exercise of such rights becomes impossible in practice</li> </ul>	

If portfolio management and risk management are delegated, they should be delegated to regulated entities. These include:

- ▶ AIFMs
- ▶ UCITS management companies
- ▶ Investment firms authorized to perform portfolio management
- ▶ Credit institutions authorized to perform portfolio management
- ▶ Third-country entities authorized or registered for the purpose of asset management and effectively supervised by a competent authority in those countries, and subject to the existence of cooperation agreements between the CSSF and the third-country supervisory authority

In the case of AIFMs and Chapter 16 management companies, the CSSF may also, on a case-by-case basis, permit delegation to unregulated entities.

AIFMs are not permitted to delegate the performance of investment management functions (i.e., portfolio management and risk management) to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself.

#### A. General requirements

Management entities and investment companies are permitted to delegate, or partially delegate, to third parties the execution of one or more of their functions on their behalf. The management entity remains responsible for the delegated activities.

<sup>36</sup> | Subject to the applicable requirements.

The requirements to be met vary between management entities. Generally, they include the following:

#### Summary of delegation requirements applicable to management entities

All types of delegation	Specific to the investment management function
<ul style="list-style-type: none"> <li>▶ The CSSF must be adequately informed of the delegation</li> <li>▶ There must be an objective reason for the delegation, such as the efficient conduct of business</li> <li>▶ The management entity must perform initial and ongoing due diligence on the delegate, following a Risk Based Approach (RBA)</li> <li>▶ The delegation should be formalized in a written agreement</li> <li>▶ The delegate should be qualified and capable of undertaking the delegated functions</li> <li>▶ The management entity must effectively supervise the delegated functions</li> <li>▶ The mandate must not prevent effective supervision of the management company or prevent it from acting, or the UCI from being managed, in the best interests of its investors</li> </ul>	<ul style="list-style-type: none"> <li>▶ Investment management should be delegated to authorized and supervised undertakings</li> <li>▶ When the investment management related mandate is given to a third-country undertaking, there should be appropriate cooperation arrangements in place between the CSSF and the supervisory authority of such country</li> <li>▶ A mandate with regard to the core function of investment management cannot be given to the depositary</li> </ul>

The delegate may sub-delegate, provided the management entity is properly informed. The requirements applicable to delegation apply to sub-delegation.

Investment companies that have not appointed a management entity are also subject to the delegation requirements of the respective fund laws:

- ▶ Self-managed UCITS are required to comply with requirements on delegation applicable to Chapter 15 management companies (see Section 6.3.3.1.G.)
- ▶ Investment companies under Part II of the 2010 Law are required to comply with requirements on delegation similar to those applicable to Chapter 16 management companies (see Section 6.3.3.1.I.); if they are full AIFM regime AIFs, they are also required to comply with AIFM requirements on delegation (see Section 6.3.3.1.H.)

SIFs or their management companies that delegate one or more of their own functions to third parties are subject to SIF Law delegation requirements (see Section 2.4.2.4.); if they are full AIFM regime AIFs, they are also required to comply with AIFM requirements on delegation (see Section 6.3.3.1.I.).

#### B. Notification and reporting to the CSSF

Chapter 15 management companies and AIFMs must notify the CSSF in advance of the intention to delegate, to change the delegate or to carry out itself one or more of the following functions previously delegated: portfolio management, risk management, central administration of UCIs and valuation.

To this end, the update of the program of activities must detail the functions delegated, the identities and the country of establishment of the delegates and, where applicable the name of their supervisory authority. The IFM is required to submit to the CSSF within five months from the end of the IFM's financial year an annual statement of all its delegates, including the due diligence procedures in place to monitor the activities of its delegates. The CSSF is also empowered to request at any time the due diligence files gathered when the IFM selected the delegates.

#### C. Obligation to conclude a contract

A written contract must be entered into between the delegate and the IFM. The mandate must not interfere with prudential supervision to which the IFM is subject and prevent the IFM from acting in accordance with the rules of conduct and, notably, the best interest of investors. The terms and conditions should specify under which circumstances the IFM is permitted to give additional instructions or withdraw the mandate when justified by the interests of the investors.

When the delegate is not precluded to do so under the legislation it is subject to, the IFM should be granted:

- ▶ A right of access, upon simple request, to documentation and data relating to the transaction carried out by the delegate for the account of the IFM
- ▶ A right to conduct an on-site visit for due diligence and ongoing monitoring purpose, at a frequency and in a manner specified in the contract

The IFM and the delegate must establish, implement and maintain operational a continuity plan which can be activated after a disaster.

#### D. Delegation Control Arrangement Procedure

The IFM is required to establish a Delegation Control Arrangement Procedure covering all aspects of delegation and including descriptions of, *inter alia*:

- ▶ The process for selecting or replacing a delegate
- ▶ The controls, which should be equivalent to the monitoring of the activities as if they were carried out internally, to ensure the delegate carries them out in compliance with applicable legal and regulatory provisions
- ▶ The reporting to the IFM
- ▶ The nature, scope and frequency (at least every three years) of the periodic due diligence, taking into account the risks associated to each delegation and the number of delegates
- ▶ The decision-making and the escalation procedure
- ▶ The department and staff members designated for the ongoing monitoring
- ▶ The measures ensuring business continuity in the event of withdrawal of the mandate
- ▶ The measures ensuring data protection at all times

The monitoring of delegated activities cannot be delegated. When specific or transversal skills existing within the group to which the IFMs belong are used for the purpose of controlling delegates, the IFM must remain involved in the selection and relationship management process and ensure it has access to documents obtained during initial due diligence and ongoing monitoring.

#### E. Initial due diligence requirements

The IFM must be satisfied that each delegate is qualified, capable and has adequate human and technical resources to perform the delegated activity and provide the information the IFM requires for ongoing monitoring purposes.

The assessment of the risks arising from delegation must take into account at least the following criteria:

- ▶ The jurisdiction in which the delegate is located (the location must not be an obstacle to regular on-site visits), whether the delegate is a regulated and/or supervised entity and the nature of any authorization obtained
- ▶ The reputation of the delegate, the existence of sanctions imposed by a supervisory authority, the absence of money laundering and terrorist financing suspicions, the complaints and claims received by the delegate
- ▶ The shareholder, governance and organizational structures (including the organization of control functions) of the delegate
- ▶ The financial situation of the delegate
- ▶ The delegate's skills and abilities
- ▶ The quality of the delegate's computer systems, business continuity plan and disaster recovery plan
- ▶ The measures taken by the delegate to ensure data protection
- ▶ The risk of conflicts of interest between the IFM and the delegate and the management of these risks
- ▶ The existence of sub-delegation by the delegate and the ongoing monitoring measures
- ▶ The delegate's ability to provide sufficient and relevant reports and key performance indicators

Each due diligence review must be formalized in a written report including:

- ▶ The description of the due diligence measures
- ▶ The description and critical analysis of the observations made
- ▶ The results of the analysis of the information and documents obtained
- ▶ The escalation measures taken where appropriate
- ▶ The conclusions adopted and validated, dated and signed by the body empowered to take decisions with regard to the delegation, stating, in particular, the frequency and nature of subsequent periodic due diligence, before the entry into force of the contract

The IFM's Approval Committee must review the report and rule as a last resort. The due diligence must be retained at the IFM's registered office and be available if requested from the CSSF.

#### F. Ongoing monitoring

The IFM must ensure that:

- ▶ The services provided by the delegate comply continuously with legal, regulatory and contractual provisions and that they meet satisfactory quality standards
- ▶ The delegate's organizational structure, procedures, qualification and capabilities remain adequate over time
- ▶ Risks arising from each delegation are reassessed and managed appropriately

Periodic due diligence consists of reassessing criteria analyzed during the initial due diligence review and includes other criteria if necessary. It must be formalized in the same way as initial due diligence and must include:

- ▶ The follow-up of observations noted during previous due diligence reviews, the action plans and the agenda for their implementation, as well as the escalation measures carried out
- ▶ The conclusions from the body of the IFM empowered to decide to maintain or terminate the delegation as well as the conditions thereof

The due diligence must be retained at the IFM's registered office and be available if requested from the CSSF.

A monitoring system must allow the IFM to access relevant data and the management information must also enable the monitoring of the delegate's activities.

Regular detailed reports including key performance indicators must be provided to the IFM conducting officers. In addition, the IFM must define and establish a methodology for analyzing the results of the monitoring system and set up its own warning systems. Such analysis must be documented and available for inspection by the CSSF.

When the delegate respects an internal control framework, documented in a written report prepared by the delegate and reviewed and reported upon by an independent auditor in accordance with a professional standard such as ISAE 3402<sup>37</sup>, or the requirements of MiFID, the management company may take this into account in the organization of its control.

### G. Chapter 15 management companies

In addition to the general requirements, the following conditions must be met for Chapter 15 management companies:

- ▶ The management company's control arrangements must cover, *inter alia*, monitoring:
  - ▶ The activities of the investment manager, including, for example, ensuring that assets of the UCITS are invested in accordance with the constitutional documents and the applicable requirements and the best execution policy is respected
  - ▶ The risk exposures of the UCITS (see also Section 7.2.)
  - ▶ The activities of the administrator, including the transfer agent. This includes verifying the existence of a second level monitoring system, covering, for example, the NAV calculation (see also Section 8.7.), or implementation of such a system itself
  - ▶ The implementation of the marketing policy, covering, for example, registration in new countries and reimbursement of distribution fees (see also Chapter 12)
- ▶ The UCITS' prospectuses must list the delegated functions

The CSSF's *Frequently Asked Questions (FAQ) concerning the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment* clarifies the conditions to comply with in case of delegation by a UCITS of the investment management function:

UCITS may delegate the function of investment management according to the requirements of Article 110 of the Law of 2010, as amended. The investment manager:

- ▶ Must be authorized or registered and subject to prudential supervision
- ▶ If located in a third country, the cooperation between the CSSF and the supervisory authority of the investment fund manager must be ensured

Investment fund managers located in an EEA or an Organisation for Economic Cooperation and Development (OECD) country and subject to prudential supervision of an authority fulfil, in principle, the above criteria.

Investment fund managers located in another country are in principle acceptable if the CSSF has signed with the relevant supervisory authority, a Memorandum of Understanding covering UCITS.

The CSSF may also, when relevant, take into account the delegation provisions applicable to AIFMs.

### H. AIFMs

In the context of delegation, it is important to distinguish between delegation of functions, which is subject to the AIFM delegation provisions, and other activities, such as provision of advice and the performance of certain preparatory tasks, which may not be subject to the AIFM delegation provisions.

In addition to the general requirements, the following conditions must be met for AIFMs:

- ▶ The AIFM must be able to justify its entire delegation structure on objective reasons, which may include:
  - ▶ Optimizing business functions and processes
  - ▶ Cost saving
  - ▶ Expertise of the delegate in administration or in specific markets or investments
  - ▶ Access of the delegate to global trading capabilities

<sup>37</sup> International Standards on Assurance Engagements (ISAE) 3402, Assurance Reports on Controls at Third Party Service Organization issued by the International Auditing and Assurance Standards Board.



- ▶ The delegation structure must not allow for the circumvention of the AIFM's responsibilities or liability
- ▶ The delegation must not prevent the effectiveness of supervision of the AIFM and, in particular, must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors. To this end, the AIFM and the competent authorities must have effective access to data related to the delegated functions and to the business premises of the delegate, the competent authorities must be able to exercise those rights of access, and the delegate must cooperate with the competent authorities of the AIFM in connection with the delegated functions
- ▶ The persons who effectively conduct the business of the delegate must be of sufficiently good repute<sup>38</sup>. When the delegate is regulated in the EU and the relevant supervisory authority has reviewed the criterion of "good repute" within the authorization procedure, this criterion is deemed to be met
- ▶ The AIFM must ensure that the delegate discloses to the AIFM any development that may have a material impact on the delegate's ability to carry out the delegated functions effectively and in compliance with applicable laws and regulatory requirements

The delegate may sub-delegate any of the functions delegated to it provided that:

- ▶ The AIFM consented in writing prior to the sub-delegation
- ▶ The AIFM notified the CSSF before the sub-delegation arrangements become effective. The notification must contain details of the delegate, the name of the competent authority where the sub-delegate is authorized or registered, the delegated functions, the AIF affected by the sub-delegation, a copy of the written consent by the AIFM, and the intended effective date of the sub-delegation
- ▶ All the delegation requirements must be complied with in relation to the sub-delegation

Any further sub-delegation is subject to the same requirements.

The AIFM's liability towards the AIF and its investors is not affected by the fact that the AIFM has delegated functions to a third party or by any further sub-delegation.

An AIFM cannot delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity. An AIFM is no longer considered to be the manager of the AIF and is deemed a letter-box entity in any of the following situations:

- ▶ The AIFM no longer retains the necessary expertise and resources to effectively supervise the delegated tasks and manage the risks associated with the delegation
- ▶ The AIFM no longer has the power to take decisions in key areas that fall under the responsibility of senior management or no longer has the power to perform senior management functions
- ▶ The AIFM loses its contractual rights to inquire, inspect, have access, or give instructions to its delegates or the exercise of such rights becomes impossible in practice
- ▶ The AIFM delegates the performance of investment management functions (portfolio management and risk management) to such an extent that the delegated functions exceed by a substantial margin the investment management functions performed by the AIFM itself. When assessing the extent of delegation, the CSSF is required to assess the entire delegation structure taking into account not only the assets managed under delegation but also the following qualitative criteria:
  - ▶ The types of assets the AIF or the AIFM acting on behalf of the AIF is invested in and the importance of the assets managed under delegation for the risk and return profile of the AIF
  - ▶ The importance of the assets under delegation for the achievement of the investment goals of the AIF
  - ▶ The geographical and sectorial spread of the AIF's investments
  - ▶ The risk profile of the AIF
  - ▶ The type of investment strategies pursued by the AIF or the AIFM acting on behalf of the AIF
  - ▶ The types of tasks delegated in relation to those retained
  - ▶ The configuration of delegates and their sub-delegates, their geographical sphere of operation, and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM

The CSSF may also, when relevant, take into account the delegation provisions applicable to UCITS management companies.

Both portfolio management and risk management are multi-faceted functions, each of which may be delegated in part or in whole. The multi-faceted nature of risk management is covered in Chapter 7 and, in the specific context of AIFs, in Section 7.3.

<sup>38</sup> Persons who effectively conduct the business of a delegate shall not be deemed of sufficiently good repute if they have any negative records relevant both for the assessment of good repute and for the proper performance of the delegated tasks or if there is other relevant information that affects their good reputation. Such negative records shall include but shall not be limited to criminal offences, judicial proceedings, or administrative sanctions relevant for the performance of the delegated tasks. Special attention shall be given to any offences related to financial activities, including but not limited to obligations relating to the prevention of money laundering, dishonesty, fraud or financial crime, bankruptcy, or insolvency. Other relevant information shall include information indicating that the person is not trustworthy or honest. Furthermore, when the delegate is regulated in respect of its professional services within the EU, the persons who conduct the business may be deemed to be of "good repute" when the relevant supervisory authority has reviewed the criterion of "good repute" within the authorization procedure, unless there is evidence to the contrary.

As the delegation structure will be assessed by the CSSF as a whole, AIFMs that manage multiple AIFs are not, in principle, prevented from delegating the performance of both portfolio management and risk management for certain AIFs they manage.

Furthermore, partial delegation of the multi-faceted investment management functions may offer AIFMs a pragmatic alternative to wholly insourcing at least one of the functions, while remaining compliant with the letter-box provisions.

Delegation of the risk management function is covered in Section 7.3.7.

AIFMs must provide a description of any delegated management function to investors before they invest (see Section 10.3.5.).

#### *I. Chapter 16 management companies*

The permitted activities of a Chapter 16 management company are outlined in Section 6.1.3.F.

A Chapter 16 management company that is also authorized as an AIFM is subject to AIFM delegation requirements (see Section 6.3.3.1.H.).

A Chapter 16 management company that is not authorized as an AIFM may also designate another entity as AIFM; in this case, the AIFM will be subject to delegation requirements. However, as an AIFM is only required to perform the key functions of portfolio management and risk management, a Chapter 16 management company is permitted to delegate to another third party, for the purposes of more efficient conduct of business, the power to carry out on its behalf one or more of the functions of administration or marketing.

Chapter 16 management companies that manage AIFs and other investment vehicles are permitted to delegate to third parties, for the purposes of more efficient conduct of business, the power to carry out on their behalf one or more of their functions.

The following general requirements must be met in case of delegation:

- The CSSF must be adequately informed of the delegation including:
  - Description of the activities delegated and of the activities performed internally by the management company
  - Draft contracts concluded with the delegates
  - Description of the controls performed by the management company on the delegates
- The mandate must not prevent effective supervision of the management company or prevent it from acting, or the UCI from being managed, in the best interests of its investors

### 6.3.3.2. Management entities as delegates

When authorized to do so, a UCITS management company or an AIFM, as a delegate, may provide services to other UCITS or their management companies or to other AIFs or their AIFMs. In such cases, the delegate management company or AIFM is not appointed as management company or AIFM of the UCITS or AIF.

For example, a UCITS management company, as a delegate, may provide portfolio management or administration services to an AIF or an AIFM.

In such cases, a UCITS management company will not need to seek additional authorization as an AIFM, or an AIFM as a UCITS management company.

#### Services that may be provided by management entities as delegates

Services provided to	UCITS management company	AIFM
A UCITS or its management company	✓	✓
An AIF or its AIFM	✓	✓

### 6.3.3.3. MiFID application in the context of delegation

The CSSF published FAQs on 10 June 2021 to clarify the application of MiFID II to IFMs and third parties providing investment services to authorized IFMs under a delegation arrangement.

MiFID II rules<sup>39</sup> apply in relation to discretionary portfolio management services, investment advice and marketing. Delegate IFMs and third-party delegates do not benefit from the MiFID exemption when they perform one or several functions included in the collective portfolio management function.

IFMs and UCIs qualify as clients under MiFID II if they are provided with an investment service relating to transactions on financial instruments and if the service is rendered by a third party established in the EU or is considered to be rendered in Luxembourg by a third-country entity.

- ▶ Portfolio management
  - Third-party delegates are required, depending on the tasks performed, to obtain a license as “portfolio manager” under MiFID II or, when they are not domiciled in the EU, to have a MiFID II third-country registration pursuant to CSSF Circular 19/716, as amended.
  - Delegate IFMs must hold a MiFID II top-up license to provide discretionary portfolio management services and non-core services, such as investment advice, administration of units of UCIs or, for AIFMs, reception and transmission of orders. Only certain MiFID II rules apply since such IFMs are not authorized to provide other MiFID services or activities.
- ▶ Investment advice
  - MiFID II rules apply to third parties providing investment advice to IFMs/UCIs. Delegate IFMs must be authorized to provide this service according to UCITS/AIFM laws.
- ▶ Marketing
  - MiFID II rules may apply to the entity performing marketing on behalf of the IFM, depending on where and to whom the UCIs are distributed.
  - Marketing is not a MiFID investment service as such but different MiFID II services<sup>40</sup> may be used for the purpose of distribution of UCIs which always qualify as financial instruments.
  - Where a Luxembourg IFM markets UCIs it does not manage, it must have a MiFID II top-up license and will be subject to MiFID II rules. EU IFMs marketing, in Luxembourg, UCIs on behalf of other IFMs must be authorized under AIFMD or the UCITS Directive.
- ▶ MiFID II exemptions
  - Third parties providing investment services to IFMs may benefit from MiFID exemptions<sup>41</sup> as long as they can demonstrate that they fall within the scope of the exemption.
  - IFMs providing MiFID II top-up services (investment services) to other IFMs are partially exempt from MiFID rules, but, when they provide discretionary portfolio management and non-core services, certain provisions apply.

The FAQ confirms a well-established supervisory practice. However, IFMs had until 31 December 2021 at the latest to comply with the FAQ, taking into account the best interests of investors. They were expected to review their organization model and ensure, where they provide MiFID II investment services, that they have a MiFID II top-up license.

IFMs also had to review compliance of their delegates with the FAQ and, where they are third-country entities, with the regime foreseen under CSSF Circular 19/716, as amended.

### 6.3.3.4. Third-country delegates

CSSF Circular 19/716, as amended by CSSF Circular 20/743 provides an overview of the regimes third country firms (TCFs) can use to service Luxembourg clients.

Since no third country has been declared equivalent by the EC to date, TCFs can only provide services to IFMs and investment companies established in Luxembourg:

- ▶ On a cross-border basis to eligible counterparties and professional clients *per se*, under the current national regime foreseen in Article 32-1(1) paragraph 2 of the Law on the financial sector, as amended, and clarified in the amended CSSF Circular
- ▶ Through a branch established in Luxembourg
- ▶ Through a subsidiary established in Luxembourg with a MiFID license
- ▶ Through a subsidiary based in another EU Member State with a MiFID license based on free provision of services within the EU
- ▶ Out of MiFID/Markets in Financial Instruments Regulation (MiFIR) scope, on a reverse solicitation basis

<sup>39</sup> Other Member States only apply AIFMD/UCITS delegation rules on the grounds that they do not consider that management of AIFs/UCITS on a delegation basis qualify as discretionary portfolio management.

<sup>40</sup> Including, *inter alia*, reception and transmission of orders, execution of orders on behalf of clients, portfolio management, investment advice, underwriting and/or placing of UCIs on a firm commitment basis and placing UCIs without a firm commitment basis.

<sup>41</sup> Intragroup service, complementary service, or investment advice non specifically remunerated rendered in the course of another professional activity not covered by MiFID II.

On the other hand, IFMs or UCIs delegating portfolio management to a TCF must submit information to the CSSF about such TCF and its authorization to carry on such service in its home country. A Memorandum of Understanding must also be established between the CSSF and the third-country delegate's national competent authority.

Where a contract is concluded between a TCF and a Luxembourg chapter 15 management company or an investment company in respect of investment advice services payable out of the assets of the UCITS, information must be provided to the CSSF about the TCF as well as certain provisions of the contract and other significant activities.

TCFs established in third countries listed in the CSSF Regulation No 20-02<sup>42</sup>, as amended, authorized in their home country to provide investment services and authorized by the CSSF to provide these services in Luxembourg, can service UCIs and IFMs on a cross-border basis. TCFs are required to submit the application form in Annex II of the CSSF Circular, as amended, to seek prior approval from the CSSF.

Once an equivalence decision is enacted at European level by the EC for a country deemed equivalent in Luxembourg, third-country firms will be able to continue relying on national third-country regimes for a period of three years after the equivalence decision.

Where a TCF makes use of the reverse solicitation regime, Part III of the Circular, as amended, clarifies that a TCF is responsible to assess whether the investment service it provides to a Luxembourg client is provided at the client's own exclusive initiative. Such assessment must be conducted on a continuous basis and for every service, taking into account ESMA's Q&As on *MIFID II and MiFIR investor protection and intermediaries topics*.

ESMA published draft technical standards (draft TS) on *the provision of investment services in the European Union (EU) by third-country firms (TCFs) under MiFID II* (the "draft ITS") and MiFIR (the "draft RTS") on 28 September 2020. However, the adoption of these draft TS has been delayed due to the upcoming MiFID and MiFIR revision.

The draft TS provide for extensive harmonized reporting requirements in accordance with Article 46 of MiFIR both at the registration stage and on a regular basis. Such reporting requirements would be applicable to TCFs providing investment services (e.g., portfolio management or investment advice) to Luxembourg "IFMs" or investment companies through a branch (draft ITS), or on a cross-border basis (draft RTS).

While these reporting requirements could bring additional costs for TCFs operating on a cross-border basis or via (an) EU based branch(es) in order to put in place the necessary IT systems, this would be compensated by the fact that future registration with ESMA would give access to the EU-based on a harmonized regime and harmonized reporting standards for EU-based branches of TCFs.

#### *Details of the draft TS*

##### ▶ Investment services provided on a cross-border basis

The Investment Firm Regulation<sup>43</sup> introduced some granular reporting requirements into MiFIR Art. 46 which are specified in the draft RTS and would apply to TCFs who register with ESMA, in the event of a future EU equivalence decision.

The reports submitted at point of registration should give ESMA a very detailed view of, *inter alia*:

- ▶ The investment services and activities TCFs are authorized to provide in their home country and those they provide in the EU, their EU client base, the types of financial instruments concerned, their annual turnover and aggregated value of assets corresponding to the services provided
- ▶ How the TCF's' EU activities contribute to their strategy and why, if relevant, they choose to provide services in the EU on a cross-border basis rather than by establishing branches or subsidiaries
- ▶ The composition of the TCF's management body, the persons conducting the EU activities in the EU and the key function holders
- ▶ Description of internal governance arrangements
- ▶ The EU marketing strategy
- ▶ Client complaint procedures and other arrangements for ensuring investor protection
- ▶ Different arrangements of the TCF to comply with MiFID/MiFIR rules of conduct and organizational requirements, where applicable

The annual reports would be submitted by 30 April of each year and cover the previous calendar year. Such regular reporting would enable ESMA to update information received at the point of registration and should also include detailed information on the operations (controls, findings, measures and actions) of the internal control functions, (i.e., compliance, internal control and risk management) in relation to services provided to EU counterparties.

ESMA would be granted with the power to request additional information, to carry out investigations or on-site inspections and to prohibit or restrict a TCF from providing services in the EU.

<sup>42</sup> Canada, Hong Kong, Japan, Singapore, Swiss Confederation, the United States of America, United Kingdom, China's People Republic and Australia.

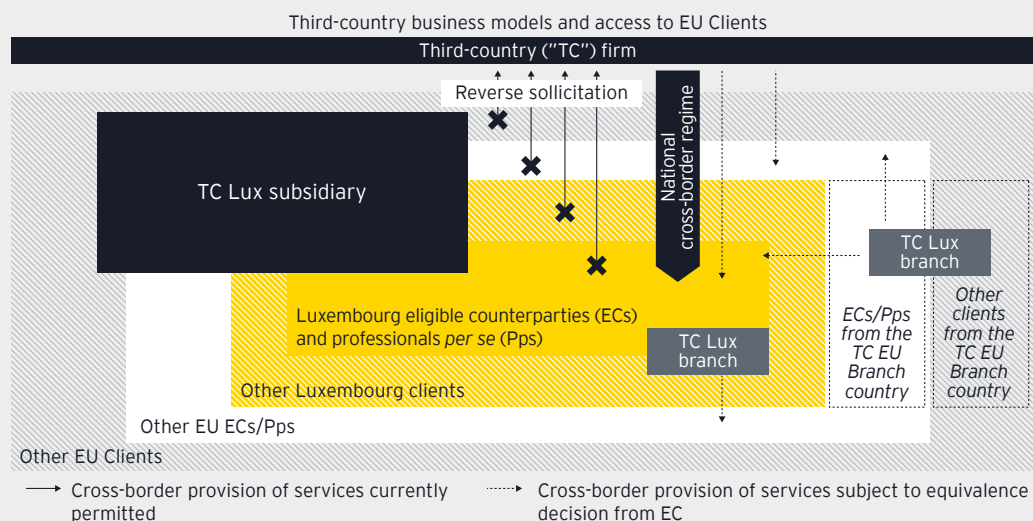
<sup>43</sup> Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014.

- ▶ Investment service provided through a branch

The draft ITS relating to MiFID II Article 41 are aligned to a large extent to the draft RTS but some of the reporting fields are adapted to the provisions of investment services and investment activities by a branch established by the TCF. ESMA also introduced some reporting fields related to services provided by a branch of a TCF to *per se* professionals and eligible counterparties located in other Member States.

The business model selected by TCFs to access the Luxembourg market is driven by the types, number and geographies of the clients they service or intend to service. The national cross-border regime based on national equivalence is only available to TCFs from a list of countries which is subject to changes and is likely to be extended to the United Kingdom in case no satisfactory trade agreement is reached with the EU.

The EU MiFIR cross-border regime may come as an alternative option in the near future but remains subject to EC adoption of draft TS and equivalence decisions which have to be taken.



## 6.3.4. Cross-border management passport

### 6.3.4.1. General principles

#### A. Introduction

Both Chapter 15 management companies and authorized AIFMs have two types of "passports":

- ▶ A "Management" passport, permitting them to perform their authorized activities in other EU/EEA Member States without obtaining prior authorization in the host Member State. Management entities may manage UCIs cross-border either through free provision of services or the establishment of a branch.

*Example:* A Luxembourg UCITS management company may, in addition to managing Luxembourg UCITS, manage:

- ▶ A UCITS in Italy through a branch
- ▶ A feeder UCITS in Sweden directly through free provision of services

The scope of the "Management" passport depends on the management entity:

- ▶ A UCITS management company can perform its authorized activities in other EU/EEA Member States
- ▶ An AIFM can manage AIFs in other EU/EEA Member States, but not perform the other activities for which it has been authorized
- ▶ A Chapter 16 management company that is not authorized as an AIFM does not benefit from a passport to perform outside Luxembourg the activities for which it has been authorized
- ▶ A "Product" passport, permitting them to market their managed UCITS or AIF in other EU/EEA Member States, following a notification (see Chapter 12)

*Example:* A Luxembourg authorized AIFM may, following notification sent to the CSSF, market its SIFs in Italy and Sweden, either directly or through an intermediary acting on its behalf. National private placement rules applicable to the marketing of AIFs in these countries do not apply.

The functioning of the “Product” passport depends on the regime:

- ▶ Authorized UCITS benefit from a passport enabling the marketing of their shares or units to retail and professional investors in EU/EEA Member States. A notification procedure must be followed to market each UCITS in each Member State, excluding Luxembourg
- ▶ An AIFM benefits from a passport enabling it to market the AIFs it manages to professional investors in EU/EEA Member States. A notification procedure must be followed to market each AIF in each Member State, including Luxembourg
- ▶ A Chapter 16 management company that is not authorized as an AIFM does not benefit from a product passport. However, the shares or units of the non-UCITS managed by a Chapter 16 management company may be marketed in Luxembourg and in other Member States under national private placement requirements

The following table summarizes the scope of the passports of management entities:

**Brief summary of scope of passports of management entities**

	Chapter 15 management company	AIFM	Chapter 16 management company (not authorized as an AIFM)
Scope of EU/EEA cross-border “management” passport:			
▶ Managing UCIs	✓ UCITS	✓ AIF	X
▶ Other activities (e.g., discretionary portfolio management)	✓	X	X
Scope of EU/EEA cross-border “product” passport	✓ UCITS marketing passport	✓ AIF marketing passport	X Private placement only

Both Chapter 15 management companies and authorized AIFMs have a “passport” permitting them to manage UCIs in other EU/EEA Member States<sup>44</sup>.

The passport allows a management entity to manage UCIs (UCITS and AIFs, respectively) in EU/EEA Member States other than their home Member State (“host” Member States) either through the “free provision of services” or the establishment of a branch.

The passport also allows a UCITS management company to perform in other EU/EEA Member States the other activities for which it has been authorized in its home Member State (e.g., providing discretionary portfolio management or investment advice).

The management passport offers asset management groups flexibility at two levels:

- ▶ The management entity appointed to manage the UCIs: The passport is an opportunity for management companies to manage UCIs cross-border, both intra-group and as a third party
- ▶ The administration service provider appointed by the management company (see Section 8.2.2.)

The management company passport does not mean additional flexibility with regard to the choice of depositary, which must be in the home Member State of the UCI.

The host Member State may not make the free provision of services, or the establishment of a branch, subject to any authorization requirement and cannot impose additional requirements on the management entity in relation to the matters covered by the relevant Directive - i.e., UCITS Directive or the AIFM Directive.

The host Member State of a UCI that is managed cross-border cannot, for example, require the performance of activities, such as administration, in the host Member State, or the delegation of an activity or function to an entity in the host Member State.

Any management entity is required to comply with its home Member State rules relating to any delegated activities or functions and, when applicable, the rules of the UCI home Member State regarding the constitution and functioning of the UCI.

<sup>44</sup> The EEA Member States are the EU Member States plus Iceland, Liechtenstein, and Norway. The reference to the EEA is clarified in Section 1.3.1.B.

The CSSF has clarified that a Chapter 15 management company that manages:

- Luxembourg UCITS is authorized to delegate the administration of the UCITS to an entity that is established in Luxembourg and that is authorized to provide administration services and has adequate organization in order to perform the administration
- UCITS domiciled in other Member States is authorized to delegate the administration of the UCITS to an entity that is established either in Luxembourg or the Member State of domicile of the UCITS and that is authorized to provide administration services and has adequate organization in order to perform the administration

A practical challenge for a management entity or a delegate of the management entity (such as an administrator or risk management service provider) operating cross-border is complying with local requirements of the host Member State in relation to the UCIs it manages. For example, administrators serving UCITS in another Member State will need to comply with the accounting requirements of the UCITS home Member State.

The following section provides an overview of the operation of the management passport and the applicable regulatory requirements, focusing on EU/EEA management entities managing EU/EEA UCIs. The taxation implications of cross-border management are covered in Section 6.5.5. This section concludes with a brief overview of the EEA - non-EEA situations: EEA AIFMs managing non-EEA AIFs and non-EEA AIFMs managing EEA AIFs.

#### *B. The free provision of services*

The management entity manages UCIs in the host Member States directly.

Under the free provision of services, a management entity can provide its services cross-border without establishing a presence in the host Member State.

For example, a Luxembourg management company will be able to manage a Polish UCITS, a Luxembourg master UCITS, and a Portuguese feeder UCITS.

#### *C. The establishment of a branch*

A management entity may manage UCIs in host Member States by establishing branches. Branches do not themselves benefit from the management company passport.

Branches are a way of having a local presence without establishing a full management entity.

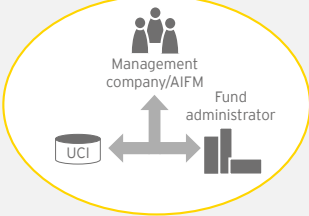
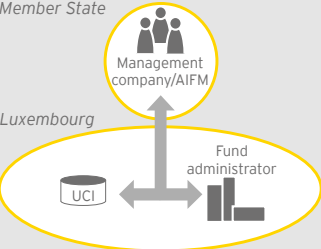
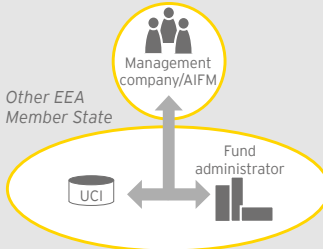
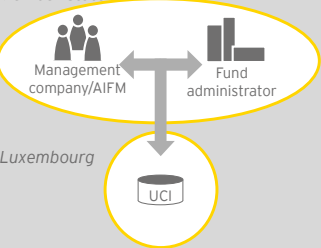
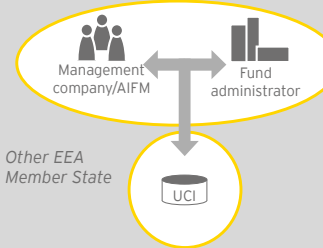
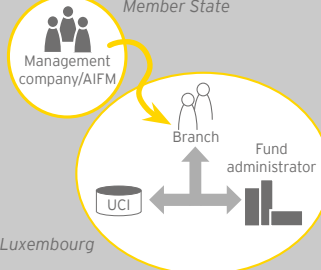
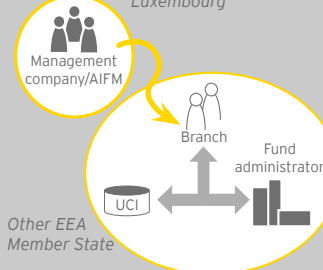
For example, the Luxembourg AIFM may also manage French or Italian AIFs by establishing branches in those countries.

For existing management companies, cross-border status can be achieved by converting an existing management company into a branch or by transferring activities via mergers, acquisitions, or liquidations.

D. Possible cross-border management scenarios

The following illustrates some of the possible cross-border management scenarios.

**Illustration of possible cross-border management scenarios**

<p><b>Scenario 1</b> No cross-border management</p>	<p>Luxembourg</p>  <p>The Luxembourg management entity manages Luxembourg UCIs. A Luxembourg administrator is appointed. The management passport is not used for the management of these UCIs.</p>	
<p><b>Scenario 2</b> Cross-border management through free provision of services: UCI and administrator in same Member State</p>	<p>Other EEA Member State</p>  <p>Luxembourg UCIs are managed cross-border by a management entity established in another EU/EEA Member State through the free provision of services. A Luxembourg administrator is appointed.</p>	<p>Luxembourg</p>  <p>A Luxembourg management entity manages UCIs established in another EU/EEA Member State cross-border through the free provision of services. An administrator in the host Member State is appointed.</p>
<p><b>Scenario 3</b> Cross-border management through free provision of services: management entity and administrator in same Member State</p>	<p>Other EEA Member State</p>  <p>Luxembourg UCIs are managed cross-border by a management entity established in another EU/EEA Member State through the free provision of services. An administrator in the host Member State is appointed.</p>	<p>Luxembourg</p>  <p>A Luxembourg management entity manages UCIs established in another EU/EEA Member State cross-border through the free provision of services. A Luxembourg administrator is appointed.</p>
<p><b>Scenario 4</b> Cross-border management through a branch: branch, UCI and administrator in same Member State</p>	<p>Other EEA Member State</p>  <p>Luxembourg UCIs are managed cross-border by a management entity established in another EU/EEA Member State through a Luxembourg branch. A Luxembourg administrator is appointed.</p>	<p>Luxembourg</p>  <p>A Luxembourg management entity manages UCIs established in another EU/EEA Member State cross-border through a branch established in the other EU/EEA Member State. An administrator in the host Member State is appointed.</p>



### 6.3.4.2. Notification of cross-border management

A UCITS management company or AIFM intending to carry out activities in another Member State must notify its intention to its home Member State competent authority and provide it with the following information:

- ▶ The host Member State in which it intends to operate or establish a branch
- ▶ The program of operations, including a description of the planned activities
- ▶ In the case of a UCITS management company:
  - ▶ The risk management process put in place by the management company
  - ▶ The measures put in place to properly deal with investor complaints and the exercise of their rights
  - ▶ The program of operations should also cover, when applicable, discretionary portfolio management mandates
- ▶ In the case of branches:
  - ▶ The organizational structure of the branch
  - ▶ The address in the host Member State from which documents may be obtained
  - ▶ Address and name of conducting officers
- ▶ In the case of management of UCITS through free provision of services: a description of the main marketing techniques that it intends to use (e.g., regular trips to the host Member State, distance marketing)

The notification should be submitted in a language mutually acceptable to the CSSF and the competent authority of the host Member State.

A UCITS management company must also provide the authorities of the host Member State with a copy of the agreement with the depository (see Section 6.3.5.1.) and information on the delegation arrangements regarding the functions of investment management and administration (unless it has already provided such information to the authorities for the same type of UCITS - see also Section 6.3.3.).

The management entity home Member State competent authority will communicate the information received to the host Member State competent authority within one month in the case of free provision of services and two months in the case of branches. In the case of collective portfolio management, the management entity home Member State competent authority will also include an attestation confirming the management entity's authorization, including a description of the scope of this authorization, and, if applicable, any restriction on the types of UCIs the management entity is authorized to manage<sup>45</sup>.

In the case of cross-border management of UCITS, the management company can start the free provision of services in the host Member State as soon as the required information has been communicated to the host Member State competent authority. Branches may start business on receipt of a communication from the host Member State competent authority or on the expiration of a further two-month period.

In the case of cross-border management of AIFs, the AIFM's home Member State competent authority must immediately notify the AIFM about the communication. Upon receipt of the notification, the AIFM may start to provide services in the host Member State.

### 6.3.4.3. Regulatory requirements

#### A. Introduction

UCITS management companies and AIFMs are subject to the requirements applicable to their setting up and operation.

In addition, the regulations lay down requirements, and provide clarifications, on the cross-border management of UCITS.

#### B. Cross-border management of UCITS

The management company (and its branches, if applicable) is subject to its home Member State's organizational requirements, including, *inter alia*:

- ▶ Delegation arrangements and risk management
- ▶ The implementation of sound administrative and accounting processes
- ▶ Control arrangements for electronic data processing
- ▶ Internal control requirements to ensure conflicts of interest are minimized
- ▶ Reporting

It is the responsibility of the home Member State competent authority to ensure compliance with these matters.

<sup>45</sup> The communication in relation to any restrictions on the activity of the management entity is explicitly stated in the UCITS Directive and the 2010 Law; however, as the CSSF may restrict the scope of authorization of an AIFM, it seems reasonable to assume that information on any restriction will be provided to the host Member State also in the case of AIFM.

ESMA clarified, in its *Q&As on the Application of the UCITS Directive*, that when a UCITS management company or an AIFM provides investment services through a branch established in a host Member State, the supervisory powers in relation to such branches are shared between the home and host country competent authorities. The host Member State competent authority is responsible for the supervision of the branch's compliance with rules of conduct and the home Member State competent authority for the other requirements.

When the management company manages UCITS cross-border, the host Member State competent authority (i.e., the UCITS home Member State competent authority) must approve the choice of management company. Management companies must ensure that each host Member States' requirements regarding the constitution and functioning of the UCITS are met, as well as the specific requirements of the UCITS' fund rules or instruments of incorporation, prospectuses, and offering documents. The activities on the constitution and functioning of a UCITS include:

- Set-up and authorization
- Issuance and redemption of shares or units
- Investment policies and limits, including the calculation of the global risk exposure and leverage
- Borrowing, lending, and short selling restrictions
- Valuation of assets and accounting
- Calculation of the issue and redemption price, the NAV computation errors, and related investor compensation
- Distribution and reinvestment of income
- Disclosure and reporting requirements of the UCITS, including the prospectus, Key Investor Information Document (KIID) and periodic reports
- Marketing arrangements
- Relationship with shareholders or unitholders
- Merging and restructuring of the UCITS
- Dissolution and liquidation of the UCITS
- Content of the shareholder or unitholder register, when applicable
- Authorization and supervision fees of the UCITS
- Exercise of the shareholders' voting rights

In addition, the UCITS home Member State competent authority must approve the fund rules or instruments of incorporation and the choice of depositary. The depositary must either have its registered office or be established in the UCITS home Member State.

The management company and depositary must enter into a written agreement on the flow of information between them to enable the depositary to carry out its duties. The minimum content of the agreement is covered in Section 6.3.5.1.

When delegating activities or functions to a third party, the management company must perform due diligence to establish whether the third party is qualified and capable of undertaking the activity or function in question. The delegation is subject to the requirements of the home Member State of the management company. The management company must verify that the third party fulfills all the organizational and conflicts of interest requirements related to the delegated activity or function, and monitor its compliance with these requirements. Such delegation does not affect the management company's liability with respect to the activity delegated by the management company (see also Section 6.3.3.).

The management company must implement procedures and arrangements to enable the host Member State to monitor the UCITS' compliance with the rules under the responsibility of the host Member State. The depositary must make available to the UCITS home Member State competent authority, on request, all the information, obtained during the exercise of its duties, that is necessary for the authority to perform its supervisory duties in relation to the UCITS.

#### 6.3.4.4. Third countries

##### A. Introduction

Further situations that are relevant from a cross-border management perspective include EEA AIFMs managing non-EEA AIFs and non-EEA AIFMs managing EEA AIFs and non-EEA AIFMs marketing EEA and non-EEA AIFs.

The extension of the "passport" regimes to non-EEA AIFs and non-EEA AIFMs is dependent on ESMA issuing a positive opinion on the functioning of the passport for EU AIFMs marketing EU AIFs and the EC adopting the required delegated act in light of ESMA's advice.

In July 2016, ESMA advised that according to its second round of assessments Canada, Guernsey, Jersey, Japan, and Switzerland may be allowed to distribute alternative funds across the EU. To date, no third-country passports have been attributed.

Marketing of AIFs is covered in Chapter 12.

## B. EEA AIFMs managing non-EEA AIFs

In summary, the provisions of the AIFM Directive apply to AIFMs in relation to the management of non-EU AIFs.

EEA AIFMs may manage non-EEA AIFs that are not marketed in the EEA if the following conditions are fulfilled:

- ▶ The EEA AIFM complies with all of the relevant requirements of the AIFMD except the requirements on depositary (see Chapter 9) and annual report (see Section 10.5.2.) in respect of those AIFs
- ▶ There must be appropriate cooperation arrangements between the EEA AIFM home Member State competent authority and the supervisory authority of the non-EEA AIF third country, to ensure at least an efficient exchange of information (see Section 6.3.4.4.C.)

## C. Non-EEA AIFMs managing EEA AIFs

Non-EEA AIFMs may continue to manage EEA AIFs, subject to national requirements, until the implementation of the management and product “passports” for non-EU AIFMs.

Following introduction of the passports for non-EEA AIFMs, a non-EEA AIFM wishing to benefit from the passport will have to comply with the requirements of the AIFM Directive and receive prior authorization from the competent authority of an EEA “Member State of reference” if it intends to:

- ▶ Manage EEA AIFs (following the phasing in of the passport for non-EEA AIFMs). Authorized non-EEA AIFMs may manage AIFs in their Member State of reference once they are authorized in that Member State. They may also manage AIFs in EEA Member States other than their Member State of reference. The procedures to be followed are similar to those applicable to EEA AIFM intending to manage an AIF established in another Member State
- ▶ Market with a passport the EEA and/or non-EEA AIFs they manage in the EEA (once the passport has been phased in for non-EEA AIFMs - see Section 12.5.3.)

To obtain such authorization in an “EEA Member State of reference”, the AIFM must comply with the requirements of the AIFM Directive or equivalent rules.

The “Member State of reference” is determined in accordance with a complex series of rules. In summary, it is generally the Member State where the applicant AIFM carries out most management or marketing. The non-EEA AIFM cannot select its “Member State of reference”.

The following conditions must also be met:

- ▶ The non-EEA AIFM must appoint a legal representative in the Member State of reference, which will, alongside the AIFM itself, have the role of a contact person for investors and EEA authorities. The legal representative must also jointly perform with the AIFM the compliance functions relating to the management and marketing activities of the AIFM under the AIFM Directive
- ▶ There must be appropriate cooperation arrangements between the Member State of reference competent authority, EEA AIF competent authority (if relevant), and the non-EEA AIFM supervisory authority at least for efficient exchange of information (see Section 12.5.3.)
- ▶ The non-EEA AIFM country must not be listed as a non-cooperative country and territory (NCCT) by the Financial Action Task Force (FATF)<sup>46</sup>
- ▶ The non-EEA AIFM country must have signed a compliant OECD Article 26 Model Tax Convention<sup>47</sup> with the AIFM Member State of reference and any other Member State in which the non-EU AIF will be marketed
- ▶ The effective exercise by the competent authority of its supervisory functions must neither be prevented by laws, regulations, or administrative provisions of the third-country governing the AIFM nor by limits on the supervisory and investigatory powers of the third-country regulator

## 6.3.5. Appointment of third parties

### 6.3.5.1. Depositary appointment

For each Luxembourg UCI, a depositary must be appointed. Furthermore, an AIFM is required to ensure that, for each AIF it manages, a single depositary is appointed.

The UCITS management company or the investment company shall have in place a decision-making process for choosing and appointing the depositary, which shall be based on objective pre-defined criteria and meet the sole interest of the UCITS/AIF and the investors of the UCITS/AIF.

<sup>46</sup> An intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.

<sup>47</sup> Article 26 of the OECD Model Tax Convention creates an obligation to exchange information that is foreseeably relevant to the correct application of a tax convention as well as for purposes of the administration and enforcement of domestic tax laws of the contracting states.

When the management company or the investment company appoints a depositary to which it has a link or a group link, it shall keep documentary evidence of the following:

- ▶ An assessment comparing the merits of appointing a depositary with a link or a group link with the merits of appointing a depositary which has no link or no group link with the management company or the investment company, taking into account at least the costs, the expertise, financial standing, and the quality of services provided by all depositaries assessed
- ▶ A report, based on the assessment referred to above, describing the way in which the appointment meets the objective pre-defined criteria and is made in the sole interest of the UCITS/AIF and the investors of the UCITS/AIF

The management company or the investment company shall demonstrate to the competent authority of the UCITS/AIF home Member State that it is satisfied with the appointment of the depositary and that the appointment is in the sole interest of the UCITS/AIF and the investors of the UCITS/AIF. The management company or the investment company shall make the documentary evidence available to the competent authority of the UCITS/AIF home Member State.

The management company or the investment company shall justify to investors, upon request, the choice of the depositary.

The depositary shall have in place a decision-making process for choosing third parties to whom it may delegate the safekeeping functions in accordance with Article 22a of Directive 2009/65/EC, as amended, or Article 19 (11) of the Law of 12 July 2013, as amended, which shall be based on objective pre-defined criteria and meet the sole interest of the UCITS/AIF and the investors of the UCITS/AIF.

The required qualifications and role of the depositary are outlined in Chapter 9.

The appointment of the depositary should be evidenced by a written contract. The minimum content of the written agreement/contract between the depositary and the management entity and/or the UCI (UCITS or AIF) is laid down in the delegated acts of the AIFM Directive and the UCITS V Directive. CSSF Circular 16/644 and CSSF Circular 18/697 are largely aligned with UCITS Directive/AIFMD delegated acts as regards to the minimum content of the contract for the appointment of a UCITS/AIF depositary.

The contract has to cover at least the following elements:

#### Summary of particulars of the depositary agreement

	UCITS	Full AIFM regime AIF
Safekeeping and oversight duties	Description of the services to be provided by the depositary and the procedures to be adopted for each type of asset in which the UCI may invest and which are entrusted to the depositary	Description of the way in which the safekeeping and oversight functions are to be performed depending on the types of assets and the geographical regions in which the UCI plans to invest. With respect to the custody duties this description shall include country lists and procedures for adding or, as the case may be, withdrawing countries from that list. This shall be consistent with the information provided in the UCI rules, instruments of incorporation, and offering documents regarding the assets in which the UCI may invest
Information to be provided by the depositary to the management entity	Description of the means and procedures by which the depositary provides to the IFM or the UCI all relevant information that it needs to perform its duties, including the exercise of any rights attached to assets, and in order to allow the IFM and the UCI to have a timely and accurate overview of the accounts of the UCI	
Information to be provided to the depositary	The means and procedures by which the IFM or the UCI provides all relevant information or ensures the depositary has access to all the information it needs to fulfill its duties, including the procedures ensuring that the depositary will receive information from other parties appointed by the UCI or the IFM	
Information on cash accounts	Information on all cash accounts opened in the name of the UCI or in the name of the IFM acting on behalf of the UCI and the procedures ensuring that the depositary will be informed when any new account is opened	
Subscriptions and redemptions	All necessary information that needs to be exchanged between the UCI or the IFM, or a third party acting on behalf of the UCI, on the one hand, and the depositary, on the other hand, related to the sale, subscription, redemption, issue, cancellation, and re-purchase of units of the UCI	
Prevention of money laundering/ financing of terrorism (ML/FT) (see Section 8.8.4.)	Tasks and responsibilities of the parties regarding obligations on the prevention of ML/FT	
Modification of UCI documentation	The procedures to be followed when an amendment to the constitutional document or offering documents is being considered, detailing the situations in which the depositary has to be informed, when the depositary should be informed, and when the depositary's prior agreement is necessary	

	UCITS	Full AIFM regime AIF
Depository monitoring of management entity	The procedures ensuring that the depository, regarding its duties, has the ability to enquire into the conduct of the IFM and, as the case may be, the UCI, and to assess the quality of information provided, including having access to the books of the UCI and/or the IFM or on-site visits	
Management entity monitoring of depository	The procedures ensuring that the IFM and/or the UCI can review the performance of the depository regarding its contractual obligations	
Depository escalation procedures	Details regarding the depository's escalation procedures, including the identification of the persons to be contacted within the UCI and/or the IFM when the depository launches such a procedure	
Segregation by sub-custodian issue notification	A commitment by the depository to notify the IFM when it becomes aware that the segregation of assets is not adequate to ensure protection from insolvency of sub-custodians	
Appointment of third parties by either party (management entity or depository)	Commitment to provide, on a regular basis, details of any third party appointed and, upon request, information on the criteria used to select the third party and the steps to monitor the activities carried out by the selected third party	
Right of pledge	Where the depository benefits from a general or specific right of pledge over the deposited assets of the UCI, the exceptions to such rights and the extent of the depository's right to use the pledged assets must be specified. The parties may agree on a set-off clause at the level of the UCI (or, where relevant, the compartment)	
Asset reuse	Not permitted	Information on whether or not the depository or a third party to whom safekeeping functions are delegated may reuse the assets it has been entrusted with and, if any, the conditions attached to any such reuse
Liability in case of delegation of custody	A statement that a depository's liability is not affected by any delegation of its custody functions	A statement that the depository's liability is not affected by any delegation of its custody functions, unless the depository has discharged itself of its liability in accordance with the relevant requirements. In case of discharge of liability, the contract must expressly permit the discharge of the depository's liability and establish the objective reason to contract such a discharge
Confidentiality	Confidentiality obligations applicable to the parties, which must not impair the ability to have access to relevant documents and information	
Amendments and termination of the agreement	Period of validity, conditions under which the contract may be amended or terminated, and transition arrangements in case of change of depository	
Applicable law	The law of the UCITS home Member State	Applicable law must be specified
Scope of agreement	List of all UCIs covered by the agreement	

The details to the elements of the depository contract described above may be included in a subsequent amendment to the contract, such as a service level agreement or other separate written agreement.

In addition to meeting the requirements laid down in the depository contract, the management entity is required to, *inter alia*:

- ▶ Ensure that all instructions and relevant information related to the UCI's assets and operations are sent to the depository (see Section 9.4.5.1.)
- ▶ Provide the depository, upon commencement of its duties and on an ongoing basis, with all relevant information it needs in order to perform the oversight duties including information to be provided to the depository by third parties
- ▶ Provide the depository with all information relating to any reservations on the UCI's financial statements expressed by the auditor

### 6.3.5.2. Prime brokers and counterparties

AIFMs must exercise due skill, care, and diligence in the selection of prime brokers and counterparties before appointing them and, thereafter, on an ongoing basis, taking into account the full range and quality of their services. When selecting prime brokers or counterparties of an AIFM or an AIF in an OTC derivative transaction, securities lending, or repurchase agreement, AIFMs must ensure that those prime brokers and counterparties:

- Are subject to ongoing supervision by a public authority
- Are financially sound, taking into account the applicable prudential regulation, including capital requirements and effective supervision
- Have the necessary organizational structure and resources to perform the services to be provided by them to the AIFM or the AIF

The list of selected prime brokers must be approved by the AIFM's senior management.

When an AIFM uses a prime broker, the arrangement must be set out in a written contract, which must cover the terms under which the prime broker may transfer and reuse AIF assets. The contract must also provide that the depositary, if separate from the prime broker, be informed of the contract.

In its application for authorization, the AIFM is required to provide details of the workflows of the processes and interactions between the prime broker, the AIFM, and other related parties.

AIFMs must ensure that from the date of the appointment of a prime broker there is an agreement that requires the prime broker to make available to the depositary daily statements providing detailed information on the assets of the AIF. The AIFM must also ensure that the depositary has a right of refusal with respect to the selection and appointment of a prime broker by the AIF or its IFM where the prime broker is required, in the performance of its duties, to hold in custody assets owned by the AIF. The relationship between the prime broker and the depositary is covered in Section 9.8.

Information that must be disclosed to investors before they invest is covered in Section 10.3.3.

## 6.4. Operating a management entity

### 6.4.1. Conflicts of interest

#### A. Introduction

Management entities should take all reasonable steps to identify, prevent, manage, and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the UCIs and their investors. When the arrangements made by the management entity to identify, prevent, manage, and monitor conflicts of interest are not adequate to ensure, with reasonable confidence, that risks of damage to investors' interests will be prevented, the management entity must disclose the general nature or sources of conflicts of interest to the investors.

Specific conflicts of interest requirements apply to SIFs (see Section 2.4.2.3.).

#### B. Applicable general rules

The wording of the general requirements on conflicts of interest differs between UCITS management companies and AIFMs:

#### General requirements on conflicts of interest applicable to management entities

Chapter 15 management company	AIFM
A UCITS management company is required to try to avoid conflicts of interest and, when they cannot be avoided, to ensure that the UCITS it manages are fairly treated.	An AIFM is required to take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, when applicable, disclose those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated.
A UCITS management company is structured and organized in such a way as to minimize the risk of UCITS' or clients' interests being prejudiced by conflicts of interest between the management company and its clients, between two of its clients, between one of its clients and a UCITS or between two UCITS.	AIFMs are required to maintain and operate effective organizational and administrative arrangements that take all reasonable steps designed to identify, prevent, manage, and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors.

Chapter 15 management company	AIFM
	AIFMs are required to segregate, within their own operating environment, tasks and responsibilities that may be regarded as incompatible with each other or that may potentially generate systematic conflicts of interest. AIFMs must assess whether their operating conditions may involve any other material conflicts of interest and disclose them to the investors of the AIF.
	When organizational arrangements to identify, prevent, manage, and monitor conflicts of interest are not adequate to ensure, with reasonable confidence, that risks of damage to investors' interests will be prevented, the AIFM must clearly disclose the general nature or sources of conflicts of interest to the investors before undertaking business on their behalf, and develop appropriate policies and procedures.

Chapter 16 management companies are required to submit a description of how they manage potential conflicts of interest in their application for authorization.

### C. Types of conflicts of interest

For the purpose of identifying the types of conflicts of interest that arise in the course of their business, UCITS management companies and AIFMs must take into account, in particular, whether the management entity, a relevant person, or a person directly or indirectly linked by way of control, in any of the following situations:

- ▶ Is likely to make a financial gain or avoid a financial loss at the expense of the UCI or its investors
- ▶ Has an interest in the outcome of a service or an activity provided to the UCI or its investors or to a client or of a transaction carried out on behalf of the UCI or a client, which is distinct from the UCI's interest in that outcome
- ▶ Has a financial or other incentive to favor the interest of a UCITS, a client or group of clients, or another UCI over the interest of the UCI or, in the case of AIFM, the interest of one investor over the interest of another investor or group of investors in the same AIF
- ▶ Carries out the same activities for the UCI and for another UCI or other client
- ▶ Receives or will receive from a person other than the UCI or its investors an inducement in relation to collective portfolio management activities provided to the UCI, in the form of monies, goods, or services other than the standard commission or fee for that service (see also Section 6.4.2.C.)

#### Conflicts of interest identification requirements applicable to management entities

Chapter 15 management	AIFM
UCITS management companies, when identifying the types of conflicts of interest, must take into account the following: <ul style="list-style-type: none"> <li>▶ The interests of the management company, including, if relevant, those deriving from its belonging to a group or from its services and activities and those of other group members</li> <li>▶ The interests of investors</li> <li>▶ The duties of the management company towards the UCITS</li> <li>▶ The interests of two or more UCITS it manages</li> </ul>	An AIFM is required to take all reasonable steps to identify conflicts of interest that arise in the course of managing AIFs between: <ul style="list-style-type: none"> <li>▶ The AIFM, including its managers, employees, or any person directly or indirectly linked to the AIFM by control, and the AIF managed by the AIFM or the investors in that AIF</li> <li>▶ The AIF or the investors in that AIF and another AIF or the investors in that AIF</li> <li>▶ The AIF or the investors in that AIF and another client of the AIFM</li> <li>▶ The AIF or the investors in that AIF and any UCITS it manages (when the AIFM has also been authorized as a UCITS management company) or the investors in any such UCITS</li> <li>▶ Two clients of the AIFM</li> </ul>

Potential conflicts of interest may exist between, for example:

- ▶ Risk management and operations: the functional and hierarchical separation of the functions of risk management and the operating units, including portfolio management, is covered in Chapter 7. The functional and hierarchical separation requirements for AIFMs are set out in more detail in Section 7.3.5.
- ▶ Internal audit function and risk management function: the roles of internal control functions are covered in Section 6.3.2.1. The role of the internal audit function of an AIFM in reviewing the performance of the risk management function is covered in Section 7.3.5.
- ▶ Internal audit function and compliance function: the roles of internal control functions are covered in Section 6.3.2.1.
- ▶ Valuation and portfolio management: the functional independence of the valuation function from the portfolio management function is covered in Section 7.6.

- ▶ Depository and portfolio management or risk management functions: requirements to be met in case of delegation of portfolio management or risk management to an entity that is part of the group of the depository or part of the group of a delegate of the depository is covered in Section 7.2.2.

Potential conflicts of interest may also arise when:

- ▶ The parent company, another group company, or a related party is appointed as portfolio manager, investment advisor, or service provider
- ▶ Related parties play an influential role within the management entity, for example, when a service provider represented in the board or an investment advisor represented in the portfolio management function or the board
- ▶ The UCI challenges the portfolio management decisions of the management entity or portfolio manager
- ▶ A deal could be allocated to several UCIs
- ▶ In the interests of investors and in accordance with the relevant UCI's valuation rules, an asset held by two different UCIs managed by the same management entity may be valued differently (see also Section 7.6.)
- ▶ Different decisions need to be taken for different UCIs, in order to act in the best interests of each, for example, in the exercise of voting rights attached to the assets of the AIF or in exiting the investment
- ▶ The interests of investors subscribing shares or units *versus* those of existing shareholders or unitholders or those of shareholders or unitholders redeeming shares or units *versus* those remaining in the UCI diverge

Delegates may be subject to conflicts of interest requirements, as described in Section 6.3.3. Transparency requirements on conflicts of interest that may arise from delegation are covered in Chapter 10.

The CSSF issued, on 18 December 2020, FAQs to clarify certain requirements in terms of prospectus disclosures, revenues and costs/fees, conflicts of interest and best execution applicable to securities financing transactions (SFTs).

IFMs are expected to assess and document the operational model and the related processes underlying the SFTs in order to identify and record potential conflicts of interest entailing a material risk of damage to the interests of a UCITS.

Where portfolio management has been delegated, robust initial and ongoing due diligence and oversight should ensure that the best execution controls performed by the delegate are adequate.

IFMs had to comply with the clarifications provided for in the FAQ by 30 September 2021 at the latest.

#### D. Conflicts of interest policy

Management companies and AIFMs must establish, implement, and apply an effective conflicts of interest policy. The policy must be set out in writing and be appropriate to the size and organization of the management entity and the nature, scale, and complexity of its business.

When the management entity is a member of a group, the policy must also take into account any circumstances that may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.

The conflicts of interest policy must cover the following:

- ▶ With reference to the activities carried out by or on behalf of the management entity, identification of the circumstances that constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the UCI or its investors or one or more other clients
- ▶ Procedures to be followed and measures to be adopted in order to prevent, manage, and monitor such conflicts

The CSSF can request a copy of these written procedures at any time.

#### E. Procedures and measures preventing or managing conflicts of interest

The procedures and measures established for the prevention or management of conflicts of interest must ensure that the relevant persons engaged in different business activities involving a risk of conflict of interest carry out these activities having a degree of independence that is appropriate to the size and activities of the UCITS management company or AIFM and of the group to which it belongs and to the materiality of the risk of damage to the interests of the UCI, its investors, or other clients.

#### F. Monitoring conflicts of interest

The UCITS management company or AIFM must keep and regularly update a record of the types of activities undertaken by or on behalf of the management entity in which a conflict of interest entailing a material risk of damage to the interests of one or more UCIs or its investors has arisen or, in the case of an ongoing activity, may arise.

The conflict of interest register must include, at least, a description of the conflict of interest, the person or unit concerned, the date it was discovered, the potential or actual impacts, the solutions or measures envisaged and, where applicable, the procedures for informing investors.



In the case of AIFMs, senior management must receive on a frequent basis, and at least annually, written reports on such activities.

The IFM must transmit a copy of the register to the CSSF upon request.

#### G. Managing conflicts of interest

When the organizational or administrative arrangements made by the UCITS management company or AIFM are not adequate to ensure, with reasonable confidence, that risks of damage to the interests of the UCI or investors in the UCI are prevented, senior management or other competent internal body of the management entity must be promptly informed in order to take any necessary decision or action to ensure that the management entity acts in the best interests of the UCIs or its investors.

#### H. Disclosure of conflicts of interest

Management entities are required to disclose to investors information on conflicts of interest that cannot, with reasonable confidence, be prevented (see Section 10.4.).

#### I. Investor liquidity

An AIFM that manages open-ended AIFs must identify, manage, and monitor conflicts of interest arising between investors wishing to redeem their investments and investors wishing to maintain their investments in the AIF and any conflicts between the AIFM's incentive to invest in illiquid assets and the AIF's redemption policy.

#### J. Voting rights

UCITS management companies and AIFMs must develop measures and procedures to prevent or manage conflicts of interest arising from the exercise of voting rights linked to instruments held in the portfolio.

## 6.4.2. Rules of conduct

### A. General rules

Chapter 15 management companies and AIFMs must at all times comply with similar rules of conduct.

#### General rules of conduct applicable to management entities

Chapter 15 management company	AIFM
<ul style="list-style-type: none"> <li>▶ Act honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market</li> <li>▶ Act with due skill, care, and diligence, in the best interests of the UCITS it manages and the integrity of the market</li> <li>▶ Have and effectively employ the resources and procedures that are necessary for the proper performance of its business activities</li> <li>▶ Try to avoid conflicts of interests and, when they cannot be avoided, ensure that the UCITS it manages are fairly treated</li> <li>▶ Comply with all regulatory requirements applicable to the conduct of its business activities to promote the best interests of its investors and the integrity of the market</li> </ul>	<ul style="list-style-type: none"> <li>▶ Act honestly, fairly, and with due skill, care, and diligence in conducting their activities</li> <li>▶ Act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market</li> <li>▶ Have and employ effectively the resources and procedures that are necessary for the proper performance of their business activities</li> <li>▶ Take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, identify, manage and monitor and, when applicable, disclose those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated</li> <li>▶ Comply with all regulatory requirements applicable to the conduct of their business activities to promote the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market</li> <li>▶ Treat all AIFs investors fairly</li> </ul>

### B. Acting in the best interests of the UCI and its investors

All actions undertaken by the management entities should be directed towards acting in the best interests of the UCI and its investors. The rules of conduct envisage the interests of the investors in their specific capacity as investors of the UCI, and not their individual interest. Investors' interests comprise, but are not limited to, their pecuniary interest.

The following table outlines the main requirements:

	Chapter 15 management company	AIFM
Treating investors fairly	Management companies must ensure that shareholders or unitholders of managed UCITS are treated fairly. Management companies cannot place the interests of any group of shareholders or unitholders above the interests of any other group of shareholders or unitholders.	<p>AIFMs must treat all AIFs investors fairly. A description of how the AIFM ensures fair treatment of investors must be provided to them before they invest.</p> <p>Any preferential treatment accorded by an AIFM to one or more investors<sup>48</sup> must not result in an overall material disadvantage to the other investors. When investors obtain preferential treatment, this must be disclosed in the relevant AIF's constitutional document.</p> <p>Whenever an investor obtains preferential treatment or the right to obtain preferential treatment, the AIFM must provide to investors before they invest a description of that preferential treatment, the type of investors who obtain such preferential treatment, as well as, when relevant, their legal or economic links with the AIF or AIFM.</p>
Market malpractices	Management entities must apply appropriate policies and procedures for preventing malpractices that might reasonably be expected to affect the stability and integrity of the market.	
Valuation (see also Section 7.6.)	Without prejudice to any other provisions of Luxembourg law, IFMs are required to ensure that fair, correct, and transparent pricing models and valuation systems are used for the UCIs they manage, in order to comply with the duty to act in the best interests of the shareholders or unitholders. IFMs must be able to demonstrate that the UCIs' portfolios have been accurately valued.	
Costs	Management entities must ensure that the UCIs they manage and their investors are not charged undue costs.	

### C. Fees and inducements

Management companies and AIFMs will not be regarded as acting fairly, honestly, and professionally in the best interests of the UCIs they manage and their investors if, in relation to the management of UCIs<sup>49</sup>, they pay, or are paid, any fee or commission, or provide or are provided with any non-monetary benefit other than:

- ▶ A fee, commission, or non-monetary benefit paid or provided to or by the UCI or a person on behalf of the UCI
- ▶ A fee, commission, or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party when:
  - ▶ The existence, nature, and amount of the fee, commission, or non-monetary benefit is clearly disclosed to the investors in the UCI in a comprehensive, accurate, and understandable manner prior to provision of the relevant service. The management entity is permitted to disclose the essential terms when it undertakes to disclose further details at the request of the investor, and fulfills that commitment
  - ▶ The payment of the fee or commission, or provision of the non-monetary benefit, is designed to enhance the quality of the service and not impair compliance with the management entity's duty to act in the best interests of the UCI or the investors in the UCI
- ▶ Proper fees that enable or are necessary for the provision of the relevant service (such as custody costs, settlement and exchange fees, regulatory levies, or legal fees) and that by their nature do not give rise to conflicts with the management entity's duties to act honestly, fairly, and in the best interests of the UCI it manages or the investors in the UCI

In practice, any new monetary or non-monetary benefit paid or received by the management company (or its outsourced service providers) should be identified, and classified as proper fees or inducements. Management entities should determine whether benefits identified as inducements comply with these criteria and terminate non-compliant agreements. Such classification and assessment should be adequately documented.

In practice, the CSSF expects that:

- ▶ The payment of any fee is aimed at remunerating a service provided to the UCI/its investors and does not impair compliance with the management company's duty to act in the best interests of the share/unitholders
- ▶ A structured and documented pricing process is in place to ensure that undue costs are not charged to investors

<sup>48</sup> Such as side letters.

<sup>49</sup> The inducements provisions applicable to UCITS management companies specifically cover the activities of investment management and administration, whereas inducement provisions applicable to AIFMs cover all management activities (i.e., including marketing). See also Section 6.1.2.

The CSSF will scrutinize:

1. Whether the costs are necessary for the UCI to operate in line with its investment objective (e.g., portfolio management fees, transaction and settlement fees) or strictly functional to the ordinary activity or to fulfil regulatory requirements (audit fees, taxes, NCA levies)
2. Whether the costs are proportionate to market standards and the type of service provided, notably in the context of potential conflicts of interest where payments are made to third parties, intragroup delegates or depositaries
3. Whether the fees are proportionate to the complexity of assets, strategies and activities performed
4. Whether the fees are sustainable in light of the expected net return of the UCI
5. Whether the costs ensure investors' equal treatment, except for AIFs not distributed to retail investors disclosing a preferential treatment, where such treatment is allowed under the applicable legislation
6. Whether there is no duplication of costs and costs are properly identified and accounted for
7. Whether a cap on fees, if any, is applied and disclosed to investors
8. Whether the performance fee model and its disclosure is compliant, where applicable, with the ESMA's *Guidelines on performance fees in UCITS and certain types of AIFs*
9. Whether all cost disclosures to investors comply with applicable EU and national rules
10. Whether the pricing process and all charged costs are based on reliable and documented data and verifiable at a single portfolio level

See also Sections 6.3.3., 6.4.1., 6.4.3. and 11.2.2.

#### D. Portfolio management

UCITS management companies and AIFMs are required to comply with rules of conduct related to their portfolio management activities including in:

- Investment due diligence in the selection and ongoing monitoring of investments
- Adequate knowledge and understanding of the assets in which the UCIs are invested
- Investment decisions carried out in compliance with the objectives, investment strategy and risk limits of the UCIs
- Best execution of decisions to deal on behalf of the UCIs:
  - Placing of orders: acting in the best interest of the UCI when placing orders to deal on behalf of the UCI with other entities for execution
  - Handling of orders: ensuring prompt, fair, and expeditious execution of portfolio transactions on behalf of the UCI

Where AIFMs invest in assets of limited liquidity and where such investment is preceded by a negotiation phase, they are required to:

- Set out and regularly update a business plan consistent with the duration of the AIF and market conditions
- Seek and select possible transactions consistent with that business plan
- Assess the selected transactions in consideration of opportunities, if any, and overall related risks, all relevant legal, tax-related, financial or other value affecting factors, human and material resources, and strategies, including exit strategies
- Perform due diligence activities related to the transactions prior to arranging execution
- Monitor the performance of the AIF with respect to the business plan

AIFMs must retain records pursuant to these activities for at least five years.

#### E. Subscriptions and redemptions

UCITS management companies and AIFMs are required to comply with reporting and record-keeping requirements regarding execution of subscription and redemption orders (see Section 8.8.3.).

#### F. Personal transactions

UCITS management companies and AIFMs are required to establish, implement, and maintain adequate arrangements designed to prevent any relevant person from:

- Entering into a personal transaction that is prohibited by the Market Abuse Directive<sup>50</sup> or the Market Abuse Law<sup>51</sup> and/or implies the misuse or improper disclosure of confidential information
- Outside the normal scope of its employment, advising any person to enter into a transaction that would constitute misuse of information relating to pending orders
- Outside the normal scope of its employment, disclosing to any person information or opinion that may lead any person to enter into a transaction that fulfills these conditions

<sup>50</sup> Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse.

<sup>51</sup> Luxembourg Law of 23 December 2016 on market abuse, as amended.

Any relevant person must be aware of the restrictions on personal transactions and the measures established by the management entity in connection with personal transactions and disclosure.

The management company must be informed promptly of any personal transaction entered into by a relevant person (by means of notification or by other measures) and the transaction must be recorded, including any authorization or prohibition of the transaction.

Exemptions are granted for:

- Personal transactions carried out in the context of discretionary portfolio management, if there is no prior communication between the relevant person and the manager
- Personal transactions on UCITS and other European regulated funds, if the relevant person is not involved in their management

See also Section 6.4.1.

IFMs must have written procedures regarding personal transactions. The procedures must enable the IFM to ensure that a delegate carrying on activities on behalf of the IFM maintains a record of the personal transactions of any persons concerned. A list of all personal transactions notified to or identified by the IFM must be available at its head office in Luxembourg and provided to the CSSF upon request.

ESMA submitted its report on the review of the Market Abuse Regulation<sup>52</sup> (MAR) to the European Commission on 23 September 2020.

ESMA advised the European Commission to clarify that:

- Managers of management companies of listed UCIs without a legal personality and externally managed funds with a legal personality should not be required to meet the MAR obligations applicable to persons discharging managerial responsibilities (PDMR obligations)
- Self-managed listed UCIs should be specifically excluded from the PDMR obligations
- Management companies of listed UCIs with legal personality should be held responsible for disclosing inside information when it arises. Asset managers to whom the execution of certain functions have been delegated by management companies should be responsible for reporting immediately to the management company any information that may be relevant in terms of possible existence of inside information
- A recital should be included to clarify that management companies of listed UCIs are responsible for drawing up and maintaining lists of those who may have inside information. Third-party delegates (asset managers, depositaries, accountants, etc.) should be explicitly in scope of the obligation to draw up and maintain their own lists of those people who may have inside information, where such information exists

### 6.4.3. Remuneration policy

The key regulations on remuneration that may be applicable in the context of Luxembourg management companies, AIFMs, and investment companies are summarized in the following table:

Key remuneration regulations

	CSSF Circular	AIFMs	UCITS Management companies
Title	<i>CSSF Circular 10/437 on Guidelines concerning the remuneration policies in the financial sector</i> <sup>53</sup>	<i>AIFM Law, as amended</i>  <i>ESMA's Guidelines on sound remuneration policies under the UCITS Directive and AIFMD (2016/411)</i>  <i>ESMA Guidelines on sound remuneration policies under AIFMD (2016/579)</i>  <i>ESMA Q&amp;A on the application of AIFMD</i>	<i>2010 Law as amended by the law of 10 May 2016, transposing the UCITS V Directive</i>  <i>ESMA's Guidelines on sound remuneration policies under the UCITS Directive and AIFMD (2016/411)</i>  <i>ESMA Guidelines on sound remuneration policies under the UCITS Directive (2016/575)</i>  <i>ESMA Q&amp;A on application of the UCITS Directive</i>
Entities in scope	All entities under the supervision of the CSSF ("financial undertakings"), including management entities and, in some cases, investment companies	AIFMs and internally managed AIFs	Management companies and investment companies that have not designated a management company authorized pursuant to the UCITS Directive

<sup>52</sup> Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse, as amended.

<sup>53</sup> The Circular implements EC Recommendation 2009/384/EC on remuneration policies in the financial services sector.

The following table outlines the main requirements of the CSSF Circular, and the AIFM and UCITS management company provisions which are very similar.

	Circular 10/437	Key AIFM and UCITS provisions
Key principles	<p>The Circular requires financial undertakings to establish, implement, and maintain a remuneration policy that is consistent with and promotes sound and effective risk management and does not induce excessive risk-taking. The policy must be in line with the business strategy, objectives, values, and long-term interests of the financial undertaking and be consistent with the principles relating to the protection of clients and investors when providing services.</p>	<p>IFM is required to have remuneration policies that:</p> <ul style="list-style-type: none"> <li>▸ Are consistent with and promote sound and effective risk management</li> <li>▸ Do not encourage risk-taking which is inconsistent with the risk profiles, rules, or instruments of incorporation, or constitutional documents of the UCIs it manages</li> <li>▸ Are in line with the business strategy, objectives, values, and interests of the UCIs that it manages and of the investors in such UCIs and includes measures to avoid conflicts of interest</li> </ul>
Staff in scope	<p>The Circular applies to the remuneration of members of the board and management bodies of financial undertakings, as well as those categories of staff whose professional activities have a material impact on the risk profile of the financial undertaking. However, when the remuneration of these individuals is fixed, the financial undertaking is exempted from applying the Circular.</p>	<p>IFM's remuneration policies and practices must cover those categories of staff whose professional activities have a material impact on the risk profiles of the IFM or of the UCI it manages including:</p> <ul style="list-style-type: none"> <li>▸ Executive and non-executive members of the governing body of the IFM, such as directors, the chief executive officer, and executive and non-executive partners</li> <li>▸ Senior management</li> <li>▸ Staff responsible for heading the investment management, administration, marketing, and human resources</li> <li>▸ Control functions</li> <li>▸ Other risk takers, such as staff whose professional activities, either individually or collectively, can exert material influence on the IFM's risk profile or on a UCI it manages, including persons capable of entering into contracts/positions and taking decisions that materially affect the risk positions of the IFM or the UCI it manages – for example, sales persons, traders, and trading desks personnel</li> <li>▸ Any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers whose activities have a material impact on the risk profile of the IFM or the UCI it manages</li> </ul> <p>IFM should define what constitutes materiality within the context of the IFM or the UCI it manages, including an analysis of the impact on the IFM's results and/or balance sheet and/or performance of the UCI and job functions and responsibilities.</p>

The Circular is applicable to entities under the supervision of the CSSF. It does not apply to fees and commissions received by intermediaries and external service providers in case of outsourced activities<sup>54</sup>.

The provisions apply to categories of staff of the entity or entities to which investment management activities have been delegated by the IFM, whose professional activities have a material impact on the risk profiles of the UCI that the IFM manages.

When delegating investment management activities (including risk management), IFMs should ensure that either of the following criteria are met:

- ▶ The entities to which portfolio management or risk management activities have been delegated are subject to regulatory requirements on remuneration that are equally as effective as those applicable under ESMA's guidelines
- ▶ Appropriate contractual arrangements are put in place with entities to which investment management activities have been delegated in order to ensure that there is no circumvention of the remuneration rules set out in the UCITS Directive, AIFM Directive, the AIFM Law, and ESMA's guidelines. These contractual arrangements should cover any payments made to the delegates' identified staff as compensation for the performance of investment management activities on behalf of the IFM

When remuneration includes a variable component or a bonus, the remuneration policy should be structured with an appropriate balance of fixed and variable remuneration components. The remuneration policy must set a maximum limit on the variable component. The fixed component of the remuneration should represent a sufficiently high proportion of the total remuneration allowing the financial undertaking to operate a fully flexible bonus policy.

When a significant bonus is awarded, the major part of the bonus should be deferred with a minimum period of deferral. The deferred element of the bonus should take into account the outstanding risks associated with the performance to which the bonus relates.

When remuneration is performance related, its total amount should be based on a combination of the assessment of the performance of the individual, of the business unit concerned, and of the overall results of the financial undertaking. The assessment of performance should be set in a multi-year framework (e.g., three to five years) in order to ensure that the assessment process is based on longer term performance and that the actual payment of bonuses is spread over the business cycle of the company.

In particular, the financial undertaking should be able to withhold bonuses entirely or partly when performance criteria are not met by the individual concerned, the business unit concerned, or the financial undertaking in its entirety.

IFMs are required to comply with a series of principles set out in Annex II of the AIFM Law or Article 14b of the UCITS Directive in a way that is appropriate to their size, internal organization, and the nature, scope, and complexity of their activities. For example:

- ▶ When remuneration is performance related, the total amount of remuneration must be based on a combination of the assessment of the performance of the individual, and of the business unit or UCI concerned, and of the overall results of the IFM. When assessing individual performance, financial as well as non-financial criteria must be taken into account
- ▶ The assessment of performance must be set in a multi-year framework appropriate to the life-cycle of the AIF/ to the holding period recommended to the investors of the UCITS managed by the IFM
- ▶ Fixed and variable components of total remuneration must be appropriately balanced and the fixed component must represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy, on variable remuneration components, including the possibility to pay no variable remuneration component
- ▶ In general, at least 50% of any variable remuneration must consist of shares or units of the UCI concerned or equivalent non-cash instruments<sup>55</sup>
- ▶ At least 40% of the variable remuneration component must be deferred over a period that is appropriate to the life-cycle/holding period recommended to the investors and redemption policy of the UCI concerned and is correctly aligned with the nature of the risks of the UCI in question (generally three to five years for AIFs, at least three years for UCITS)
- ▶ Staff engaged in control functions must be compensated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control

<sup>54</sup> CSSF Circular 10/437 is applicable to entities under the supervision of the CSSF. Entities not under the supervision of the CSSF, for example delegates, may be subject to certain remuneration provisions of the UCITS and AIFM Directives: please, refer to ESMA's Q&A on the application of the UCITS Directive and ESMA's Q&A on the application of the AIFMD.

<sup>55</sup> ESMA clarified in the report on UCITS remuneration guidelines that this requirement does not apply where the management of UCITS, in terms of NAV, accounts for less than 50% of the total portfolio managed by the management company.

Group remuneration policy	<p>ESMA's guidelines apply in any case to any IFM. In particular, there should be no exception to the application to any of the IFMs that are subsidiaries of a credit institution of the sector-specific remuneration principles set out in the AIFMD, the UCITS Directive and in the ESMA guidelines (2016/579).</p> <p>It may be the case that in a group-context, non-IFM sectorial prudential rules applying to group entities may lead certain staff of the IFM that are part of that group to be "identified staff" for the purpose of those sectorial remuneration rules.</p>
Proportionality - general principles	<p>IFM should comply with remuneration principles in a way and to the extent that is appropriate to their size, internal organization, and the nature, scope, and complexity of their activities.</p> <p>Not all IFMs will have to comply with the remuneration requirements in the same way and to the same extent. Proportionality should operate both ways: some IFM will need to apply more sophisticated policies or practices in fulfilling the requirements; other IFM may meet the requirements in a simpler way.</p> <p>The IFM has the responsibility to assess its own characteristics and to develop and implement remuneration policies and practices that appropriately align the risks faced and provide adequate and effective incentives to its staff.</p>
Proportionality in respect of the characteristics of the IFM <sup>56</sup>	<p>The criteria relevant to the application of the proportionality principle are:</p> <ul style="list-style-type: none"> <li>▶ Size: The criterion relates to the value of the IFM capital and to the value of the assets of the UCI it manages; liabilities or risk exposures of the IFM and of the UCI managed; the number of staff, branches, or subsidiaries of an IFM. The full remuneration principles apply when the aggregate set of the UCI it manages becomes potentially systemically important (e.g., in terms of total AUM) or leads to complex investment management activities</li> <li>▶ Internal organization: The assessment should take into consideration the entire organization of the IFM, including the legal structure, the complexity and internal governance structure, all the UCIs managed, and the listing on a regulated market of the IFM or UCIs it manages</li> <li>▶ Nature, scope, and complexity of the activities: The underlying risk profile of the business activity should be taken into account. Such elements could include the type of authorized activities, the type of investment policies and strategies of the UCI the IFM manages, the cross-border nature of the business activities, and, where applicable, the additional management of UCITS by AIFMs or AIFs by UCITS management companies</li> </ul>

<sup>56</sup> On 31 March 2016, ESMA wrote a letter to the European Commission (EC), European Council, and European Parliament on the proportionality principle and remuneration rules in the financial sector (ESMA/2016/412), stating that it would be inappropriate for (i) smaller fund managers, (ii) fund managers with simpler internal organization or nature of activities, or (iii) fund managers whose scope and complexity of activities is more limited to be subject in all circumstances to the requirements on the pay-out process. ESMA also considers that it would be disproportionate to apply the requirements to relatively small amounts of variable remuneration and to apply certain requirements to certain staff when this would not result in an effective alignment of interests between the staff and the investors in the funds. ESMA is of the view that legislative changes in the relevant asset management legislation could be one way to further clarify the applicable regulatory framework and ensure consistent application of the remuneration requirements in the asset management sector.

For AIFMs only:

Proportionality may apply, on an exceptional basis and taking into account specific facts, to the disapplication of some requirements if this is consistent with the risk profile, risk appetite, and the strategy of the AIFMs and the AIF it manages. AIFMs should be able to explain to competent authorities, if requested, the rationale for each requirement that is disapplied. AIFMs should perform an assessment for each of the remuneration requirements to determine whether proportionality allows them not to apply each individual requirement.

The following are the only requirements that may be disapplied if it is proportionate to do so:

- ▶ Pay-out process - some AIFMs, either for the total of their identified staff or for some categories within their identified staff, may not apply the requirements on:
  - ▶ Variable remuneration in instruments
  - ▶ Retention
  - ▶ Deferral
  - ▶ *Ex-post* risk adjustment of variable remuneration
- ▶ The requirement to establish a remuneration committee  
If not applied, the minimum deferral period of three to five years, the minimum portion of 40 to 60% of variable remuneration that should be deferred, and the minimum portion of 50% of variable remuneration that should be paid in instruments must be disapplied in its entirety; it is not possible to apply lower thresholds based on proportionality

An IFM's remuneration policy should encourage the alignment of the risks taken by its staff with those of the UCI it manages, the investors of such UCI, and the IFM itself. The general requirements on risk alignment should be applied by the IFM only to the individual remuneration packages of the identified staff, but a voluntary IFM-wide application is strongly recommended.

The key provisions on risk alignment include:

- ▶ A fully flexible policy on variable remuneration: A fully flexible policy implies not only that the variable remuneration should decrease as a result of negative performance but also that it can go down to zero in some cases
- ▶ Risk alignment of variable remuneration: Variable remuneration should be performance-based and risk adjusted. The risk alignment process should include performance and risk measurement, award, and payout processes

The remuneration system should start by defining the objectives of the IFM, the unit, as well as the staff and the investment strategy of the UCI concerned. The right to receive the variable remuneration is earned ("awarded") at the end of the accrual period or during the accrual period, which should be at least one year, but may be longer.



Risk alignment (cont'd)		<p>When assessing the risk and performance, IFMs should take into account both current and future risks that are taken by the staff member, the business unit, the UCI concerned, or the IFM as a whole. The risk alignment process should use a mix of quantitative and qualitative approaches. IFMs should take into account all risks, whether on or off balance sheet, differentiating among risks affecting the IFM, the UCI it manages, business units, and individuals. In order to take into account all material risks, IFMs should use the same risk measurement methods as those used in the risk management policy established for the UCI managed by the IFM (see Sections 7.2. and 7.3.). IFMs should also take into account, if relevant, the risks arising from the management of UCITS by AIFMs or AIFs by UCITS management companies, and, where applicable, from additional services. AIFMs should take into consideration the risk arising from the potential professional liability risks that the AIFM has to cover.</p> <p>In order to align the actual payment of remuneration to the life-cycle and redemption policy (AIFM) or holding period recommended to the investors (UCITS) of the UCIs managed by the IFM and their investment risks, the variable remuneration should partly be paid upfront (short term) and partly deferred (long term):</p> <ul style="list-style-type: none"> <li>▶ The short-term component should be paid directly after the award and should reward staff for performance delivered in the accrual period</li> <li>▶ The long-term component should be awarded to staff during and after the deferral period. It should reward staff for the sustainability of the performance in the long term, which is the result of decisions taken in the past</li> <li>▶ Before paying out the deferred portion, a reassessment of the performance and, if necessary, a risk adjustment should be required in order to align variable remuneration to risks and errors in the performance and risk assessments that have appeared since the staff members were awarded their variable remuneration component (<i>ex-post</i> risk adjustment)</li> </ul>
Governance	<p>Under the Circular, the remuneration policy should include measures to avoid conflicts of interest. The procedures for determining remuneration within the financial undertaking should be clear and documented and should be internally transparent. The board of directors is responsible for:</p> <ul style="list-style-type: none"> <li>▶ Determining the remuneration of the members of the board of directors and management bodies of the financial undertaking</li> <li>▶ Establishing the general principles of the remuneration policy of the financial undertaking and supervising its implementation</li> </ul> <p>A remuneration committee may assist the board of directors in its duties. The implementation of the remuneration policy should be subject to central and independent internal review, at least annually, by control functions, for compliance with policies and procedures defined by the board. The report of the internal control review must be sent to the board of directors and be available to the CSSF.</p>	<p>The management body of the IFM must adopt and, at least yearly (UCITS) or periodically (AIFM), review the general principles of the remuneration policy and is responsible for its implementation. There must be at least annual, central, and independent internal reviews of compliance with remuneration policies and procedures. IFMs that are significant in terms of their size or the size of the AIFs they manage, their internal organization, and the nature, scope, and complexity of their activities are required to establish a remuneration committee<sup>57</sup>. The remuneration committee is responsible for the preparation of decisions regarding remuneration. It is required to directly oversee and provide recommendations in relation to the remuneration of the senior officers in the risk management and compliance functions. The remuneration committee must exercise independent judgment. It must be chaired by, and composed of, non-executive directors<sup>58 59</sup>.</p>

<sup>57</sup> The following are examples of IFMs that may not need to establish a remuneration committee:

- ▶ IFMs for which the value of the portfolios of UCIs that they manage does not exceed EUR1.25 billion and not having more than 50 employees, including those dedicated to the management of UCIs and the provision of non-core services other than the management of UCIs
- ▶ IFMs that are part of banking, insurance, investment groups, or financial conglomerates within which an entity is obliged to set up a remuneration committee that performs its tasks and duties for the whole group, subject to equivalent governing rules and the existing remuneration committee takes responsibility for checking the compliance of the IFM with the rules set out in ESMA's guidelines

<sup>58</sup> Directors who are not members of the management body.

<sup>59</sup> If the management body of a UCITS management company includes an employee representation, the remuneration committee shall include one or more employee representatives.

Relevant information on the remuneration policy, and any updates in case of policy changes, should be disclosed by the financial undertaking in a clear and easily understandable way to relevant stakeholders. Such disclosure may take the form of an independent remuneration policy statement, a periodic disclosure in annual financial statements, or any other form (see Section 10.4.3.).

The annual report of the UCI must disclose (see Sections 10.5.1. and 10.5.2.):

- ▶ The total amount of remuneration for the financial year, split into fixed and variable, paid by the IFM, number of beneficiaries, and, when relevant, carried interest paid by the UCI
  - ▶ The aggregate amount of remuneration broken down by senior management and staff impacting the risk profile of the UCI
  - ▶ A description of the manner in which the remuneration and benefits have been calculated (UCITS only)
  - ▶ Each significant modification to the adopted remuneration policy (UCITS only)
- The remuneration policy of an IFM should be accessible to all staff members of that AIFM. The staff members should know in advance the criteria that will be used to determine their remuneration. The appraisal process should be properly documented and should be transparent to the member of staff concerned

ESMA clarified, in its *Q&A on the application of the UCITS Directive*, that the remuneration-related disclosure requirements under Article 69(3)(a) of the UCITS Directive, as amended, also apply to the staff of the delegate of a management company to whom portfolio management or risk management activities have been delegated. More precisely, and in line with the approach followed under the UCITS Remuneration Guidelines, management companies can ensure compliance in one of the following two ways:

- ▶ Where the delegate is subject to regulatory requirements on remuneration disclosure for its staff to whom portfolio management (including risk management) activities have been delegated that are equally as effective as those under Article 69(3)(a) of the UCITS Directive, the management company should use the information disclosed by the delegate for the purposes of fulfilling its obligations under Article 69(3)(a) of the UCITS Directive, as amended; or
- ▶ In other cases, appropriate contractual arrangements should be put in place with the delegate allowing the management company to receive (and disclose in the annual report for the relevant UCITS that it manages) at least information on the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the management company, the investment company and, where relevant the UCITS itself to the identified staff of the delegate – and number of beneficiaries, and, where relevant, performance fee – which is linked to the delegated portfolio. This means that the disclosure should be made on a prorated basis for the part of the UCITS' assets which are managed by the identified staff within the delegate

Equivalent clarification is included in ESMA's *Q&A on the application of the AIFMD*.

#### 6.4.4. Complaints handling

IFMs are required to establish, implement, and maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from investors.

The IFM must ensure that each complaint and the measures taken for its resolution are recorded.

The IFM must designate among its staff one person responsible for the handling, centralization, and follow-up of complaints. A specific mandate for the handling of complaints can be given to a specialized third party.

The name of the person responsible must be communicated to the CSSF in the application for authorization. The IFM must also communicate a list of third parties authorized to handle complaints.

The IFM is required to submit to the CSSF, within five months following the end of the IFM's financial year, annual information on the investor complaints, the reasons for the complaints, and the status of their handling.

The information regarding complaints handling procedures must be made available to investors free of charge by UCITS management companies<sup>60</sup> who must also communicate a description of the complaint handling procedures to the CSSF in the application for authorization.

<sup>60</sup> | The CSSF also recommends that AIFMs make such procedures available to investors free of charge.

On 11 November 2016, the CSSF published Regulation 16-07 relating to *out-of-court complaint resolution* replacing Regulation 13-02. The Regulation specifies the obligations of financial sector entities on the handling of complaints, including:

- ▶ Complaints handling policy, procedure, and responsibility for complaints handling:
  - ▶ The complaints management policy should be defined, endorsed, and implemented by the management of the entity. It should be set out in a document and available to all relevant staff members
  - ▶ The procedure must be efficient and transparent and reflect the need for objectivity and search for truth. It must enable the identification and mitigation of any conflict of interest
  - ▶ The person responsible for the complaints must ensure that every complaint as well as each measure taken is properly registered. It is his responsibility to inform the complainant of the name and contact details of the person in charge of his file
  - ▶ Entities must provide clear, precise, and up-to-date information on the complaints procedure to be followed
  - ▶ Entities must acknowledge receipt of a complaint within 10 working days and provide an answer without undue delay, in any case within one month
- ▶ Communication of information to the CSSF:
  - ▶ The entity must cooperate with the CSSF and provide the CSSF with comprehensive answers to any query that they have
  - ▶ The person responsible for complaints must communicate to the CSSF on an annual basis indicating the number of complaints registered, sorted by type of complaints, a summary report, and the measures taken to deal with them

The Regulation also covers the rules applicable to the request for the out-of-court resolution of complaints filed with the CSSF. The procedure aims to facilitate the resolution of complaints against professionals without judicial proceedings. The procedure is not a mediation procedure within the meaning of the Luxembourg Mediation Law.

CSSF Circular 17/671, as amended, provides specifications regarding CSSF Regulation 16-07.

## 6.5. Reporting, expenses and taxation

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### 6.5.1. Regulatory reporting duties and communication with the CSSF

CSSF Circular 18/698 largely formalizes existing best practices in the market, but also outlines new regulatory and reporting requirements, including:

- ▶ Mandates of the board members and the conducting officers
- ▶ Annual risk management reporting and adequacy assessment
- ▶ Annual and *ad hoc* submission of up-to-date risk management procedures (pre-defined format)
- ▶ Annual record of delegates, marketing intermediaries and control activities
- ▶ Annual AML/CTF compliance reporting

Reference period: financial year of the IFM

! Alignment in terms of deadline for submission to CSSF for items 3-14 five months after closing of financial year



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|--|--|---|
| <p><b>1</b> <b>Audited annual report of the IFM</b><br/>▶ Audited financial accounts and written commentaries</p> <p><b>2</b> <b>Management Letter</b><br/>▶ Issued by the approved statutory auditor</p> <p><b>3</b> <b>Report on the permanent risk management function</b><br/>▶ Report on the assessment of the adequacy and effectiveness of the management of risks<br/>▶ Status of any corrective actions</p> <p><b>4</b> <b>Report on the types of instruments used, the underlying risks, quantitative limits and methods chosen to assess the risk associated with transactions on derivative instruments (IFM)</b></p> <p><b>5</b> <b>Report on the compliance function</b><br/>▶ Synthetic report on compliances activities and operation<br/>▶ Nature and degree of recourse to external experts</p> <p><b>6</b> <b>Report on the internal audit function</b><br/>▶ Summary report on internal audit activities and functioning<br/>▶ Nature and degree of recourse to external experts<br/>▶ Record of principle recommendations, significant findings, corrective actions as well as open items</p> <p><b>7</b> <b>Report on AML/CTF compliance</b><br/>▶ Internal audit assessment on compliance with the professional obligations in respect of AML/CTF</p> | <p>To be submitted one month following the ordinary general meeting which has approved the annual accounts of the IFM and at the latest seven months after the closing date of the financial year of the IFM</p> | <p><b>8</b> <b>Complaints management</b><br/>▶ Summary of complaints register and measures taken<br/>▶ List of third parties authorized to handle complaints</p> <p><b>9</b> <b>Risk management procedure (RMP)</b><br/>▶ Format in Annex 1 of the Circular to be respected for electronic submission</p> <p><b>10</b> <b>Organization chart</b><br/>▶ Comprehensive organization chart (if any changes)</p> <p><b>11</b> <b>Summary table of mandates</b><br/>▶ Table listing the professional activities as well as the mandates exercised in regulated or non-regulated entities (format available on CSSF website)</p> <p><b>12</b> <b>Annual record of all delegates and marketing intermediaries</b><br/>▶ Record of all delegates for key functions (incl. valuation)<br/>▶ Record of all marketing intermediaries (direct relationship)<br/>▶ Procedures which the IFM has at its disposal to control the delegated activities</p> <p><b>13</b> <b>Report on the activity of the branch</b><br/>▶ Activities carried out within each branch, geographical distribution, financial situation, compliance with Luxembourg AML/CFT obligations</p> <p><b>14</b> <b>Final calculation of the own funds for IFMs authorized for discretionary management</b></p> |
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CSSF Circular 19/708 establishes the procedures and the nomenclature to use for documents which must be exclusively submitted electronically to the CSSF.

CSSF FAQ on submission of closing documents and financial information by managers was issued on 29 June 2021.

With regard to closing documents, the CSSF FAQ clarifies:

- ▶ The list of documents to be submitted depending of the type of authorization of the IFM
- ▶ The procedures applicable to electronic transmission of closing documents
- ▶ Formatting requirements for electronic transmission of closing documents
- ▶ The nomenclature and the type of document to use
- ▶ The deadlines for submission
- ▶ The list of documents to be submitted quarterly or on *ad hoc* basis

With regard to financial information, the CSSF FAQ clarifies:

- ▶ The list of financial information to submit and the deadlines
- ▶ The general accounting principles to use

Document submissions which do not comply with these rules are considered missing and may trigger reminders, sanctions and administrative measures

Required communication with the CSSF relating to modifications are either subject to CSSF authorization, or notification.

*Modifications subject to authorization from the CSSF*

- ▶ Amendments to the constitutional documents
- ▶ Change of shareholding structure and any cases of exceeding and falling below thresholds
- ▶ Changes affecting the conditions of compliance of eligible own funds
- ▶ Acquisition of holdings/creation of subsidiary
- ▶ Authorization of members of the governing/management/supervisory body and directors
- ▶ Amendment of the distribution of responsibilities between directors
- ▶ Approval to exercise (partially) internally the function of UCI administration
- ▶ Approval for UCI administration function and delegation of certain related tasks
- ▶ Permanent presence of directors in Luxembourg
- ▶ Application for derogation for sharing of staff
- ▶ Delegation or amendment of the delegation model or decision to perform internally a function which was previously delegated
- ▶ Appointment/change of the external valuer
- ▶ Decision to delegate the internal control functions or amendment of the program of operations to perform functions internally which were previously delegated
- ▶ Initial decision of the IFM to invest part of its non-regulated own funds in units of UCIs
- ▶ Change of the independent auditor
- ▶ Application of proportionality principle for the organization of its control functions
- ▶ Extension of the investment strategies of AIFs
- ▶ Intention to manage AIFs qualifying as money market funds

Case of branches:

- ▶ Notification in accordance with the directives applicable
- ▶ Change of director responsible for the follow-up of the activity of the branch

Case of free provision of services (FPS): notification in accordance with the directives applicable

*Modifications subject to notification to the CSSF*

- ▶ Change in the shareholder structure not subject to authorization (i.e., entry of a shareholder representing less than 10% of the shareholding structure, including at the level of indirect shareholders, certain group restructuring, the fact of exceeding or falling below thresholds for an AIFM)
- ▶ Delegation of the performance of the accounting function or the IT function
- ▶ Resignation of the members of the governing body/management body and/or directors and, if applicable, of the members of the supervisory board
- ▶ Delegation of the handling of complaints
- ▶ Substantial modification of the program of operations
- ▶ Change in the identity of the following persons:
  - ▶ Compliance Officer
  - ▶ Person responsible for the follow-up of the work of third parties responsible for the compliance function when the performance of the compliance function is delegated
  - ▶ Person in charge of the internal audit function
  - ▶ Person responsible for the follow-up of the work of the internal auditor when the performance of the function is delegated
  - ▶ Person responsible for the permanent risk management function
  - ▶ Person responsible for compliance with professional obligations as regards AML/CFT at the level of the senior management
  - ▶ Person responsible for the control of compliance with professional obligations as regards AML/CFT
  - ▶ Person responsible for the accounting function of the IFM
  - ▶ Person responsible for the accounting administration of UCIs
- ▶ Change affecting consolidated prudential supervision
- ▶ Change of premises (when it is not subject to amendment of the articles of association)
- ▶ Substantial modification made to the risk management procedure
- ▶ Application of proportionality principle in the remuneration policy

Case of branches:

- ▶ Change in the organization of the branch
- ▶ Substantial change affecting the number of staff employed in the branch and the nature and volume of activities carried out from the branch

UCITS management companies are required to establish, implement, and maintain accounting policies and procedures that enable them, at the request of the CSSF, to deliver in a timely manner financial reports that reflect a true and fair view of their financial position and comply with all applicable accounting standards and rules.

UCITS management companies and self-managed investment companies are required to send financial information to the CSSF on a quarterly basis in accordance with CSSF Circular 18/698 and CSSF Circular 10/467, supplemented by CSSF Circular 15/633.

The head of the compliance function is required to prepare a summary report on its activities and operations once a year. The report must be approved by the management/governing body, the specialized committees, where appropriate, and sent to the CSSF no later than five months after the end of the financial year of the IFM.

The report should cover at least the following information:

- ▶ The description and the appreciation of the organization of the permanent compliance function, and, if applicable, a description of the nature and the degree of the reliance on external experts as well as the appreciation of eventual related problems
- ▶ The description of main objectives and work carried out by the compliance function during the financial year, including an update on new procedures, regulatory watch and analyses of legal and regulatory texts
- ▶ The description of the compliance monitoring plan adopted using a risk-based approach, including the monitored activities, the risk assessed for each activity and the timetable adopted for carrying out the monitoring provided for in the Compliance Monitoring Plan following a multi-year program
- ▶ A list of the main recommendations addressed to the IFM senior management, the existing or emerging problems, significant deficiencies and irregularities which have occurred since the last report and the measures taken, significant deficiencies and irregularities identified in the last report but which have not been subject to corrective actions, in particular with regard to AML/CFT, the monitoring of delegates and the compliance of the activities carried out within branches and subsidiaries

The head of compliance must take into account, where relevant, the following elements:

- ▶ Governance of the IFM
- ▶ Compliance with legal and regulatory requirements regarding own funds and their use
- ▶ Management of conflicts of interest
- ▶ Errors in the NAV
- ▶ Non-compliance with the investment policy and restrictions
- ▶ Personal transactions
- ▶ Best execution
- ▶ Complaints handling and third-party claims
- ▶ Treatment of whistleblowing reports
- ▶ Failure to comply with applicable reporting deadlines
- ▶ Fraud and cyber attacks
- ▶ Update of the procedures manual
- ▶ Approval of new business relationships and products
- ▶ Update of contracts
- ▶ Follow-up carried out following interaction with the supervisory authorities (on-site reviews, meetings, written correspondence, telephone, communications, etc.)
- ▶ Staff training
- ▶ Changes to the compliance policy and to the compliance charter

The compliance officer for AML/CFT obligations at senior management level is required to provide to the CSSF a summary report on compliance with professional AML/CFT obligations, approved by the managing body/governing body and sent to the CSSF annually within five months following the end of the IFM's financial year.

The report should cover at least the following information:

- ▶ The results of the identification, assessment and mitigation of ML/FT risks and the IFM's ML/FT risk tolerance level
- ▶ The results of due diligence carried out on clients, UCI initiators, portfolio management to whom it has delegated the management, investment advisors, including ongoing due diligence
- ▶ The results of enhanced due diligence carried out on politically exposed persons acting on behalf of their clients, including ongoing due diligence
- ▶ The results of due diligence measures carried out on the assets of UCIs, including ongoing due diligence. The monitoring of positions blocked for AML/CFT reasons in the registers of unitholders of UCIs and/or intermediaries involved in the marketing of UCIs
- ▶ The periodic review of all business relationships according to their level of risk

- ▶ The results of the monitoring carried out on the compliance of services provided by delegates with legal, regulatory and contractual provisions; where applicable, the reasons why the IFM chose new parties during the year
- ▶ The statistical history of suspicious transactions detected, providing information on the number of suspicious transaction reports made by the IFM to the Financial Intelligence Unit and the amount of funds involved
- ▶ The statistical history of transactions reported in the context of financial sanctions relating to terrorist financing as well as the amount of funds involved
- ▶ The number of breaches to AML/CFT professional obligations identified
- ▶ The number of AML/CFT actions initiated by the AML/CFT compliance officer, internal audit, the external auditor and the CSSF to be implemented, with a description of the main actions, as well as their implementation period

The report must be accompanied by documentation relating to the identification, assessment and mitigation of the ML/TF risks.

Where the IFM has established branches, the IFM must draw up a report describing the activities carried out by each branch, their geographical distribution and their financial situation. This report describes the organization implemented within the branches to fight ML/TF, as well as the controls carried out and the compliance of each branch with Luxembourg's AML/CFT requirements. Any non-compliance must be explained and the remediation actions and their time limits must be included. The report must specify whether policies and procedures have been implemented at group level.

The CSSF *FAQ on the AML/CFT RC report for CSSF supervised Luxembourg Investment Funds and Luxembourg Investment Fund Managers*, released on March 2022, clarifies:

- ▶ The entities that are required to write and submit an AML/CFT RC report to the CSSF
- ▶ When entities in dissolution and placed into non-judicial liquidation are required to submit the AML/CFT RC report
- ▶ The deadline for the submission of the AML/CFT RC report and by which means
- ▶ The minimum content of the AML/CFT RC report
- ▶ The meaning of "results of AML/CFT due diligence"

The head of the internal audit function is required to provide to the CSSF a summary report on its activities and operations, approved by the managing body/governing body and sent to the CSSF annually within five months following the end of the IFM's financial year.

This summary report must state:

- ▶ The nature and extent of the use of external experts and problems that have arisen in this context
- ▶ A list of the main recommendations addressed to senior management
- ▶ Significant deficiencies and irregularities that have arisen since the last report and the corrective actions taken
- ▶ Deficiencies and irregularities identified in the last report which have not been subject to appropriate corrective measures

The report must cover a multi-year period (in principle, three years) and include at least the following information:

- ▶ The portfolio management, administration and marketing functions for IFMs, and any activities related to the assets of AIFs for AIFMs
- ▶ The discretionary management and ancillary services permitted for both UCITS management companies and AIFMs
- ▶ The valuation function
- ▶ The compliance and risk management functions
- ▶ The follow-up of delegated activities
- ▶ The accounting function
- ▶ The IT function
- ▶ The functioning of the senior management and the managing/governing body
- ▶ The rules of conduct
- ▶ The management of conflicts of interest
- ▶ The complaints and claims handling
- ▶ The remuneration policy
- ▶ The approval of new business relationships and new products
- ▶ The branches and subsidiaries, where applicable

### A. Chapter 15 management companies

They are required to report information on:

- The financial situation
- The profit and loss account
- The management of Luxembourg and foreign UCIs:
  - UCIs managed by the management company
  - UCIs managed under delegation
- Additional activities
- Staff

In addition to the tables related to the activities of the registered office, management companies that have one or more branches are required to submit tables regarding activities of each individual branch, as well as global figures, totaling those of the registered office and of the branches (see also Section 6.3.4.).

The report formats are included as appendices to CSSF Circular 10/467. The Circular also covers the secure transmission requirements and the transmission channels.

Both of the transmission channels commonly used by the CSSF - *e-file* and *Sofie* - include a secure transmission module.

*e-file* (*e-file.lu*) is a communication platform for the transmission of data, documents, and regulatory and statistical reports between financial institutions and the Luxembourg authorities. The e-file system is a joint initiative of the Luxembourg Stock Exchange and its subsidiary, Fundsquare. Fundsquare also provides a database of Luxembourg investment funds.

*Sofie* - *SORT* is a reporting tool offered by CETREL Securities, a subsidiary of CETREL specialized in financial data processing.

Reports have to be received by the CSSF by the 20<sup>th</sup> day of the following month.

Management companies are also required to submit, within one month of the general meeting, information that reflects the figures audited by the independent auditor at the end of each financial year.

Management companies are required to communicate their risk management process to the CSSF (see Section 7.2.8.).

Management companies are required to communicate annual information on investor complaints (see Section 6.4.4.).

Disclosures to investors are covered in Chapter 10 (e.g., on fees, conflicts of interest, and voting policies).

Reporting to the authorities in relation to UCIs is covered in Section 10.8.

### B. AIFMs

AIFMs, including simplified registration regime AIFMs, are required to report to the CSSF on a regular basis information on their activities and those of the AIFs they manage or market in the EU/EEA, including:

- Principal markets in which it trades on behalf of the AIFs it manages
- Principal instruments in which it trades on behalf of the AIFs it manages
- Values of AUM for all AIFs managed
- AIFs' names
- Fund manager
- Fund identification codes
- Inception date
- Domicile
- Identification of the prime broker(s)
- Base currency
- Jurisdictions of three main funding sources
- Predominant AIF type (hedge fund, private equity fund, real estate fund, fund of funds, other) and breakdown of investment strategies
- Main instruments in which the AIF is trading (type of instrument, value, long/short position)
- Geographical focus (by region) as a percentage of the NAV
- 10 principal exposures of the AIF at reporting date
- 5 most important portfolio concentrations



- ▶ Typical deal/position size
- ▶ Principal markets in which the AIF trades
- ▶ Investor concentration (percentage of AIF shares or units held by five largest beneficial owners (implementing look-through when possible), breakdown by MiFID status: professional and retail)

ESMA clarified in its Q&As on the application of the AIFMD that, *inter alia*,

- ▶ When a non-AIFM reports information to national competent authorities of a Member State, only the AIFs marketed in the Member State have to be taken into account for the purpose of reporting
- ▶ When information on the breakdown between retail and professional investors is not available, AIFMs should report "0" for each question and use the assumption boxes to indicate that the information is not available

For each of the EEA AIFs they manage and for each of the AIFs they market in the EEA, AIFMs (not including simplified registration regime AIFMs) must provide the CSSF with:

- ▶ Detailed list of all AIFs which it manages
- ▶ Identification of the AIFs:
  - ▶ AIFs' names
  - ▶ Fund manager
  - ▶ Fund identification codes
  - ▶ Inception date
  - ▶ Domicile
  - ▶ Identification of the prime broker(s)
  - ▶ Base currency
  - ▶ Jurisdictions of three main funding sources
- ▶ Instruments traded and individual exposures:
  - ▶ Individual exposures in which it is trading and the main categories of assets in which the AIF invested as at the reporting date (securities by category and sub-category, derivatives by category and sub-category, physical assets by category and sub-category, UCIs by category and sub-category, other asset classes)
  - ▶ Value of turnover in each asset class over the reporting months (securities by category, derivatives by category, physical assets by category, UCIs by category, other asset classes)
  - ▶ Total long and short value of exposures (before currency hedging) by currency group
  - ▶ Private equity funds:
    - ▶ Typical deal/position size
    - ▶ Name of each company over which the AIF has a dominant influence (including name, percentage of voting rights, and transaction type)
- ▶ Risk profile of the AIFs:
  - ▶ Market risk profile:
    - ▶ Expected annual investment return/IRR in normal market conditions (in percent) (Net Equity Delta, Net DV01, Net CS01)
- ▶ Counterparty risk profile:
  - ▶ Estimated percentage (in terms of market value) of securities and derivatives traded (on a regulated exchange and OTC) and derivatives transactions cleared (by a central clearing counterparty (CCP) and bilaterally)
  - ▶ Value of collateral and other credit support that the AIF has posted to all counterparties (in the form of cash and cash equivalents, securities, letters of credit, and similar instruments)
  - ▶ Percentage of the amount of collateral and other credit support that the AIF has posted to counterparties and that has been re-hypothecated by counterparties
  - ▶ Identity of top five counterparties:
    - ▶ To which the AIF has the greatest mark-to-market net counterparty credit exposure, measured as a percentage of the NAV of the AIF
    - ▶ That have the greatest mark-to-market net counterparty credit exposure to the AIF, measured as a percentage of the NAV of the AIF
  - ▶ Direct clearing through CCPs, including, when relevant, identity of the top three CCPs in terms of net credit exposure
- ▶ Liquidity profile:
  - ▶ Portfolio liquidity profile:
    - ▶ Percentage of portfolio capable of being liquidated within specified periods
    - ▶ Value of unencumbered cash

- ▶ Investor liquidity profile:
  - ▶ Percentage of investor equity that can be redeemed within specified periods (as a percentage of the NAV of the AIF)
- ▶ Investor redemptions:
  - ▶ Whether AIFs provide investors with withdrawal/redemption rights in the ordinary course of business
  - ▶ Frequency of investor redemptions (if multiple classes of shares or units, report for the largest share class by NAV)
  - ▶ Notice period in days required by investors for redemptions (asset weighted notice period if multiple classes or shares or units)
  - ▶ Investor lock up period in days (asset weighted notice period if multiple classes or shares or units)
  - ▶ Special arrangements (percentage of the AIF's NAV subject to arrangements by category, the percentage of NAV of the AIF's assets that are currently subject to the special arrangements arising from their illiquid nature)
  - ▶ Whether any investors receive preferential treatment or right to preferential treatment and, when relevant, type of preferential treatment
  - ▶ Breakdown of the ownership of units in the AIFs by investor group (percentage of the NAV of the AIFs; look-through to the beneficial owners when known or possible)
- ▶ Financing liquidity:
  - ▶ Aggregate amount of borrowing by and cash financing available to the AIF (including all drawn and undrawn, committed and uncommitted lines of credit as well as any term financing) and breakdown by length of period for which the creditor is contractually committed to provide such financing
- ▶ Borrowing and exposure risk:
  - ▶ Value of borrowings of cash or securities represented by unsecured cash borrowing and breakdown of collateralized/secured cash borrowing
  - ▶ Breakdown of value of borrowing embedded in financial instruments
  - ▶ Value of securities borrowed for short positions
  - ▶ Gross exposure of financial and/or legal structures controlled by the AIF
  - ▶ Leverage of the AIF as calculated under the gross method and the commitment method
- ▶ Operational and other risk aspects:
  - ▶ Total number of open positions
  - ▶ Historical risk profile:
    - ▶ Gross investment returns or IRR of the AIF over the reporting period (in percent, gross of management and performance fees)
    - ▶ Net investment returns or IRR of the AIF over the reporting period (in percent, net of management and performance fees)
    - ▶ Change in NAV of the AIF over the reporting period (in percent, including the impact of subscriptions and redemptions)
    - ▶ Subscriptions over the reporting period
    - ▶ Redemptions over the reporting period
- ▶ Results of stress tests:
  - ▶ Stress tests on risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio
  - ▶ Assessment and monitoring of the liquidity risk of the AIF under normal and exceptional liquidity conditions
- ▶ Additional reporting by AIFMs managing AIFs employing leverage on a substantial basis (i.e., above three times the NAV calculated according to the commitment method – see Section 7.3.6.A.):
  - ▶ Percentage of the amount of collateral and other credit support that the reporting AIF has posted to counterparties and that has been re-hypothecated by counterparties
  - ▶ Borrowing and exposure risk
    - ▶ Value of borrowings of cash or securities represented by unsecured cash borrowing and breakdown of collateralized/secured cash borrowing
    - ▶ Breakdown of value of borrowing embedded in financial instruments
    - ▶ Five largest sources of borrowed cash or securities (short positions)
    - ▶ Value of securities borrowed for short positions
  - ▶ Gross exposure of financial and/or legal structures controlled by the AIF
  - ▶ Leverage of the AIF as calculated under the gross method and the commitment method

When necessary for the effective monitoring of systemic risk, the CSSF may require additional information, on a periodic as well as on an *ad hoc* basis. Additional information would cover:

- ▶ Information on the total number of transactions carried out using high frequency algorithmic trading, together with the corresponding market value of buys and sells in the base currency of the AIF over the reporting period
- ▶ Information on geographical focus based on the domicile of investments expressed as a percentage of the total value of AUM
- ▶ When the five most important instruments in which the AIF is trading includes short positions, the extent of the hedging
- ▶ Information on the Value at Risk (VaR) of the AIFs and, when relevant according to the investment strategy of the AIFs, the portfolio's sensitivity to changes in FX rates or commodity prices
- ▶ Information on non-EU master AIFs not marketed in the EU, in so far as one of the feeder AIFs of these master AIFs is an EU AIF or is marketed in the EU and is managed by the same AIFM as the master AIF

The minimum frequency of the reporting is as follows:

- ▶ On a semi-annual basis by AIFMs managing portfolios of AIFs whose AUM calculated in total exceeds the applicable EUR 100 million or EUR 500 million threshold (see Section 6.1.3.D.) but do not exceed EUR 1 billion, for each of the EU AIFs they manage and for each of the AIFs they market in the EEA
- ▶ On a quarterly basis by AIFMs, for each AIF whose AUM, including any assets acquired through use of leverage, in total exceeds EUR 500 million, in respect of that AIF
- ▶ On a quarterly basis by AIFMs managing portfolios of AIFs whose AUM in total exceeds EUR 1 billion, for each of the EU AIFs they manage and for each of the AIFs they market in the EEA
- ▶ On an annual basis by AIFMs in respect of each managed unleveraged AIF that, in accordance with its core investment policy, invests in non-listed companies and issuers in order to acquire control

In addition, AIFMs (not including simplified registration regime AIFMs) are required at the end of each quarter to provide the CSSF with a detailed list of all the AIFs that they manage (EU and non-EU AIFs) including:

- ▶ AIF name
- ▶ Fund identification codes
- ▶ Inception date
- ▶ AIF type (hedge fund, private equity fund, real estate fund, fund of funds, other)
- ▶ NAV
- ▶ Whether the AIF is an EU AIF

Registered and authorized AIFMs must inform the CSSF by completing forms appended to CSSF Circular 15/612 for each additional AIF they start to manage, meaning each unregulated AIF (e.g., RAIF) and each regulated AIF established in a third country that was not communicated to the CSSF either during the initial application process of the AIFM or on update of its authorization file. AIFMs also need to inform the CSSF as soon as they stop managing an unregulated AIF and/or a regulated AIF established in a third country. If the AIF comprises several compartments, the obligations regarding information apply at compartment level.

Requirements applicable to specific types of AIFs include:

- ▶ Master-feeder AIFs:  
AIFMs should treat feeder AIFs of the same master fund individually. AIFMs should not aggregate master-feeder structures in a single report.  
When reporting information on feeder AIFs, AIFMs should identify the master AIF in which each feeder invests but should not look through the master AIF(s) to its (their) holdings. If applicable, AIFMs should also report detailed information on investments that are made at feeder AIF level, such as investments in financial derivative instruments.
- ▶ Funds of funds: When reporting information on funds of funds, AIFMs should not look through the holdings of the underlying funds in which the AIF invests
- ▶ Multiple compartment AIFs: If an AIF takes the form of an umbrella AIF with several compartments, AIF-specific information should be reported at the level of the compartments

In cases when AIFMs do not have any information on AIFs to report, such as when there is a delay between the authorization or registration being granted to a new AIFMs and the actual start of activity or between the creation of an AIF and the first investments. AIFMs should still provide a report to the CSSF by indicating that no information is available by using a specific field.

AIFMs should generally start reporting from the first day of the following quarter after they have information to report until the end of the first reporting period.

The deadline for submitting the reporting is the last day of the month following the end of the period. When the AIF is a fund of funds, this deadline is extended to the 15<sup>th</sup> day of the following month.

The reporting to the CSSF should be transmitted to the CSSF via *e-file* system or via *Sofie - SORT*.

## 6.5.2. Annual accounts

The annual accounts of management companies are subject to the provisions of the Law of 19 December 2002 on the *Trade and Companies Register and the accounting and annual accounts of companies*, as amended.

A company may prepare its annual accounts under Luxembourg generally accepted accounting principles (Lux GAAP), International Financial Reporting Standards (IFRS), as adopted by the EU, or Lux GAAP with the fair value option.

The annual report of a management company should, in addition to the annual accounts, also include a management report<sup>61</sup> which should cover, *inter alia*:

- ▶ A fair review of the development and performance of the company's business and of its position, including financial and non-financial key performance indicators relevant to the business and information relating to environmental and employee matters
- ▶ A description of the main risks and uncertainties that the company faces
- ▶ Any important events that have occurred since the end of the financial year
- ▶ The company's likely future development
- ▶ Activities in the field of research and development
- ▶ Information on the acquisition of its own shares, if applicable
- ▶ Existence of branches of the company
- ▶ Transactions carried out under Article 420-26 (6) of the 1915 Law, as amended, in relation to the allocation of free shares to staff
- ▶ With respect to the use of financial instruments and when such instruments are material for the assessment of the company's assets, liabilities, financial position, and profits or losses:
  - ▶ Financial risk management objectives and policies
  - ▶ Exposure to price risk, credit risk, liquidity risk and cash flow risk

The management report should also, where appropriate, include references to, and additional explanations of, amounts reported in the annual accounts.

The layout of the annual report and the contents of the notes will depend on the size of the company and the legal form, as well as the accounting principles chosen.

Annual accounts of the management entity must be audited by an independent auditor. Any change of independent auditor must be previously approved by the CSSF. The duties and obligations of the independent auditor of a management company are similar to those of the independent auditor of a UCI, as outlined in Section 10.5.10.

The IFM is required to spontaneously submit, within one month following the ordinary general meeting which approved the annual accounts of the IFM and at the latest seven months after the closing date of the financial year of the IFM, the audited annual accounts and management letter issued by the approved statutory auditor in the context of its audit of the annual accounting documents.

The annual accounts of the management entity should be transmitted to the CSSF via the *e-file* system (see Section 6.5.1.).

Following CSSF Circular 21/789, the independent auditor draws the management letter relative to the audit of the annual accounts of the management entity in the eDesk platform and this should then be submitted by the IFM to the CSSF.

<sup>61</sup> Mandatory for management companies that are not considered of small size. A management company is of small size if, on its balance sheet date, it does not exceed two of the following three criteria:

- ▶ Balance sheet total of EUR 4.4 million
- ▶ Net turnover of EUR 8.8 million
- ▶ Average number of full-time staff during the year of 50

### 6.5.3. Self-assessment questionnaire (SAQ) and the separate report

CSSF Circular 21/789 introduced an obligation for IFMs to complete an SAQ for each year or period subject to a statutory audit, where IFMs must assess their compliance with applicable legal and regulatory requirements. Topics covered include shareholding and own funds, internal organization, IFM bodies, permanent risk management function, compliance function, internal audit function, delegation, IT requirement, other key functions and requirements. Assessment of compliance with AML/CTF regulations is covered in a separate external report to be provided in accordance with CSSF Circular 21/788 (see Section 6.5.4.).

The management body/governing body and the senior management of the IFM are responsible for the content and completion of the SAQ and should implement an adequate organization to ensure that the information required in the questionnaire is provided to them. Those responsible must review and validate the content of the questionnaire and submit it to the CSSF, via the eDesk portal, at the latest four months (except for the first submission which may be filed at latest six months) after the closing date of the financial year of the IFM. Where an IFM authorization is removed or written off during a fiscal year, the questionnaire should be filed within four months of the removal/write-off date.

CSSF Circular 21/789 also introduces the requirement for the independent auditor of IFMs to draw up a separate report on an annual basis via the eDesk. The separate report contains the SAQ completed by the IFM and a section completed by the independent auditor which aims to corroborate the responses given by the IFM in the context of the SAQ and to provide responses to questions determined by the CSSF. The results of these procedures are, in principle, registered in the form of responses to closed-ended questions and do not entail judgement by the independent auditor. The separate report is submitted by the management body/governing body to the CSSF via the eDesk at the latest seven months (except for the first submission which may be filed at latest nine months) after the closing date of the financial year of the IFM. Where an IFM authorization is removed or written off during a fiscal year, the separate report is filed within seven months of the removal/write-off date.

### 6.5.4. CSSF AML/CFT external report

CSSF Circular 21/788 introduced an obligation for independent auditors of IFMs and all Luxembourg UCIs supervised by the CSSF for AML/CFT purposes, except those UCIs managed by a Luxembourg or foreign IFM, to draw up an AML/CFT report. The CSSF AML/CFT report is divided into two sections that cover key AML/CFT controls of the IFM. The first section concerns the corroboration of answers given by IFMs in scope in the context of the CSSF annual AML/CFT online survey, whereas the second section is dedicated to sample testing or specific work to be performed by the independent auditor, where the sample is determined by the CSSF using a risk based approach and must be detailed in the CSSF AML/CFT external report. The work of the independent auditor consists of replying to a number of closed questions, as determined by the CSSF, and the CSSF AML/CFT report allows both the independent auditor and the IFM to comment on the work performed. The CSSF AML/CFT external report should be submitted by the person responsible for the control of compliance with professional obligations as regards AML/CFT (RR) or by the person responsible for compliance with professional obligations as regards AML/CFT (RC) or by a member of the managing body/governing body via the eDesk, on an annual basis at the latest six months after the closing date of the financial year of the IFM.

### 6.5.5. Expenses and taxation of management entities

#### 6.5.5.1. Introduction

This section covers:

- The formation and operating expenses incurred by management entities
- The taxation of Luxembourg management entities

Advisory companies are also covered in this section.

Management companies are commercial companies, therefore, they are subject to normal corporate taxes in Luxembourg.

Fees that management companies are required to pay to the CSSF in relation to their application for authorization and ongoing supervision are covered in Section 11.2.

#### 6.5.5.2. Expenses

Formation expenses of a Luxembourg management entity, or a Luxembourg general partner, excluding own funds and professional liability cover (see Section 6.2.3.2.), may include the following:

- Notary fees
- Legal fees
- Advisory fees on initial structuring and product marketing

- ▶ CSSF initial management entity authorization fee:
  - ▶ Chapter 15 management company that is not an AIFM: EUR 15,000
  - ▶ Chapter 15 management company and AIFM: EUR 15,000
  - ▶ Chapter 16 management company that is not an AIFM: EUR 8,000
  - ▶ Chapter 16 management company and AIFM: EUR 15,000
  - ▶ AIFM: EUR 15,000
- ▶ Formation expenses of UCIs they manage, or a portion thereof (if applicable) (see Section 11.2.1.)

Ongoing expenses of a Luxembourg management entity, or a Luxembourg general partner, may include the following:

- ▶ Staff costs (e.g., wages, pensions, benefits, social security)
- ▶ Office-related costs (e.g., rent, furniture)
- ▶ IT infrastructure costs (e.g., hardware, software, maintenance, internet, and telephone)
- ▶ Legal and audit fees
- ▶ Directors fees and expenses
- ▶ Accounting fees
- ▶ Insurance
- ▶ CSSF annual fees for a management company:
  - ▶ Chapter 15 management company that is not an AIFM: EUR 35,000
  - ▶ Chapter 15 management company and AIFM: EUR 35,000
  - ▶ Chapter 16 management company that is not an AIFM: EUR 15,000
  - ▶ Chapter 16 management company and AIFM: EUR 35,000
  - ▶ AIFM: EUR 35,000
  - ▶ An additional EUR 15,000 for each branch
- ▶ UCI management-related costs (if applicable) (see Section 11.2.2.)
- ▶ UCI reorganization costs (if applicable)

### 6.5.5.3. Registration duty

Luxembourg companies are subject to a registration duty of EUR 75 on incorporation and in case of:

- ▶ Modification of the articles of incorporation
- ▶ Transfer of the effective place of management or registered office to Luxembourg

In the case of management companies of single common funds, although the registration duty is payable by the management company, it may be charged to the common fund.

### 6.5.5.4. Annual taxation

#### A. General

Luxembourg resident capital companies are fully taxable entities. Their worldwide taxable income is subject to corporate income tax (CIT) plus an employment fund surcharge and municipal business tax (MBT). The nominal rate of CIT is 17% (18.19% including the contribution to the employment fund). The global tax rate, including MBT, for a company with its statutory seat in Luxembourg City is thus 24.94%. Companies are subject to the annual Luxembourg net worth tax (NWT) at a rate of 0.5% on the adjusted NAV (the "unitary value") up to and including EUR 500 million and 0.05% on the part of adjusted NAV exceeding EUR 500 million at the beginning of the year. All Luxembourg resident entities in corporate form that are subject to Luxembourg CIT must pay a minimum NWT equal to EUR 4,815 if the sum of financial fixed assets, amounts owed by affiliated undertakings and by undertakings with which the company is linked by virtue of participating interests, transferable securities, cash in banks, cash in postal check accounts, checks and cash in hand, exceeds 90% of the company's balance sheet total and EUR 350,000. Luxembourg resident entities in corporate form that are subject to Luxembourg CIT must pay the higher of the minimum NWT or the NWT determined on the basis of their unitary value. If the minimum NWT applies, it is reduced by the amount of CIT (including contribution to the employment fund but after deduction of possible tax credits) due by the company for the preceding year.

#### B. Management companies of a single common fund

The Luxembourg tax authorities have clarified that all Luxembourg management companies, including management companies managing a single common fund, are considered as fully taxable entities.

### C. Tax regime for carried interest

The Luxembourg AIFM Law, as amended, defines “carried interest” as a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF (see Section 11.3.5.2.).

### D. VAT

Management companies are considered as taxable persons for Luxembourg VAT purposes but may be relieved from the obligation to register for Luxembourg VAT (subject to certain conditions being met). Management services provided to UCIs, including AIFs and other investment vehicles, are VAT exempt (see Section 11.4.).

## 6.5.5.5. Dividends and interest

For capital companies, withholding tax (WHT) on dividends amounts to 15% of the gross amount<sup>62</sup>. Under Luxembourg domestic law, a full WHT exemption applies to dividends if they are paid to qualifying entities, to a permanent establishment of a qualifying entity established in EU/EEA Member States, or a country with which Luxembourg has entered into a double taxation treaty (DTT) or to qualifying entities established in Switzerland and if certain conditions are met.

Management or advisory companies are subject to the normal authorization procedures for paying interim dividends and are also required to create a legal reserve. The interim dividend authorization procedures include specific authorization in the articles of association and the preparation of interim financial statements. The independent auditor must issue a report stating whether the conditions of the 1915 Law<sup>63</sup> on the payment of interim dividends have been satisfied. The legal reserve requirement is 5% of net profit until the accumulated reserve equals 10% of subscribed capital.

Luxembourg does not levy any WHT on interest payments made by Luxembourg resident companies except in very specific cases (e.g., under certain conditions if interest is paid to Luxembourg resident individuals or if interest is paid on specific profit participating bonds (see Section 11.3.3.3.)).

## 6.5.5.6. Dissolution

Liquidation proceeds distributed by normal taxable companies are not subject to WHT in Luxembourg. Nevertheless, the liquidation triggers the realization of all the assets of the company; consequently the liquidation profit will include all unrealized capital gains and will be subject to CIT.

## 6.5.5.7. Management passport

A UCITS management company or AIFM may manage UCIs in other EU/EEA Member States. A UCITS management company may also perform the other activities for which it has been authorized in its home Member State in other EU/EEA Member States (see Section 6.3.4.). However, a careful evaluation is recommended in order to understand the tax implications before deciding to make use of the management company passport.

<sup>62</sup> A 17.65% rate applies on the net dividend if the WHT is not charged to the recipient.

<sup>63</sup> Article 461-3 of the Law of 10 August 1915 on commercial companies, as amended.

The main types of tax implications include:

- ▶ Transformation - one-off tax cost of the restructuring:
  - ▶ Taxation related to the transfer of the management entity's business (client base, etc.) to another management entity (cross-border or within the same country)
  - ▶ Taxation issues relating to the merger, relocation, or liquidation of a management entity, or conversion into a branch
  - ▶ Transfer pricing including cross-border transfer pricing
  - ▶ Payroll taxes and expatriation
- ▶ Ongoing direct and indirect tax impacts for the management entity and group going forward:
  - ▶ Corporate taxation
  - ▶ Access to DTTs
  - ▶ Group tax filing requirements
  - ▶ VAT on services provided to, and by, the management entity (see Section 11.4.)
- ▶ The direct and indirect tax impacts on the UCIs and their investors, *inter alia*, including:
  - ▶ Tax residency of UCIs: The management company passport may raise the question of the tax residency and treatment of a UCI established under the law of an EU/EEA Member State and managed by a management company located in another EU/EEA Member State. In certain cases, this could lead to one or more of the following:
    - ▶ Taxation of the UCI income in the Member State of the management entity
    - ▶ Additional WHT on distribution from the UCI
    - ▶ Taxation of unrealized gains in the hands of the investor

The 2010 Law and the AIFM Law have introduced provisions into Luxembourg tax law whereby UCIs established under foreign law and whose place of effective management or central administration is in Luxembourg are exempt from CIT, municipal business tax, and NWT in Luxembourg. With regard to Luxembourg common funds, and in particular common funds managed cross-border, the 2010 Law, as amended, clarifies that the management regulations are subject to Luxembourg law (see also Section 11.3.7.).

- ▶ Access to DTTs (see also Section 11.3.3.1.)
- ▶ VAT on services provided to the UCIs by the management entity and the service providers (see Section 11.4.)



# 07

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## RISK MANAGEMENT AND VALUATION

EY supports asset managers, alternative investment fund houses and service providers in defining or reviewing their risk management processes, performing risk management reporting, with specific risk areas (e.g., stress testing, liquidity risk management, back testing), valuation model reviews and independent valuation.



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## 7.1. Introduction

This Chapter covers the risk management and valuation requirements applicable to UCIs, management companies and AIFMs:

- ▶ UCITS management companies and self-managed UCITS
- ▶ AIFMs and internally managed AIFs that are subject to the AIFM Directive
- ▶ SIFs
- ▶ RAIFs
- ▶ MMFs

The following sections provide a brief summary of the risk management and valuation requirements and some practical perspectives thereon.

### A. Risk management

The risk profile developed for each UCI plays a central role in the mission of the permanent risk management function. It is expected to be comprehensively documented prior to launching the UCI, ensuring that all material risks are identified, captured in regular monitoring tasks with assigned limits or triggers as well as subsequently updated as appropriate. Finally, it should be disclosed to investors before they invest. The management entity<sup>1</sup> should implement a risk management system to ensure that the UCI complies with the risk profile disclosed to investors and, where relevant, take remedial action in the best interests of investors.

The remainder of this section provides a brief overview of how these objectives should be achieved.

Management entities should:

- ▶ Ensure that the risk profile of the UCI corresponds to the objectives of the UCI as laid down in the UCI's constitutional document, prospectus and offering documents
- ▶ Establish and implement quantitative or qualitative risk limits, or both, for each UCI it manages, taking into account all relevant risks. The risk limits define the risk appetite of the UCI and ensure compliance with the risk profile
- ▶ Implement an adequate risk management system (the "risk management process" for UCITS; the "risk management system" for AIFs) in order to identify, measure, manage and monitor appropriately all risks relevant to each UCI's investment strategy and to which each UCI is or may be exposed. The risk management system should be reviewed at an appropriate frequency and at least once a year and updated where necessary
- ▶ Establish, implement and maintain an adequate and documented risk management policy that:
  - ▶ Identifies all the relevant risks to which the UCIs it manages are or may be exposed
  - ▶ Describes the procedures necessary to enable the management entity to assess, for each UCI it manages, the exposure of the UCI to each risk that may be material
- ▶ Ensure that risks are assessed in relation to each investment:
  - ▶ Implement a documented and regularly updated due diligence process when investing on behalf of the UCI. Such due diligence process should be appropriate to the investment strategy, objectives and risk profile of the UCI
  - ▶ Ensure that the risks associated with each investment position of the UCI and their overall effect on the UCI's portfolio can be properly identified, measured, managed and monitored on an ongoing basis
- ▶ Implement a risk management function that should:
  - ▶ Be functionally and hierarchically separate from the operating units, including from the functions of portfolio management, unless this is not proportional, in which case, the management entity should be able to demonstrate that specific safeguards have been taken against conflicts of interest to allow the independent performance of risk management activities and that the risk management process is effective
  - ▶ Implement the risk management policies
  - ▶ Ensure that the risk profile disclosure to investors is consistent with the risk limits
  - ▶ Monitor compliance with the risk limits
  - ▶ Provide to the governing body regular updates on compliance with the risk limits and the adequacy and effectiveness of the risk management process (see also Section 5.1.6.1.)
  - ▶ Provide to senior management regular updates on the current levels of risk and any foreseeable or actual breaches of risk limits (see also Section 5.1.6.2.)
- ▶ Test the risk management system by conducting periodic back tests in order to review the validity of risk measurement arrangements, which include model-based forecasts and estimates
- ▶ Assess the impact of changes in market conditions that might adversely impact the UCI by conducting periodic appropriate stress tests and scenario analyses, including extreme scenarios
- ▶ Provide the CSSF with a description of the risk management system
- ▶ Regularly disclose information on the risk profile of the UCI both to the investors in the UCI and the CSSF

<sup>1</sup> | In the case of a UCI that has not appointed a management entity, the board of directors of a UCI.

The definitions of the risks that should be covered by adequate risk management systems and, for which risk limits should be set, may vary according to the asset classes in which the UCI invests. The following are indicative descriptions of selected types of risks:

- ▶ Market risk: The risk of loss for the UCI resulting from fluctuations in the market value of positions in its portfolio, such as fluctuations attributable to changes in market variables such as interest rates, exchange rates, equity and commodity prices
- ▶ Credit risk: The risk of loss that could arise from a credit event, such as a credit downgrade or a counterparty's inability to repay some or all of a debt
- ▶ Counterparty risk: The risk of loss for the UCI resulting from the fact that the counterparty to a transaction may default on its obligations prior to the final settlement of the transaction's cash flow
- ▶ Issuer risk: The risk of loss resulting from the default of an issuer of securities
- ▶ Concentration risk: The risk of loss arising from a significant exposure, for example to a group of issuers and/or counterparties, an asset class, geographic region or market
- ▶ Liquidity risk<sup>2</sup>: The risk that a position in the portfolio of the UCI cannot be sold, liquidated or closed at a limited cost in a sufficiently short time frame and that the ability of the UCI to comply at any time with the terms and forms of redemption laid down in the constitutional document of the UCI is thereby compromised
- ▶ Operational risk: The risk of loss for the UCI resulting from the inadequate internal processes and failures in relation to people and systems, or entailed by delegated activities, or resulting from external events, including legal and documentation risk and risk resulting from trading, settlement and valuation procedures executed on behalf of the UCI

The risk management function will play a key role in ensuring that the management entity is compliant with these requirements. The risk management function will generally also, *inter alia*, oversee or perform:

- ▶ Implementation of risk modeling and risk aggregation techniques
- ▶ Calculation of investment risk exposures (at portfolio and aggregate level), working in collaboration with the portfolio management function, including:
  - ▶ Calculation of market risk using the commitment approach or advanced risk measurement techniques (model-based approaches - value-at-risk (VaR) and/or more appropriate model - including stress testing scenario analysis and back testing)
  - ▶ Calculation of counterparty risk/issuer concentration measures (ultimate risk exposure)
- ▶ Calculation of liquidity risk exposure (at portfolio and investor level)
- ▶ Monitoring of the leverage levels (at portfolio and aggregate level)
- ▶ Interaction with the pricing and valuation of over-the-counter (OTC) derivative instruments (e.g., data sources, illiquid assets)

The functional and hierarchical separation of the risk management function must be implemented at senior management level to avoid conflicts of interest.

The same conducting officer cannot be responsible for both portfolio management and risk management (see Section 5.1.6.2.).

For UCITS, the risk management requirements focus in detail on risk measurement, in particular on market risk measurement, whereas the AIFM Directive lays down an overall risk management framework, with a particular focus on liquidity risk management.

For AIFMs, the portfolio management and risk management functions are classified together as "investment management" functions. The risk management function is considered to be one of the two essential functions of an AIFM (see also Sections 6.1.3. and 7.3.).

Management entities are permitted to delegate the risk management activity (entirely or a part thereof) to specialist third parties. In this case, they are required to exercise due skill, care and diligence when entering into, managing and terminating any such arrangements. The management entity remains responsible for the delegated risk management activity. The specific requirements on delegation are covered in more detail in the following sections:

- ▶ UCITS and their management companies: Section 7.2.7.
- ▶ AIFMs and internally managed AIFs: Section 7.3.7.
- ▶ SIFs: Section 7.4.4.

The general requirements on delegation are covered in Section 6.3.3.

<sup>2</sup> | The AIFM Directive exempts unleveraged closed-ended AIFs from some of the liquidity risk management requirements.

On 6 February 2022, ALFI issued *key principles and common practices for the organization of the independent risk function of an investment fund manager*. These guidelines provide, *inter alia*:

- A description of the key documents: risk management policy, risk management process and risk profile document
- Clarifications on the role of the IFM board and the role of senior management/conducting officers
- Examples of risk management governance structures
- A typology of risk categories
- An exemplary overview of risk measurement and management approaches for some risk categories
- The content and frequency of risk reporting
- Some considerations on the role of risk management in the life cycle of a UCI

Management entities are required to implement remuneration policies that cover, *inter alia*, staff whose professional activities have a material impact on the risk profiles of the UCIs they manage. The policies should promote sound and effective risk management and not encourage risk-taking that is inconsistent with the risk profiles or constitutional documents of the UCIs they manage (see Section 6.4.3.).

Management entities are also required to appropriately mitigate or manage the risks related to conflicts of interest and provide disclosures to investors on conflicts of interest (see Sections 6.4.1. and 10.4.1.1.).

Management entities are also required to comply with anti-money laundering and counter-terrorist financing (AML/CFT) requirements, *inter alia*, on documenting their risk management approach in relation to AML/CFT and the AML/CFT risk analysis report to be issued (see Section 8.8.4.).

Risk management activities comprise two levels of responsibilities: the risks of the management entity and the investment risks of the UCIs it manages. The risk management requirements focus primarily on the risks faced by the UCIs themselves, including the operational risks of the management entity.

In practice, the risk management function may also play an important role in managing the risk of the management entity as a business.

Risks inherent in the business of the management entity itself are partially covered by the own funds requirements and, in the case of AIFMs, the professional liability cover (see Section 6.2.3.2.). In addition, the shareholders of the management entity must be appropriately qualified. In the case of a UCITS (Chapter 15) management company, the CSSF may request a letter of sponsorship, in which the sponsor makes a commitment in relation to the management company's respect of the applicable prudential requirements, in particular, in relation to the own funds of the management company.

The following table summarizes most of the potential risks faced by UCIs and their management entities:

Risks faced by UCIs and their management entities <sup>3</sup>	
Potential risks impacting UCIs (investment risks)	Potential risks impacting management entities
<ul style="list-style-type: none"> <li>▸ Market risk</li> <li>▸ Credit risk</li> <li>▸ Counterparty risk</li> <li>▸ Issuer risk</li> <li>▸ Concentration risk</li> <li>▸ Liquidity risk</li> </ul>	<ul style="list-style-type: none"> <li>▸ Risks related to own investments</li> <li>▸ Management entity liquidity risk</li> <li>▸ Business/product risk</li> </ul>
Potential risks impacting both UCIs and management entities	
Operational risks: <ul style="list-style-type: none"> <li>▸ Technical resources/IT-related risks</li> <li>▸ People risks</li> <li>▸ Organizational/process risks</li> <li>▸ Fraud risks</li> <li>▸ Delegated function and outsourcing risks</li> <li>▸ Other external factor risks</li> </ul>	Other risks: <ul style="list-style-type: none"> <li>▸ Legal/regulatory risk</li> <li>▸ Model risk</li> <li>▸ Tax risk</li> <li>▸ Distribution risk</li> <li>▸ Reputational risk</li> </ul>

<sup>3</sup> | Based on ALFI's Risk Management Guidelines, March 2012.

In the context of IT risk mitigation, on 24 September 2020, the European Commission (EC) proposed to introduce a financial services Digital Operational Resilience Act (DORA)<sup>4</sup> which will enable a comprehensive framework at EU level with consistent rules addressing the digital operational resilience needs of all regulated financial entities and will establish an oversight framework for critical information and communication technologies (ICT) third-party providers (CCTPs).

A set of rules has been defined and is spread over seven sections:

- ▶ Covering existing typical requirements on ICT governance and ICT risk management (Chapter II) and ICT-related incident reporting (Chapter III)
- ▶ Introducing new requirements for digital testing (Chapter IV), information sharing (Chapter VI) and management of ICT third-party risks (Chapter V)
- ▶ Providing financial supervisors with the tools to fulfill their mandate to contain financial instability stemming from those ICT vulnerabilities (Chapter VII)

A key principle is to align financial entities' business strategy with ICT risk management. Aligned with the joint European Supervisory Authorities (ESAs) technical advice, industry standards (such as NIST<sup>5</sup>) or best practices, entities are required to:

- ▶ Identify, classify and document all ICT-related business functions, information assets supporting these functions, all sources of risks and perform – at least annually – an ICT risk assessment
- ▶ Protect and prevent ICT risks by implementing adequate technical and organizational mitigation measures
- ▶ Detect single points of failure and unusual activities through regular testing
- ▶ Respond to disruption and recover from incidents by implementing a dedicated and comprehensive ICT Business Continuity Policy and an ICT Disaster Recovery Plan respectively, both maintained and tested regularly
- ▶ Learn, evolve and communicate by analyzing the root causes of incidents and the effectiveness of the protection and detection measures in place and ensure communication plans enabling a responsible disclosure of ICT-related incidents or major vulnerabilities to clients and counterparts as well as to the public are in place

DORA defines common standards for digital operational resilience testing with the objective to ensure firms are prepared when ICT-related incidents happen. Beyond the traditional ICT testing techniques, the testing program should include a full range of appropriate tests, including vulnerability assessments and scans, open source analyses, network security assessments, penetration testing and even source code reviews (where feasible).

The DORA proposal suggests and strongly recommends advanced testing of ICT tools, systems and processes based on threat led penetration testing (TLPT), carried out at least every three years. The technical standards to apply, when conducting intelligence-based penetration testing, should be developed by the joint ESAs and are likely to be aligned with the voluntary TIBER-EU<sup>6</sup> developed by the European Central Bank (ECB).

At the end of the tests, financial entities should communicate agreed reports and remediation plans to the competent authority and should confirm that penetration tests have been performed in accordance with the requirements. The competent authority, in this case, will review, validate and issue an attestation.

The competent authority should consider proportionate application of this requirement: TLPT will be carried out in a manner proportionate to the size, scale, activity and overall risk of the financial entity.

On 11 May 2022, the Council presidency and the European Parliament reached a provisional agreement on DORA. Once the DORA proposal is formally adopted, it will be passed into law by each EU Member State. The relevant European Supervisory Authorities (ESAs) will then develop technical standards. DORA is expected to become operational in 2024.

## B. Valuation

The regimes covering the valuation of the assets of a UCI and the calculation of the net asset value (NAV) vary significantly:

- ▶ For 2010 Law UCIs, management companies are required to establish appropriate procedures to ensure the proper and accurate valuation of the assets and liabilities of the UCI. The valuation requirements are not set out in detail, but specific requirements cover, for example, the valuation of over-the-counter (OTC) derivatives
- ▶ AIFMs are required to establish, maintain, implement and review, for each AIF they manage, written policies and procedures that ensure a sound, transparent, comprehensive and appropriately documented valuation process. The valuation requirements are set out in detail
- ▶ The rules for the valuation of assets must be disclosed to investors before they invest, in the prospectus of 2010 Law UCIs or in the disclosure to investors before they invest in the case of AIFs
- ▶ For SIFs and RAIFs, the assets should be valued at fair value

<sup>4</sup> Proposal for a Regulation of the European Parliament and of the Council on digital operational resilience for the financial sector - 2020/026 (COD).

<sup>5</sup> National Institute of Standards and Technology.

<sup>6</sup> European Framework for Threat Intelligence-based Ethical Red-Teaming.

## 7.2. Risk management of UCITS

### 7.2.1. Introduction

A UCITS management company or self-managed UCITS investment company (referred to collectively in this section as the management company) must implement and apply a risk management process that enables it to monitor and measure at any time the risk of the positions and its contribution to the overall risk profile of the portfolio. It must assess, monitor and periodically review the adequacy and effectiveness of the risk management policy and any measures taken to address any deficiencies in the risk management process.

### 7.2.2. Key regulations

The fundamental risk management requirements are laid down in the 2010 Law. CSSF Regulation 10-4 lays down more detailed requirements, *inter alia*, on:

- ▶ The risk management function
- ▶ The risk management policy, its assessment, monitoring and review
- ▶ The risk management processes including measurement and management of risk and calculation of global exposure, liquidity risk, counterparty risk exposure and issuer concentration
- ▶ Procedures for the valuation of OTC FDI<sup>7</sup>

CSSF Circular 11/512, as amended, details the risk management requirements applicable to Luxembourg UCITS management companies and UCITS (including self-managed UCITS). The Circular provides guidelines for the implementation of a risk management framework. It covers the main regulatory risk management requirements for UCITS, *inter alia*, covering:

- ▶ The risk management policy
- ▶ The risk management function
- ▶ The risk profile and limits
- ▶ The delegation of risk management
- ▶ The risk measurement techniques (including liquidity and operational risk)
- ▶ Risk management in relation to OTC derivatives and efficient portfolio management (EPM) transactions
- ▶ Risk-related disclosures in the prospectus and annual accounts
- ▶ The structure of the Risk Management Process (RMP)

CSSF Circular 18/698 of 23 August 2018 on the *authorization of investment fund managers incorporated under Luxembourg Law - specific provisions on the fight against money laundering and terrorist financing applicable to investment fund managers and entities carrying out the activity of registrar agent* also sets out some additional requirements in relation to the governance and implementation of the risk management function. The Circular repealed CSSF Circular 12/546 on the authorization and organization of Chapter 15 management companies and UCITS investment companies that have not designated a management company.

The CSSF's *Guidelines on UCITS risk reporting* were issued on 16 June 2022 and provide detailed explanations on principles and instructions to report UCITS risk data.

In addition to Circular 11/512, the following ESMA guidelines are relevant in the context of the risk management framework:

- ▶ ESMA's<sup>8</sup> *Risk management principles for UCITS*, February 2009
- ▶ ESMA's *Guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS*, July 2010
- ▶ ESMA's *Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS*, April 2011, updated in March 2012
- ▶ ESMA's *Guidelines on ETFs and other UCITS issues* of 18 December 2012, as amended
- ▶ ESMA's *Questions and Answers on the application of the UCITS Directive*, May 2017 (bringing together the following four ESMA Q&As on UCITS: *The Key Investor Information Document (KIID) for UCITS* (2015/631); *Q&A on ESMA's Guidelines on ETFs and other UCITS issues* (2015/12); *Notification of UCITS and exchange of information between competent authorities* (2012/428); and *Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS* (2013/1950))
- ▶ ESMA's *Guidelines on stress test scenarios under the MMF Regulation*, December 2020
- ▶ ESMA's *Guidelines on liquidity stress testing in UCITS and AIFs*, September 2019

<sup>7</sup> Over-the-Counter Financial Derivative Instruments.

<sup>8</sup> The Committee of European Securities Regulators (CESR) became the ESMA on 1 January 2011.

IOSCO, ESMA and ALFI have issued documents providing additional recommendations, guidance and clarifications including:

- ▶ The International Organization of Securities Commission's (IOSCO) *Statement on IOSCO liquidity risk management recommendations for investment funds, 18 July 2019*. The IOSCO recommendations have been adopted in Luxembourg by CSSF Circular 19/733 published in December 2019
- ▶ The Board of the IOSCO's *Recommendations for Liquidity Risk Management for Collective Investment Schemes (FR01/2018)*, February 2018
- ▶ ESMA's *Questions and Answers on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS*, July 2012, the latest update of which is dated April 2016, covering, *inter alia*:
  - ▶ Hedging strategies
  - ▶ Disclosure of leverage by UCITS
  - ▶ Concentration rules
  - ▶ Calculation of global exposure for fund of funds
  - ▶ Calculation of counterparty risk for exchange-traded derivatives and centrally-cleared OTC transactions
- ▶ ALFI and ALRiM guidelines on the *ABC of VaR Model Backtesting, A Practitioner's Guide*, May 2017
- ▶ ALFI and ALRiM guidelines on *VaR Model Backtesting C.S.I., Practitioners' Thoughts*, May 2017
- ▶ ALFI's *Principles of the Oversight of Financial Intermediaries in Distribution of Funds*, May 2017, providing management companies with a set of high-level common principles for their considerations in the areas of Financial Intermediary oversight namely risk assessment of the distribution model, initial due diligence, ongoing due diligence/monitoring, governance of the intermediary and reporting
- ▶ ALFI's *Guidelines on Considerations for the Management of Operational Risks Associated with the Distribution of Funds*, June 2016, which presents to Board members and senior management those areas that they may wish to consider when looking at the management of operational risks associated with the marketing/distribution of funds and covers:
  - ▶ Key sources of legal and regulatory guidance in relation to risk management
  - ▶ A potential approach to (i) the identification of relevant operational risks associated with distribution/marketing to which funds or their management companies may be exposed, (ii) the measurement and management of these identified operational risks and (iii) the reporting with regard to these risks and related information to senior management and the board by the risk management function
- ▶ ALFI's *Guidelines on Operational Risk Management within UCITS*, May 2014
- ▶ ALFI's *Principles for sound stress testing practices*, April 2013
- ▶ ALFI's *Practical guidelines on UCITS Liquidity Risk Management*, March 2013
- ▶ ALFI's *Risk Management Guidelines*, March 2012, covering:
  - ▶ Good practices for the organization of the risk function of a UCITS management company or UCITS investment company
  - ▶ Guidance paper for the risk monitoring of functions outsourced/delegated by a management company or investment company
  - ▶ Collateral management
- ▶ ALFI's *FAQ on CSSF Circular 11/512*, December 2011, covering, *inter alia*:
  - ▶ Risk disclosures, including leverage
  - ▶ Portfolio risk calculation methods, including stress testing
  - ▶ Content of risk management reporting to conducting officers and the board of directors

### 7.2.3. Risk profile and risk limits

The board of directors of the management company must define and approve a risk profile for each UCITS it manages. The risk profile will be defined on the basis of advice from the risk management function and result from the process of risk identification, which must take into account all the risks that may be material for the UCITS.

The risk profile of a UCITS could be defined as a measure of the risk appetite relative to the investment strategy (i.e., risk and reward trade-off given the material risks implied by the investment strategy).

The management company must establish, implement and maintain a documented system of internal limits regarding risks that may be material to the UCITS and ensure compliance with the risk profile of the UCITS. The UCITS risk limit system should take into account applicable legal limits. Senior management must approve and review on a periodic basis the risk limit system for each managed UCITS.

Internal limits (stricter than regulatory limits) may be defined by the management company.

Management companies must implement appropriate procedures on remedial action to be taken, in the best interests of unitholders, in case of breaches or foreseeable breaches of the limits.

## 7.2.4. Risk management policy

Management companies are required to establish, implement and maintain an adequate and documented risk management policy that identifies the risks to which the UCITS are or might be exposed, taking into account the nature, scale and complexity of their business and of the UCITS they manage.

The risk management policy must comprise the procedures necessary to enable the management company to assess for each UCITS it manages the exposure of that UCITS to market risks (including global exposure), credit, liquidity and counterparty risks as well as all other risks, including operational risks, that may be material for each UCITS it manages, considering the investment objectives and strategies, the styles or methods of management and the process of assessment.

The risk management policy must cover:

- ▶ The techniques, tools and arrangements to enable the management company to comply with its obligations regarding the measurement and management of risk
- ▶ The allocation of risk management responsibilities within the management company

The risk management policy must state the terms, contents and frequency of reporting of the risk management function to the board of directors and to senior management and, where appropriate, to the supervisory function.

The risk management policy should detail the risk management process (RMP - see also Section 7.2.8.) implemented by the management company for the identification, measurement, monitoring and reporting of the risks. This includes, *inter alia*, how the market risks (including global exposure), liquidity, counterparty and all other risks, including operational risks, must be measured. Guidance on the methodologies applied must be documented.

The policy should also detail techniques, tools and resources. The measurement techniques should include both quantitative and qualitative methods and allow an adequate assessment of the concentration and interaction of risks at the level of the portfolios managed by the management company.

The risk management policy may take the form of a manual.

Senior management must approve and review on a periodic basis (at least once a year) the risk management policy and arrangements, processes and techniques for implementing that policy.

Management companies must assess, monitor and periodically (at least once a year) review:

- ▶ The adequacy and effectiveness of the risk management policy and of the arrangements, processes and techniques implemented for the measurement and management of risk and the calculation of global exposure
- ▶ The level of compliance by the management company with the risk management policy and with arrangements, processes and techniques for the measurement and management of risk and the calculation of global exposure
- ▶ The adequacy and effectiveness of measures taken to address any deficiencies in the performance of the risk management process

## 7.2.5. Risk management function

Management companies are required to establish and maintain a permanent risk management function.

The permanent risk management function is responsible for:

- ▶ Implementing the risk management policy and procedures
- ▶ Ensuring compliance with the UCITS risk limit system, including statutory limits concerning global exposure and counterparty risk
- ▶ Providing advice to the board of directors as regards the identification of the risk profile of each UCITS
- ▶ Providing regular reports to the board of directors and, where it exists, the supervisory function, on:
  - ▶ The consistency between the current levels of risk incurred by each managed UCITS and the risk profile agreed for that UCITS
  - ▶ The compliance of each managed UCITS with relevant risk limit systems
  - ▶ The adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies
- ▶ Providing regular reports to senior management outlining the current level of risk incurred by each managed UCITS and any actual or foreseeable breaches to their limits to ensure that prompt and appropriate action can be taken



- ▶ For UCITS using VaR to calculate global exposure, validating, implementing and monitoring a system of VaR limits consistent with the risk profile approved by senior management and the board of directors and monitoring and control of the VaR limits
- ▶ Reviewing and supporting, where appropriate, the arrangements and procedures for the valuation of OTC derivatives

The main mission of the permanent risk management function is therefore to identify, measure and manage the risks of the UCITS which the management company is responsible for and to report to the management body/governing body and to the senior management. These written reports must include analyses which allow the addressees to verify the consistency between:

- ▶ The risk levels and the risk profile of each UCITS
- ▶ The risk levels and the limits set for each UCITS
- ▶ The risk profile and the limits set for each UCITS

and to ensure that no new risk arises.

The reports must also include the measures to address identified deficiencies and to report on the effectiveness of the measures taken.

In general, all interventions of the permanent risk management function must be documented.

The permanent risk management function should be in regular communication with the portfolio management function in order to enable the efficient conduct of risk management activities.

The permanent risk management function should be hierarchically and functionally independent from operating units. However, the CSSF may allow management companies to derogate from this obligation where the derogation is appropriate and proportionate in view of the nature, scale and complexity of the management company's business and of the UCITS it manages. A management company must, in any case, be able to demonstrate that appropriate safeguards against conflicts of interest have been adopted to allow an independent performance of risk management activities and that its risk management process satisfies the requirements of the 2010 Law.

The permanent risk management function must have the necessary qualifications, knowledge and expertise in this area. In addition, it must have the necessary authority and access to all the relevant information which is necessary to fulfill its functions. The person must perform his/her mandate under the direct responsibility of the conducting officer who is responsible for the risk management function. By virtue of the principle of proportionality, one of the conducting officers may be directly appointed as a person responsible for the permanent risk management function where he has the necessary qualifications, knowledge and expertise.

The tasks of the person responsible for the permanent risk management function cannot be exercised directly by a member of the management body/governing body of the management company, unless he/she is part of its senior management.

The management company must communicate beforehand to the CSSF the name of the person responsible for the permanent risk management function supplemented by the following information and any other document which might be subsequently requested by the CSSF:

- ▶ A recent *curriculum vitae*, signed and dated
- ▶ A copy of the passport/identity card
- ▶ A declaration of honor, as may be downloaded on the CSSF website ([www.cssf.lu](http://www.cssf.lu))
- ▶ A recent extract of the criminal record, if available, or any other equivalent document

In the event of a change of the person responsible for the permanent risk management function, the management company must communicate beforehand to the CSSF the name of the person succeeding him/her in office supplemented by the documents required (see above).

The same conducting officer cannot be responsible for both portfolio management and risk management, even if it is delegated to a third party (see Section 5.1.6.2.). The relationship between the internal control functions and the board of directors and between internal control functions themselves is covered in Section 6.3.2.1.

The independence of the risk management function is meant to avoid conflicts of interest and to be able to escalate issues to senior management and/or the board of directors.

ALFI's *Best Practice Proposals for the Organization of the Risk Function of a UCITS Management Company or UCITS Investment Company* are part of its *Risk Management Guidelines* issued in March 2012. They cover, *inter alia*:

- Risk management principles, risk management function and other control functions:
  - Risk management function
  - Risk management and its relationship with other control functions
- Practical implementation of a risk management function:
  - Governance and organization
  - Identification of risks
  - Measurement and management of risks
  - Reporting
- Role of risk management in the life-cycle of a fund

In practice, the risk management function will also play a key role in the calculation of the synthetic risk and reward indicator (SRRI) in the KIID (see Section 7.2.9.).

## 7.2.6. Risk measurement and management

### 7.2.6.1. Introduction

The techniques and resources dedicated to the measurement of risks should be commensurate to the nature and scale of the activities of the management company and to the complexity of the investment strategy of the UCITS, including, *inter alia*, the extent to which derivative instruments are used.

The risk categories listed hereafter are the minimum requirements set by the CSSF in terms of risk measurement. UCITS and their management companies may be exposed to other types of risks (e.g., tax risk, legal risk).

As part of the risk measurement process, management companies are required to use sound and reliable data and when appropriate, undertake periodic stress tests and scenario analysis to ensure the adequacy of the methodologies applied.

ALFI's guidelines on stress testing practice for UCITS entitled *Principles for sound stress testing practices*, issued in April 2013, are relevant for all types of risk and all types of UCITS products. They focus on:

- Use of stress testing and integration in UCITS risk governance
- Stress testing methodologies and scenario selection
- Specific areas of focus: specific risks and products
- Reporting and management actions
- Areas of development and improvement in stress testing practices

### 7.2.6.2. Global risk exposure (market risk)

Management companies are required to self-assess the individual risk profile of each UCITS and to determine, accordingly, the adequate global risk exposure methodology (commitment approach or value-at-risk (VaR)/internal model based approach).

In its *Guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS, of July 2010*, ESMA indicates that the commitment approach should not be applied to UCITS:

- That engage in complex investment strategies that represent more than a negligible part of the UCITS' investment policy
- That have more than a negligible exposure to exotic derivatives
- For which the commitment approach may not adequately capture the related risks (e.g., non-directional risks like volatility risk, gamma risk or basis risk)

UCITS are expected to use a maximum loss approach to assess whether the complex investment strategy or the use of exotic derivatives represent more than negligible exposure.

Index tracking leveraged UCITS (and UCITS replicating leveraged indices) must comply with the limits and rules on global exposure, using either the commitment approach or the relative VaR approach.

Calculation, measurement and monitoring of the global exposure need to be performed at least on a daily basis.

CSSF Circular 11/512, as amended, introduced the intra-day calculation concept, whenever required.

ESMA's guidelines also provide some clarifications on the extent to which intra-day market risk calculations would need to be performed: in case of exceptional market circumstances (e.g., on a particular day due to increased volatility) or on the basis of complex investment strategies for which the global exposure would change significantly from one day to the next.

Where FDIs are used and benefit only specific share classes (e.g., hedging, leverage), it is good practice to calculate global risk exposure (market risk) and leverage at share class level, although there are no specific requirements on calculations at share class level.

#### A. Commitment approach

The total commitment is considered to be the sum of the absolute value of the commitment of each individual position, after taking into account netting and hedging.

The management company should convert each FDI position into the market value of an equivalent position in the underlying asset of that derivative (standard commitment approach). Management companies may apply other calculation methods that are equivalent to the standard commitment approach.

CSSF Circular 11/512, as amended, refers to the ESMA guidelines on the calculation methodologies to be adopted for the most common FDIs:

- ▶ Futures
- ▶ Plain vanilla options (bought/sold puts and calls)
- ▶ Swaps
- ▶ Forwards
- ▶ Financial instruments that embed derivatives

Non-standard (exotic) derivatives calculation methodologies are detailed for variance swaps, volatility swaps and barrier (knock-in knock-out) options.

ESMA excludes an FDI from the calculation of the global exposure when it meets all of the following criteria:

- ▶ It swaps the performance of the assets held in the UCITS portfolio for the performance of other assets
- ▶ It totally offsets the market risks of the swapped assets held in the UCITS portfolio
- ▶ It includes neither additional optional features, leverage clauses, nor additional risks as compared to a direct holding in the reference financial assets

The management company may take account of netting and hedging arrangements when calculating global exposure, where these arrangements do not disregard obvious and material risks and result in a clear reduction in risk exposure.

Where the use of FDIs does not generate incremental exposure for the UCITS, the underlying exposure need not be included in the commitment calculation.

Temporary borrowing arrangements need not be included in the global exposure calculation.

An optional regime is available to structured UCITS that meet specific criteria. In such cases, based on the pay-off structure of the UCITS and the applicable scenarios for the investor, the commitment approach may be used to calculate the global exposure for each scenario. The global exposure of each individual scenario would need to comply with the limit set for the UCITS.

#### B. Value-at-risk (VaR)/internal model approach

UCITS using the approach of estimating their maximum loss at a high confidence level should base the calculation of the market risk on an internal model taking into consideration general market risk as well as specific market risk. The most commonly accepted internal model is the VaR model supplemented by stress tests. Other models can be used provided they receive CSSF approval. The choice of the appropriate VaR model (e.g., parametric, historical simulation or Monte Carlo) remains the responsibility of the UCITS.

ESMA considers, in particular, that the VaR model selected should include all the positions of the UCITS portfolio and capture all the material risks associated with the portfolio positions.

Models need to be independently validated and back tested before being used for the first time. The validation should cover the implementation of the VaR model in the overall risk management framework, providing highlights on governance, data management, methodologies, reporting and use.

The validation is expected to be performed by an independent business unit dedicated to internal controls or model validation or by an external entity (different to the entity providing the VaR model) that would be able to demonstrate sufficient knowledge and expertise on risk management (e.g., internal audit, external auditor).

Should a significant change be made to the model, independent validation must be repeated.

The validation of the VaR model to be undertaken by a party independent from that involved in the development process is intended to ensure the model is conceptually sound and adequately captures all material risks.

A model governance process should also be put in place to make sure that the model is fit for purpose.

CSSF Circular 11/512, as amended, introduces two concepts of VaR with different limits:

- ▶ If a reference portfolio (or “benchmark”) can be determined, the CSSF allows the use of a relative VaR where the portfolio VaR cannot be more than twice (200%) the reference portfolio VaR. The choice of the reference portfolio needs to be duly documented
- ▶ Where there is no reference portfolio, an absolute VaR figure must be calculated. Absolute VaR limit cannot exceed 20% of the NAV

Under the relative VaR approach, ESMA detailed the requirements related to the selection of a reference portfolio. The reference portfolio should comply with the following criteria:

- ▶ It should be unleveraged and not contain any derivatives (or embedded derivatives), except for UCITS investing in long/short investment strategies and UCITS that intend to have a currency hedged portfolio
- ▶ The risk profile of the reference portfolio should be consistent with the UCITS investment objectives
- ▶ The risk/return profile of the UCITS should not change frequently
- ▶ The process relating to the determination and maintenance of the reference portfolio should be documented

The risk management function must, for each UCITS, validate and implement a system of VaR limits consistent with the risk profile that is to be approved by senior management and the board of directors. This may be in the form of a separate document. The monitoring and control of the VaR limits must be undertaken by the risk management function on a daily basis and regular control over the level of leverage generated by the UCITS must be performed. Through regular reports, senior management must be informed of the current VaR measures.

The VaR model parameters to be used are the following:

- ▶ Confidence interval: 99%
- ▶ Holding period: equivalent to one month (20 days)
- ▶ Observation period of risk factors: at least one year (250 days), unless a shorter period is justified by a significant increase in price volatility
- ▶ Data update: quarterly (particularly relevant to parametric VaR models)
- ▶ Calculation frequency: at least daily

A different confidence interval or holding period may be used with prior approval from the CSSF provided a conversion is made to bring the VaR to an equivalent value. Additional details on the rescaling of the VaR limit are provided in ESMA's guidelines.

The risk management function is responsible for sourcing, testing, maintaining and using internal models (e.g., VaR models) on a day-to-day basis. As part of its responsibility, the risk management function must ensure the model is adapted to the UCITS' portfolio on a continuous basis and perform regular validations.

The VaR model should be fully integrated within the risk management function and be part of its daily work. The VaR process should be developed in coordination with the investment process led by the investment managers in order to keep the UCITS risk profile under control and consistent with the investment strategy.

The management company must adequately document the VaR model and the related processes and techniques. The documentation must cover, *inter alia*, the following:

- ▶ Risks covered by the model
- ▶ Model methodology
- ▶ Mathematical assumptions and foundations
- ▶ Data used
- ▶ Accuracy and completeness of the risk assessment
- ▶ Back testing process
- ▶ Stress testing process
- ▶ Validity range of the model
- ▶ Operational implementation

### C. Additional techniques/measures to be implemented in case of the use of a VaR approach

#### Backtesting

In addition to the daily computation of the VaR, the accuracy and performance of the model (i.e., prediction capacity of risk estimates) need to be monitored by conducting a back testing program at least on a monthly basis.

ESMA provided guidelines in relation to back testing:

- ▶ The backtesting program should provide for each business day a comparison of the one-day VaR measure generated by the UCITS model for the UCITS' end-of-day positions to the one-day change of the UCITS' portfolio value by the end of the subsequent business day
- ▶ The UCITS should carry out the backtesting program at least on a monthly basis, subject to always performing retroactively the comparison for each business day in the previous bullet point
- ▶ The UCITS should determine and monitor the "overshootings" on the basis of this backtesting program. An "overshooting" is a one-day change in the portfolio's value that exceeds the related one-day VaR measure calculated by the model
- ▶ If the backtesting results reveal a percentage of "overshootings" that appears to be too high, the UCITS should review the VaR model and make appropriate adjustments
- ▶ The UCITS senior management should be informed at least on a quarterly basis (and where applicable the UCITS competent authority should be informed on a semi-annual basis) if the number of "overshootings" for each UCITS for the most recent 250 business days exceeds four in the case of a 99% confidence interval. This information should contain an analysis and explanation of the sources of "overshootings" and a statement of what measures, if any, were taken to improve the accuracy of the model. The competent authority may take measures and apply stricter criteria to the use of VaR if the "overshootings" exceed an unacceptable number

The ALFI's *Guidelines related to VAR model backtesting*, issued in May 2017, aim to help practitioners perform and interpret backtests and to find answers as to what they could do when faced with a risk model that fails regular backtests and analysis. As such, it goes through the impacts of varying market conditions and underlying assumptions that may bias the results generated by typical VaR models.

#### Stress testing

CSSF Circular 11/512, as amended, requires UCITS using a VaR model to complement the approach with a stress testing program. Stress tests aim at capturing extreme markets events (e.g., 9/11 attacks, Lehman default) with theoretical or historical scenarios. ESMA's guidelines provide additional details on stress testing qualitative and quantitative requirements.

The stress testing program should capture the impact of unexpected changes in market parameters and correlation factors on the UCITS portfolio value. Results should be taken into account in the investment management and risk management process.

Under the quantitative requirements, stress tests must capture all the risks not adequately covered by the VaR model and those risks that, though not significant in normal circumstances, are likely to be significant in situations of stress (e.g., unusual correlation changes, illiquidity of markets in stressed market situations or the behavior of complex structured products under stressed liquidity conditions). Finally, stress tests should foresee scenarios exposing the UCITS portfolio to large downside risks leading to events such as the default of the UCITS (i.e., NAV < 0) in case of significant leverage.

Under the qualitative requirements, stress tests must be performed at least on a monthly basis. The design of the scenarios should be suitable to the UCITS portfolio composition and market conditions. The design of the program should be duly justified and documented.

Further guidance is provided in ALFI's *Principles for sound stress testing practices*.

#### Leverage ratio

Additional safeguards require regular monitoring of the UCITS leverage. Leverage should be calculated as the sum of the notional amounts of the derivatives used. The level of leverage may, for example, be the average of the levels of leverage observed during the financial year. The data must be at least bi-monthly.

CSSF *Communiqué 12/29* clarifies that, in line with ESMA's *Guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS*, the leverage to be included in the prospectus (see also Section 10.3.1.) and the annual report (see also Section 10.5.1.) for those UCITS determining the global exposure using a VaR approach is to be calculated on the basis of the sum of the notionals of derivative instruments used, while allowing these UCITS to supplement this information using (a) leverage figure(s) calculated through the commitment approach.

UCITS employing high levels of leverage are required to provide additional information to the CSSF (see Section 7.2.8.).

The International Capital Market Association's (ICMA) Asset Management and Investors Council (AMIC) and the European Fund and Asset Management Association (EFAMA) issued a paper on 19 July 2017 analyzing how leverage is used, how the European legislative framework addresses leverage and how the related risks are addressed from a technical perspective. In order to contribute to recent debates launched by regulators and supervisors, it also looks at the updates and improvements that could be proposed to ensure that the European regulation remains a cutting-edge framework at global level.

#### *Additional risk indicators*

ESMA's guidelines indicate that UCITS should supplement the VaR and stress testing framework, where appropriate, by taking into account the risk profile and the investment strategy being pursued, with other risk measurement methods.

Conditional VaR (CVaR) or Extreme Value Theory (EVT) approaches might be considered together with basic risk indicators (e.g., Greeks).

#### *7.2.6.3. Counterparty risk*

The counterparty risk linked to over-the-counter (OTC) FDIs should be calculated as the positive mark-to-market value of the contract. The 2010 Law, as amended, limits the OTC counterparty risk exposure to 10% of the NAV when the counterparty is an EU credit institution or a credit institution subject to prudential rules considered by the CSSF to be equivalent to that laid down in EU Law and 5% of the NAV in all other cases. Eligible counterparties must be subject to CSSF supervision or equivalent prudential supervision and specialized in this type of transaction.

The net exposures of UCITS to a counterparty arising from securities lending transactions or reverse purchase/repurchase agreement transactions should be taken into account within the limit of 20% provided for in Section 4.2.2.8.1.1.(6).

If there are no arrangements that protect UCITS against the risk of insolvency of the relevant broker, exposure in relation to the initial margins posted by UCITS to a broker and variation margins to be received by UCITS from the broker within the context of FDIs dealt in on a regulated market or OTC FDIs must be included within the counterparty risk limits of 5% and 10%.

ESMA's guidelines set out general principles related to collateral eligibility for netting purposes (e.g., with respect to liquidity, valuation and issuer credit rating).

ESMA's *Guidelines on ETFs and other UCITS issues* lay down rules on the management of collateral for OTC FDI transactions (see Section 4.2.2.3.F.) and efficient portfolio management (EPM) techniques (see Section 4.2.2.6.). These include, *inter alia*:

- ▶ Risk exposures to a counterparty arising from OTC FDI transactions and EPM techniques should be combined when calculating the counterparty risk limits
- ▶ Operational and legal risk related to the management of collateral need to be mentioned in the risk management process (see Section 7.2.8.)
- ▶ UCITS receiving collateral for at least 30% of its assets need to design a stress testing policy in order to assess the liquidity risk attached to the collateral
- ▶ UCITS need to define a clear haircut policy adapted for each class of assets received as collateral

Additionally, UCITS using EPM techniques need to:

- ▶ Adequately capture in the RMP the risks arising from these activities, with a focus on counterparty risk
- ▶ Ensure EPM does not add substantial supplementary risks in comparison to the original risk policy
- ▶ Consider the EPM usage when developing the liquidity risk management process in order to comply at any time with redemption obligations

OTC FDI transactions may be excluded from the counterparty risk exposure, if all of the following requirements are met:

- ▶ Backing by an appropriate completion guarantee
- ▶ Daily valuation of the market values of the positions on FDIs
- ▶ Making margin calls at least once a day

ALFI issued practical guidelines in its *Industry work paper - collateral management* as part of its *Risk Management Guidelines* of March 2012.

According to ESMA's *Questions and Answers on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS*, when calculating the counterparty risk for exchange-traded derivatives and OTC transactions that are centrally cleared, UCITS should look at the clearing model used to determine the existence of counterparty risk and, if any, where the counterparty risk is located. When analyzing the clearing model used, UCITS should have regard to the existence of segregation arrangements of the assets and the treatment of claims on these assets in the event of bankruptcy of the clearing member or central counterparty.

According to ESMA's *Q&A on Application of the UCITS Directive*, when a UCITS has a hedged share class in a different currency and uses FX forwards as a hedging mechanism, the UCITS should comply with the counterparty risk limits laid down in Article 52(1) of the UCITS Directive in respect to the NAV of the share class as provided in paragraph 26a of the ESMA's *Opinion on share classes*. Therefore, unrealized FX profits and losses should be counted towards the NAV of the hedged share class of the UCITS and taken into account when calculating the counterparty risk limits with respect to the NAV of the hedged share class.

#### 7.2.6.4. Liquidity risk

Management companies are required to implement an appropriate liquidity risk management procedure supported by a stress testing program (if appropriate) in order to ensure that the liquidity profile of the investments of the UCITS is appropriate to the redemption policy.

Liquidity risk is the risk that a position in the UCITS portfolio cannot be sold, liquidated or closed at limited cost in an adequately short time frame or that the ability of a UCITS to proceed, at any time, with investor redemptions is compromised.

The liquidity risk framework should cover funding risk, market liquidity risk, reconciliation to other risk types and regulatory requirements and operational issues and be integrated into the current global risk management framework.

##### A. Liquidity risk management

ALFI's *Guidelines on UCITS Liquidity Risk Management*, published in March 2013, cover, *inter alia*:

- Principles of liquidity risk management for UCITS funds distinguishing between:
  - Market liquidity risk (also referred to as asset liquidity risk)
  - Funding liquidity risk (also referred to as investor behavior risk or subscription/redemption risk)
  - Elements of a sound liquidity risk management framework
  - Liquidity risk management tools and techniques

In December 2019, the CSSF published CSSF Circular 19/733 implementing the IOSCO *Recommendations for Liquidity Risk Management for Collective Investment Schemes* (FR01/2018), issued in February 2018, in Luxembourg with immediate effect.

The Circular emphasizes that there should be an appropriate alignment between portfolio assets and redemption terms throughout the entire lifecycle of the fund (design, pre-launch, launch and subsequent operations).

##### Design phase

CSSF Circular 19/733 provides that, during the design phase, the responsible body in charge of the UCI should, *inter alia*:

- Draw up an effective liquidity risk management process, effective in both normal and stressed conditions, compliant with local jurisdictional liquidity requirements
- Have a liquidity risk management process, which is supported by strong and effective governance
- Set dealing frequency arrangements which are appropriate with regards to the investment strategy and underlying assets through the entire life cycle of the UCI
  - On the asset side, current and historical liquidity of target assets and instruments must be considered
  - On the liability side, UCIs should take reasonable steps to understand the target investor base, the concentration thereof and the expected redemption patterns
- Set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the UCI
- Carefully determine a suitable dealing frequency for units in the UCI
- Ensure that the UCI's dealing (subscription and redemption) arrangements are appropriate for its investment strategy and underlying assets throughout the entire product life cycle, starting at the product design phase
- Consider liquidity aspects related to its proposed distribution channels
- Ensure to have access to, or can effectively estimate, relevant information for liquidity management. (IOSCO recommendation 5 suggests contractual arrangements with nominees to secure access to investor concentration data or other investor information as appropriate. As a matter of principle, UCIs should be able to access all information which is relevant for liquidity risk management.)
- Consider an appropriate range of liquidity management tools (LMTs) built in the dealing policies or contingent to the occurrence of certain events such as redemption requests above a predetermined threshold. These include, *inter alia*, exit charges, limited redemption restrictions, gates, anti-dilution levies, swing pricing, in specie transfers, lock-up periods, contractual limitations of redemption rights, notice periods, side-pockets and suspensions
- Ensure that liquidity risk and its liquidity risk management process are effectively disclosed to investors and prospective investors in a manner which is effective, adapted to the nature of underlying assets, adapted to the degree of sophistication of the investors' profile and proportionate to the risks

### Day-to-day

On a day-to-day basis, the UCI's governing body should, *inter alia*:

- ▶ Effectively perform and maintain its liquidity risk management process
- ▶ Regularly assess the liquidity of the assets held in the portfolio
- ▶ In assessing the liquidity of portfolio assets, due care should be given to compliance with defined liquidity limits and the redemption policy (indicators to monitor include, in particular, time-to-liquidate assets, price, financial settlement lags and interdependence with other market risks and factors)
- ▶ Integrate liquidity management in investment decisions
- ▶ Have a liquidity risk management process, which should facilitate the ability to identify an emerging liquidity shortage before it occurs, allowing prompt and appropriate remedial actions with the objective to protect investors' interests
- ▶ Be able to incorporate relevant data and factors into the liquidity risk management process in order to create a robust and holistic view of the possible risks
- ▶ Assess the liquidity quality of securities accepted as collateral and pay particular attention to temporary borrowing
- ▶ Review the effectiveness of the LRM process on a regular basis and update as appropriate, notably in case of certain events such as an investment in a new type of asset
- ▶ Conduct ongoing liquidity assessments in different scenarios, which could include fund level stress testing, in line with regulatory guidance
- ▶ Ensure appropriate records are kept and relevant disclosures made, relating to the performance of its liquidity risk management process
- ▶ Put in place and periodically test contingency plans with the aim of ensuring that any applicable liquidity management tools can be used where necessary and, if being activated, can be exercised in a prompt and orderly manner
- ▶ Consider the use of additional liquidity management tools to the extent allowed by local law and regulation, in order to protect investors from, *inter alia*, unfair treatment, or prevent the UCI from diverging significantly from its investment strategy

On 11 December 2020, the CSSF issued Circular 20/761 on liquidity risks arising from margin calls.

Where a counterparty enters into non-centrally cleared OTC derivative contracts and securities financing transactions, it should ensure that its risk management procedure does not result in the event of downgrades of credit ratings, in sudden and significant changes and cliff effects in margin calls and collection and in collateral practices.

The Circular provides that this could be achieved, for example, by:

- ▶ Using a progressive and granular sequence when implementing downgrades of credit ratings, in their overall risk management practices
- ▶ Maintaining a comprehensive approach to limiting procyclical features in accordance with the regulatory requirements in Article 11 of Regulation (EU) No 648/2012, as amended, especially with respect to rating downgrades

On 25 November 2021, the EC issued a proposal to amend Directives 2011/61/EU (AIFMD) and 2009/65/EC (UCITS Directive). The proposal foresees that IFMs should select suspension of redemptions/subscriptions and at least one additional LMT from a list of LMTs including redemption gates, notice periods, redemption fees, swing pricing, anti-dilution levy and redemption in kind. At the time of writing, the exact circumstances permitting the use of side-pockets are not yet determined but it is likely that side-pockets should only be used as a last resort in situations where the AIFM/UCITS cannot ensure the fair and accurate valuation of some assets or where some assets have become non-tradeable.

IFMs should notify their National Competent Authority (NCA) where they (de-) activate LMTs.

A delegated act should specify the conditions where (de-) activation of LMTs is appropriate.

Disclosures are also foreseen to describe the redemption rights both in normal conditions and in exceptional circumstances, notably the possibility and conditions for using LMTs and the existing redemption arrangements with investors.



On 14 June 2022, the CSSF released an assessment of the effectiveness of liquidity management tools used by Luxembourg-domiciled UCITS prior to and during the COVID-19 crisis.

The main findings are the following:

- ▶ For most UCITS, the liquid asset ratio generally exceeded the maximum daily redemptions, suggesting that these UCIs have sufficient liquidity buffers to meet elevated redemptions. However, UCITS increased cash positions in periods of high volatility, such as the March 2020 market turmoil, and thereby contributed to pro-cyclical selling of assets
- ▶ IFM's estimates of how the liquidity of the UCI's portfolio would be affected in a stress scenario vary considerably across UCITS. Some assessments may underestimate the potential impact of concerted sales of the same, or highly correlated, assets by other UCIs
- ▶ UCITS frequently used swing pricing to pass on the trading costs to transacting investors and mitigate the dilution of the UCI's value
- ▶ UCITS rarely suspended redemptions. Suspensions often precede the permanent closure and liquidation of the UCI. They may also lead to higher outflows from UCIs with similar portfolios. Lower survival rates and adverse signaling effects may imply that UCIs wait too long before suspending redemptions

## B. Stress testing

ESMA's *Guidelines on liquidity stress testing (LST)* in UCITS and AIFs were implemented in Luxembourg by CSSF Circular 20/752 and have been applicable since 30 September 2020.

Pursuant to the Circular, LST should be undertaken for UCITS and AIFs, including exchange-traded funds and leveraged closed-ended AIFs, by the IFMs<sup>9</sup>.

The Circular also clarifies the scope of the Guidelines which is extended to open-ended and leveraged closed-ended SIFs which are not managed by an AIFM.

Guidelines on the design of models, the understanding of liquidity risk, the governance principles and the LST policy as well as guidelines applicable to depositaries and interaction with the national competent authorities also apply to MMFs. The MMF regulation<sup>10</sup> and ESMA's *Guidelines on stress test scenarios* implemented in Luxembourg by CSSF Circular 18/696 and subsequently updated by Circular 20/735 prevail in the event of any conflict.

The CSSF also recommends that the following vehicles managed by a registered AIFM consider the provisions of the Circular:

- ▶ Open-ended and leveraged closed-ended UCIs subject to Part II of the 2010 Law
- ▶ Leveraged SICARs that are not AIFs managed by a registered AIFM

The Circular requires UCIs to have, *inter alia*:

- ▶ A LST policy embedded in the UCI's risk management framework and subject to appropriate governance, oversight, reporting and escalation
- ▶ A validation of the LST model which is independent from the portfolio management function
- ▶ LST models adapted to each UCI using specific liquidity risk factors and including difficult-to-model parameters
- ▶ Sufficiently severe hypothetical and historical scenarios, including reverse stress testing where appropriate
- ▶ Combined testing of UCIs' assets and liabilities
- ▶ Appropriate oversight of third-party models
- ▶ LSTs carried out at least annually, when material risk must be addressed in a timely manner and during all stages of a UCI's lifecycle
- ▶ LST indicators which:
  - ▶ Facilitate liquidity management in the best interest of the investors and in compliance with the UCI rules
  - ▶ Help identify potential liquidity weaknesses of an investment strategy
  - ▶ Assist decision-making, including setting relevant limits by the manager
- ▶ At the product development stage, a manager of a UCI which requires authorization from the CSSF should be able to demonstrate that its strategy and dealing frequency enable the UCI to remain sufficiently liquid in normal and stressed conditions. Where appropriate, managers should undertake LST, using a model portfolio and expected investor profiles at all stages of the UCI's lifecycle
- ▶ Managers should notify the CSSF of material liquidity risks and actions undertaken to mitigate them. NCAs may also request managers to provide their LST models and their results
- ▶ Depositaries have a duty to ensure that a manager of a UCI has documented procedures for its LST program, but not to challenge the LST

<sup>9</sup> Defined in Section 5.1.6.1.

<sup>10</sup> Regulation (EU) 2017/1131 of 14 June 2017 on money market funds, as amended.

In a report issued on 12 November 2020, ESMA defined five priority areas to enhance the preparedness of UCIs to future liquidity shocks:

- ▶ *Alignment of the funds' investment strategy, liquidity profile and redemption policy*
- ▶ *Liquidity risk assessments*: Liquidity risk assessments should comply with the obligation to take into consideration all factors which could have an impact on fund liquidity or could trigger unwanted sales, such as margin calls or loan covenants, including all relevant liabilities
- ▶ *Fund liquidity profiles*
- ▶ *Liquidity management tools*
- ▶ *Valuation processes in a context of valuation uncertainty*: Management companies' valuation procedures should include valuation approaches for stressed market conditions. Where portfolio management is delegated, valuation teams should have sufficient expertise and access to information in order to assess the reliability of valuation sources and establish a fair valuation of the portfolio

ESMA proposed reforms considering the liquidity challenges and significant difficulties faced by MMFs during the COVID-19 pandemic. ESMA published, on 16 February 2022, its opinion laying out proposals to amend the MMF Regulation. The main proposals addressed by the reform are described in Section 2.6.1.

#### 7.2.6.5. Concentration risk

The issuer concentration risk must be calculated using the commitment approach, if this is appropriate, or the maximum potential loss approach. Netting is authorized, provided certain conditions are met. For concentration risk requirements, see Section 4.2.2.8.1.

#### 7.2.6.6. Operational risk

Operational risk is defined as the risk of loss for the UCITS resulting from inadequate internal processes and failures in relation to people and systems of the management company or from external events and includes legal and documentation risk and risk resulting from the trading, settlement and valuation procedures operated on behalf of the UCITS.

A management company is required to cover operational risks in its risk management policy. The operational risk entailed by delegated activities is covered in Section 7.2.7.

ALFI's Guidelines, of April 2014, on *Operational Risk Management within UCITS cover, inter alia*:

- ▶ Legal and regulatory framework as well as European and Luxembourg industry guidelines
- ▶ The governance and management of operational risks, including examples of generic and specific operational risks to UCITS funds and recommended risk mitigants. The aim of these guidelines on operational risks is to present good practice proposals
- ▶ Tools to assist with the assessment, monitoring and tracking of operational risks for UCITS. The tools include:
  - ▶ An operational risk monitoring table providing an overview of risk measurement and monitoring approaches for the categories of operational risk, focusing on the three main functions of a management company (investment management, administration, marketing/distribution)
  - ▶ Well-defined policies and procedures
  - ▶ Risk control self-assessments (RCSA)
  - ▶ Key risk indicators/key performance indicators
  - ▶ Risk management approval for new business
  - ▶ Due diligence on delegates
  - ▶ Maintenance of a risk event database (RED)
  - ▶ Additional recommended tools (Internal Capital Adequacy Assessment Process (ICAAP), scenario analysis, post implementation reviews)
- ▶ General principles on the effective reporting of risk management issues to senior management and the Board, covering to whom and when to effectively escalate operational risk issues
- ▶ Key risk indicators for operational risk

#### 7.2.6.7. Reliance on external credit ratings

*Directive 2013/14/EU on over-reliance on credit ratings*, as amended, sets out a general principle against the over-reliance on credit ratings that should be integrated into the risk management processes and systems of a UCITS management company or investment company.

A UCITS management company or investment company must not solely or mechanically rely on external credit ratings issued by credit rating agencies for assessing the creditworthiness of the UCITS' assets.

Taking into account the nature, scale and complexity of the UCITS' activities, the national competent authority (i.e., CSSF) is required to monitor the adequacy of the credit assessment processes of the management company or investment company, assess the use of references to external credit ratings and, where appropriate, encourage mitigation of the impact of such references, with a view to reduce sole and mechanistic reliance on such external credit ratings.

ESMA publishes a list of registered and certified credit rating agencies.

## 7.2.7. Delegation of risk management activities

Where management companies delegate the risk management function to third parties, the responsibility for risk management remains with the management company.

Management companies are required to exercise due skill, care and diligence when entering into, managing or terminating any arrangements with third parties in relation to the performance of risk management activities. Before entering into such arrangements, management companies must take the necessary steps in order to verify that the third party has the ability and capacity to perform the risk management activities reliably, professionally and effectively. The management company must establish methods for the ongoing assessment of the standard of performance of the third party (see also Section 6.3.5.1.).

ALFI issued a *Guidance paper for the risk monitoring of functions outsourced/delegated by a management company or investment company* as part of its *Risk Management Guidelines* of March 2012.

The paper covers each phase of delegation of outsourcing relationships:

- Initiation (planning to outsource)
- Life (ongoing delegate monitoring)
- Termination

## 7.2.8. Communication to the CSSF

The CSSF requires management companies to provide certain information in relation to the risk management policy in order to identify, measure, manage, control and report on the risks that may be material for the UCITS they manage.

CSSF Circular 11/512, as amended, lays down the required content and format of the risk management process document (RMP):

- |  |  |
|--|--|
| 1. Governance and risk management function organization              | 2.3 VaR approach   |
| 1.1 Organization chart   | 2.4 Backtesting  |
| 1.2 Governance structure   | 2.5 Stress testing   |
| 1.3 Independence of the risk management function                     | 2.6 Disclosure   |
| 1.4 Risk management policy   | 3. Liquidity risk  |
| 1.5 Permanent risk management function                               | 4. Counterparty risk of OTC FDIs                                 |
| 1.6 Adequacy and review of the risk management policy                | 5. Counterparty risk linked to EPM techniques                    |
| 1.7 Risk reporting   | 6. Operational risk  |
| 1.8 IT tools and systems   | 7. Concentration risk  |
| 1.9 Delegation   | 8. Pricing risk  |
| 1.10 New products approval process                                   | 9. Legal risk  |
| 1.11 Interaction with compliance and internal audit                  | 10. OTC FDI valuation  |
| 2. Global exposure   | 11. Cover rules  |
| 2.1 General description (frequency, self-assessment and methodology) | 12. Specific requirements for discretionary portfolio management |
| 2.2 Commitment approach  | 13. List of UCITS  |
|  | 14. Conclusion   |

The RMP must be included in the application for authorization for a management company.

It must be updated at least on a yearly basis and it must be submitted to the CSSF within five months of the closing date of the management company's financial year or the self-managed UCITS financial year.

In case of any material modification to the risk management policy, the RMP must be updated promptly and communicated to the CSSF.

The documentation of the risk profile of the compartments managed and that of the analysis of the consistency with the set limits and identified risk levels must be immediately available upon the CSSF's request.

A copy of the report regularly established by the risk management function for the senior management and governing body relating to the adequacy and effectiveness of the method for risk management must be included with the RMP transmitted to the CSSF.

UCITS employing high levels of leverage should provide the CSSF with information on the ownership structure (e.g., target investors). The CSSF may request such UCITS to provide additional quarterly *ad hoc* reporting on performance and risks (e.g., leverage, VaR, stress tests).

As regards identification and reporting of breaches of VaR limit requirements to the CSSF, please refer to Section 8.9.3.1.

Semi-annual UCITS risk reporting must be filed within the deadline provided by the CSSF in a circular letter issued for each reporting period. For the first semester 2022, the reporting deadline was 16 August 2022.

All UCITS must complete two separate worksheets:

- ▶ “DataURR” mainly referring to risk information at UCITS level
- ▶ “Contact details” aimed at collecting contact details at the level of the management company or self-managed investment company in order to enable the CSSF, *inter alia*, to send the circular letter for UCITS risk reporting by e-mail (in addition to the posted letter) to all addressees

All the aforesaid UCITS, without exception, have to provide contact details in the second sheet as well as the data items referred to in Section I (“Functional Data”) of the UCITS risk data.

Detailed reporting is required for UCITS meeting one of the following criteria:

- ▶ UCITS with total net assets at the reporting reference date equal to or higher than EUR 500 million
- ▶ UCITS using the VaR method for calculating the global exposure as laid down in Article 42(3) of the 2010 Law, as further detailed by the CSSF Regulation 10-4 and CESR’s *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* (Ref. 10-788), with an arithmetic average leverage (calculated as the sum of the notionals of the derivatives used) over the reference semester greater than or equal to 250% of the UCITS total net assets

This detailed reporting includes information and data on:

- ▶ Key investment strategy
- ▶ Global exposure and leverage
- ▶ Stress testing and other risk indicators
- ▶ Efficient portfolio management (EPM) techniques
- ▶ Counterparty risk and collateral in relation to EPM techniques/OTC financial derivative instruments and traded derivatives
- ▶ Liquidity risk
- ▶ Credit risk

Reporting of UCI financial information to the CSSF is covered in Chapter 10.

## 7.2.9. Disclosures to investors

The risk and reward profile of a UCITS must be disclosed in the key investor information document (KIID), including guidance on the associated risks. This will take the form of:

- ▶ A synthetic risk and reward indicator (SRRRI): The SRRRI aims to provide potential investors with an indication of the overall risk and reward profile of a UCITS. The SRRRI corresponds to an integer number designed to rank the UCITS, according to its increasing level of volatility, on a scale from 1 to 7
- ▶ A narrative explanation of the main limitations of the SRRRI
- ▶ A narrative presentation of the material risks that are not fully captured by the methodology of the SRRRI

For further information, see Section 10.3.2.1.

Prospectus disclosures in relation to market risk are required on:

- ▶ The method to calculate the global exposure
- ▶ Expected level of leverage as well as possibility of higher leverage levels, where relevant
- ▶ Information on reference portfolio for UCITS using a relative VaR approach

Additional risk-related prospectus disclosures are required, *inter alia*, for:

- ▶ Structured UCITS where the commitment approach is used for the calculation of global exposure
- ▶ UCITS using efficient portfolio management (EPM) techniques
- ▶ UCITS entering into total return swaps (TRS) or similar derivative instruments
- ▶ Management of collateral
- ▶ Index-tracking UCITS

For further information, see Section 10.3.1.

Annual report disclosures are required on:

- The method to calculate the global exposure
- Information on reference portfolio for UCITS using a relative VaR approach
- Information on the VaR limit – the lowest, highest and average levels
- The leverage level during the last financial year for UCITS using the VaR to determine the global exposure

Good practice would also be to disclose such information in the semi-annual report.

For further information, see Section 10.5.1.

## 7.3. Risk management for AIFs

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### 7.3.1. Introduction

In this section, reference to AIFMs refers both to alternative investment fund managers and internally managed AIFs.

AIFMs must implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed.

2010 Law Part II UCIs, ELTIFs and RAIFs automatically qualify as AIFs. SIFs, EuVECAs and EuSEFs may qualify as AIFs.

Risk management systems comprise relevant elements of the organizational structure of the AIFM, with a central role for a permanent risk management function, policies and procedures related to the management of risk relevant to each AIF's investment strategy and arrangements, processes and techniques related to risk measurement and management employed by the AIFM in relation to each AIF it manages.

AIFMs must review their risk management systems and update them whenever necessary:

- With appropriate frequency and at least once a year
- Where material changes are made to risk management policies, internal or external events indicate that a review is required or material changes are made to the investment strategy and objectives of the AIF

AIFMs must, for each managed AIF that is not an unleveraged closed-ended AIF, employ an appropriate liquidity management system and adopt procedures that enable them to monitor the liquidity risk of the AIF and ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations.

### 7.3.2. Key regulations

The risk and liquidity management requirements applicable to AIFM are laid down in the AIFM Law and the AIFM Level 2 implementing regulation.

In addition, CSSF Circular 18/698 of 23 August 2018 on the *authorization of investment fund managers incorporated under Luxembourg law - specific provisions on the fight against money laundering and terrorist financing applicable to investment fund managers and entities carrying out the activity of registrar agent* also sets out some additional requirements in relation to the governance and implementation of the risk management function.

In May 2014, ALFI published a document entitled *Risk Management under AIFMD*. The document outlines general principles on and illustrates the risk management function under AIFMD.

This guidance covers, *inter alia*:

- An overview of risk management areas addressed by AIFMD
- High level principles when implementing a risk management function:
  - Governance and organization of risk management
    - Risk management models
    - Risk management policy, procedures and process
  - Identification of risks
  - Measurement and management of risks
  - Reporting of risks and related information
    - To the senior management or the board
    - To the competent authorities
    - To investors

As each AIFM should tailor its risk management systems to its own structure and AIFs and taking into account the principle of proportionality where relevant, the document does not provide detailed rules on risk management under AIFMD.

In addition to the guidelines, ALFI also published the first edition of the Q&A document *Risk Management for AIF under AIFMD* in April 2014. The document covers, *inter alia*:

- Leverage:
  - The difference between the “sum of notional” approach for UCITS and the “gross” and commitment approaches under AIFMD
  - The meaning of “cash and cash equivalents”
- Risk governance and risk processes:
  - Comparison of UCITS and AIFMD risk limits
  - Reliance on data from private sources
  - Role and responsibilities of the conducting officer and of the permanent risk management function

### 7.3.3. Risk profile and risk limits

An AIFM's governing body is required to approve the risk profile of the AIF it manages. The AIFM must ensure that the risk profile of the AIF corresponds to the size, portfolio structure and investment strategies and objectives of the AIF as laid down in the constitutional document, prospectus and offering documents. The AIFM is required to periodically disclose to investors the current risk profile of the AIF and the risk management systems employed to manage those risks.

The AIFM is required to establish and implement quantitative or qualitative risk limits, or both, for each AIF it manages, taking into account all relevant risks. The qualitative and quantitative risk limits for each AIF must, at least, cover:

- Market risks
- Credit risks
- Liquidity risks
- Counterparty risks
- Operational risks

The risk management function is required to ensure that the risk profile of the AIF disclosed to investors is consistent with the risk limits. Senior management must approve and review on a periodic basis the risk limit system for each AIF.

AIFMs must implement appropriate procedures on remedial action to be taken, in the best interests of shareholders or unitholders, in case of breaches or foreseeable breaches of the limits (see also Section 8.9.3.).

### 7.3.4. Risk management policy

An AIFM is required to establish, implement and maintain an adequate and documented risk management policy that identifies all the relevant risks to which the AIFs it manages are or may be exposed.

The risk management policy must comprise the procedures necessary to enable the AIFM to assess for each AIF it manages the exposure of that AIF to market, liquidity and counterparty risks and the exposure of the AIF to all other relevant risks, including operational risks, that may be material for each AIF it manages.

The risk management policy must cover:

- ▶ The techniques, tools and arrangements that enable it to comply with its obligations regarding the measurement and management of risk
- ▶ The techniques, tools and arrangements that enable liquidity risk of the AIF to be assessed and monitored under normal and exceptional liquidity conditions including through the use of regularly conducted stress tests
- ▶ The allocation of responsibilities within the AIFM pertaining to risk management
- ▶ The risk limits set and a justification of how these are aligned with the risk profile of the AIF disclosed to investors
- ▶ The terms, contents, frequency and addressees of reporting by the permanent risk management function to the governing body and senior management

The risk management policy must include a description of the safeguards against conflicts of interest to allow for the independent performance of the risk management activities (see Section 7.3.5.).

The risk management policy must be appropriate to the nature, scale and complexity of the business of the AIFM and of the AIFs it manages.

Senior management must approve and review on a periodic basis the risk management policy and arrangements, processes and techniques for implementing that policy.

AIFMs must assess, monitor and periodically, at least once a year, review:

- ▶ The adequacy and effectiveness of the risk management policy and of the arrangements, processes and techniques implemented for the measurement and management of risk
- ▶ The degree of compliance by the AIFM with the risk management policy and with arrangements, processes and techniques for the measurement and management of risk
- ▶ The adequacy and effectiveness of measures taken to address any deficiencies in the performance of the risk management process

### 7.3.5. Risk management function

An AIFM must establish and maintain a permanent risk management function.

The permanent risk management function is responsible for:

- ▶ Implementing effective risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks relevant to each AIF's investment strategy to which each AIF is or may be exposed
- ▶ Participating in the identification, development and monitoring of risk profiles of the AIFs
- ▶ Ensuring that the risk profile of the AIF disclosed to investors is consistent with the risk limits
- ▶ Monitoring compliance with the risk limits and notifying the AIFM's governing body and, where it exists, the AIFM's supervisory function in a timely manner when it considers the AIF's risk profile inconsistent with these limits or sees a material risk that the risk profile will become inconsistent with these limits
- ▶ Providing regular updates to the governing body of the AIFM and, where it exists, the AIFM's supervisory function at a frequency that is in accordance with the nature, scale and complexity of the AIF or the AIFM's activities on:
  - ▶ The consistency between and compliance with the risk limits and the risk profile of the AIF as disclosed to investors
  - ▶ The adequacy and effectiveness of the risk management process, indicating, in particular, whether appropriate remedial measures have been or will be taken in the event of any actual or anticipated deficiencies
- ▶ Providing regular updates to senior management outlining the current level of risk incurred by each managed AIF and any actual or foreseeable breaches of any risk limits set to ensure that prompt and appropriate action can be taken
- ▶ Assessing and, where appropriate, contributing to the effectiveness of asset valuation systems and procedures

The main mission of the permanent risk management function is therefore to identify, measure and manage the risks of UCIs and to report to the management body/governing body and to the senior management of the AIFM. These written reports must include analyses which allow the addressees to verify the consistency between:

- ▶ The risk levels and the risk profile of each AIF
- ▶ The risk levels and the limits set for each AIF
- ▶ The risk profile and the limits set for each AIF

and to ensure that no new risk arises.

The reports must also include the measures to address identified deficiencies and to report on the effectiveness of the measures taken to this end.

The risk management function must have the necessary authority and access to all relevant information necessary to fulfill its tasks.

In general, all interventions of the permanent risk management function must be documented.

Every AIFM must, in principle, designate a person among its staff who is responsible for the permanent risk management function and who possesses the necessary skills, knowledge and expertise in the area. This person must perform his/her function under the direct responsibility of the conducting officer in charge of the risk management function.

The AIFM must communicate beforehand to the CSSF the name of the person responsible for the permanent risk management function supplemented by the following pieces of information and any other document which might be subsequently indicated by the CSSF:

- A recent *curriculum vitae*, signed and dated
- A copy of the passport/identity card
- A declaration of honor, as may be downloaded on the CSSF website ([www.cssf.lu](http://www.cssf.lu))
- A recent extract of the criminal record, if available, or any other equivalent document

In the event of a change of the person responsible for the permanent risk management function, the AIFM must communicate beforehand to the CSSF the name of the person succeeding him/her in office supplemented by the documents required (see above).

The tasks of the person responsible for the permanent risk management function cannot be exercised directly by a member of the management body/governing body of the management company, unless he is part of its senior management.

The conducting officer in charge of the permanent risk management function or directly responsible for the permanent risk management function may not, at the same time, be the conducting officer responsible for investment management, even if this function is delegated to a third party. Furthermore, the conducting officer in charge of the permanent risk management function may not be in charge of the internal audit function.

The person responsible for the permanent risk management function cannot at the same time be responsible for the internal audit function. By contrast, it is permissible to combine the responsibilities for the compliance and the risk management functions.

AIFMs must functionally and hierarchically separate the functions of risk management from the operating units, including from the functions of portfolio management. However, the CSSF may allow AIFMs to derogate from this obligation in accordance with the principle of proportionality. The AIFM must, in any case, be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities and that the risk management process satisfies the requirements of the AIFM and is consistently effective.

The functional and hierarchical separation of the risk management function must be ensured throughout the whole hierarchical structure of the AIFM, up to its governing body and must be reviewed by the governing body and, where it exists, the supervisory function of the AIFM.

The risk management function is considered as functionally and hierarchically separated from the operating units, including the portfolio management function, when all the following conditions are satisfied:

- Persons engaged in the performance of the risk management function are not supervised by those responsible for the performance of the operating units, including the portfolio management function, of the AIFM
- Persons engaged in the performance of the risk management function are not engaged in the performance of activities within the operating units, including the portfolio management function
- Persons engaged in the performance of the risk management function are compensated in accordance with the achievement of the objectives linked to that function, independently of the performance of the operating units, including the portfolio management function
- The remuneration of senior officers in the risk management function is directly overseen by the remuneration committee, where such a committee has been established (see also Section 6.4.3.)

The risk management policy must include a description of the safeguards against conflicts of interest to allow for the independent performance of the risk management activities, in particular:

- The nature of the potential conflicts of interest
- The remedial measures put in place
- The reasons why these measures should be reasonably expected to result in independent performance of the risk management function
- How the AIFM expects to ensure that the safeguards are consistently effective



The safeguards against conflicts of interest must ensure, at least, that:

- ▶ Decisions taken by the risk management function are based on reliable data that are subject to an appropriate degree of control by the risk management function
- ▶ The remuneration of those engaged in the performance of the risk management function reflects the achievement of the objectives linked to the risk management function, independently of the performance of the business areas in which they are engaged
- ▶ The risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently
- ▶ The risk management function is represented in the governing body or the supervisory function, where it has been established, at least with the same authority as the portfolio management function
- ▶ Any conflicting duties are properly segregated
- ▶ Where proportionate, taking into account the nature, scale and complexity of the AIFM:
  - ▶ The performance of the risk management function is reviewed regularly by the internal audit function or, if the latter has not been established, by an external party appointed by the governing body
  - ▶ Where a risk committee has been established, it is appropriately resourced and its non-independent members do not have undue influence over the performance of the risk management function

AIFMs must assess, monitor and periodically review:

- ▶ The performance of the risk management function
- ▶ The adequacy and effectiveness of measures aiming to ensure the functional and hierarchical separation of the risk management function

### 7.3.6. Risk measurement and management

AIFMs are required to implement adequate and effective arrangements, processes and techniques in order to identify, measure, manage and monitor at any time the risks to which the AIFs under their management are or might be exposed and in order to comply with the risk limits. This implies at least:

- ▶ Putting in place such risk measurement arrangements, processes and techniques necessary to ensure that the risks of positions taken and their contribution to the overall risk profile are accurately measured on the basis of sound and reliable data, on an ongoing basis and that the risk measurement arrangements, processes and techniques are adequately documented
- ▶ Conducting periodic backtests in order to review the validity of risk measurement arrangements which include model-based forecasts and estimates
- ▶ Conducting appropriate periodic stress tests and scenario analyses to address risks arising from potential changes in market conditions that might adversely impact the AIF
- ▶ Ensuring that the current level of risk complies with the risk limits
- ▶ Establishing, implementing and maintaining adequate procedures that, in the event of actual or anticipated breaches of the risk limits of the AIFs, result in timely remedial actions in the best interest of investors
- ▶ Ensuring that there are appropriate liquidity management systems and procedures for each AIF

The arrangements, processes and techniques must be proportionate to the nature, scale and complexity of the business of the AIFM and of each AIF it manages and consistent with the AIF's risk profile as disclosed to investors.

Where FDIs are used and benefit only specific share classes (e.g., hedging, leverage), consideration should be given to calculate global risk exposure (market risk) and leverage at share class level, although there are no specific requirements on calculations at share class level.

#### A. Leverage

Leverage is defined as any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means. Leverage of an AIF is expressed as the ratio between the exposure of an AIF and its NAV.

The AIFM is required to set a maximum level of leverage that the AIFM may employ on behalf of each AIF it manages as well as the extent of the right of the reuse of collateral or guarantee that could be granted under the leveraging arrangement.

The AIFM must demonstrate that the leverage limits for each AIF it manages are reasonable and that it complies at all times with the leverage limits set by it. The competent authority of the AIFM may impose limits on the use of leverage for systemic risk mitigation purposes.

ESMA clarified that an AIFM should calculate the leverage of each AIF that it manages as often as is required to ensure that the AIF is capable of remaining in compliance with leverage limits at all times. Consequently, leverage should be calculated at least as often as the NAV is calculated, or more frequently if required. Circumstances which may lead to increased frequency of leverage calculation include material market movements, changes to portfolio composition and any other factors the AIFM believes require calculation of leverage more frequently than the NAV calculation in order for the AIF to remain in compliance with leverage limits at all times.

Leverage is considered to be employed on a substantial basis when the exposure of an AIF as calculated according to the commitment method exceeds three times its NAV.

AIFMs that employ leverage on a substantial basis are required to provide additional reporting to their competent authorities (see Section 6.5.1.B.). AIFMs are required to calculate the exposure of the AIF managed in accordance with both the gross method and the commitment method.

(a) General rules

An AIFM must have appropriately documented procedures to calculate the exposure of each AIF under its management in accordance with the gross method and the commitment method. The calculation must be applied consistently over time.

The following general rules apply when calculating leverage:

- ▶ Private equity: For AIFs whose core investment policy is to acquire control of non-listed companies or issuers, the AIFM should not include in the calculation of the leverage any exposure that exists at the level of those non-listed companies and issuers provided that the AIF or the AIFM acting on behalf of the AIF does not have to bear potential losses beyond its investment in the respective company or issuer
- ▶ Certain holding structures set up to increase the leverage of the AIF: Exposure contained in any financial or legal structures involving third parties controlled by the relevant AIF must be included in the calculation of the exposure where the structures referred to are specifically set up to directly or indirectly increase the exposure at the level of the AIF. For example, some real estate AIFs may have to include certain holding structures in their leverage calculations
- ▶ Temporary borrowing: AIFMs should exclude temporary borrowing arrangements if these are fully covered by contractual capital commitments from investors in the AIF

(b) Gross method for calculating the exposure of an AIF

The exposure of an AIF calculated in accordance with the gross method is the sum of the absolute values of all positions. The value of positions should be calculated in accordance with the AIFM Law valuation requirements (see Section 7.6.2.).

To calculate the exposure of an AIF according to the gross method, an AIFM must:

- ▶ Exclude the value of any cash and cash equivalents, which are highly liquid investments held in the base currency of the AIF
- ▶ Convert derivative instruments into the equivalent position in their underlying assets
- ▶ Exclude cash borrowings that remain in cash or cash equivalents
- ▶ Include exposure resulting from the reinvestment of cash borrowings
- ▶ Include positions within repurchase or reverse repurchase agreements and securities lending or borrowing or other arrangements

The AIFM Level 2 measures outline methods of increasing exposure of an AIF for:

- ▶ Derivative instruments: interest rate swaps, contracts for differences, futures contracts, total return swaps, forward contracts, options and credit default swaps
- ▶ Arrangements: convertible borrowings, repurchase agreements, reverse repurchase agreements, securities lending arrangements and securities borrowing arrangements

The Level 2 measures lay down calculation methodologies to be adopted for the most common financial derivative instruments:

- ▶ Futures contracts
- ▶ Plain vanilla options (bought/sold puts and calls)
- ▶ Swaps
- ▶ Forward contracts
- ▶ Financial instruments that embed derivatives

Non-standard (exotic) derivatives calculation methodologies are detailed for variance swaps, volatility swaps and barrier (knock-in knock-out) options.

(c) Commitment method for calculating the exposure of an AIF

The exposure of an AIF calculated in accordance with the commitment method shall be the sum of the absolute values of all positions, after taking into account netting and hedging.

The value of positions should be calculated in accordance with the AIFM Law valuation requirements (see Section 7.6.2.).

To calculate the exposure of an AIF according to the commitment method, an AIFM must:

- ▶ Convert each derivative instrument position into an equivalent position in the underlying asset of that derivative, in accordance with the same methodologies and methods as those applied under the gross method (see Section 7.3.6.A.(b))
- ▶ Apply netting and hedging arrangements
- ▶ Calculate the exposure created through the reinvestment of borrowings where such reinvestment increases the exposure of the AIF
- ▶ Include positions within repurchase or reverse repurchase agreements and securities lending or borrowing or other arrangements (see Section 7.3.6.A.(a))

The AIFM Level 2 measures set out rules to be applied in relation to:

- ▶ Netting arrangements
- ▶ Hedging arrangements
- ▶ Instruments that should not be converted into an equivalent position in the underlying asset: swaps meeting certain criteria and derivatives equivalent to long positions
- ▶ Exclusion of derivative instruments used for currency hedging purposes meeting certain criteria

ALFI's Q&A document on *Risk Management for AIF under AIFMD* of 29 April 2014 provides further clarification on the difference between the gross approach and the commitment approach under AIFMD. The main difference stems from the inclusion in the leverage calculation under the commitment method and exclusion under the gross method, of "cash and cash equivalents" in the fund currency.

"Cash and cash equivalents" are also explicitly defined in this Q&A document as being highly liquid, held in the AIF's base currency, readily convertible to a known amount of cash, subject to insignificant risk of change in value and provide a return no greater than a three-month high quality (investment grade) government bond (in the base currency of the AIF).

AIFMs managing AIFs that, in accordance with their core investment policy, primarily invest in interest rate derivatives are required to make use of the specific duration netting rules in order to take into account the correlation between the maturity segments of the interest rate curve.

On 23 June 2021, ESMA published translations of the *Guidelines on Art. 25 of Directive 2011/61/EU*, i.e., the AIFMD.

These Guidelines aim to provide NCAs enhanced supervisory tools to assess the extent to which the use of leverage within the AIF sector contributes to the build-up of systemic risk in the financial system and impose macroprudential leverage limits on AIFs where and when needed to prevent that leverage might contribute to procyclicality, especially in times of economic cycle-downturn or increase in market volatility.

The Guidelines provide, *inter alia*:

- ▶ Which risks should be considered by NCAs when deciding to impose leverage limits
- ▶ How the leverage limits should be implemented both in terms of timing and phasing in and out
- ▶ How NCAs should assess their effectiveness in addressing systemic risks
- ▶ Which criteria NCAs should consider in evaluating the efficiency of leverage limits

The Guidelines have been applicable since 23 August 2021.

## B. Operational risk

AIFMs are required to implement effective internal operational risk management policies and procedures in order to identify, measure, manage and monitor appropriately operational risks including professional liability risks to which the AIFM is or could be reasonably exposed. It should implement effective measures for the treatment of non-compliance with these policies and for taking corrective action.

Professional liability risks include, *inter alia*, risks of:

- ▶ Loss of documents evidencing title to assets of the AIF
- ▶ Misrepresentations or misleading statements made to the AIF or its investors

- ▶ Acts, errors or omissions resulting in a breach of:
  - ▶ Legal and regulatory obligations
  - ▶ Duty of skill and care towards the AIF and its investors
  - ▶ Fiduciary duties
  - ▶ Obligations of confidentiality
  - ▶ AIF rules or instruments of incorporation
  - ▶ Terms of appointment of the AIFM by the AIF
- ▶ Failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts
- ▶ Improperly carried out valuation of assets or calculation of share or unit prices
- ▶ Losses arising from business disruption, system failures, failure of transaction processing or process management

Operational risk management must be performed independently as part of the risk management policy.

Operational risk exposures and loss experience must be monitored on an ongoing basis and must be subject to regular internal reporting. The AIFM must set up a historical loss database, in which any operational failures, loss and damage experience must be recorded. This database must record, *inter alia*, any professional liability risks that have materialized. The AIFM should make use of its internal historical loss data and, where appropriate, external data, scenario analysis and factors reflecting the business environment and internal control systems.

See also Section 6.2.3.2.D.

ALFI's guidelines of June 2016 on *Considerations for the Management of Operational Risks Associated with the Distribution of Funds* provide board members and senior management with areas that they may wish to consider when looking at the management of operational risks associated with the marketing/distribution of funds and cover:

- ▶ Key sources of legal and regulatory guidance in relation to risk management
- ▶ A potential approach to (i) the identification of relevant operational risks associated with distribution/marketing to which funds or their management companies may be exposed, (ii) the measurement and management of these identified operational risks and (iii) the reporting with regard to these risks and related information provided to senior management and the board by the risk management function

### C. Liquidity risk

AIFMs must, for each managed AIF that is not an unleveraged closed-ended AIF, employ an appropriate liquidity management system and adopt procedures that enable them to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations.

AIFMs must ensure that, for each AIF that they manage, the investment strategy, the liquidity profile and the redemption policy are consistent, i.e., when investors have the ability to redeem their investments in a manner consistent with the fair treatment of all AIF investors and in accordance with the AIF's redemption policy and its obligations.

The liquidity management system and procedures must at least ensure that:

- ▶ The AIFM maintains a level of liquidity in the AIF appropriate to its underlying obligations
- ▶ The AIFM monitors the liquidity profile of the AIF's portfolio of assets and the material liabilities and commitments, contingent or otherwise, that the AIF may have in relation to its underlying obligations. For these purposes, the AIFM shall take into account the profile of the investor base of the AIF, including the type of investors, the relative size of investments and the redemption terms to which these investments are subject
- ▶ Where the AIF invests in other UCIs, the AIFM monitors the liquidity management approach adopted by the managers of those other UCIs
- ▶ The AIFM implements and maintains appropriate liquidity measurement arrangements and procedures to assess the quantitative and qualitative risks of positions and of intended investments that have a material impact on the liquidity profile of the portfolio of the AIF's assets to enable their effects on the overall liquidity profile to be appropriately measured
- ▶ The AIFM considers and puts into effect the tools and arrangements, including special arrangements (e.g., side pockets, gates), necessary to manage the liquidity risk of each AIF under its management

AIFMs must include appropriate escalation measures in their liquidity management system and procedures to address anticipated or actual liquidity shortages or other distressed situations of the AIF.

Where appropriate, considering the nature, scale and complexity of each AIF they manage, AIFMs must implement and maintain adequate limits for the liquidity or illiquidity of the AIF consistent with its underlying obligations and redemption policy and in accordance with the quantitative and qualitative risk limits. AIFMs should monitor compliance with those limits and, where limits are exceeded or likely to be exceeded, determine the required (or necessary) course of action.

AIFMs are required to regularly conduct stress tests, at least annually, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of each AIF under their management. The stress tests must:

- ▶ Where appropriate, simulate a shortage of liquidity of the assets in the AIF and atypical redemption requests
- ▶ Cover market risks and any resulting impact, including on margin calls, collateral requirements or credit lines
- ▶ Account for valuation sensitivities under stressed conditions

ALFI issued *Liquidity Stress Testing Considerations for Real Estate Funds* in May 2018 which are aimed at supporting the practical implementation of stress testing arrangement for real estate investment funds.

In February 2018, IOSCO issued *Recommendations for Liquidity Risk Management for Collective Investment Schemes* (FRO1/2018). These recommendations complete the report issued in 2013 relating to the principles of Liquidity Risk Management for Collective Investment Schemes. Further details can be found in Section 7.2.6.4.

#### D. Securitization

Risk management requirements in relation to investments in securitization positions are covered in Section 4.5.

#### E. Reliance on external credit rating

*Directive 2013/14/EU on over-reliance on credit ratings*, as amended, sets out a general principle against the over-reliance on credit ratings that should be integrated into the risk management processes and systems of AIFM.

An AIFM must not solely or mechanically rely on external credit ratings issued by credit rating agencies for assessing the creditworthiness of the AIF's assets.

Taking into account the nature, scale and complexity of the AIF's activities, the NCA (i.e., CSSF) is required to monitor the adequacy of the credit assessment processes of the AIFM, assess the use of references to external credit ratings and, where appropriate, encourage mitigation of the impact of such references, with a view to reducing sole and mechanistic reliance on such external credit ratings.

ESMA publishes a list of registered and certified credit rating agencies.

According to ALFI's Q&A document on *Risk Management for AIF under AIFMD*, data from external sources should be subject to qualitative checks. The risk data interpretation and management task should be performed by the risk management function of the AIFM.

### 7.3.7. Delegation of risk management activities

Delegation of the risk management function is subject to the general provisions on delegation. For example: the delegation arrangement must take the form of a written agreement between the delegate and the AIFM. The general provisions on delegation are covered in Section 6.3.3.

The AIFM is not permitted to delegate the performance of investment management functions (portfolio management and risk management) to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself. When assessing the extent of delegation, the CSSF is required to assess the entire delegation structure taking into account not only the assets managed under delegation but also the qualitative criteria. These are outlined in Section 6.3.3.

As well as the general provisions on delegation, specific provisions apply to the delegation of investment management functions, including risk management.

### 7.3.8. Communication to the CSSF

The CSSF requires AIFMs to provide certain information in relation to the risk management policy in order to identify, measure, manage, control and report on the risks that may be material for the AIFs they manage.

CSSF Circular 18/698, in its Appendix I, lays down the required content and format of the risk management process document (RMP):

1. General section: Governance and risk management function organization
  - 1.1 Organization chart
  - 1.2 Governance structure
  - 1.3 Independence of the risk management function
  - 1.4 Risk management policy
  - 1.5 Permanent risk management function
  - 1.6 Adequacy and review of the risk management policy
  - 1.7 Risk reporting
  - 1.8 IT tools and systems
  - 1.9 Delegation
  - 1.10 New products approval process
  - 1.11 Interaction with compliance and internal audit
2. Specific complementary section to be created for each type of investment strategy of the AIFs as defined in Annex IV of Delegated Regulation (EU) 231/2013, as amended, (“Hedge Fund Strategy”, “Private Equity Strategy”, “Real Estate Strategy”, “Fund of Fund Strategy” and “Other Strategy”) (for Risk management policy in respect of strategies)
  - 2.1 Name of Strategy
  - 2.2 Description of the strategy and instruments used
  - 2.3 Description of the investment process and name of players involved
  - 2.4 Where appropriate, description of the elements regarding risk management differing from general section
  - 2.5 Market risk management policy
  - 2.6 Liquidity risk management policy
  - 2.7 Counterparty risk management policy
  - 2.8 Credit risk management policy
  - 2.9 Operational risk management policy
  - 2.10 Valuation policy of assets
  - 2.11 Policy on use of leverage
  - 2.12 List of AIFs covered by the complementary section
3. Specific complementary section on discretionary management

The IFM must briefly describe the manner in which it provides discretionary management services and services on an individual basis, in the framework of a mandate given by investors, complies with the risk management requirements under the MiFID II Regulation.

The RMP must be included in the application for authorization for an AIFM.

It must be updated at least on a yearly basis and it must be submitted to the CSSF within five months of the closing date of the AIFM’s financial year.

In case of any material modification to the risk management policy, the RMP must be updated promptly and communicated to the CSSF.

Before launching a new UCI, the AIFM must particularly ensure that the risk management policy and thus the RMP is adequate.

The risk profiles of AIFs must be communicated in the application for authorization of the AIFM.

The documentation of the risk profile and that of the analysis of the consistency with the set limits and identified risk levels must be immediately available upon the CSSF’s request.

AIFMs are required to report to the CSSF information on the current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, credit risk, liquidity risk, counterparty risk and other risks including operational risk (see Section 6.5.1.B.).

A copy of the report regularly established by the risk management function for the senior management and governing body relating to the adequacy and effectiveness of the method for risk management must be included with the RMP transmitted to the CSSF.

AIFMs managing one or more AIFs employing leverage on a “substantial basis” (i.e., exceeding three times the NAV) must make available to the CSSF information about the overall level of leverage employed by each AIF it manages, a breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, the five largest sources of borrowed cash or securities and the extent to which their assets have been reused under leveraging arrangements (see Section 6.5.1.B.).

## 7.3.9. Disclosures to investors

AIFMs are required to disclose to investors, before they invest, a description of the AIF's liquidity risk management, including the redemption rights both in normal and in exceptional circumstances and the existing redemption arrangements with investors (see also Section 10.3.3.).

AIFMs are required to periodically disclose to investors:

- The percentage of the AIF's assets that are subject to special arrangements arising from their illiquid nature and information on the arrangements
- Any new liquidity management arrangements, systems and procedures
- The current risk profile of the AIF
- The main features of the risk management systems employed by the AIFM

See Section 10.4.2.

AIFMs must disclose information on leverage to investors before they invest in an AIF (see Section 10.3.3.). AIFMs managing leveraged AIFs are also required to disclose information on leverage to investors on a regular basis (see Section 10.4.2.3.).

## 7.4. Risk management of SIFs

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### 7.4.1. Introduction

SIFs are required to implement risk management systems to identify, measure, manage and monitor appropriately the risks associated with the investment positions and their contribution to the overall risk profile of the portfolio. The directors<sup>11</sup> of the SIF or its management company must adopt the risk management system of the SIF and, subsequently, have it reviewed and documented on a regular basis.

SIFs qualifying as AIFs will also have to comply with the risk management provision of the AIFM Law.

### 7.4.2. Key regulations

The risk management requirements applicable to SIFs are outlined in the SIF Law and *CSSF Regulation No 15-07 laying down detailed rules for the application of Article 42a of the Law of 13 February 2007 relating to specialised investment funds as regards the requirements in relation to risk management and conflicts of interest for specialized investment funds which are not referred to in the specific provisions of Part II of that law.*

ALFI issued *Recommendations on the Risk Management System for Specialised Investment Funds* in June 2012. They cover:

- The risk management function and implementation of appropriate risk management systems:
  - Responsibility for the maintenance of the risk management system
  - Interpretation of results
  - Ownership of the function within the decision making bodies
  - Independence of the function
- Risk identification, measurement and monitoring:
  - Determining the material risks to which the SIF is or may be exposed
  - Determining the method to measure the risks identified
  - Approach to qualitative and quantitative risk limits and the monitoring frequency
  - Determining the process for reporting and escalation of breaches

<sup>11</sup> "Directors" means, in the case of public limited companies and in the case of cooperatives in the form of a public limited company, the members of the board of directors; in the case of partnerships limited by shares, the general partner; in the case of private limited liability companies, the manager(s); and in the case of common funds, the members of the board of directors or the managers of the management company.

### 7.4.3. Risk management function

SIFs are required to establish and maintain a risk management function.

The role of the risk management function includes:

- ▶ Implementing and maintaining an appropriate and documented risk management policy that allows adequate detection, measurement, management and monitoring of exposure to market, liquidity and counterparty risks, as well as of exposure to all other risks, including operational risk, that may be significant in the context of the activities of the SIF (or compartments thereof)
- ▶ Ensuring compliance with the risk limit system of the SIF

SIFs are required to take into account the nature, scale and complexity of their activities, as well as their structure.

The risk management function must have the necessary authority and access to all relevant information that is necessary for the performance of its tasks.

The risk management function should be hierarchically and functionally independent from operating units. However, the CSSF may allow a SIF to derogate from this obligation of independence where this derogation is appropriate and proportionate in view of the nature, scale and complexity of the activities and the structure of the SIF.

A SIF must be able to demonstrate that appropriate safeguards against conflicts of interests have been adopted to allow the independent performance of risk management activities and that its risk management system fulfills the SIF Law.

### 7.4.4. Delegation of risk management activities

SIFs are permitted to delegate all or part of the activities of the risk management function to third parties, provided that the third party has the necessary competence and capacity to exercise the activities of the risk management function in a reliable, professional and efficient manner and in accordance with the applicable legal and regulatory requirements.

The delegation does not impact the liability of the directors of the SIF or its management company in relation to the adequacy and efficiency of the risk management system and the monitoring of risks linked to the activities of the SIF.

### 7.4.5. Communication to the CSSF

SIFs must provide a description of the risk management system to the CSSF as part of their application for authorization.

This description must cover, *inter alia*:

- ▶ The risk management function (including the allocation of responsibilities), its independence or the specific protection measures implemented to avoid conflicts of interest and, ultimately, to allow independent execution of the risk management activities or procedures
- ▶ Processes and methods to appropriately measure and manage the risks arising from the investment strategies and the risk profile of the SIF (or compartments thereof)

Any subsequent major change to their risk management system must be notified to the CSSF.

See also Sections 3.3. and 3.4.

## 7.5. Risk management of MMFs

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### 7.5.1. Introduction

On 30 June 2017, the final text of Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on *money market funds* was published in the Official Journal of the European Union. The Regulation, as amended, applies to UCIs and compartments that qualify as MMFs as per the definition set out in Article 1 of the Regulation.

This Regulation has been amended and supplemented by the Commission Delegated Regulation (EU) 2018/990 of 10 April 2018 *with regard to simple, transparent and standardized (STS) securitizations and asset-backed commercial papers (ABCPs) and requirements for assets received as part of reverse repurchase agreements and credit quality assessment methodologies*.

On 21 March 2018, ESMA published its *Guidelines on stress test scenarios under Article 28 of the MMF Regulation*, in which they established common reference parameters of the scenarios to be included in the stress tests, taking into account the factors specified in Article 28(1) of the MMF Regulation. These Guidelines apply to NCAs and to MMFs and their managers. These guidelines were last updated in May 2022.



With regard to risk management, in addition to the rules applicable to the portfolios of MMFs (see Section 4.8.), the key provisions of the Regulation include the following:

- An internal credit quality assessment procedure
- Stress testing
- “Know your customer” policy

## 7.5.2. Internal credit quality assessment

The manager of an MMF must establish, implement and consistently apply a prudent internal credit quality assessment procedure for determining the credit quality of money market instruments (MMIs), securitizations and asset-backed commercial papers (ABCPs), taking into account the issuer of the instrument and the characteristics of the instrument itself and whether this credit quality receives a favorable assessment.

The manager must also ensure that the information used in applying the internal credit quality assessment procedure is of sufficient quality, up-to-date and from reliable sources.

The internal assessment procedure must be based on prudent, systematic and continuous assessment methodologies. The methodologies used must be subject to validation by the manager of an MMF based on historical experience and empirical evidence, including backtesting.

The manager of an MMF must ensure that the internal credit quality assessment procedure complies with all of the following general principles:

- a) An effective process must be established to obtain and update relevant information on the issuer and the instrument's characteristics
- b) Adequate measures must be adopted and implemented to ensure that the internal credit quality assessment is based on a thorough analysis of the information that is available and pertinent and includes all relevant driving factors that influence the creditworthiness of the issuer and the credit quality of the instrument
- c) The internal credit quality assessment procedure must be monitored on an ongoing basis and all credit quality assessments must be reviewed at least annually
- d) While there must not be mechanistic over-reliance on external ratings, the manager of an MMF must undertake a new credit quality assessment for an MMI, securitizations and ABCPs when there is a material change that could have an impact on the existing assessment of the instrument
- e) The credit quality assessment methodologies must be reviewed at least annually by the manager of an MMF to determine whether they remain appropriate for the current portfolio and external conditions and the review must be transmitted to the competent authority of the manager of the MMF. Where the manager of the MMF becomes aware of errors in the credit quality assessment methodology or in its application, it must immediately correct those errors
- f) When methodologies, models or key assumptions used in the internal credit quality assessment procedure are changed, the manager of an MMF must review all affected internal credit quality assessments as soon as possible

The credit quality assessment must take into account at least the following factors and general principles:

- a) The quantification of the credit risk of the issuer and of the relative risk of default of the issuer and of the instrument
- b) Qualitative indicators on the issuer of the instrument, including in the light of the macroeconomic and financial market situation
- c) The short-term nature of MMIs
- d) The asset class of the instrument
- e) The type of issuer distinguishing at least the following types of issuers: national, regional or local administrations, financial corporations and non-financial corporations
- f) For structured financial instruments, the operational and counterparty risk inherent within the structured financial transaction and, in case of exposure to securitizations, the credit risk of the issuer, the structure of the securitization and the credit risk of the underlying assets
- g) The liquidity profile of the instrument

The internal credit quality assessment procedure and credit quality assessments must be adequately documented.

The documentation must include all of the following:

- a) The design and operational details of its internal credit quality assessment procedure in a manner that allows competent authorities to understand and evaluate the appropriateness of a credit quality assessment
- b) The rationale for and the analysis supporting the credit quality assessment, as well as the manager of the MMF's choice of criteria for and the frequency of, the review of the credit quality assessment
- c) All major changes to the internal credit quality assessment procedure, including identification of the triggers of such changes
- d) The organization of the internal credit quality assessment procedure and the internal control structure
- e) Complete internal credit quality assessment histories on instruments, issuers and, where relevant, recognized guarantors
- f) The person or persons responsible for the internal credit quality assessment procedure

The manager of an MMF must keep all the documentation for at least three complete annual accounting periods.

All documents must be made available upon request to the competent authorities of the MMF and to the competent authorities of the manager of the MMF.

The internal credit quality assessment procedure must be detailed in the fund rules or rules of incorporation of the MMF.

The internal credit quality assessment procedure must be approved by the senior management, the governing body and, where it exists, the supervisory function of the manager of an MMF. Those parties must have a good understanding of the internal credit quality assessment procedure and the methodologies applied by the manager of an MMF, as well as a detailed comprehension of the associated reports.

The manager of an MMF must report to the management of the MMF on the MMF's credit risk profile, based on an analysis of the MMF's internal credit quality assessments. Reporting frequencies depend on the significance and type of information and must be at least annual.

Senior management must ensure, on an ongoing basis, that the internal credit quality assessment procedure is operating properly. Senior management must be regularly informed about the performance of the internal credit quality assessment procedures, the areas where deficiencies were identified and the status of efforts and actions taken to improve previously identified deficiencies.

Internal credit quality assessments and their periodic reviews by the manager of an MMF must not be performed by the persons performing or responsible for the portfolio management of an MMF.

The EC adopted a delegated act in April 2018 (2018/990) in order to supplement the Regulation by, *inter alia*, specifying the following points relating to risk management aspects of the MMF regulation:

***The criteria for the validation of the credit quality assessment methodology***

- a) They must be applied in a systematic way with respect to different issuers and instruments
- b) They must be supported by a sufficient number of relevant qualitative and quantitative criteria
- c) Their qualitative and quantitative inputs must be reliable, using data samples of an appropriate size
- d) Past assessments produced using the internal credit quality assessment methodologies should be properly reviewed to determine whether the credit quality assessment methodologies are a suitable indicator of credit quality
- e) They must contain controls and processes for their development and related approvals that allow for suitable challenge
- f) They must incorporate relevant factors to determine the credit quality of an issuer or an instrument
- g) They systematically apply key credit quality assumptions and supporting criteria to produce all credit quality assessments, unless there is an objective reason for diverging from this requirement
- h) They must contain procedures to ensure that the criteria referred to in points b), c) and g) supporting the relevant factors in the internal credit quality assessment methodologies are of a reliable quality and relevant to the issuer or instrument being assessed

***The criteria for quantification of the credit risk and of the relative risk of default of an issuer and of the instrument***

- a) Bond pricing information, including credit spreads and the pricing of comparable fixed income instruments and related securities
- b) Pricing of MMIs relating to the issuer, the instrument or the industry sector
- c) Credit default swap pricing information, including credit default swap spreads for comparable instruments
- d) Default statistics relating to the issuer, the instrument or the industry sector
- e) Financial indices relating to the geographic location, the industry sector or the asset class of the issuer or instrument
- f) Financial information relating to the issuer, including profitability ratios, interest coverage ratio, leverage metrics and the pricing of new issues, including the existence of more junior securities

Where necessary and relevant, additional criteria may be applied at the manager's discretion.

***The criteria for establishing qualitative indicators on the issuer of the instrument***

- a) An analysis of any underlying assets, which, for exposure to securitization, must include the credit risk of the issuer and the credit risk of the underlying assets
- b) An analysis of any structural aspects of the relevant instruments issued by an issuer, which for structured finance instruments shall include an analysis of the inherent operational and counterparty risk of the structured finance instrument
- c) An analysis of the relevant market(s), including the degree of volume and liquidity of those markets
- d) A sovereign analysis, including the extent of explicit and contingent liabilities and the size of foreign exchange reserves compared to foreign exchange liabilities
- e) An analysis of governance risk relating to the issuer, including frauds, conduct fines, litigation, financial restatements, exceptional items, management turnover, borrower concentration and audit quality
- f) Securities-related research on the issuer or market sector
- g) Where relevant, an analysis of the credit ratings or rating outlook given to the issuer of an instrument by a credit rating agency registered with ESMA and selected by the manager if suited to the specific investment portfolio of the MMF

**Criteria for establishing qualitative credit risk indicators in relation to the issuer of the instrument:**

- a) The financial situation of the issuer, or, where applicable, of the guarantor
- b) The sources of liquidity of the issuer, or, where applicable, of the guarantor
- c) The ability of the issuer to react to future market-wide or issuer-specific events, including the ability to repay debt in a highly adverse situation
- d) The strength of the issuer's industry within the economy relative to economic trends and the issuer's competitive position in its industry

**For the purpose of undertaking a new credit quality assessment, material changes are deemed to occur whenever:**

- a) There is a material change with respect to:
  - ▶ Bond pricing information, including credit spreads and the pricing of comparable fixed income instruments and related securities
  - ▶ Credit default swap pricing information, including credit default swap spreads for comparable instruments
  - ▶ Default statistics relating to the issuer or instrument
  - ▶ Financial indices relating to the geographic location, industry sector or asset class of the issuer or instrument
  - ▶ Analysis of underlying assets, in particular for structured instruments
  - ▶ Analysis of the relevant market(s), including their volume and liquidity
  - ▶ Analysis of the structural aspects of the relevant instruments
  - ▶ Securities-related research
  - ▶ Financial situation of the issuer
  - ▶ Sources of liquidity of the issuer
  - ▶ Ability of the issuer to react to future market-wide or issuer-specific events, including the ability to repay debt in a highly adverse situation
  - ▶ Strength of the issuer's industry within the economy relative to economic trends and the issuer's competitive position in its industry
  - ▶ Analysis of the credit ratings or rating outlook given to the issuer or instrument by a credit rating agency or agencies selected by the manager of the MMF as being suited to the specific investment portfolio of the MMF
- b) An MMI, securitization or ABCP is downgraded below the two highest short-term credit ratings provided by any credit rating agency regulated and certified in accordance with Regulation (EC) No 1060/2009 of the European Parliament and of the Council on credit rating agencies, as amended

Managers of MMFs must assess the material change in the criteria referred to in a) above by considering risk factors and the results of the stress tests scenarios.

Managers of MMFs must establish an internal procedure for the selection of credit rating agencies suited to the specific investment portfolio of the MMF concerned.

A downgrading referred to in b) above should be taken into account when the manager of the MMF carries out its own assessment according to internal credit quality assessment methodology.

Finally, the revision of the internal credit quality assessment methodology must constitute a material change, except if managers of MMFs can substantiate that the change is not material.

### 7.5.3. Stress testing

Each MMF must have in place sound stress testing processes that identify possible events or future changes in economic conditions which could have unfavorable effects on the MMF. The MMF or the manager of an MMF must assess the possible impact that those events or changes could have on the MMF. The MMF or the manager of an MMF must regularly conduct stress testing for different possible scenarios.

The stress tests must be based on objective criteria and consider the effects of severe plausible scenarios. The stress test scenarios must at least take into consideration reference parameters that include the following factors:

- a) Hypothetical changes in the level of liquidity of the assets held in the portfolio of the MMF
- b) Hypothetical changes in the level of credit risk of the assets held in the portfolio of the MMF, including credit events and rating events
- c) Hypothetical movements of the interest rates and exchange rates
- d) Hypothetical levels of redemptions
- e) Hypothetical widening or narrowing of spreads among indices to which interest rates of portfolio securities are tied
- f) Hypothetical macro systemic shocks affecting the economy as a whole

In addition, in the case of public debt CNAV<sup>12</sup> MMFs and LVNAV<sup>13</sup> MMFs, the stress tests must estimate, for different scenarios, the difference between the constant NAV per unit or share and the NAV per unit or share.

Stress tests must be conducted at least bi-annually and at a frequency determined by the board of directors of the MMF, where applicable, or the board of directors of the manager of an MMF, after considering what an appropriate and reasonable interval in light of the market conditions is and after considering any envisaged changes in the portfolio of the MMF.

If the stress test reveals any vulnerability of the MMF, the manager of an MMF must draw up an extensive report with the results of the stress testing and a proposed action plan. Where necessary, the manager of an MMF must take action to strengthen the robustness of the MMF, including actions that reinforce the liquidity or the quality of the assets of the MMF and must immediately inform the competent authority of the MMF of the measures taken.

The extensive report with the results of the stress testing and proposed action plan must be submitted for examination to the board of directors of the MMF, where applicable, or the board of directors of the manager of an MMF. The board of directors must amend the proposed action plan if necessary and approve the final action plan. The extensive report and the action plan must be kept for a period of at least five years. The extensive report and the action plan must be submitted to the competent authority of the MMF for review.

The competent authority of the MMF must send the extensive report referred to ESMA.

On 21 March 2018, ESMA issued *Guidelines on stress tests scenarios under Article 28 of the MMF Regulation* (ESMA 34-49-115). These guidelines are updated at least every year taking into account the latest market developments.

These guidelines include practical examples and detailed guidance for the establishment of a stress test scenario framework for MMF funds. These guidelines cover, *inter alia*:

- ▶ Certain general features of the stress test scenarios of MMFs
- ▶ The establishment of common reference parameters of the stress test scenarios (the result of which should not be included in the reporting template of the MMF regulation) in relation to:
  - ▶ Hypothetical changes in the level of liquidity of the assets held in the portfolio of the MMF
  - ▶ Hypothetical changes in the level of credit risk of the assets held in the portfolio of the MMF, including credit events and rating events
  - ▶ Hypothetical movements of the interest rates and exchange rates
  - ▶ Hypothetical levels of redemption
  - ▶ Hypothetical widening or narrowing of spreads among indexes to which interest rates of portfolio securities are tied
  - ▶ Hypothetical macro systemic shocks affecting the economy as a whole
- ▶ The establishment of additional common reference stress test scenarios (the results of which should be included in the reporting template of the MMF Regulation). The result of the following stress tests should be provided in the reporting:
  - ▶ Liquidity
  - ▶ Credit
  - ▶ FX Rate
  - ▶ Interest Rate
  - ▶ Level of Redemption
  - ▶ Spread among indices to which interest rates of portfolio securities are tied
  - ▶ Macro
  - ▶ Multivariate

The December 2020 guidelines, implemented by CSSF Circular 21/780, take into consideration extreme market movements observed during the COVID-19 pandemic and update the previously published common reference parameters accordingly. Notably, the weekly liquidity stress test that assesses the UCI's capacity to meet outflows with available weekly assets should use a scenario where the UCI receives net weekly redemption requests from 40% of the professional investors and 30% of the retail investors, instead of 25% and 15% respectively previously.

ESMA issued 2021 guidelines, implemented by CSSF Circular 22/818, which update, *inter alia*, certain calibration parameters concerning liquidity discount factors for sovereign bonds, credit spreads by residual maturities for government bonds, corporate credit spreads for corporate bonds and asset-backed securities, interest rate yield shocks and FX rates shocks. The 2021 guidelines apply for the preparation of the required MMF reporting as from the reporting date 30 September onwards.

<sup>12</sup> | Constant Net Asset Value.

<sup>13</sup> | Low Volatility Net Asset Value.

## 7.5.4. “Know your customer” policy

The manager of an MMF must establish, implement and apply procedures and exercise all due diligence with a view to anticipate the effect of concurrent redemptions by several investors, taking into account at least the type of investor, the number of units or shares in the UCI owned by a single investor and the evolution of inflows and outflows.

If the value of the units or shares held by a single investor exceeds the amount of the corresponding daily liquidity requirement of an MMF, the manager of the MMF must consider, in addition to the factors set out in the preceding paragraph, all of the following:

- a) Identifiable patterns in investor cash needs, including the cyclical evolution of the number of shares in the MMF
- b) The risk aversion of the different investors
- c) The degree of correlation or close links between different investors in the MMF

Where investors route their investments via an intermediary, the manager of an MMF must request the information to comply with the preceding paragraphs from the intermediary in order to manage appropriately the liquidity and investor concentration of the MMF.

The manager of an MMF must ensure that the value of the units or shares held by a single investor does not materially impact the liquidity profile of the MMF where it accounts for a substantial part of the total NAV of the MMF.

## 7.6. Valuation

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This section covers the rules applicable to the valuation of the assets and liabilities of 2010 Law UCIs, full AIFM regime AIFs (including RAIFs) and SIFs.

The NAV calculation is covered in Section 8.7. The role of the depositary in ensuring that the value of the shares or units is calculated in accordance with the applicable law and the constitutional document of the UCI is covered in Section 9.4.5.3.

Throughout 2022, ESMA has coordinated a common supervisory action (CSA) on the valuation of UCITS and open-ended AIFs. The CSA focuses on IFMs investing in less liquid assets, e.g., unlisted equities, unrated bonds, corporate debt, real estate, high yield bonds, emerging markets, listed equities that are not actively traded, bank loans, etc. The CSA aims to assess compliance of supervised entities with the relevant valuation related provisions in the UCITS and AIFMD framework. In March 2022, the CSSF asked a sample of Luxembourg-based UCITS and AIF IFMs to complete a dedicated questionnaire for all UCITS and AIFs they manage.

### 7.6.1. 2010 Law UCIs

Management companies are required to establish appropriate procedures which are consistent with the constitutional document to ensure the proper and accurate valuation of the assets and liabilities of the UCI.

In order to comply with the duty to act in the best interests of the shareholders or unitholders, management companies are required to ensure that fair, correct and transparent pricing models and valuation systems are used for the UCITS they manage. Management companies must be able to demonstrate that the UCITS' portfolios have been accurately valued.

The 2010 Law states that unless otherwise provided for in the constitutional document of the UCI, the valuation of the assets of the UCI must be based, in the case of officially listed securities, on the last known stock exchange price, unless such price is not representative. For securities not so listed and for securities which are so listed, but for which the latest price is not representative, the valuation must be based on the probable realization value, estimated with care and in good faith.

For UCITS, the NAV per share or unit must be calculated at least twice a month. For 2010 Law Part II UCIs, the NAV per share or unit must be calculated at least monthly (see Section 8.7.1.).

The rules for the valuation of assets must be described in the prospectus (see Section 10.3.1.).

The protective measures adopted by a UCI against late trading and market timing practices may include the valuation of securities at “fair value” (see Section 8.8.5.).

Detailed valuation rules or guidelines have been laid down for specific cases. These include the use of amortized cost as the valuation basis for sub-three month papers and valuation of OTC FDIs in the portfolios of UCITS.

CSSF Circular 18/698 mentions that the CSSF recommends that management companies also comply with sub-chapter 6.6. of CSSF Circular 18/698 *Organization of the valuation function (specific provisions applicable to IFMs authorized as AIFM)*.

A. *The use of amortized cost as the valuation basis for sub-three month papers (see also Section 4.2.2.7.5.)*

In February 2009, ALFI issued recommendations on the use of amortized cost as the valuation basis for sub-three month papers.

In accordance with Article 9(3) and Article 28(4) of the 2010 Law, as amended, the CSSF accepts that the board of directors of management companies or investment companies may permit the inclusion of sub-three month papers in the mark-to-market assessment at an amortized cost price, if they consider that amortized cost is the closest to the probable realization value, estimated with care and in good faith.

In such cases, ALFI recommends the following conditions be met:

- ▶ Fair valuation at amortized cost should be restricted to securities with the highest-level credit rating (A1/P1 and A1+/P1 or equivalent) and with a final residual maturity of less than three months. Where such securities are downgraded, full mark-to-market valuation should immediately be applied
- ▶ Full mark-to-market valuation should be applied to structured investment vehicles (SIVs)
- ▶ The decision to value the MMIs on an amortized cost basis for the mark-to-market assessment must be approved by the directors of the UCI and the rationale underlying the decision documented

The exclusion of MMIs from the mark-to-market valuation is based on the premise that such securities will be held to maturity or are realizable at par. If required to meet potential liquidity needs of the UCI, these securities or a portion thereof should be reclassified within the full mark-to-market analysis. The reclassification process should be documented, reviewed and approved on a periodic basis by the board of directors of the investment company or management company.

B. *OTC FDIs*

A reliable and verifiable valuation is required for OTC FDIs (see also Section 4.2.2.7.6.(3)).

Management companies are thus required to establish, document, implement and maintain arrangements and procedures that ensure appropriate, transparent and fair valuation of OTC FDIs.

CSSF Circular 11/512, as amended, requires UCITS and management companies to draft policies and procedures for valuing OTC FDIs in a transparent, independent and fair manner. Valuation principles should be presented in the format laid out in the Appendix to the Circular on the content of the risk management process to be communicated to the CSSF, including the following information: type of FDIs, volume, price provider, frequency of valuation, valuing system, independence of source and valuation controls performed on the price.

A reliable and verifiable valuation is understood to refer to a valuation corresponding to the “fair value”. “Fair value” is understood as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e., an exit price). It should not rely only on the market quotations by the counterparty. The valuation should fulfill the following criteria:

- ▶ The valuation must be based on a current market value. If no such market value is available, then the valuation should be based on a valuation model that uses an appropriate and recognized methodology
- ▶ The verification of the valuation must be performed by one of the following:
  - ▶ An independent third party who performs the verification on a sufficiently frequent basis (in practice, at a frequency at least equal to the NAV calculation frequency) and following a process that can be monitored by the UCITS
  - ▶ A unit independent of the portfolio management of the UCITS. The UCITS may use a third-party valuation system or market data but must verify their adequacy. Models used by a party linked to the UCITS (such as a dealing room through which the UCITS settles its FDI transactions) are expressly prohibited if they have not been reviewed by the UCITS

The UCITS must be able to determine with reasonable accuracy the fair value of the OTC FDIs throughout their entire lifespan.

ESMA is of the view that a process must be developed that enables the UCITS, throughout the life of the FDI, to value the investment concerned with reasonable accuracy at its fair value on a reliable basis reflecting an up-to-date market value. This process must include organization and means of allowing for a risk analysis realized by a department independent from commercial or operational units and from the counterparty or, if these conditions cannot be fulfilled, by an independent third party.

In the latter case, the UCITS remains responsible for the correct valuation of the OTC FDIs and must, *inter alia*, check that the independent third party can adequately value the types of OTC FDIs it wishes to invest in.

Lastly, this organization of the UCITS implies that risk limits are to be defined.

ESMA believes that “independent” and “adequately equipped” means a unit that has the adequate means to perform the valuation. This implies that the UCITS uses its own valuation systems, which can however be provided by an independent third party – excluding the use of valuation models provided by a third party related to the UCITS (such as a dealing room with which OTC FDIs are concluded) which have not been reviewed by the UCITS and excluding the use of data (such as volatility or correlations) produced by a process that has not been qualified by the UCITS.

## 7.6.2. Full AIFM regime AIFs

AIFMs are required to establish, maintain, implement and review, for each AIF they manage, written policies and procedures that ensure a sound, transparent, comprehensive and appropriately documented valuation process. The AIFM must ensure that fair, appropriate and transparent valuation methodologies are consistently applied for the AIFs it manages.

AIFMs must ensure that the NAV per share or unit is calculated, at each subscription or redemption of shares or units and at least once a year according to documented procedures and the methodology.

The AIFM is responsible for the proper valuation of the AIF assets, the calculation of the NAV and the publication of the NAV.

A description of the AIF’s valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets, must be disclosed to investors before they invest (see Section 10.3.3.).

### A. Implementation of valuation policies and procedures

The valuation policies must identify and the procedures implement, the valuation methodologies used for each type of asset in which the AIF may invest in accordance with applicable national law and the AIF constitutional document. The AIFM cannot invest in a particular type of asset for the first time unless the valuation policy covers appropriate valuation methodology or methodologies for that specific type of asset. The selection process of a particular methodology must include an assessment of the available relevant methodologies, taking into account their sensitivity to changes in variables and how specific strategies determine the relative value of the assets in the portfolio. Prices must be obtained from independent sources whenever possible and appropriate.

The valuation policies and procedures must cover:

- ▶ Valuation methodologies covering, *inter alia*:
  - ▶ Inputs, including selection criteria for pricing and market data sources
  - ▶ Models: main features (see Section 7.6.2.B.)
- ▶ The obligations, roles and responsibilities of all parties involved in the valuation process, including the senior management of the AIFM
- ▶ The competence and independence of personnel who are effectively carrying out the valuation of assets
- ▶ The specific investment strategies of the AIF and the assets the AIF might invest in
- ▶ The controls over the selection of valuation inputs, sources and methodologies
- ▶ Review process for the individual values of assets and escalation channels for resolving differences in values for assets (see Section 7.6.2.F.)
- ▶ The valuation of any adjustments related to the size and liquidity of positions or to changes in the market conditions, as appropriate
- ▶ The appropriate time for closing the books for valuation purposes
- ▶ The appropriate frequency for valuing assets
- ▶ How a change to the valuation policy may be implemented (see Section 7.6.2.D.)

The valuation policies and procedures and the designated valuation methodologies must be applied consistently:

- ▶ To all assets within an AIF taking into account the investment strategy, the type of asset and, if applicable, the existence of different external valuers
- ▶ Over time, where no update is required and ensuring that valuation sources and rules remain consistent over time
- ▶ Across all AIFs managed by the same AIFM, taking into account the investment strategies and the types of asset held by the AIF and, if applicable, the existence of different external valuers

## B. Use of models to value assets

If a model is used to value the assets of an AIF, the model and its main features must be explained and justified in the valuation policies and procedures. The reason for the choice of the model, the underlying data, the assumptions used in the model and the rationale for using them and the limitations of the model-based valuation must be appropriately documented.

The valuation policies and procedures must ensure that, before being used, a model is validated by a person with sufficient expertise who has not been involved in the process of building that model. The model must be subject to prior approval by the senior management of the AIFM.

## C. Valuation function

The valuation function must be either performed by:

- ▶ The AIFM itself, provided that the valuation task is functionally independent from the portfolio management and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employees is prevented

In this case, the valuation policies must include a description of the safeguards for the functionally independent performance of the valuation task. Such safeguards must include measures to prevent or restrain any person from exercising inappropriate influence over the way in which a person carries out valuation activities.

The AIFM must also ensure the independence between the risk management and valuation activities.

The CSSF may require the AIFM to have its valuation procedures and/or valuations verified by an external valuer or, where appropriate, an auditor.

Where the AIFM establishes a valuation committee, it is recommended that the AIFM complies with the following conditions:

- ▶ The members of the committee as a whole have the necessary professional experience and skills with regard to the managed strategies
- ▶ The committee is (not necessarily exclusively) composed of members of the senior management and of the staff of the AIFM who are permanently located in Luxembourg or who have their domicile in a place allowing them, in principle, to come to Luxembourg every day; it is recommended that the conducting officer in charge of the valuation function be part of the valuation committee
- ▶ The operational arrangements of the committee including, in particular, the composition of the committee and the rules regarding the voting rights (majority, veto, etc.) in compliance with the legal provisions relating to the independence of the functions must be documented; this document must be made available to the CSSF upon request; the composition of the valuation committee and the rules regarding the voting rights must ensure an independent valuation of the AIF's assets; thus, for example, in order to ensure that the valuation is performed impartially and with all due skill, care and diligence in accordance with Article 17(8) of the 2013 Law, as amended, proof must be provided that the members of the valuation committee are functionally independent from the investment management process, including from the selection of investments; the AIFM must apply the above principle irrespective of the fact that the portfolio management function is performed internally, possibly relying on investment advisors, or is delegated
- ▶ The work of the committee must be documented. This documentation includes the agenda of the meetings, the minutes of the meetings documenting, in particular, the assessment of risks associated with the investments, the decisions and measures taken by the committee
- ▶ An external valuer subject to mandatory professional registration, independent from the AIF, the AIFM and any other persons with close links to the AIF or the AIFM

In this case, the valuation policies and procedures must:

- ▶ Set out a process for the exchange of information between the AIFM and the external valuer to ensure that all necessary information required for the purpose of performing the valuation task is provided
- ▶ Ensure that the AIFM conducts initial and periodic due diligence on third parties that are appointed to perform valuation services

External valuers must provide upon request professional guarantees to demonstrate their ability to perform the valuation function.

The professional guarantees must contain evidence of the external valuer's qualification and capability to perform proper and independent valuation, including, *inter alia*, evidence of:

- ▶ Sufficient personnel and technical resources
- ▶ Adequate procedures safeguarding proper and independent valuation
- ▶ Adequate knowledge and understanding of the investment strategy of the AIF and of the assets the external valuer is appointed to value
- ▶ A sufficiently good reputation and sufficient experience with valuation
- ▶ If the external valuer is subject to registration, name of the authority and indication of the legal or regulatory provisions or rules of professional conduct to which the external valuer is subject



The CSSF's *Frequently Asked Questions* (FAQ) on Luxembourg's AIFM Law and on Commission Delegated Regulation (EU) No 231/2013 ("Level 2") (the FAQ on AIFM) clarify that:

- ▶ The appointment of the depositary of an AIF as external valuer of that AIF is subject to the condition that it has functionally and hierarchically separated the performance of its depositary functions from its tasks as external valuer and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF
- ▶ A third party that has been appointed to perform administration for an AIF (i.e., the AIF's administrator), including calculation of the NAV, can be considered as an external valuer for the purposes of the AIFMD if it provides tailor-made valuations for individual assets, specifically for those requiring subjective judgment on the value of the assets. However, it should be noted that the administrator should not be assumed to always be the external valuer. The administrator's appointment as the AIF's external valuer should be clearly stated in the terms of the contract with the administrator
- ▶ The appointment of a third party as the AIF's external valuer has to be formalized by a written contract, which clearly states that the third party is appointed as external valuer

An AIFM must notify the CSSF of the designation of an external valuer.

#### *D. Periodic review of valuation policies and procedures*

Valuation policies must provide for a periodic review of the policies and procedures, including of the valuation methodologies. The review must be carried out at least annually and before the AIF engages with a new investment strategy or a new type of asset that is not covered by the existing valuation policy.

The valuation policies and procedures must cover how a change to the valuation policy, including a methodology, may be effected and in what circumstances this would be appropriate. Senior management must review and approve any changes to the policies and procedures.

#### *E. Frequency of valuation of assets*

The assets of an AIF must be valued and the NAV per share or unit calculated (see Section 8.7.) at least once a year.

For open-ended AIFs, financial instruments held must be valued every time the NAV per share or unit is calculated.

Other assets held by open-ended AIFs must be valued at least once a year and every time there is evidence that the last determined value is no longer fair or proper.

For closed-ended AIFs, such valuations and calculations must also be carried out in case of an increase or decrease of the capital by the relevant AIF.

#### *F. Review of individual values of assets*

AIFMs must ensure that all assets held by the AIF are fairly and appropriately valued and document the way the appropriateness and fairness of the individual values is assessed.

The valuation policies and procedures must set out a review process for the individual values of assets, where a material risk of an inappropriate valuation exists, including in the following cases:

- ▶ The valuation is based on prices only available from a single counterparty or broker source
- ▶ The valuation is based on illiquid exchange prices
- ▶ The valuation is influenced by parties related to the AIFM
- ▶ The valuation is influenced by other entities that may have a financial interest in the AIF's performance
- ▶ The valuation is based on prices supplied by the counterparty who originated an instrument, in particular, where the originator is also financing the AIF's position in the instrument
- ▶ The valuation is influenced by one or more individuals within the AIFM

The review process must include sufficient and appropriate checks and controls on the reasonableness of individual values, including:

- ▶ Verifying values by a comparison among counterparty-sourced pricings and over time
- ▶ Validating values by comparison of realized prices with recent carrying values
- ▶ Considering the reputation, consistency and quality of the valuation source
- ▶ A comparison with values generated by a third party
- ▶ An examination and documentation of exemptions
- ▶ Highlighting and researching any differences that appear unusual or any variations from valuation benchmarks established for the type of asset
- ▶ Testing for stale prices and implied parameters
- ▶ A comparison with the prices of any related assets or their hedges
- ▶ A review of the inputs used in model-based pricing, in particular of those to which the model's price exhibits significant sensitivity

The valuation policies and procedures shall include appropriate escalation measures to address differences or other problems in the valuation of assets.

## G. Liability

The AIFM is responsible towards the AIF and its investors for the proper valuation of the assets of the AIF, the calculation of the NAV and its publication (see Section 8.7.).

However, when an external valuer is appointed, the external valuer should be liable to the AIFM for any losses suffered by the AIFM as a result of its negligence or intentional failure to perform its tasks.

### 7.6.3. SIFs

The valuation of the assets of SIFs should be based on the fair value<sup>14</sup>. This value must be determined in accordance with the rules set forth in the constitutional document and, in practice, disclosed in the offering document. These procedures could, for example, provide for valuation principles established by professional associations of a specific industry<sup>15</sup>.

For SIFs that are not full AIFM regime AIFs (see Section 7.6.2.), there are no specific requirements on the independence of the valuation of the assets.

The minimum frequency of NAV calculation of a SIF is once a year (see Section 8.7.).

### 7.6.4. RAIFs

Unless otherwise provided for in the constitutional document of the RAIF the valuation of the assets of a RAIF should be based on fair value. The value must be determined in accordance with the rules set forth in the constitutional document.

The valuation of the assets of a RAIF should be performed in accordance with Article 17 of the AIFM Law and the related Delegated Acts (see Section 7.6.2).

### 7.6.5. MMFs

On 30 June 2017, the final text of Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on *money market funds* was published in the Official Journal of the European Union. The Regulation applies to UCIs and compartments that qualify as MMFs as per the definition set out in Article 1 of the Regulation.

This Regulation replaced ESMA's *Guidelines on a common definition of European money market funds* issued in May 2010.

The Regulation introduced the following valuation rules to be applied by MMFs:

- ▶ The assets of an MMF must be valued on at least a daily basis
- ▶ The assets of an MMF must be valued by using mark-to-market whenever possible
- ▶ When using mark-to-market:
  - ▶ The asset of a MMF must be valued at the more prudent side of bid and offer unless the asset can be closed out at mid-market
  - ▶ Only good quality market data must be used; such data must be assessed on the basis of all of the following factors:
    - (i) The number and quality of the counterparties
    - (ii) The volume and turnover in the market of the asset of the MMF
    - (iii) The issue size and the portion of the issue that the MMF plans to buy or sell
- ▶ Where use of mark-to-market is not possible or the market data is not of sufficient quality, an asset of a MMF must be valued conservatively by using mark-to-model

The model must accurately estimate the intrinsic value of the asset of a MMF, based on all of the following up-to-date key factors:

- ▶ The volume and turnover in the market of that asset
  - ▶ The issue size and the portion of the issue that the MMF plans to buy or sell
  - ▶ Market risk, interest rate risk, credit risk attached to the asset
- When using mark-to-model, the amortized cost method may not be used
- ▶ The valuation method must be communicated to the competent authorities
  - ▶ The assets of public debt constant NAV MMFs may additionally be valued by using the amortized cost method
  - ▶ By way of derogation to the mark-to-market and the mark-to-model valuation referred to above, the assets of LVNAV MMFs that have a residual maturity of up to 75 days may be valued by using the amortized cost method

The amortized cost method may only be used for valuing an asset of an LVNAV MMF in circumstances where the price of that asset calculated using the mark-to-market and the mark-to-model method does not deviate from the price of that asset calculated using the amortized cost method by more than 10 basis points. In the event of such a deviation, the price of that asset must be calculated using the mark-to-market or the mark-to-model method.

<sup>14</sup> Although the SIF Law states "The valuation of the assets of the SIF must be based on the fair value unless otherwise provided for in the constitutional document", in practice assets should be valued at fair value.

<sup>15</sup> The International Private Equity and Venture Capital Guidelines for private equity/venture capital funds and the Royal Institution of Chartered Surveyors (RICS) Valuation Standards in the case of real estate funds.

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## ADMINISTRATION

EY supports fund administrators in defining or upgrading their operating models and business plans, including set-up and application for authorization, with anti-money laundering and counter terrorist financing issues, benchmarking of fee structures and reporting on controls.



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## 8.1. Introduction

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This Chapter covers the administration function including:

- ▶ The roles and responsibilities of the administrator
- ▶ Entities that may perform administration of Luxembourg UCIs: management company, AIFM or third-party administrator
- ▶ The authorization procedure for administrators
- ▶ The regulatory requirements applicable where administration is performed by the management company or AIFM, or delegated
- ▶ Organizational requirements covering, *inter alia*, policies, procedures and systems
- ▶ UCI portfolio requirements on recording of portfolio transactions
- ▶ Net asset value (NAV) calculation, use of the NAV and swing pricing
- ▶ Compliance monitoring, NAV errors, breaches or operational incidents
- ▶ The subscription and redemption of shares or units, anti-money laundering and counter terrorist financing (AML/CFT) procedures, protection against late trading and market timing practices and payment of dividends
- ▶ The treatment of NAV computation errors and compensation of losses arising from non-compliance with applicable investment restrictions

## 8.2. Administration function

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### 8.2.1. Scope of administration activities

The 2010 Law, the AIFM Law and CSSF Circular 22/811 define the activities of administration of UCIs. These include:

- ▶ Legal and fund management accounting services
- ▶ Customer inquiries
- ▶ Valuation of the portfolio (see Section 7.6.) and pricing of the shares or units (i.e., calculating the NAV) (see Section 8.7.)
- ▶ Regulatory compliance monitoring
- ▶ Maintenance of shareholder or unitholder register
- ▶ Distribution of income
- ▶ Share or unit issues and redemptions
- ▶ Contract settlements (including certificate dispatch)
- ▶ Record-keeping

In practice, the services provided by the administrator may include, *inter alia*, the following:

- ▶ Client due diligence and onboarding of new UCIs
- ▶ Domiciliation of the UCI
- ▶ Supporting the drawing up of the prospectus, financial reports and all other documents intended for investors and other legal services to the UCI
- ▶ UCI investment portfolio:
  - ▶ Recording of trading activity from the investment manager(s)
  - ▶ Handling and processing of corporate actions and income from the investment portfolio
  - ▶ Valuation of the portfolio (see Section 7.6.)
- ▶ Pricing of the shares or units (i.e., calculating the NAV)
- ▶ Shareholder or unitholder relationship:
  - ▶ Maintenance of shareholder or unitholder register
  - ▶ Share or unit issues and redemptions
  - ▶ Distribution of income
  - ▶ Dispatching of financial reports and other documents intended for the shareholders or unitholders
  - ▶ Services related to tax reporting
  - ▶ Handling of restructuring events (e.g., mergers, conversions, liquidations - see Chapter 3)
  - ▶ Customer inquiries

- ▶ Fund accounting:
  - ▶ Valuation of UCIs' other assets and liabilities
  - ▶ Performance fee calculation
  - ▶ Recording of investment and other income
  - ▶ Recording of operating and other expenses
  - ▶ Recording of shares/units transactions (subscriptions and redemptions) (see Section 8.8.1. and 8.8.2.)
  - ▶ Recording of dividend distribution to share/unitholder(s) (see Section 8.8.6.)
  - ▶ Series accounting and equalization support
- ▶ Cash management
- ▶ Record-keeping
- ▶ Regulatory compliance monitoring
- ▶ Reporting of financial information and electronic transmission of prospectus, Key Investor Information Document (KIID) for UCITS and financial reports (see Chapter 10) to the CSSF

CSSF Circular 22/811 distinguishes three administration functions: registrar, NAV calculation and accounting, and client communication.

Only one service provider may be designated and responsible for the specific UCI administration function for a UCI, across all compartments. The specific tasks of handling customer queries, regulatory compliance monitoring and record-keeping apply to all three administration functions.

### Overview of the three administrative functions

Administrative Function	Overview
Registrar	<ul style="list-style-type: none"> <li>▶ Where intermediaries are appointed as authorized agents and representatives for subscriptions and redemptions of their units or shares, the ability of investors to deal directly with the UCI or IFM should not be restricted and this possibility should be explicitly and prominently mentioned in their offering documents</li> <li>▶ Dispatching of confidential documents sent to investors must remain under the supervision of the UCI administrator</li> </ul>
NAV calculation and accounting	<ul style="list-style-type: none"> <li>▶ The UCI administrator should exercise critical judgement regarding information received from third parties, such as the portfolio manager, and the production of NAVs should encompass controls that must be adequately documented</li> <li>▶ In case of delegation, the UCI administrator must remain in charge of the final step and validation of the NAV</li> </ul>
Client communication	<ul style="list-style-type: none"> <li>▶ The UCI administrator must have specific <i>ex-post</i> controls to ensure that documents are duly transmitted to the final investors</li> </ul>

## 8.2.2. Entities performing administration of Luxembourg UCIs

Administration is one of the functions of the management company, the AIFM, the self-managed UCITS or internally managed AIF.

In practice, management companies, AIFMs, self-managed UCITS or internally managed AIFs generally delegate administration to a specialized third-party administrator (hereafter referred to as an "administrator").

One service provider may be appointed to carry out the activities of:

- ▶ Fund administration (covering, for example, accounting services)
- ▶ Registrar and transfer agent (generally referred to as "transfer agent", covering, *inter alia*, the maintenance of the shareholder or unitholder register)
- ▶ Domiciliation agent

It is also possible to appoint different service providers to carry out these activities (e.g., registrar and transfer agent services), which may or may not be part of the same group.

In May 2015, ALFI issued a *Framework for Due Diligence Information Packs for service providers acting as central administrators and/or depositary/custodian with a view to simplify and facilitate initial and ongoing due diligence reviews*. This Framework seeks to provide a table of contents upon which service providers (delegates) – to which a UCI's board of directors, management company or AIFM has delegated activities and services – can base their preparation of documentation required to support the initial and ongoing due diligence reviews of a UCI and/ or its management company under Luxembourg regulations.

A Luxembourg administrator of UCIs may be one of the following entities:

- ▶ A credit institution (or its Luxembourg branch)
- ▶ An investment firm
- ▶ A financial sector professional (PSF) authorized as a registrar agent or an administrative agent of the financial sector
- ▶ A management company
- ▶ An AIFM
- ▶ A foreign IFM pursuing the activity of UCI administrator for UCIs established in Luxembourg
- ▶ Regulated Luxembourg UCIs (only acting as UCI administrator for themselves and may not offer those services to other UCIs)

A registrar may be one of the following entities:

- ▶ A credit institution
- ▶ An investment firm
- ▶ A financial sector professional (PSF) authorized as a registrar agent or a distributor of units/shares of UCIs
- ▶ A management company
- ▶ An AIFM

A domiciliation agent may be one of the following entities:

- ▶ A credit institution
- ▶ An investment firm
- ▶ A PSF authorized as a corporate domiciliation agent

Management entities are permitted to provide domiciliary services (see Section 6.1.2.) to:

- ▶ The UCIs they manage
- ▶ Subsidiaries of the UCIs they manage

PSFs that offer administration services will generally be authorized as registrar agents. This authorization automatically permits them also to provide the services of client communication agents and financial sector administrative agents.

Luxembourg administrators are required to comply with the relevant laws and regulatory requirements and to have adequate organization in order to obtain authorization from the CSSF and perform the administration (see Section 8.2.3.).

### 8.2.3. Authorization

Management companies (Chapters 15 and 16), AIFMs, foreign IFMs performing administration functions of Luxembourg UCIs, regulated Luxembourg UCIs and credit institutions must obtain an authorization from the CSSF to perform UCI administration activities.

These prospective UCI administrators should provide the following information to the CSSF for approval, described in detail in Annex A of CSSF Circular 22/811:

- ▶ A description of the function(s) and tasks performed by the UCI administrator
- ▶ The program of activity
- ▶ A description of the human resources
- ▶ A description of the technical infrastructure
- ▶ A detailed description of all controls covering the function(s) and tasks performed by the UCI administrator
- ▶ When applicable, a description of the delegation model (see Section 8.5.)
- ▶ A description of the procedures implemented for handling complaints
- ▶ A confirmation that the written procedures regarding conflicts of interest have been put in place

Existing UCI administrators should: (i) apply for authorization from the CSSF in case of substantial changes with regard to operational models, and (ii) notify the CSSF when there are substantial changes to aspects of delegation of critical or important operational tasks.

In addition to the above, in the CSSF Press Release of 7 November 2019, the CSSF has reminded professionals of the AML/CFT investment fund market entry form, created in May 2019, that must be provided in addition to the standard application. It has to be submitted for each licensing application for a new UCI supervised by the CSSF. A form has also been created for IFMs applying for authorized and registered status.

These forms must be renewed for each of the following situations:

- ▶ When requesting approval of an additional compartment
- ▶ When information previously submitted is updated
- ▶ When an additional license or a license extension is requested
- ▶ When there is a change in the shareholder structure of the IFM

Management company authorization is covered in Section 6.2.1.

In June 2021, the CSSF issued the *FAQ Market Entry Form* in relation to the completion of the AML/CFT Market Entry Form (Funds and IFMs) within the eDesk platform.

The FAQ clarifies:

- ▶ When a Market Entry Form should be completed
- ▶ Who can initiate, contribute and/or submit a Market Entry Form
- ▶ Certain practical details on the completion and submission of information

## 8.3. Regulatory requirements and reporting

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A UCITS management company, AIFM or the third-party administrator acting on their behalf is subject to the management company's or AIFM's home Member State's organizational requirements, including those on administration. These include, *inter alia*:

- ▶ Requirements to have and employ the human and technical resources and procedures that are necessary for the proper performance of their business activities
- ▶ Requirements on the implementation of sound administrative and accounting processes
- ▶ Control and security arrangements for electronic data processing
- ▶ Reporting requirements

In the case of UCITS, the management company or the third-party administrator acting on their behalf must ensure the UCITS home Member State requirements regarding the constitution and functioning of the UCITS, as well as the specific requirements of the UCITS' fund rules or instruments of incorporation, prospectuses and offering documents, including in cases where the UCITS is managed cross-border, are met. For example, the accounting and valuation must be performed in accordance with the UCITS' home Member State requirements (see Section 6.3.4.).

A Luxembourg UCITS management company may delegate the administration of the UCITS it manages to a third party that is authorized to provide administration services and has an adequate organization in order to perform the administration:

- ▶ A Luxembourg UCITS management company that manages a Luxembourg UCITS is authorized to delegate the administration of the UCITS to an entity established in Luxembourg
- ▶ A Luxembourg UCITS management company that manages a UCITS domiciled in another Member State is authorized to delegate the administration of the UCITS to an entity established in either:
  - ▶ Luxembourg, or
  - ▶ The Member State where the UCITS is domiciled

In the case of AIFs, the AIFM and, where applicable, the third-party administrator acting on its behalf, is required to comply with the relevant national AIF product rules.

The central administration of a Luxembourg AIF (2010 Law Part II UCIs, SIFs, RAIFs and other Luxembourg AIFs) must be in Luxembourg.

Delegation is discussed in more detail in Section 8.5.

The requirements applicable to administration are laid down in:

- ▶ For UCITS and other UCIs:
  - ▶ The 2010 Law, as amended
  - ▶ CSSF Regulation No 10-4, *inter alia*, on organizational, conflicts of interest, conduct of business and risk management requirements applicable to Chapter 15 management companies
  - ▶ CSSF Circular 18/698 on the authorization and organization of investment fund managers (IFMs)

- ▶ For AIFs:
  - ▶ The AIFM Law, as amended
  - ▶ European Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/61/EU with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, as amended
  - ▶ CSSF Circular 18/698 on the authorization and organization of investment fund managers (IFMs)

UCI administrators should file a specific report with the CSSF at the latest five months after the financial year end, starting 30 June 2023. This report must include the below information, detailed in Annex B of CSSF Circular 22/811:

Business of UCI administration and significant information on the activity	<ul style="list-style-type: none"> <li>▶ Number of regulated and non-regulated UCIs, and compartments of regulated and non-regulated UCIs established in Luxembourg administered</li> <li>▶ Number of foreign UCIs and compartments of foreign UCIs administered</li> <li>▶ Number of daily, weekly, monthly, quarterly and NAVs administered</li> <li>▶ Number of investors', UCIs' and IFMs' complaints received</li> <li>▶ Number of NAV errors</li> <li>▶ Number of NAV errors for which the UCI administrator is contractually responsible</li> <li>▶ For regulated UCIs established in Luxembourg, number of material<sup>1</sup> NAV errors</li> <li>▶ For regulated UCIs established in Luxembourg, number of material<sup>2</sup> NAV errors for which the UCI administrator is contractually responsible</li> <li>▶ Number of corrected NAVs</li> <li>▶ Number of corrected NAVs for which the UCI administrator is contractually responsible</li> <li>▶ When applicable<sup>3</sup>, number of active investment breaches</li> <li>▶ Date of the last review/update of the procedures (dd/mm/yyyy)</li> <li>▶ List of procedures with an indication of the thematic covered</li> <li>▶ Delegated task(s), when applicable</li> </ul>
Human Resources	<ul style="list-style-type: none"> <li>▶ Name of the person responsible for the UCI administration (including nomination date)</li> <li>▶ Contact information (email/telephone(s))</li> <li>▶ Number of staff in the UCI administration</li> <li>▶ Number of staff expressed in full-time equivalents (FTEs) in the UCI administration</li> <li>▶ Any changes (Yes/No)</li> <li>▶ If any change, current organizational chart</li> </ul>
Technical Resources	<ul style="list-style-type: none"> <li>▶ Hardware and software used</li> <li>▶ Any changes (Yes/No)</li> <li>▶ Number and description of information and communications technology (ICT) related issues (system breakdowns leading to major delays in NAV calculation, major bugs detected, problems with new patches/system implementations, interface issues, or other major incidents including cyber incidents), including system outage duration, root cause and mitigating or corrective measures</li> </ul>

## 8.4. Organizational requirements

### 8.4.1. Contractual arrangements

A written contract setting out the roles, responsibilities, rights and obligations of each party must be concluded between the UCI administrator and the UCI and/or the IFM - a tripartite contract being recommended by the CSSF. The UCI or its IFM should retain the power to give instructions to the UCI administrator or to withdraw the mandate with immediate effect when it is in the best interest of investors.

<sup>1</sup> Defined by CSSF Circular 02/77.

<sup>2</sup> Idem.

<sup>3</sup> Applicable to UCI administrators which are in charge of monitoring compliance of the investment policy and restrictions as detailed in Point 13 of CSSF Circular 22/811.



## 8.4.2. Access to information

Rights of access to documents and data upon simple request should be granted to the UCI and when applicable, the IFM, the external auditor, the liquidator and the CSSF or any other national competent authority (NCA) of a UCI. The UCI or the IFM should also be allowed to conduct on-site visits and the administrator should proactively communicate information, documents and data necessary to perform its duties to the UCI or its IFM.

## 8.4.3. Communication and documentation

The UCI administrator should answer requests from the external auditor or the NCA in a diligent and professional manner.

The UCI administrator's role, duties, procedures, processes and records are subject to formalization and documentation requirements.

The documentation requirements are set out as follows:

- ▶ The offering document of a UCI should disclose all entities covering administrative functions
- ▶ The UCI administrator must maintain a manual of written procedures and processes covering all administration functions. Procedures and processes should be kept up-to-date, considering the evolution of business and regulatory updates, and assessed and reviewed at least annually. Those procedures and processes should at least cover:
  - ▶ Duties and obligations towards the UCI or its IFM, when applicable
  - ▶ Duties and obligations towards the depositary
  - ▶ Duties and obligations towards all stakeholders appearing in the written contract (as mentioned above)
  - ▶ Duties and obligations towards delegates, when applicable
  - ▶ Exchange of information with the UCI and its IFM, when applicable, the depositary, other third parties and when applicable, delegates
  - ▶ Allocation of tasks among the staff as well as reporting lines
  - ▶ Daily and other regular important controls performed on the main functions, including the way such control results are properly evidenced
  - ▶ Escalation process for main functions
  - ▶ Dedicated procedures covering NAV suspension, NAV calculation errors (material or non-material), non-compliance with investment policy and restrictions, reporting deadlines, or operational incidents
  - ▶ Approval of new business relationships and new services
  - ▶ Handling of reports of infringements of the regulatory framework (whistleblowing)
  - ▶ Monitoring and oversight of the delegation model
  - ▶ Reasonable and prompt handling of investor complaints. Each complaint and the measures taken for its resolution should be recorded and properly documented. Investors shall be able to file such a complaint free of charge. The information regarding the handling of complaints should also be made available to investors free of charge
- ▶ Means and procedures for information flows between the UCI administrator and the UCI depositary must be documented and formalized in an agreed-upon operating memorandum
- ▶ Adequate records, including a full audit trail, should be maintained and accessible to any authorized party
- ▶ In case of change of the UCI administrator, a proportionate and documented transfer process must be agreed upon
- ▶ Irreplaceable and critical physical documents initially kept by a delegate must be transferred to the UCI administrator without delay
- ▶ The UCI administrator's work and activities must be formalized and documented in agendas and minutes of meetings recording decisions taken, and oversight of delegation. Minutes must be available or accessible at the premises of the UCI administrator

Key performance indicators (KPIs) and key risk indicators (KRIs) should be in place and should consider the services rendered, the number of UCIs, the compartments and unit/share classes administered, along with the volume and complexity of the UCIs.

## 8.4.4. Record-keeping

The records of Chapter 15 management companies and AIFMs should be kept for at least five years in a medium that must allow for:

- ▶ Easy reconstitution of all steps of each portfolio transaction (see also Section 8.6.)
- ▶ Easy identification of any correction or update to the original records, as well as having access to the original records
- ▶ No manipulation or alteration of the record content
- ▶ Ready access by the CSSF

The books and records of the UCI should be kept in such a way that all assets and liabilities of the UCI can be directly identified at all times. For UCIs with multiple compartments and/or unit/share classes, separate books and records should be maintained for the distinct compartments and adequate records for each unit/share classes, respectively.

The data necessary to keep adequate records of the UCI's activity and encompassing the core UCI documentation, should be retained on a medium that allows for the storage of information in a way for it to be accessible for future reference by the UCI, the IFM when applicable, the independent auditor of the UCI and the CSSF or any other NCA of the UCI, where applicable, and in such a form and manner that the following conditions are met:

- ▶ These records must be readily accessible and enable the reconstruction of each key stage of the processing of each portfolio transaction
- ▶ Any corrections or other amendments to these records may be possible but the content of the records prior to such corrections or amendments, must remain easily ascertained ("audit trail")
- ▶ It must not be possible to manipulate or fraudulently alter these records

The UCI administrator must keep all accounting and other documents which constitute the core UCI documentation and which are necessary to the proper performance of its obligations. The aforementioned documents of the UCI may be kept electronically by the UCI administrator. Physical documents kept initially by the delegate of the UCI administrator that are irreplaceable and critical must be transferred to the UCI administrator without delay. This storage is to be ensured for a period of time as further defined by the laws applicable to the UCI for which UCI administration activities are performed.

In case of liquidation of regulated UCIs established in Luxembourg, the UCI administrator must ensure that the essential documents necessary for the NAV calculation, as mentioned above, are (i) stored for a period of 10 years after the end of the relevant accounting period, and (ii) made available upon request to the independent auditor of the UCI and the CSSF.

The UCI's books and essential documents at the liquidation date must be kept in Luxembourg.

In case of a non-judicial liquidation of a UCI, the UCI's books and documents must be kept for at least five years in Luxembourg after the closure of the liquidation in the Luxembourg Business Register.

In case of liquidation of non-regulated UCIs established in Luxembourg and foreign UCIs, the UCI administrator must ensure that the UCIs' books and essential documents are kept and made available in accordance with the relevant laws and regulations.

#### 8.4.5. Human resources

UCI administrators must have at all times sufficient substance and resources which should be proportionate and adapted to the complexity of business. The four eyes principle must be enforced at all times. The person responsible for the UCI administration business line should be the head of operations, a conducting officer or a member of the management body and should prove to be of good professional repute and possess sufficient skills and experience.

#### 8.4.6. New business relationships

The approval of new business relationships and new services should:

- ▶ Follow a documented risk acceptance policy and decision-making process, compliant with the UCI administrator risk profile and providing escalation measures
- ▶ Include an adequate risk assessment and an appropriate, formalized and documented due diligence
- ▶ Follow sound and prudent management principles in its interest, promoting a sound risk culture

#### 8.4.7. Conflict of interest and independence

With regard to conflicts of interest, UCI administrators must implement:

- ▶ An effective and proportionate policy
- ▶ Appropriate segregation of duties and activities considering the relationship with the UCI, the IFM and the depositary
- ▶ A record of the types of activities and clients in which a conflict of interest entailing a material risk of damage to the interest of one or more UCIs or its investors has arisen or may arise
- ▶ Disclosures to investors where conflicts of interest cannot be avoided

When the administration and the depositary functions of a UCI are performed by the same entity, functional and hierarchical separation between business lines must be implemented, as opposed to a legal and structural independence, taking into consideration specific requirements of the sectoral legislation.

The administrator should use different independent and reliable sources to confirm the existence of each kind of reconciled assets.

## 8.4.8. ICT resources, business continuity and disaster recovery planning

The CSSF recommends to UCIs and IFMs to comply with the principles contained within the European Banking Authority (EBA) *Guidelines on ICT and security risk management* implemented in Luxembourg by CSSF Circular 20/750. A UCI administrator must have its own technical and ICT infrastructures as well as procedures. Furthermore the UCI administrator must use dedicated professional software to calculate NAVs and maintain unit/shareholder registers, except when it is not proportionate to the volume and complexity of the UCI administered. When end-user systems (e.g., MS Excel, MS Access) are used, specific controls should be implemented to reduce and mitigate the risks associated to such systems.

On 21 June 2022, the CSSF issued an *FAQ on UCI Administrators Circular*. The FAQ clarifies, *inter alia*, that UCI administrators may use distributed ledger technology (DLT) to maintain the unit/shareholder register. The CSSF emphasizes that only one service provider should remain for the registrar function.

A UCI administrator is required to safeguard the confidentiality, integrity and availability of information by implementing security systems and procedures and by granting access rights on a need-to-know/need to have basis.

Business continuity and disaster recovery plans must take into account the NAV calculation frequency. Secure back-up of accounting and register positions at the end of each NAV calculation day should be stored in the European Economic Area (EEA), either in the UCI administrator's premises, or by a service provider different from the one to whom the system is outsourced or by a group entity.

Regulatory developments in the field of ICT such as the upcoming Regulation on Digital Operational Resilience (DORA) (see Section 7.1.) or the guidelines, recommendations or questions from ESMA should be monitored to amend or supplement the organizational requirements of the Circular.

On April 2022, the CSSF released *Circular 22/806 on outsourcing arrangements*. This Circular integrates the EBA's *Guidelines on Outsourcing arrangements* into the CSSF's regulatory approach and also clarifies certain local requirements. The Circular either amends or repeals other Circulars related to outsourcing. While supervisory requirements related to ICT outsourcing were disseminated in multiple circulars, Circular 22/806 consolidates them in one single document. This outsourcing arrangement Circular applies to Luxembourg administrators (credit institutions, investment firms, PFSs) and IFMs subject to CSSF Circular 18/698 (only for ICT outsourcing).

## 8.5. Delegation of the administration function

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### 8.5.1. Contractual arrangements, due diligence and ongoing monitoring

A written contract should be concluded between the UCI administrator and the delegates, and should include, at least, the elements listed in CSSF Circular 22/811.

The UCI administrator must also implement procedures and processes to efficiently monitor the delegated activities. The results of the due diligence and ongoing oversight must be formalized in writing. To that effect, the UCI administrator must, at least, ensure that:

- ▶ The necessary workflows and controls in place are detailed in a written policy, memorandum or procedure available at the delegate and the UCI administrator. Such documents must be reviewed regularly - at least annually
- ▶ The delegates provide in writing on a regular basis and, when necessary, on an *ad hoc* basis, to the UCI administrator detailed information, reports and/or KPIs/KRIs regarding the status (completion, volume, etc.), the quality and any issues relating to the delegated tasks
- ▶ It retains the capacity and skills to adequately monitor the delegated activities on an ongoing basis
- ▶ An escalation procedure in case of problems, shortcomings and irregularities, exists and is implemented

Adequate initial and ongoing due diligence must be performed by the UCI administrator on its delegates. The UCI administrator must in this context:

- ▶ Design, implement and keep up-to-date a procedure regarding the selection, monitoring and change of delegates. The nature, scope and frequency of the periodic due diligence to be carried out on delegates must also be covered by this procedure. In the case where the delegate obtains a service auditor's report on the operating effectiveness of its internal controls prepared in accordance with a recognized standard such as ISAE 3402, the UCI administrator may take this information into account for the organization of its monitoring of the delegate
- ▶ Implement and monitor defined KPIs/KRIs on a regular basis adapted to the UCI activity (at least annually)
- ▶ Review the IT systems, operational processes and procedures
- ▶ Review the agreements/contracts with the delegates
- ▶ Have regular contact with the delegates (including periodic calls/chats, meetings, at least monthly)
- ▶ Conduct a periodic due diligence, in particular organize regular on-site and/or virtual visits. A sole recourse to virtual on-site visits is not deemed to be sufficient in this context

Any requirements applicable to delegation apply *mutatis mutandis* to sub-delegation and subsequent sub-delegation. The CSSF prohibits delegation or sub-delegation of UCI administration outside the group or to an entity which is not supervised by the CSSF.

## 8.5.2. Access to information and communication

In order to guarantee access to its data at all times, a UCI administrator must have immediate and unlimited editor access to the delegate's systems. If it is not possible, the UCI administrator must be provided with non-restrictive and immediate reader access allowing extraction of the data necessary to perform its duties.

The UCI administrator should assess whether or not the third parties and investors concerned by the delegation should be informed or their consent be confirmed. In case of transfer of information to a third party, the UCI administrator must ensure the UCI or its IFM, when applicable, has accepted the delegation of the service, the type of information transmitted and the country of establishment of the delegate. Investors should be informed prior to any transfer of their data.

Further, delegation of critical or important operational tasks should be notified to the CSSF three months before the task is delegated. The notice period is reduced to one month when the task is delegated to a PFS.

## 8.5.3. Responsibility and independence

In any event the UCI administrator remains fully responsible to comply with laws and regulation as regards delegation and must assess the criticality, or importance of tasks against the impact of a failure in their performance on:

- Its continuous compliance with the conditions of its authorization and or other legal and regulatory obligations
- Its financial performance
- The soundness or continuity of its activity

Division of tasks must not result in a fragmentation which would impair coordination, supervision and an unnecessary increase in costs and risks.

The UCI administrator must perform an independent review of any due diligence or oversight conducted by another group entity to ensure the overall delegation model remains under the control of the UCI administrator.

## 8.5.4. Business continuity and ICT

The Business Continuity Plan (BCP) should pay attention to the revocable nature of the delegate and the UCI administrator must always be able to take over or transfer to an alternative service provider. In any case the UCI administrator should retain sufficient staff to not qualify as a letter-box entity.

ICT delegations are excluded from the scope of the delegation section of CSSF Circular 22/811 and subject to the applicable sectorial legislation.

# 8.6. UCI portfolio requirements

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## 8.6.1. Recording of portfolio transactions

The management company (for each portfolio transaction relating to UCITS), AIFM or its administrator must ensure that a record of information that is sufficient to reconstruct the details of the order and the executed transaction or of the agreement (in the case of AIF) is produced without delay.

The record must include:

- The name or other designation of the UCI and of the person acting on account of the UCI
- The details necessary to identify the instrument in question or, in the case of an AIF, the asset
- The quantity
- The type of the order or transaction
- The price
- For orders, the date and exact time of the transmission of the order and name or other designation of the person to whom the order was transmitted, or for transactions, the date and exact time of the decision to deal and execution of the transaction
- The name of the person transmitting the order or executing the transaction
- Where applicable, the reasons for the revocation of an order
- For executed transactions, the counterparty and execution venue identification

## 8.7. Net asset value (NAV)

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### 8.7.1. Determining the NAV

The NAV of a UCI is defined as the value of its assets less the value of its liabilities.

A NAV calculation is the result of the process of the accounting procedures performed by the UCI administration.

These accounting procedures are usually supported by computerized systems and involve a series of accounting tasks aimed at recording any change in a UCI's financial position including investor capital inflows and outflows, dividend distribution, purchases and sales of investments and related investment income, portfolio valuation, gains, losses and operating expenses of the UCI.

A NAV per share/unit is calculated by dividing the UCI NAV by the number of outstanding shares or units. Such a price may be increased in the case of subscriptions and reduced in the case of redemptions by a specified percentage to cover commissions and expenses. In certain cases, a swing factor may be applied to the NAV (see Section 8.7.4.).

The procedures and the methodology for calculating the NAV per share or unit must be documented.

The NAV calculation methodology used depends on accounting principles, Luxembourg or international regulations that may apply and the specific rules that apply to the UCI in question.

The frequency of NAV per share or unit calculation is specified in the UCI's constitutional document. The NAV must, in general, be calculated each time the shares or units are issued or repurchased and at least twice a month for a UCITS, at least monthly for 2010 Law Part II UCIs and at least annually for SIFs and RAIFs.

The entity in charge of the NAV calculation and accounting function must ensure that the UCI's NAV is accurate. It must ensure the correct and complete recording of transactions to adequately keep the UCI's books and records in compliance with applicable legal, regulatory and contractual requirements as well as the applicable accounting principles.

The UCI's books must be available at all times to the UCI administrator. The calculation and production of the NAV of UCIs must be performed in accordance with the applicable laws and regulations, along with the UCI rules as set out in the offering documents.

To calculate the UCI's NAV and, when applicable, the NAV of its units/shares at compartment and/or class level, the fund accounting function must at least cover the following operations:

- ▶ Identification and correct recording of all accounting movements in the UCI's books against proper instructions and supporting documents and, when applicable, the consolidation of underlying assets/vehicles
- ▶ Valuation of liquid investments (using appropriate reliable valuation sources, in accordance with the UCI valuation policy)
- ▶ Valuation of complex and illiquid investments (using proper and independent valuations in accordance with the UCI valuation policy), or verification that the valuation of complex and illiquid investments is compliant with the UCI valuation policy when this valuation is performed by the UCI or its IFM, when applicable, or when this task has been delegated to an external valuer
- ▶ Determination of the amount of unrealized and realized gain/loss generated by those investments
- ▶ Calculation of income to be distributed to investors as per the UCI rules, when applicable
- ▶ Compilation, provision, and allocation of fees, commissions and taxes, to be borne by the UCI as well as all income to which the UCI is entitled
- ▶ Conversion of operations in foreign currencies in the reference currency of the UCI's books
- ▶ Calculation of the total NAV of the UCI, and validation of the NAV per unit/share (including, when applicable, the NAV per unit/share classes according to the provisions of the offering documents)
- ▶ When applicable, calculation of the exchange ratio in case of merger, as well as subscription, redemption or distribution in kind
- ▶ Publication of the UCI's NAV per unit/share
- ▶ In cooperation with the UCI and/or its IFM, when applicable, drawing-up of financial reports and other documents intended for investors. This task may be performed by the NAV calculation and accounting function or the client communication function as contractually agreed upon with the UCI and/or its IFM
- ▶ Maintenance of adequate records of the UCI's activity relating to the NAV calculation and accounting function

For the completion of the above tasks and the calculation of the NAV, the UCI administrator may receive information and support from third parties in particular regarding the valuation of the investments or the computation of performance fees.

The UCI administrator is in charge of the correct booking of any entries in accordance with UCI rules, in compliance with applicable accounting and valuation policies (types of documents used, information channels, sources, etc.). The UCI administrator must be critical of the information received. The sole compilation/input of accounting information is not sufficient to comply with the duties of the UCI administrator. UCI accounting and NAV calculation must be performed by the UCI administrator in a timely manner in accordance with the provisions of the offering documents.

The production of the NAV also encompasses related controls that must be adequately documented. In this context, the UCI administrator should perform, at least, the following controls in addition to the operations detailed above:

- ▶ Review of unusual or significant movements of all or some of the NAV components (in particular of the NAV per unit/share, investments, cash, fees, invoices), including using benchmark comparison, when applicable
- ▶ Comparison and reconciliation of NAV per unit/share prices, when applicable
- ▶ Reconciliation of the investments and cash accounts (including those in relation to the subscription and redemption orders) against reliable and independent sources
- ▶ Reconciliation between the total number of outstanding units/shares in the UCI's accounts and the total number of outstanding units/shares in the UCI's unit/shareholder register
- ▶ Oversight of accruals and provisions
- ▶ Controls of the performance fees and carried interest calculation and their conformity with the provisions laid out in the offering documents, when applicable
- ▶ Review of the application of liquidity management tools, when applicable (such as, but not limited to, the anti-dilution levy assessment, or the control of the application of swing factors)
- ▶ Calculation and control of the Total Expense Ratio (TER), when applicable

The UCI administrator must reconcile the accounting entries against reliable and independent sources, in particular transactions on investments, cash accounts and other assets.

In case of delegation, the UCI administrator is always in charge of the final step of the NAV production and must perform a final validation.

AIFMD specifically mentions that for AIFs managed by authorized AIFMs, the AIFM is required as a minimum to:

- ▶ Ensure that for each AIF they manage the NAV per share or unit is calculated on the occasion of each issue or subscription or redemption or cancellation of shares or units and at least once a year
- ▶ Regularly verify the NAV calculation procedures and methodologies and their application
- ▶ Ensure that the number of shares or units in issue is subject to regular verification, at least as often as the share or unit price is calculated

The valuation of the assets of UCIs is covered in Section 7.6.

An AIFM is responsible towards the AIF and its investors for the proper valuation of the assets of the AIF, the calculation of the NAV and its publication.

The requirement for the depositary to ensure that the value of the shares or units is calculated in accordance with the applicable law and the constitutional document of the UCI is covered in Section 9.4.5.3.

### 8.7.2. Compliance monitoring, NAV errors, breaches or operational incidents

The UCI administrator may, on the basis of delegation, perform the compliance monitoring, or part thereof, of the investment policy and investment restrictions in accordance with the applicable laws and regulations, along with the UCI rules as set out in the offering documents. The restrictions and limits in the scope of such delegated compliance monitoring must be agreed upon between the UCI administrator and the UCI or its IFM, when applicable, in a contract. In this context, the UCI administrator must establish, implement and maintain procedures to detect, assess and notify the UCI or its IFM, when applicable, without delay, of any instances of noncompliance with the investment policy and restrictions.

The UCI administrator must establish, implement and maintain procedures to detect, assess and, when applicable, notify the UCI or its IFM, when applicable, without delay, of material or non-material NAV errors, breaches or operational incidents (with a financial impact or "near-by" incident).

Such material or non material NAV errors, breaches or operational incidents must be logged by the UCI administrator and in case of relevant or significant shortcomings, the UCI administrator, in cooperation with the other parties, should design a remediation plan to be approved by the UCI or its IFM, when applicable and implement the related corrective measures as well as ensure that a proper follow-up is being performed.

In accordance with the aforementioned requirements, the UCI administrator must establish, implement and maintain an escalation process detailing for each type of error/breach/incident, the type of information to be exchanged, the parties to be involved (internally and externally) and the steps to be taken (log, corrective actions, etc.). In particular, the UCI administrator must, when applicable, ensure that an adequate notification is sent to the CSSF or any other NCA of the UCI either by the UCI itself, the IFM, when applicable, or by the UCI administrator itself (as required or agreed upon contractually).

For regulated UCIs established in Luxembourg, such procedures and processes must comply with CSSF Circular 02/77, when applicable.

For regulated UCIs established in Luxembourg, the UCI administrator must inform the CSSF without undue delay in case the UCI administrator becomes aware that the UCI or its IFM, when applicable, does not properly fulfil its legal, regulatory or contractual obligations and/or does not notify the CSSF as required by applicable laws and regulations of material or non-material NAV errors/breaches/incidents.

Remedial procedures must be implemented in the event of an incorrect calculation of the NAV (See Section 8.9.).

### 8.7.3. Use of NAV in subscriptions and redemptions

The NAV per share/unit is generally the price at which shares/units can be bought (subscriptions) and sold (redemptions) by investors.

For 2010 Law UCIs, shares or units must be issued and repurchased at a price that corresponds to the NAV of the relevant share or unit class.

The price must be determined and made public each time the shares or units are issued or repurchased and at least twice a month for a UCITS and at least monthly for 2010 Law Part II UCIs.

Under the SIF Law and the RAIF Law, there is significant flexibility regarding subscription and redemption of shares or units. The subscription and redemption of shares or units must be carried out in accordance with the rules laid down in the constitutional document. These rules could provide, for example, for shares or units to be subscribed or redeemed at a price other than the NAV. The subscription and redemption conditions, including the determination of the price and the frequency, are specified in the constitutional document.

Subscriptions and redemptions are covered in Section 8.8.

### 8.7.4. Swing pricing

#### 8.7.4.1. Definition - a method of counteracting dilution

Swing pricing has been identified as a possible means of protecting a UCI's performance and thus the interest of existing investors from the dilution effect of frequent trading, which is also a characteristic of market timing activity.

Swinging a UCI's NAV price is an attempt to pass on the cost of underlying capital activity to the active shareholders or unitholders and thus protect investors from costs associated with capital activity. However, it must be understood that swing pricing affords protection against dilution at the UCI level and is not designed to address specific shareholder or unitholder transactions.

The swing pricing policy should be approved by the UCI's board of directors and reviewed at least annually.

The prospectus should disclose the swing pricing policy, including, *inter alia*, the possibility for the UCI to swing the NAV, a short description of the swing pricing mechanism, the maximum swing factor as a percentage of a UCI's NAV and appropriate wording explaining that swing pricing is designed to prevent the dilution of existing investors.

#### 8.7.4.2. The operational process

The primary operational considerations associated with swing pricing comprise:

- ▶ Whether to adopt full or partial swing
- ▶ If a partial swing is adopted, the appropriate swing threshold for a particular UCI
- ▶ Once the decision is made to swing the NAV, the appropriate swing factor for a particular UCI
- ▶ Determination of the frequency of review

On 30 July 2019, the CSSF published its *FAQ - Swing Pricing Mechanism*.

This FAQ applies to all Luxembourg regulated UCIs (UCITS, Part II 2010 Law UCIs and SIFs) which apply swing pricing.

The FAQ provided the following clarifications:

- ▶ The use of a swing pricing mechanism, being adjustments to the NAV in order to counter the dilution effects of capital activity, should be provided for in the articles of incorporation or the management regulations
- ▶ The prospectus of a UCI applying a swing pricing mechanism should describe, at a minimum:
  - ▶ The swing pricing mechanism, including details on the NAV adjustment mechanism in case of net subscriptions (inflows) or redemptions (outflows), the use of any specific subscription/redemption threshold before the swing pricing mechanism becomes applicable (i.e., whether a partial or full swing pricing mechanism is utilized)
  - ▶ The reasons for applying the swing pricing mechanism, including notably the benefits for the investors
  - ▶ The impacts of using the swing pricing mechanism, including the impact on the subscribing and redeeming investors and the fact that the swing pricing mechanism is applied on the capital activity at the level of the UCI and does not address the specific circumstances of each individual investor transaction
  - ▶ The maximum swing factor applicable (as a percentage of the NAV or in monetary value); UCIs can differentiate in this context between normal and unusual market conditions if they provide a precise definition of unusual market conditions (e.g., higher market volatility)
  - ▶ An indication of the components underlying the swing factor, e.g., the bid/ask spread, transaction costs, transaction taxes and other tax-related matters, market impact
  - ▶ An indication of the decision process and the decision makers approving the swing factor to be applied
  - ▶ The compartments of a UCI in scope of the swing pricing mechanism (this information may be shared as well through a reference to a website)
  - ▶ That any performance fee will be charged on the basis of the unswung NAV
- ▶ Annual and semi-annual reports of UCIs should describe the swing pricing mechanism and cover as a minimum:
  - ▶ Details on the NAV adjustment mechanism in case of net subscriptions or redemptions, the use of any specific subscription/redemption threshold before the swing pricing mechanism becomes applicable (i.e., whether a full or partial swing is used)
  - ▶ The maximum swing factor applicable
  - ▶ The list of compartments that have applied the mechanism (whether swung or not) during the financial period (this may be mentioned either in the annual/semi-annual report or by referencing, in the annual/semi-annual report, a website where the information is available)
- ▶ In case of a material NAV error arising as a result of an administrative error (i.e., application of the incorrect swing factor, or the NAV was swung in the wrong direction) in the application of the swing pricing mechanism, the procedures set out in CSSF Circular 02/77 (refer to Section 8.9.) must be followed. If the impact of the error is below the materiality threshold, the CSSF considers that the UCI should still be compensated when it was not protected from the level of dilution it should have been, had the swing pricing mechanism policy been applied properly. The FAQ provides illustrative examples of such types or errors
- ▶ A detailed swing pricing mechanism policy approved by the board of directors of the IFM and, where applicable, the board of directors of the UCI, should be established and implemented, as well as specific operational procedures over the day-to-day application of the swing pricing mechanism. Such policies and procedures should be in place before the use of the swing pricing mechanism. The policy and procedures should cover, *inter alia*:
  - ▶ The governance process, together with the different stakeholders involved, applied in relation to the application of the swing pricing mechanism
  - ▶ The oversight of the delegate in case of delegation of activities pertaining to the application of the swing pricing mechanism
  - ▶ The methodology applied for the determination and the periodic review of the swing factors and thresholds
  - ▶ The maximum swing factor applicable (as a percentage of the NAV or in monetary value) - a differentiation in this context between normal and unusual market conditions can be performed if a precise definition of unusual market conditions (e.g., higher market volatility) is provided for in the policy
  - ▶ The review process, together with the related frequency and the related triggers (e.g., market circumstances, portfolio composition), of the swing factors as well as the operational implementation of potential swing factor changes
  - ▶ The situations which may result in the non-application of the swing pricing mechanism (e.g., grace period on initial launch)
  - ▶ The treatment of corporate actions concerning the UCI (mergers, liquidations, contributions in kind)
  - ▶ The ongoing monitoring of the application of the swing pricing mechanism
  - ▶ The periodic review of the adequacy and the effectiveness of the swing pricing mechanism policy, processes and procedure



On 20 March 2020 and 7 April 2020, the CSSF published its *FAQ - COVID-19* and provided the following clarifications on swing pricing:

The CSSF confirmed that UCIs using swing pricing as an anti-dilution mechanism can increase the swing factor:

- i. Up to the maximum laid down in the prospectus without prior notification to the CSSF
- ii. Beyond the maximum laid down in the prospectus where the prospectus offers this possibility to the board of directors of the UCI, provided that such decision is duly justified and takes into account the best interests of the investors. Investors must be informed and the CSSF provided with a detailed notification of the resolution, including a specific explanation of the reasons
- iii. Beyond the maximum laid down in the prospectus, on a temporary basis, given the exceptional market circumstances arising from COVID-19, where the prospectus does not offer this possibility to the board of directors of the UCI, provided that conditions laid down in (ii) are met and that the prospectus is updated to offer this possibility during the next update. In this case, the investors and the CSSF must be informed prior to applying the increased swing factors

The CSSF does not set a quantitative maximum but the revised swing factors must be the result of a robust internal governance process and must be based on a robust methodology. The CSSF may request justification for the revised swing factors on an *ex-post* basis.

ALFI updated its guidance on swing pricing in July 2022, to reflect CSSF clarifications, notably on governance, disclosure and error compensation.

#### *Full or partial swing*

Generally, the NAV is swung using one of the following methods:

- ▶ Full swing: The NAV is swung on every dealing date on a net deal basis regardless of the size of the net capital activity. No threshold is therefore applied in the full swing model
- ▶ Partial swing: The process is triggered and the NAV swung, only when the net capital activity exceeds a predefined threshold known as the “swing threshold”

#### *Determination of the “swing threshold”*

In principle, the swing threshold should reflect the point at which net capital activity triggers the investment manager to trade a UCI's securities. As an example, the policy would state that a net capital activity greater than X% of the UCI's NAV would trigger swing pricing. Factors influencing the determination of the swing threshold ordinarily include:

- ▶ The type of threshold (percentage, monetary or a combination)
- ▶ Whether single or multiple thresholds (e.g., “tiered thresholds”) will be applied
- ▶ The size of the UCI
- ▶ The UCI's client base and its concentration
- ▶ The type and liquidity of securities in which the UCI invests
- ▶ The costs and hence the dilution impact, associated with the markets in which the UCI invests
- ▶ The investment manager's investment policy and the extent to which a UCI can retain cash (or near cash) as opposed to always being fully invested
- ▶ Consistency considerations within a UCI complex
- ▶ The accepted level of client net capital activity for which transaction costs can be absorbed by the UCI
- ▶ Soft closure measures on capacity constrained UCIs
- ▶ The frequency of the threshold review, and any specific triggers to review
- ▶ Transparency considerations

Ideally, the application of swing pricing should be mechanical and triggered on a consistent basis.

#### *Determination of the appropriate swing factor*

The swing factor is the amount (normally expressed as a percentage) by which the NAV is adjusted in order to protect existing investors in a UCI from the cost of trading securities as a result of capital activity.

The swing factor is determined by assessing those transactions and market impacts expected to be incurred as a result of investing or disinvesting the net capital activity for that day. A key item in the determination of the swing factor is the bid offer spread. Other items influencing the determination of the appropriate swing factor include:

- ▶ Broker commissions paid by the UCI
- ▶ Custody transaction charges
- ▶ Fiscal charges
- ▶ Market impact
- ▶ Share class specific items
- ▶ Swing factors or spread applied to the underlying investment funds or derivative instruments
- ▶ Passive vs. active investment
- ▶ Potential tiering of the swing factor
- ▶ Asymmetry of the swing-to-offer factor and the swing-to-bid factor
- ▶ Scalability and agility of the review process
- ▶ Operational processes relating to the application of swing factors as part of the NAV calculation process

#### *Governance*

A governing body needs to be established under final responsibility of the UCI's board of directors. It can be the UCI's board, the IFM as delegated by the UCI's board, a swing pricing committee or any other grouping.

Approved terms of reference or equivalent documentation should define the extent of powers delegated, membership of the governing body, frequency of meetings and nature and frequency of reporting responsibilities. There should be a clearly documented swing pricing policy, which could, but does not have to, be incorporated into the terms of reference. Meetings and decisions should be appropriately documented, with a critical focus on any variations from application of the standard policy.

It is recommended that the swing factor should be monitored to ensure reasonability when compared to the charges incurred and should be revised as and when necessary. The objective is to ensure that the swing factor is consistent with the UCI's security and investment profile, the markets in which it invests and the various cost components. This should be undertaken by a swing pricing committee under the supervision of the UCI's board of directors or equivalent responsible body.

#### *Disclosures*

It is recommended that the points addressed in the CSSF FAQ regarding disclosures<sup>4</sup> to be made in the UCI's articles of association and prospectus be taken into consideration. The annual and semi-annual report of a UCI should provide for a description of the swing pricing mechanism.

The guidelines also include considerations in relation to transaction costs reporting under PRIIPs and Markets in Financial Instruments Directive II (MiFID II). They also clarify that swing pricing is not a charge but an adjustment in the NAV and as such does not need to be described in the UCITS KIID.

While market practice is to report only the swung NAV for shareholder dealing, external performance and comparison purposes, the unswung NAV can have certain purposes:

- ▶ Performance fees should be exclusively based on the unswung NAV
- ▶ Depending on the sequence of the NAV calculation process, assets under management (AUM) based fees, where applicable, may also be calculated based on the unswung NAV so that the swing factor is the very last adjustment recorded in the NAV before its publication
- ▶ Certain investors or regulators may have an interest in the swung and unswung NAV
- ▶ The unswung NAV may be considered as a more relevant basis for internal performance measurement as well as for risk management purposes (e.g., back-testing of Value-at-Risk)

#### *Recording the swing factor*

Generally, once the net capital activity is known for a given dealing date and the swing pricing process is triggered, the NAV of all of the UCI's share or unit classes (in the case of a multi-share or unit class UCI) is swung on the following basis:

- ▶ Net inflows: The price used to process all transactions is adjusted upwards by the swing factor to a notional offer price
- ▶ Net outflows: The price used to process all transactions is adjusted downwards by the swing factor to a notional bid price

<sup>4</sup> | See point 1, 2 and 3 of the CSSF Swing Pricing Mechanism FAQ.

There are three main approaches to determine the amount by which the NAV is swung once the swing process is triggered:

- One-line adjustment in the fund accounting system
- Revaluation of portfolio securities to bid or offer
- Outside of the UCI

The governing body in charge of swing pricing should have structures in place to allow for early identification of significant market events and be able to react quickly, as required, in the best interest of shareholders.

*Additional topics covered by the guidelines*

The guidelines also cover, *inter alia*:

- The pros and cons of swing pricing
- Operational considerations including capital activity, other operational issues to consider, fund mergers, contributions and redemptions in kind, launch of a new fund, launch of a new share class and liquidating funds
- The different investment fund structures to which swing pricing can be applied: funds with a single share class, funds with multiple share classes, master-feeder fund structures, fund of fund structures and pooling
- Performance considerations: pricing and the impact on performance, risk assessment, competitor and peer performance analysis, fund performance reporting, internal fund performance reporting and performance fee calculations
- Regulatory and tax considerations

## 8.8. Subscriptions and redemptions of shares or units and payment of dividends

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This section covers:

- The specific requirements applicable to subscriptions and redemptions
- The recording and reporting to investors of subscription and redemption orders
- Prevention of money laundering and terrorist financing (ML/FT)
- Prevention of late trading and market timing
- Payment of dividends

The use of the NAV in subscriptions and redemptions is covered in Section 8.7.3.

### 8.8.1. Subscriptions (issues)

Shares or units are represented by certificates in registered or bearer form or by a confirmation of registration. Fractions of shares or units are permitted. Shares or units are to be issued in accordance with the conditions laid down in the constitutional document and may be denominated in any currency. In the case of a common fund, the management company and the depositary are required to sign the certificates and securities representing one or more portions of the common fund.

SIFs and RAIAs must implement procedures to ensure that the shares or units are only distributed to well-informed investors (see Sections 2.4.2. and 2.4.3.).

A law voted in July 2014 introduced the requirement to deposit bearer shares or units with a depositary (which is not necessarily a bank). The depositary should be appointed by the board of directors or management of the UCI or its management company.

The depositary is required to maintain a register of bearer shares or units containing, *inter alia*, information on each shareholder or unitholder. Each bearer shareholder or unitholder will be permitted to request a certificate listing all inscriptions in the register that concern themselves.

Companies that have outstanding bearer shares or units and, in the case of common funds, their managers were required to appoint a depositary by 18 February 2015 at the latest. Bearer shares or units had to be deposited with the depositary by 18 February 2016. Bearer shares or units not deposited by that time were cancelled.

Subscriptions are routinely made in exchange for cash; however, the UCI, at the discretion of the board of directors, may accept payment for shares by an in kind subscription of suitable investments.

For in kind subscriptions (contributions in kind), an independent auditor is required to review the valuation of the assets and liabilities subscribed.

Marketing is covered in Chapter 12.

### 8.8.1.1. Master-feeder UCITS

In master-feeder UCITS structures, the agreement between the master UCITS and the feeder UCITS or, where the master and feeder are managed by the same management company, the management company's internal conduct of business rules must cover the following in relation to subscriptions and redemptions (see also Section 2.3.4.1.):

- Basis of investment and divestment by the feeder UCITS:
  - A statement of which share or unit classes of the master UCITS are available for investment by the feeder UCITS
  - The charges and expenses to be borne by the feeder UCITS and details of any rebate or retrocession of charges or expenses by the master UCITS
  - Where applicable, the terms on which any initial or subsequent transfer of assets in kind may be made from the feeder UCITS to the master UCITS
- Standard dealing arrangements including:
  - Coordination and frequency of NAV calculation process and the publication of prices of shares or units
  - Coordination of transmission of dealing orders by the feeder UCITS, including, where applicable, the role of transfer agents or any other third party
- Events affecting dealing arrangements:
  - The manner and timing of a notification by either UCITS of the temporary suspension and the resumption of redemption or subscription of shares or units of that UCITS
  - Arrangements for notifying and resolving pricing errors in the master UCITS

Conversion of UCITS into feeder UCITS and change of master UCITS are covered in Section 3.6.3.

### 8.8.1.2. Venture capital UCIs

The shares or units of venture capital UCIs under Part II of the 2010 Law, which may be in registered or bearer form, must have a minimum value of EUR 12,400 at the time of issue.

### 8.8.1.3. Futures contracts and options UCIs

The shares or units of futures contracts and options UCIs under Part II of the 2010 Law, which may be in registered or bearer form, must have a minimum value of EUR 12,400 at the time of issue.

### 8.8.1.4. Real estate UCIs

The NAV of real estate UCIs under Part II of the 2010 Law must be calculated at the year end and on each day when the UCI's shares or units are issued or repurchased.

Property valuations at the year-end may be used in the determination of the NAV during the following year, unless a change of circumstances renders such valuation inappropriate.

## 8.8.2. Redemptions (repurchases)

Redemptions of shares or units have to take place in accordance with the conditions laid down in the constitutional document.

UCITS are required to repurchase their shares or units at the request of investors. However, a UCITS may, if it can be justified, provide in its constitutional document that management is able, in specific circumstances (e.g., temporary liquidity shortage) or when requests in a single dealing day exceed a certain set level in relation to the number of shares or units in circulation, to arrange for a delay in settlement of redemption requests for a specific time or for a proportional reduction of all redemption requests so that the set level is not exceeded.

Redemptions may be suspended under the conditions specified in the constitutional document or, in certain circumstances, at the request of the CSSF.

Redemptions are routinely made in exchange for cash; however, the UCI or the investor, in certain circumstances, may request payment by an in kind distribution of investments, in lieu of cash. An in kind distribution can be derived using a proportional or non-proportional basis. A proportional basis requires that the in kind redemptions comprise an equal share of all of the UCI's investments. In certain circumstances, in kind redemptions may also be performed on a non-proportional basis whereby the investor receives different weightings of the portfolio holdings.

For in kind redemptions, an independent auditor is required to review the valuation of the assets and liabilities redeemed. Unless stipulated by the prospectus or offering document of the UCI, the CSSF may permit an exemption from the requirement for a review by the independent auditor where the redemption is performed on a proportional basis.

Such reviews are conducted in accordance with the professional guidance issued by the Luxembourg Institute of Auditors (*Institut des Réviseurs d'Entreprises* - IRE). The valuation, together with the NAV of the share or unit class, determines the investments to be distributed.

### 8.8.2.1. Master-feeder UCITS

See Section 8.8.1.1.

### 8.8.2.2. Venture capital UCIs

Where investors have the right to redeem their shares or units in a venture capital UCI under Part II of the 2010 Law, the UCI may provide for certain restrictions to this right. Any such restrictions must be stated in the prospectus.

### 8.8.2.3. Real estate UCIs

Where investors have the right to redeem their shares or units in a real estate UCI under Part II of the 2010 Law, the UCI may provide for certain restrictions to that right. Any such restrictions must be stated in the prospectus. See also Section 8.8.1.4.

## 8.8.3. Subscription and redemption orders

### A. Recording

The management company, AIFM or its administrator must take all reasonable steps to ensure that the subscription and redemption orders received are centralized and recorded immediately after receipt of any such order in the case of UCITS or without undue delay after receipt of any such order in the case of AIFs.

That record includes information on the following:

- ▶ The relevant UCI
- ▶ The person giving or transmitting the order
- ▶ The person receiving the order
- ▶ The date and time of the order
- ▶ The terms and means of payment
- ▶ The type of the order
- ▶ The date of execution of the order
- ▶ The number of shares or units subscribed or redeemed
- ▶ The subscription or redemption price for each share or unit or, in the case of AIFs, the amount of capital committed and paid
- ▶ The total subscription or redemption value of the shares or units
- ▶ The gross value of the order including charges for subscription or net amount after charges for redemption

### B. Reporting to investors

UCITS management companies and AIFMs are subject to similar although not identical requirements on reporting of subscription and redemption orders to investors.

Management companies are required to notify investors, no later than the first business day following execution of a subscription or redemption, by means of a durable medium, confirming execution of the order. The notice should contain the following information:

- ▶ Management company identification
- ▶ Designation of the shareholder, unitholder or client
- ▶ Date and time of the receipt of the order and method of payment
- ▶ Date of execution
- ▶ UCITS identification
- ▶ Order type (subscription or redemption)
- ▶ Number of shares or units involved
- ▶ NAV per share/unit
- ▶ Value date
- ▶ Gross value of the order including charges for subscription or net amount after deduction of charges for redemptions
- ▶ Total sum of commission and expenses charged and, if requested by the investor, an itemized breakdown

If the UCITS management company does not execute the order itself, it should confirm execution of the order no later than one day after reception of the third party's notice.

Where shareholders' or unitholders' orders are executed periodically on their behalf, the UCITS management company may provide investors with periodic disclosure, at least every six months.

UCITS management companies must, on request, provide investors with information about the status of their orders.

Where AIFMs have carried out a subscription or, where relevant, a redemption order from an investor, they must promptly provide the investor, by means of a durable medium, with the essential information concerning the execution of that order or the acceptance of the subscription offer, as the case may be.

The essential information must include the following:

- The identification of the AIFM
- The identification of the investor
- The date and time of receipt of the order
- The date of execution
- The identification of the AIF
- The gross value of the order including charges for subscription or the net amount after charges for redemptions

## 8.8.4. Prevention of money laundering and terrorist financing

### 8.8.4.1. Legal framework

#### Key laws

The Law of 12 November 2004 on *the fight against money laundering and terrorist financing*, (“the AML Law”) as amended, is the principal law with respect to anti-money laundering and terrorist financing. Two other important texts are the Grand-Ducal Regulation of 1 February 2010 and CSSF Regulation No 12-02 as amended (notably by CSSF Regulation No 20-05). In general, these documents set out the legal framework on the fight against money laundering and terrorist financing and the obligations applicable to persons and entities in Luxembourg.

The Law of 13 February 2018 partially transposes the 4<sup>th</sup> EU AML Directive, *inter alia*, aligning the European regulations with the latest recommendations from the Financial Action Task Force (FATF<sup>5</sup>) of 2012 and EU Regulation 2015/847 on information accompanying transfers of funds. The main changes are, *inter alia*:

- Substantial increase of criminal sanctions and administrative fines by supervisory authorities
- Reshaped risk assessment
- Extension of the definition of beneficial owners regarding trusts
- Strengthening of the definition of politically exposed persons (PEPs) (local and foreign)

The Law of 10 August 2018 partially transposed Article 31 of the 4<sup>th</sup> EU AML Directive, introducing new obligations for fiduciary arrangements, *inter alia*, changes for fiduciary agents to obtain and hold adequate, accurate and up-to-date information on the beneficial owner. This Law was repealed by the Law of 10 July 2020 which still allows supervisory authorities to have, *inter alia*, access to all documents and to carry out on-site inspections or investigations.

The Law of 13 January 2019, as amended, establishes a register of beneficial owners of companies and similar entities registered with the Luxembourg trade and companies register (RBE). The objective of the register is to make available information on the ultimate beneficiaries of the entities registered.

All entities registered with the “*Registre de Commerce et des Sociétés*” (RCS) are required to provide information about their beneficial owners and keep the information in an internal file.

All registered entities need to make available the following information:

1. Surname(s)
2. First name(s)
3. Nationality/ies
4. Birth date (day, month and year)
5. Place of birth
6. Country of residence
7. Exact home or professional address
8. National Natural Persons Registry (“*Registre national des personnes physiques*”) number, as applicable
9. Foreign identification number, as applicable
10. Type(s) of interest(s) beneficially owned
11. Nature and extent of interest(s) beneficially owned

Listed entities are only required to register the name of the regulated market on which they are admitted to trading.

On 25 March 2020, the Luxembourg legislator published two new laws:

- 1) The 1<sup>st</sup> Law of 25 March 2020 transposing certain provisions of Directive (EU) 2018/843 (the 5<sup>th</sup> EU AML Directive)
- 2) The 2<sup>nd</sup> Law of 25 March 2020 establishing a central electronic data retrieval system concerning IBAN accounts and safe-deposit boxes, as amended

<sup>5</sup> | An intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.

The aim of the 1<sup>st</sup> Law of 25 March 2020 is to implement the majority of the 5<sup>th</sup> EU AML Directive (certain sections of the Directive have already been implemented via the Law of 13 January 2019) and to expand the scope of the amended Law of 12 November 2004 on the fight against ML/TF. The main changes to the AML law are the following:

1. Clarification and extension of customer due diligence (CDD) measures and enhanced due diligence (EDD) measures to be applied, most notably, regarding high-risk countries
2. Specifications clarifying the methodology for identification and verification of beneficial owners (following CSSF Circular 19/732)
3. Additional details regarding internal management requirements and group-wide policies and procedures
4. Enhanced cooperation framework between the various competent authorities and self-regulated bodies

The 2<sup>nd</sup> Law of 25 March 2020, as amended, introduces a Luxembourg central electronic data retrieval system which gathers data about payment and bank accounts identified by an IBAN number and safe deposit boxes.

The Law of 10 July 2020, as amended, establishes a register of beneficial owner for *fiducies* and trusts which transpose Article 31 of Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purpose of ML/TF. The Law provides important information regarding the registration of data for the beneficial owner(s) of *fiducies* and trusts. This Law complements the Law of 13 January 2019 which established a register of beneficial owners of companies and similar entities registered with the RBE. The Law of 10 July 2020, as amended, details a list of information required for the beneficial owners of a trust administered in the Grand Duchy of Luxembourg and any *fiducie* for which they act as trustee or *fiduciaire*. The information must be kept by the trustees or fiduciaries five years after ceasing to be involved in the trust or *fiducie*.

The main changes brought by the *Law of 19 December 2020 implementing financial restrictive measures and repealing the former law of 27 October 2010 implementing United Nations Security Council resolutions as well as acts adopted by the European Union concerning prohibitions and restrictive measures in financial matters in respect of certain persons, entities and groups in the context of the combat against terrorist financing* include:

- 1) Increased scope of persons covered by the new law, including branches of Luxembourg legal persons established abroad, branches of foreign legal persons in Luxembourg and other natural and legal persons operating in Luxembourg
- 2) Scope of application is adapted to encompass restrictive measures in financial matters adopted by the UN and the EU which take the form of:
  - a. The prohibition or restriction of financial activities of any kind
  - b. The prohibition or restriction on the provision of financial services, technical assistance, training or advice in relation to a state, natural or legal person, entity or group subject to restrictions, or
  - c. The freezing of funds, assets or other economic resources owned or controlled, directly, indirectly or jointly, with or by a person, entity or group subject to restrictions or by a person acting on their behalf or at their direction
- 3) Increase of criminal sanctions for non-compliance with restrictive measures ranging from EUR 12,500 to EUR 5,000,000 or, if the offence has resulted in substantial financial gain, the fine may be increased to four times the amount of the offence

The Law of 17 December 2021, published on 20 December 2021, and entered into force on 24 December 2021, aims at partially implementing EU Directive 2018/1673 *on combating money laundering by criminal law*.

The law amends, *inter alia*, the Luxembourg Criminal Code by, most notably:

- a. The addition of an aggravating circumstance to the offence of ML when the offender is a professional within the meaning of the Law of 12 November 2004 which leads to the applicability of more severe criminal sanctions
- b. The allowance to prosecute in Luxembourg a perpetrator of an ML offence, even in such cases where: a) the predicate offence is committed outside of Luxembourg, b) has been carried out by a foreigner who is not a Luxembourg resident or does not have his main residence in Luxembourg, and c) the underlying primary offence is not punishable by the legislation of the country in which the act has been committed
- c. Specifying that for the prosecution or conviction of an act of ML, pursuant to Article 506-1 of the Luxembourg Criminal Code, it is not necessary that all factual elements and circumstances in relation to the underlying primary offence are known, including the identity of the offender

#### *Key Grand-Ducal Regulations*

Grand-Ducal Regulation of 1 February 2010, as amended by the Grand-Ducal Regulation of 5 August 2015 and the Grand-Ducal Regulation of 14 August 2020, clarifies certain provisions of the amended Law of 12 November 2004 on the fight against ML/TF, covering, *inter alia*:

- The different types of customer due diligence:
  - Standard customer due diligence
  - Simplified customer due diligence (SDD)
  - Enhanced customer due diligence (EDD)
- Customer due diligence performed by third parties
- Obligations of branches and subsidiaries in foreign countries

Grand-Ducal Regulation of 15 February 2019 on *the arrangements regarding registration, payment of administrative costs and access to the information contained in the Register of Beneficial Owners* covers, *inter alia*, the arrangements for access to the register, which is free of charge and accessible to the general public. Searches can be performed on “entity name” and “registration number”. A search by beneficial owner name is not possible for the general public.

#### Key Ministerial Regulations

Ministerial Regulation of 16 November 2018 amending the Ministerial Regulation of 9 July 2009 establishes the Committee for the Prevention of Money Laundering and the Financing of Terrorism.

Ministerial Regulation of 13 March 2020 amending the Ministerial Regulation of 16 November 2018 creates the Committee on the prevention of money laundering and terrorist financing.

#### Key CSSF Regulation

CSSF Regulation No 12-02 of 14 December 2012 on *the fight against money laundering and terrorist financing* as amended by CSSF Regulation No 20-05 of 14 August 2020 makes existing AML/CFT professional obligations legally binding.

It clarifies certain elements of the Law of 12 November 2004, as amended, and the Grand-Ducal Regulation of 1 February 2010, as amended, with regard to the following topics:

- ▶ Risk-based approach
- ▶ Client due diligence
- ▶ Internal organization
- ▶ Cooperation with authorities
- ▶ Review by the external auditor

The Regulation takes into account some of the features of the FATF recommendations released in February 2012 and amended several times since 2012 to specify, *inter alia*:

- ▶ The risk assessment and the risk-based approach (recommendation 1) with a focus on identification, assessment, management and mitigation of risks of financing the proliferation of weapons of mass destruction
- ▶ The national cooperation, co-ordination and information exchange (recommendation 2)

#### Main CSSF Circulars

CSSF Circular 17/650 of 17 February 2017 (as amended by CSSF Circular 20/744) on combating money laundering and terrorist financing providing details of certain provisions of the Law of 12 November 2004, as amended, and of the Grand-Ducal Regulation of 1 February 2010 with regard to primary tax offences, is part of the criminal provisions provided by the Law of 23 December 2016, relating to the 2017 Luxembourg Tax Reform and was issued as an advance text of the 4<sup>th</sup> EU AML Directive. It added two tax offences to the list of primary offences for ML from 1 January 2017: serious tax offence (“*fraude fiscale aggravée*”) and tax fraud (“*escroquerie fiscale*”). Simple offences (offences which are neither serious tax offences or tax fraud) will be sanctioned via administrative courts.

The Circular, as amended, puts the emphasis on tax offences and potential indicators of tax offences for Luxembourg resident and non-resident customers. The Circular requires professionals of the financial sector to declare known or suspected tax offences which have been committed or have been attempted.

The purpose of the CSSF Circular 20/744 issued on 3 July 2020 is to complement the CSSF Circular 17/650 of February 2017 (which provides guidance on the different types of tax fraud and professional obligations in terms of AML/CFT) specifically for collective investment activities. CSSF Circular 20/744 has extended the list of 21 indicators to detect money laundering relating to aggravated tax fraud or tax evasion from the Annex 1 of CSSF Circular 17/650, as amended, to include:

- ▶ Complex investment structuring: recourse to one or several interposed entities or structures located in jurisdictions not complying with international transparency standards
- ▶ Tax base erosion: use of cross-border transfers to significantly erode the tax base of the investment manager
- ▶ Investment transactions:
  - ▶ Use of transactions on unregulated markets with intermediaries located in jurisdictions not subject to the automatic exchange of information
  - ▶ Use of transactions that do not have apparent rationale in a specific context
  - ▶ Recurring use of loss-making transactions
- ▶ Efficient portfolio management techniques: recourse to securities lending transactions which may create tax arbitrage or tax refunds that have been or could be considered as aggravated tax fraud or tax evasion
- ▶ SICAR: illegal recourse to the SICAR status that would not be in line with the “risk capital” concept and the requirements of Circular 06/241 in this field
- ▶ Subscription tax: the UCI or the IFM is not able to file subscription tax returns that are in line with the Luxembourg requirements, due to the lack of information on the investors
- ▶ Investor tax reporting: the UCI or the IFM does not comply with the local laws of the country of distribution
- ▶ Clarifications on the term “customer” included in the list of indicators in CSSF Circular 17/650, as amended, which should be understood as “investor” in the context of the collective investment activities



The following CSSF Circulars may also be applicable:

- Circular 10/486 and 10/484, both relating to the role of the external auditor
- Circulars 11/519 and 11/529 on the *risk analysis regarding the fight against money laundering and terrorist financing*, applicable to credit institutions and other financial sector professional entities under the supervision of the CSSF
- Circular 11/528 on the *abolition of the transmission to the CSSF of suspicious transaction reports regarding potential money laundering or terrorist financing*
- Circular 15/609 on the *developments in automatic exchange of tax information and anti-money laundering in tax matters*
- Circular 18/680 relating to the *joint Guidelines of the three European Supervisory Authorities on the measures payment service providers should take to detect missing or incomplete information on the payer or the payee*
- Circular 18/684 relating to the *entry into force of the Law of 13 February 2018 amending, inter alia, the Law of 12 November 2004 on the fight against money laundering and terrorist financing*
- Circular 18/690 on the *Guidelines of the European Securities and Markets Authority (ESMA) on the management body of market operators and data reporting services providers*
- Circular 18/698 including specific provisions on the fight against money laundering and terrorist financing applicable to investment fund managers and entities carrying out the activity of registrar agent
- Circulars issued in light of FATF statements regarding jurisdictions whose AML/CFT regime:
  - Has substantial and strategic deficiencies
  - Is not making sufficient progress in remedying the deficiencies
  - Is not satisfactory
- Circular 19/732 on the clarifications on the identification and verification of the identity of the ultimate beneficial owner(s)
- Circular 20/740 on the *Financial Crime and AML/CFT implications during the COVID-19 pandemic*
- Circular 20/744 which complements the Circular CSSF 17/650 of February 2017 (which provides guidance of the different tax fraud and professional obligations in term of AML/CFT)
- Circular 21/782 on the adoption of the revised guidelines, by EBA, on ML/TF risk factors
- Circular 21/788 on the guidelines for the collective investment sector on the CSSF AML/CFT external report
- Circular 22/807 on central administration, internal governance and risk management

On 22 December 2021, the CSSF issued Circular 21/788 providing *Guidelines for the Collective Investment Sector on the CSSF AML/CFT external report*.

The circular introduces a new report to be prepared and approved by the independent auditor (*Réviseur d'Entreprises Agréé*) applicable from the year ended 31 December 2021 for all Luxembourg IFMs, including registered AIFMs and all Luxembourg UCIs supervised by the CSSF for AML/CFT purposes. The AML/CFT external report is not required for Luxembourg UCIs which have appointed an IFM (established in Luxembourg or abroad). Any significant deficiencies resulting from the independent auditor's procedures should be reported in the UCI's management letter.

The AML/CFT External Report comprises two sections: the first covers the corroboration of responses given by the entity in the context of the annual CSSF AML/CFT survey, the second includes sample testing or specific procedures performed by the independent auditor. The size of the sample to be tested by the independent auditor will be determined by the methodology set up by the CSSF using a risk-based approach.

The External Report must be submitted via the e-Desk platform by the RR, the RC or by a member of the board of directors/managers of the entity, on an annual basis within six months after the end of the financial year of the relevant IFM or UCI for the financial years ending after 31 December 2021.

The deadline for the financial year-end of 31 December 2021 is extended by three months, until end of September 2022.

The areas covered by the report will include:

- AML/CFT Procedures
- Risk-Based Approach
- Funds Due Diligence
- Channels of Distribution Due Diligence
- Discretionary Portfolio Management (DPM) - client identification
- Transfer Agent (TA) - investor identification
- Investments (Assets) Due Diligence
- Name Screening
- Oversight on Delegates/Service providers performing AML/CFT controls
- Oversight on branches/subsidiaries
- Cooperation with the authorities

## EU Directives

- ▶ Directive (EU) 2019/1153 *laying down rules facilitating the use of financial and other information for the prevention, detection, investigation or prosecution of certain criminal offences*. The Directive has been transposed by the Law of 22 June 2022 on the management and recovery of seized or confiscated assets
- ▶ Regulation (EU) 2018/1672 on controls on cash entering or leaving the EU. This Regulation will apply in Member States from 3 June 2021
- ▶ Directive (EU) 2018/1673 of the European Parliament and of the Council of 23 October 2018 on combating money laundering by criminal law – the 6<sup>th</sup> EU AML Directive. This directive establishes minimum standards for offences and penalties and sets out specific obligations regarding predicate offences, ML offences, liability of legal persons and dual criminality<sup>6</sup>. The transposition was completed into national law by 19 December 2020

### 8.8.4.2. Industry practice

In July 2013, AML/CFT guidance for the Luxembourg fund industry entitled *Practices and Recommendations aimed at reducing the risk of money laundering and terrorist financing in the Luxembourg Fund Industry* was issued by ALFI, in association with the Luxembourg Bankers' Association (ABBL), the Association of Luxembourg Compliance Officers (ALCO) and the Association of Professionals in Risk Management, Luxembourg (ALRiM). These practices and recommendations cover:

- ▶ AML/CFT responsibilities
- ▶ Persons responsible for compliance
- ▶ Oversight obligations
- ▶ ML/TF risk appetite and risk assessment
- ▶ Customer due diligence
- ▶ Asset due diligence

The guidelines include, *inter alia*:

- ▶ Guidance on a risk-based approach in relation to customer identification and transaction monitoring, in line with international standards, including the FATF "40 Recommendations" entitled *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation*
- ▶ A methodology for assessing the equivalence of legal and regulatory know your customer (KYC) requirements of foreign jurisdictions by comparing them to FATF standards

The *Practices and Recommendations* also include the notion of "correspondent relationships" representing the business relationship between the UCI (or a third party acting on behalf of the UCI, such as service providers) and any intermediary, for which specific due diligence must be performed and documented.

These practices and recommendations may not be used to overrule any provision of the Luxembourg legislation on the fight against ML/TF or any Circular on this topic.

### 8.8.4.3. Scope of the AML/CFT legal framework

#### A. AML/CFT offences

ML/TF offences are defined in Articles 506-1 to 506-7 of the Luxembourg Criminal Code. In general terms, the offences consist of any of the following:

- ▶ Helping to justify the untrue origin of the subject or the proceeds of certain criminal activities
- ▶ Helping to place, convert or hide the subject or proceeds of such activities
- ▶ Acquiring, detaining or using the proceeds of such activities

The underlying criminal activities concerned include, for example, drug trafficking, tax offences, organized crime, kidnapping of minors, sexual offence against minors and prostitution.

The definition of ML offences includes any crime punished by a prison sentence of more than six months.

The 6<sup>th</sup> EU AML Directive, partially implemented in Luxembourg Law, has defined a list of 22 essential ML offences. Article 2 of the directive contains a list of categories of offences considered as "criminal activities". Furthermore, "self-laundering" becomes an offence.

On 26 January 2020, the CSSF published a statement regarding the ML/TF risk analysis of the investment fund sector. This analysis followed the Luxembourg's first risk assessment of ML/TF published in 2018. Building a tailor-made risk assessment allows the CSSF to both have a closer look at the ML/TF risks that specific financial actors are exposed to as well as the mitigating factors they apply.

<sup>6</sup> Offences provided for the Luxembourg Criminal Law are also punishable when the primary offense was committed abroad. However, with the exception of offenses for which the Law allows prosecution even if they are not punishable in the State where they were committed, this offense must be punishable in the State where it was committed.

The investment fund industry is composed mainly of four types of participants:

- ▶ Investors
- ▶ UCIs
- ▶ IFMs
- ▶ Service providers (e.g., depositary, external auditors, central administrators)

The scope of the risk assessment published by the CSSF covers all Luxembourg regulated UCIs but with a focus on roles and responsibilities that IFMs have with respect to AML/CTF matters. The assessment highlights the best practices and most frequent shortcomings identified in the AML/CTF procedures and is structured in three main sections:

- ▶ Inherent risk - threat assessment: This section describes the main threats UCIs are exposed to in relation to ML risks (fraud, tax crime, corruption, bribery and market manipulation)

Predicate Offence	Features Increasing Risk
Fraud	<ul style="list-style-type: none"> <li>▶ International exposure</li> <li>▶ Complexity and opacity of set-up</li> <li>▶ Cross-border delegation of services</li> <li>▶ Diversity of asset classes</li> <li>▶ Conflict of interest</li> </ul>
Tax crimes	<ul style="list-style-type: none"> <li>▶ International exposure</li> <li>▶ Complexity and opacity of set-up</li> <li>▶ Concealed beneficial ownership</li> <li>▶ Cross-border operations</li> <li>▶ Cross-border investments</li> </ul>
Corruption and bribery	<ul style="list-style-type: none"> <li>▶ Ties and connections with public officials</li> <li>▶ Over-reliance on government approval</li> <li>▶ Use of third parties or local arrangements</li> <li>▶ Unconstrained discretion over investment and portfolio allocation decisions</li> <li>▶ Large stakes in portfolio companies</li> </ul>
Insider trading and market manipulation	<ul style="list-style-type: none"> <li>▶ International portfolio of securities, especially from less transparent markets</li> <li>▶ Active portfolio management in highly competitive environment</li> </ul>

In accordance with this document, the general terrorist financing risk within the investment fund industry is considered low due to several factors:

- ▶ Terrorist financing requires short-term and transitory cash flows (generally not compatible with a fund industry focus on a medium- to long-term horizon)
- ▶ Terrorist financing favors the use of transfer methods outside of the banking system (not compatible with custodian obligations)
- ▶ Terrorist financing focuses on transferring low amounts of money to minimize scrutiny by bank systems (systems have been created to detect certain operations with a specific threshold or unusual transactions) which are not compatible with UCIs' minimum subscription requirements

## B. Entities in scope

The scope of application of the legal framework is as follows:

- (1) Entities covered by prevention of ML/TF obligations (referred to in this section as "Entities") include, *inter alia*:
  - ▶ Banks and PSFs entities that are authorized to exercise their activities in Luxembourg on the basis of the 1993 Law. These include, for example, banks, investment advisors, distributors of shares or units of UCIs and domiciliation agents
  - ▶ 2010 Law UCIs and SIFs
  - ▶ Management companies that market shares or units of UCIs or perform additional activities (see Section 6.1.2.)
  - ▶ Managers and advisors of UCIs and pension funds
  - ▶ Securitization vehicles where they provide services to companies
  - ▶ Foreign firms providing services into Luxembourg on a cross-border basis (without establishing a branch)
  - ▶ Real estate developers
  - ▶ Exchange platforms for virtual currencies (including exchanges dealing with fiat currency and virtual currency)
  - ▶ Custodian wallet providers
  - ▶ Rental brokers (when the value of the monthly rent is equal to or above EUR 10,000)
  - ▶ Art dealers (or persons who act as intermediaries in the trade in works of art including galleries)

(2) Branches and subsidiaries of Luxembourg Entities:

All Entities within the scope of the Law of 12 November 2004, as amended, are required to ensure that their AML/CFT obligations are also complied with by their branches and subsidiaries located abroad (paying particular attention to branches and subsidiaries in countries that do not apply equivalent AML/CFT standards).

The branches and subsidiaries of foreign Entities established in Luxembourg are also in scope of Luxembourg AML/CFT obligations and must therefore comply with them.

#### 8.8.4.4. Professional AML/CFT obligations applicable to financial services Entities

##### 8.8.4.4.1. Introduction

Entities are required to implement appropriate AML/CFT policies, procedures and controls that are tailored to the specific situation of the Entity.

Entities are required to perform customer due diligence or to ensure that customer due diligence is duly performed. The customer due diligence must be adapted to the client AML/CFT risks:

- ▶ Identification of the client - i.e., the investor (potential shareholder or unitholder) - generally referred to in AML/CFT terms as the “beneficial owner”
- ▶ Verification of the client and beneficial owner identity (including the senior management officers, in case the client is an Entity and there is no beneficial owner)

There are three types of customer due diligence:

- ▶ Standard customer due diligence
- ▶ Simplified customer due diligence (SDD)
- ▶ Enhanced customer due diligence (EDD)

The customer due diligence may be performed by:

- ▶ The Entity itself
- ▶ A third party, such as the entities that are part of a financial group. Third parties may be:
  - ▶ An Entity that introduces the client
  - ▶ A delegate of the Entity that performs the AML/CFT risk assessment

The type of customer due diligence method will depend on a number of factors including:

- ▶ Country/geographical area of residency of the customer
- ▶ Type of customer (e.g., individual, corporate entity, purchase of securities using physical cash, transparency of the ownership structure)
- ▶ Type of product, services (e.g., complexity or size of the product or service, use of new technologies or payment methods not used in the normal course of business by the securities provider)
- ▶ Transactions and delivery channel (e.g., penny and microcap stocks, non-face-to-face relationship, third parties)
- ▶ Evidence of AML/CFT framework applicable to and implemented by third parties:
  - ▶ The AML/CFT regulatory and supervisory regime applicable to any third party
  - ▶ The AML/CFT measures implemented by the third party

Entities are required to perform ongoing monitoring of:

- ▶ Their book of clients against AML/CFT blacklists
- ▶ Client transactions in order to identify potentially suspicious transactions
- ▶ Third parties acting on their behalf
- ▶ Related stakeholders (including directors and shareholders owning more than 25% of the shares of an entity and proxies)

Entities are required to:

- ▶ Appoint an officer responsible for AML/CFT (see also 8.8.4.4.2.B.)
- ▶ Keep adequate records of AML/CFT documentation for a required period of time
- ▶ Establish a written AML/CFT risk analysis report
- ▶ Take appropriate AML/CFT measures in relation to hiring and training employees
- ▶ Integrate AML/CFT reviews into the tasks of the internal audit function

The remainder of this section summarizes the professional AML/CFT obligations applicable to financial services Entities.

## 8.8.4.4.2. Internal organization

### A. Obligation to establish adequate internal organization

Entities must implement adequate and appropriate policies and procedures on customer due diligence, reporting, record-keeping, internal control, risk assessment, risk management, compliance management and communication in order to meet their AML/CFT legal obligations.

Policies, controls and procedures must be validated by the person in charge of AML/CFT and approved by management and, for credit institutions and investment firms, by the board of directors. AML/CFT procedures must include, *inter alia*:

- ▶ Procedures to follow in cases where the account is opened before the achievement of the verification of the identity of the client and, when required, of the ultimate beneficial owner
- ▶ Procedures to follow in case of numbered account opening (i.e., accounts where the name of the client or beneficial owner is replaced by numbers)
- ▶ Procedures to follow to respect the obligations included in the European Regulation (EC) 1781/2006 in relation to transfers of funds (see Section 8.8.4.4.7.B.) repealed by Regulation EU 2015/847 of May 2015 that has applied since 1 January 2017
- ▶ AML/CFT hiring and training procedures

Entities are also required to coordinate their AML/CFT procedures with their branches and subsidiaries in foreign countries. Entities using their group policies and procedures should, in addition to complying with conditions specified in the AML Law, mitigate risks linked to countries classified as high-risk pursuant to the AML Law.

### B. Appointment of an AML/CFT officer

Each Entity must designate a person specifically in charge of ensuring compliance with AML/CFT obligations. This may be the compliance officer. This person must ensure implementation of internal policies and procedures relating to customer acceptance, identification, monitoring and risk management.

On 25 November 2019, the CSSF published an FAQ document in order to clarify the requirements in Article 4 (1) of the Law of 12 November 2004, as amended, to appoint two different persons in charge of AML/CFT for supervised UCIs and IFMs and their obligations, *inter alia*:

- ▶ The person responsible for AML/CFT compliance at the level of the board of directors/governing body (*Responsable du respect des obligations* or *RR*) can be the board of directors (or other governing body depending of the legal structure of the entity) acting as a collegial body, or can be one of the members of such board of directors (or other governing body)
- ▶ The compliance officer at the appropriate hierarchical level (*Le responsable du contrôle du respect des obligations* or *RC*):
  - ▶ For investment funds, the RC can be a member of the board with appropriate experience, a contractually appointed third party or a staff member of the appointed IFM, mandated in a personal capacity by the board of directors (or other governing body) of the fund. The RC must be available in Luxembourg, except where the IFM and the relevant staff member are not domiciled in Luxembourg
  - ▶ For IFMs, the RC should be the compliance officer at the appropriate hierarchical level in charge of AML/CFT aspects for the IFM. The RC must (i) have sufficient experience and knowledge of the Luxembourg legal and regulatory framework on AML/CFT, (ii) allocate sufficient time for their function, (iii) be permanently located in Luxembourg (or have their domicile in a place allowing them, in principle, to come to Luxembourg every day), (iv) be employed by the IFM. Any change in the aforementioned persons must be communicated in advance to the CSSF. If the RR is a collegial body, at least one of its members must fulfill the availability requirement. The RC should have access to all internal documents and systems which are necessary to perform its tasks and comply with the skills and duties requirements from Articles 40 (3) to 43 of CSSF Regulation No 12-02
- ▶ The AML/CFT Compliance Officer at the management level must draw up a summary report on compliance with AML/CFT professional obligations at least once a year

CSSF Circular 18/698 specifies the items to be covered in the summary report, including, most notably:

- ▶ The results of the identification and assessment of ML/TF risks and measures taken to mitigate them
- ▶ The results of due diligence
- ▶ Results of enhanced due diligence performed on PEPs
- ▶ The number of identified breaches of AML/CFT professional obligations
- ▶ The monitoring of the positions blocked due to AML/CFT
- ▶ The periodic review of all business relationships according to their risk level
- ▶ Number of AML/CFT actions implemented with an explanation and a deadline for the implementation

The table below provides information on the RR's and RC's respective responsibilities:

		RR = Person responsible for compliance		RC = Compliance officer		
		UCI	IFM	UCI	IFM	
Eligibility criteria	Board member	Board member	Board member	Person mandated <i>intuitu personae</i> by the UCI board (may be chosen among the staff of the designated IFM for externally managed UCIs)	Compliance officer	
	Board collectively	Board collectively	Board collectively			
Additional requirements	<ul style="list-style-type: none"> <li>▶ Demonstrable AML/CFT knowledge with regard to applicable Luxembourg legislation</li> <li>▶ Available (at least one member if the RR is a collegial body) without delay upon contact by Luxembourg competent authorities</li> </ul>			<ul style="list-style-type: none"> <li>▶ Demonstrable AML/CFT knowledge, expertise and experience with regard to applicable Luxembourg legislation</li> <li>▶ Available without delay upon contact by Luxembourg competent authorities</li> <li>▶ Has access to all internal documents and systems required for performing its tasks</li> </ul>		
	Knowledge about investment and distribution strategies of the UCI		Knowledge about the services offered by the IFM		Knowledge about investment and distribution strategies of the UCI	Knowledge about the services offered by the IFM
Duties	<ul style="list-style-type: none"> <li>▶ Validates the supervisory system</li> <li>▶ Approves business relationships with PEPs (establishing/continuing)</li> <li>▶ Approves business relationships involving high-risk countries</li> <li>▶ In case of branches/subsidiaries established in third countries where the law does not permit to implement group-wide AML policies, the RR must:                             <ul style="list-style-type: none"> <li>▶ Approve the AML/CFT risk assessment and the group AML/CFT policies and procedures</li> <li>▶ Be provided at least with information on the number of suspicious transactions reports filed within a set period and aggregated data providing an overview of the circumstances that gave rise to suspicion</li> <li>▶ Be provided with at least the number of high-risk customers and aggregated statistical data providing an overview of the reasons why customers have been classified as high risk, such as PEP status</li> <li>▶ Approve the establishment and maintenance of higher-risk business relationships, or a higher risk occasional transaction</li> </ul> </li> <li>▶ Receives regular and <i>ad hoc</i> reports from the compliance officer on the follow up of the recommendations, problems and shortcomings and irregularities identified during the course of regular controls and verifications of the compliance with the AML/CFT policy. Reports should specify the related risks and their seriousness, propose corrective measures and the position of persons concerned. These reports must allow:                             <ul style="list-style-type: none"> <li>▶ Assessing the scale of the suspicions or reasonable grounds for suspicion of (i) money laundering, (ii) an associated predicate offence or (iii) terrorism financing which were identified and</li> <li>▶ Expressing a judgement on (i) the adequacy of the AML/CFT policy, procedures and systems and (ii) the collaboration between the professional's departments as regards AML/CFT</li> </ul> </li> <li>▶ Where a suspicious activity/transaction is identified, the compliance officer should consult the RR where appropriate</li> <li>▶ Submits summary report to the CSSF within six months of the year end</li> </ul>			<ul style="list-style-type: none"> <li>▶ Applies the AML/CFT policy and procedure and has the power to propose to the authorized management on his own initiative any measure necessary or useful to this end, including the release of required means</li> <li>▶ Reviews the AML/CFT policy on a regular basis</li> <li>▶ Performs regular control of the supervisory system</li> <li>▶ Ensures the quality of the AML/CFT controls carried out by the first line of defence and, as the second line of defence, must verify compliance by the professional with all the AML/CFT professional obligations</li> <li>▶ Must provide written authorization for the acceptance of new customers, where appropriate and for customers with a high-risk profile</li> <li>▶ Must be provided with an internal report when it is impossible to verify at the earliest opportunity the identity of a customer and beneficial owner (in case where an account is opened before or during the verification of the identity)</li> <li>▶ Must be provided with an internal report when it is impossible to verify at the earliest opportunity the identity of the founders, of a company and of the beneficial owner (in case where an account is opened for a company in the process of incorporation)</li> <li>▶ Must be involved systematically in the acceptance of customers involving high-risk countries</li> <li>▶ Must be provided with reports on suspicious transactions/persons identified and is solely competent to decide on the application and scope of measures required where a suspicious activity or transaction is identified and their termination. The RC is consulted where appropriate</li> <li>▶ Must provide the RR, the authorized management and, where appropriate the board regular and <i>ad hoc</i> reports on the follow-up of the recommendations, problems and shortcomings and irregularities identified during the course of regular controls and verifications of the compliance with the AML/CFT policy. Reports should specify the related risks and their severity, propose corrective measures and the position of persons concerned. These reports must allow:                             <ul style="list-style-type: none"> <li>▶ Assessing the scale of the suspicions or reasonable grounds for suspicion of (i) money laundering, (ii) an associated predicate offence or (iii) terrorism financing which were identified and</li> <li>▶ Expressing a judgement on (i) the adequacy of the AML/CFT policy, procedures and systems and (ii) the collaboration between the professional's departments as regards AML/CFT</li> </ul> </li> <li>▶ Must prepare at least once a year, a summary report on his activities and his operation and submit it to the person responsible for compliance, the authorized management and the board and, where appropriate, the specialized committees</li> <li>▶ Is the privileged contact person for the Luxembourg authorities as regards AML/CFT issues and for the competent authorities with respect to the application of restrictive measures in financial matters. He is also in charge of the transmission of any information or statement to these authorities</li> </ul>		

Every Luxembourg fund and IFM must designate an RR who is responsible for the compliance with the AML/CFT obligations, and an RC (otherwise known as the AML/CFT Compliance Officer). The RC can be a third party but, in this case, a contract must be signed between the company who outsourced the function and the person or the company acting as the RC.

The RC must not only have the professional experience and knowledge of the legal and regulatory framework in force in Luxembourg, but also access to the identification data and other relevant documents and information and the necessary availability required to efficiently and autonomously perform his functions.

It is possible to delegate the AML/CFT activities, although responsibility remains with the AML/CFT officer, senior management and the governing body.

The RC is required to report regularly and on an *ad hoc* basis if necessary, to authorized management and, where relevant, to the board of directors or specialized committees. The report must cover the follow-up of recommendations, issues, deficiencies and exceptions identified in the past and new matters identified. Each report must specify the related risks and their degree of importance (measurement of impact) and remediation action proposed. These reports must enable the evaluation of the significance of suspicions of ML/TF and provide an opinion on the adequacy of the AML/CFT policy.

Once a year, the RC must produce a summary report on its activities and its operations. This report must be submitted to the board of directors for approval and provided, for information, to authorized management (see also Section 8.8.4.4.7.F.).

The *FAQ on the AML/CFT RC Report for CSSF supervised Luxembourg Investment Funds and Luxembourg Investment Fund Managers* issued in March 2022 states that as per Article 42 (7) of the CSSF Regulation 12-02 (RCCSF 12-02), the following entities are required to submit the AML/CFT RC report to the CSSF:

- ▶ Luxembourg IFMs
- ▶ Luxembourg UCIs which have appointed a foreign IFM
- ▶ Luxembourg UCIs which have not appointed an IFM (“self-managed funds”)

In accordance with Article 42 (7) of the RCCSF 12-02, the entities are obliged to submit the AML/CFT RC report “within five months following the end of the professional’s financial year”.

The CSSF expects the AML/CFT RC report to clearly illustrate/demonstrate the results of the work of the RC (including, *inter alia*, results on AML/CFT due diligence on investors, distributors, PEPs, and assets).

If the inquiries and diligences conducted by the RC raise no shortcomings, this information must be mentioned in the report. When shortcomings are identified, however, it is then expected that their severity be assessed by the RC and that a remediation plan be proposed. Subsequent AML/CFT RC reports must include a follow-up/update of previous remediation plans.

The RC Report must be transmitted regardless of his/her nomination date.

One or more other functions held by the RC must not jeopardize his/her independence, objectivity and independent decision-making. His/her workload must be adapted in order not to jeopardize the effectiveness of the AML/CFT framework.

On 14 June 2022, the EBA published the Guidelines specifying the role, tasks and responsibilities of the AML/CFT compliance officer, the management body and senior manager in charge of AML/CFT compliance as well as internal policies, controls and procedures as referred to in Article 8, and Article 45 and Article 46 of Directive (EU) 2015/849 (4<sup>th</sup> EU AML Directive).

The key provisions set out in the Guidelines concern:

- ▶ Governance: clarification of the role of the management body in its management function and the role of the management body in its supervisory function
- ▶ Proportionality: proportionality criteria for the appointment of a separate AML/CFT compliance officer
- ▶ Assessment: assessment prior to the appointment of the suitability, skills and expertise that the AML/CFT compliance officer should possess
- ▶ Tasks and responsibilities: clarification of expectations regarding the role, tasks and responsibilities of the AML/CFT compliance officer and management (including the member of the management body who will be responsible for implementing the AML/CFT obligations). In particular:
  - ▶ Details of the AML/CFT’s reporting expectations (i.e., a list of information to be included in the AML/CFT compliance officer’s report)
  - ▶ Information transmitted to the FIU (i.e. reporting of suspicious transactions)
  - ▶ Training (i.e., including practical training to be provided to individuals exposed to different levels of ML/FT risks)
  - ▶ Cooperation between the AML/CFT compliance function and other functions (e.g., risk and internal audit)
- ▶ Outsourcing: clarification of the list of strategic decisions to comply with AML/CFT obligations that should not be outsourced. The new Guidelines refer to the outsourcing process as defined in the ESAs Guidelines on outsourcing, in particular when outsourcing operational functions of the AML/CFT compliance officer
- ▶ Group level: the organization of the AML/CFT compliance function at group level with the appointment of a group AML/CFT compliance officer and the tasks and responsibilities assigned

The Guidelines will apply from 1 December 2022.

#### 8.8.4.4.3. Risk-based approach

Entities must define and implement a “risk-based approach” in relation to customer identification, asset due diligence, and transaction monitoring. The concept of a risk-based approach implies that entities should concentrate their efforts on clients/assets assessed as higher risk because of, for example, their country, type of listing, sector of activity or level of regulation. Entities are required to adapt their practices and processes to the assessed level of risk of ML/TF.

Entities are required to perform an assessment of the AML/CFT risk exposure related to their activities (see Section 8.8.4.4.7.F.).

The level of due diligence will depend upon factors including, but not limited to, whether the client is an individual or a legal entity, the level of transparency or opaqueness of the client, asset, product, service or transactions and country risk linked with the client (see Section 8.8.4.4.6.D.).

Each Entity should design questionnaires for prospective clients appropriate to the situation (e.g., the communication medium used and the nature of the business relationship with the prospective client, including the types of services) and the associated risks.

Standard customer due diligence must be applied systematically. However, the level of customer due diligence must be adapted depending on the risk. In specific cases, simplified customer due diligence will be sufficient (see Section 8.8.4.4.5.). When there is a higher risk of money laundering or terrorist financing, enhanced customer due diligence must be applied in addition to the standard measures - for example, in the instance where the client is located in a high-risk country (see Section 8.8.4.4.6.).

Any refusal to enter into a relationship must be documented. The refusal must be documented even if the refusal is not related to a suspicion of ML/TF.

CSSF Regulation No 20-05 added a Know Your Assets (KYA) requirement in the context of investment businesses. Entities must analyze, based on a risk-based approach, the ML/TF risk posed by investments. Further due diligence measures taken should be commensurate with the outcome of the risk-based approach. The Regulation stipulates that such risk-based approaches should be formalized and reviewed at least annually or based on a trigger event which would require a re-evaluation of the risk.

The Entity must also identify the states, persons, entities and groups subject to restrictive measures in financial matters with respect to the assets it manages and ensure that funds will not be made available to such parties.

The Entity has the obligation to perform controls over targeted financial sanctions, clustered munitions financing and proliferation financing, on all assets, regardless of the risk and, depending on the asset type, over the parties linked to the transaction (including issuer and (if unlisted) principal/agent).

#### 8.8.4.4.4. Customer due diligence

##### A. Performed by the Entity

The Entity must identify its client and verify his identity by means of documentary evidence at the outset of a business relationship and, in particular, when opening an account.

##### (1) Required identification documentation

The identification of a physical person requires gathering and registering key information about the identity of the person (e.g., surname and first name, date and place of birth, nationality, address). The verification of physical persons must be based on a valid document issued by a competent authority, bearing a photo and signature. Passports, identity cards and other official documents, such as residential permits, can be accepted.

The identification of a legal person or a legal arrangement requires gathering and registering key information regarding the identity of the company (e.g., denomination, legal form, directors). The verification of the identity of corporate (legal entity) clients must be based on the latest and coordinated articles of association (or equivalent) and a recent extract from the Trade and Companies Register.

The CSSF Regulation No 20-05 specified that the information required for the identification of the customer should also be gathered for initiators and promoters who launched an investment fund supervised by the CSSF and who will be a future customer of a professional.

For prospective corporate clients, the Entity must at least identify and verify the identity of the members of management and board of directors (including those having no power to operate the account) with whom it is in contact. This principle also applies to well-known prospective institutional clients.

For physical and corporate clients, supplementary verification measures to be applied based on the risk assessment of the client may include, for example:

- For corporate entities, a review of latest annual report, and/or on-site visit to the company
- For physical clients, the verification of the address indicated by the client by evidence of domicile



The obligation for the client documentation, data or information, to be kept up-to-date is an integral part of the professional AML/CFT obligations. The Entity must conduct a periodical review, especially of documents that are essential to the business relationship and knowledge of the client, at a frequency that depends on the client risk assessment and the risk associated to this business relationship. Documents must be updated in case of any change since the previous review.

(2) Persons to be identified

Client identification and verification must cover both the direct customer, which may be a representative and the persons on whose account the direct customer is acting - i.e., the "beneficial owner(s)".

A beneficial owner is always to be considered as a natural person.

The principle of identifying beneficial owners applies both to individuals and legal persons. Identification of both the persons in whose names an account is opened and the persons for whose account these clients are acting is mandatory when the customers do not act on their own behalf.

For companies, identifying the ultimate beneficial owner implies identifying the individuals with a "controlling interest and the individuals who comprise the mind and management of the company".

As a minimum the following should be considered:

▶ In case of general companies - a threefold "cascading" approach has been clarified by CSSF Circular 19/732:

- i. Any individual who ultimately owns or controls a legal entity, by direct or indirect control of a sufficient number of shares over the entity, including bearer shares or other means, other than a company listed on a regulated market that is subject to obligations similar to the EU directives or equivalent international standards which guarantee adequate transparency for ownership information

A shareholding of 25% plus one share, voting rights, ownership, or a participation in the capital of the client of more than 25%, held by an individual, is an indicator of direct ownership.

A shareholding of 25% plus one share, voting rights, ownership, or a participation in the capital of the client of more than 25%, owned by a legal entity which is controlled by one or more individuals is an indicator of indirect ownership.

- ii. If no individual can be identified via the procedure under i), the individual who controls the legal entity via other means where other means should be interpreted broadly, namely having the power to exercise or actually exercise dominant influence or control by any means over the customer. Such other means can be, *inter alia*:

- ▶ Individuals granted control through shareholders agreements
- ▶ Individuals with the ability to *de facto* control the customer
- ▶ Personal relationships with the customer, for example family members
- ▶ Individuals possessing a significant minority interest whereas the other shareholders have significantly lower participations

- iii. Having exhausted all other possibilities and provided that there is no grounds for suspicion, no individual has been identified as per the previous points and it is not clear whether the persons identified are the effective beneficial owners, a senior managing official (*dirigeant principal*) should be identified

If a step is skipped, it should be duly documented on file why information for such a step could not be obtained.

▶ In case of fiduciaries or trusts, the following parties should be identified:

- ▶ Settlor, if any
- ▶ Any trustee or fiduciary
- ▶ Protector (if any)
- ▶ Beneficiaries or when not yet designated, the category of persons in whose main interest the construction or the entity has been established or operates
- ▶ Any other individual exercising ultimate control or influence over the trust or fiduciary by direct or indirect ownership or otherwise

Where the professional is not able to identify the beneficiary of a trust or similar legal arrangements and where the beneficiaries are not physical persons but designated by characteristics or by class, the professional should obtain sufficient information to be able to identify the beneficiary at the time of the payment or when the beneficiary will exercise his right.

In case of legal entities like foundations and legal constructions like trusts or fiduciaries, the concept of ultimate beneficial owner should at least include any individual holding the same or similar function as in the case of fiduciaries or trusts.

A beneficial owner can be someone who owns less than 25% of a company structure but nevertheless controls the company, hence, all individuals who, ultimately, own or control the client or any individuals on whose behalf a transaction has been executed or an activity realized is considered a beneficial owner.

In case no ultimate beneficial owner is identified as required by the laws and regulations, the business relationship cannot be established.

A person holding less than 25% of a company can be the ultimate beneficial owner if he/she otherwise exercises control over the legal entity, even if another person has a participation exceeding this 25% threshold.

It is therefore important that Entities look beyond the 25% threshold and take reasonable measures to enable them to fully understand the structure of ownership and control of the company.

The 25% threshold is purely indicative and may, in some cases, not be sufficient to determine the correct ultimate beneficial owner.

A beneficial owner declaration should be signed by the client (the account holder) or by the beneficial owner himself. However, the client must inform the Entity of any change related to the beneficial owner.

The notion of representative also covers legal representatives of physical persons who are incapable of managing their own affairs and representatives of physical or corporate persons authorized to act on behalf of clients based on a proxy.

### (3) Information to be collected/verification

For the purposes of the identification and verification of the ultimate beneficial owner(s), Entities are required to collect and store at least the following information:

- ▶ For physical persons:
  - ▶ Surname
  - ▶ First name
  - ▶ Nationality
  - ▶ Date and place of birth
  - ▶ Personal address
- ▶ For legal persons or arrangements (for example, a trust) that exist between the customer (legal owner - for example, the trustee in the case of a trust) and the natural person (beneficial owner - for example, trust beneficiaries) the following information shall be recorded:
  - ▶ Denomination
  - ▶ Legal form
  - ▶ Address of the registered office and, if different, a principal place of business
  - ▶ Where appropriate, official national identification number
  - ▶ Directors (*dirigeants*) (for the legal persons) and directors (*administrateurs*) or persons exercising similar positions (for the legal arrangements)

When establishing a relation with a client, the information on the origin of funds must form part of the initial customer due diligence, whatever the risk level of the client.

When verifying the ultimate beneficial owner(s) of their customers, professionals should collect proof of registration or an excerpt of the RBE register or similar registers abroad. Similar measures should be taken with respect to customers that are foreign legal persons or arrangements and where such type of registers are available for consultation without restrictions to foreign financial institutions.

Professionals must not rely exclusively on the central registers referred to in the Law of 13 January 2019 to fulfil their customer due diligence requirements.

### (4) Electronic identification and verification

The AML Law foresees rules for electronic identification and verification of identity via trusted services as set out in Regulation (EU) No 910/2014 (eIDAS Regulation). The eIDAS regulation:

- ▶ Ensures that businesses can use their own national electronic identification schemes (eIDs) to access public services in other EU countries where eIDs are available
- ▶ Creates a European internal market for electronic trust services - namely electronic signatures, electronic seals, time stamps, electronic delivery services and website authentication – by ensuring that they will work across borders and have the same legal status as traditional paper based processes

Transactions:

Professionals are required to retain documents, data and information regarding the supporting evidence and records of transactions which are necessary to identify or reconstruct transactions, for a period of five years after the end of a business relationship with their customer or after the date of an occasional transaction.

CSSF Circular 20/740 also foresees the following points regarding Customer Due Diligence (CDD):

- a. If no safeguards are put in place for non-face-to-face businesses, CDD measures should be strengthened to mitigate the impact of a lack of face-to-face contact with customers in line with a risk-based approach. Measures could include performing more frequent checks against lists of PEPs and conducting additional or more detailed checks as part of enhanced due diligence processes

It is particularly important to employ appropriate CDD processes when approving applications for government support, due to the short timelines often associated with such requests and the possible additional associated ML/TF risk.

- b. The CSSF encourages professionals to consider that digital ID systems should rely upon technology, processes, governance and other safeguards, that provide an appropriate level of trustworthiness
- c. The verification of customer identity via live video-chat, or the use of electronic identification means, could be considered an appropriate safeguard in view of the lack of face-to-face contact. The CSSF highlights that other mitigation measures in such situations may include: (1) the collection of additional documents; (2) the certification of documents; (3) the reliance on a third party having already identified the customer (e.g., other PFS, or service providers offering document verification services); and (4) the check by means of a first transfer of funds from a bank account in the name of the customer with a credit institution established in Luxembourg, in the EU, or in any other country respecting equivalent AML/CFT obligations and being supervised for that purpose

#### B. Performed by a third-party introducer

A specific introductory regime is foreseen where the client is identified through a Luxembourg financial institution or a foreign financial institution subject to customer identification requirements equivalent to those provided under Luxembourg law.

A UCI, its management company or AIFM that markets its shares or units via an intermediary (distributor) that is a regulated domestic or foreign financial institution subject to equivalent AML/CFT obligations will be exempt from the requirement to identify the underlying investors as they may rely on identification performed by the intermediary.

The third-party introduction regime avoids the duplication of KYC procedures.

In this case, the intermediary must be:

- ▶ A Luxembourg credit or financial institution, a Luxembourg auditor, notary or lawyer
- ▶ A credit or financial institution established in a foreign Member State that:
  - ▶ Is subject to mandatory professional registration, recognized by law
  - ▶ Applies customer due diligence and record keeping requirements laid down or equivalent to those laid down in Luxembourg law, in the Directive (EU) 2015/849<sup>7</sup>, as amended, or equivalent rules
  - ▶ Is supervised in compliance with the requirements of Luxembourg law, the Directive (EU) 2015/849, as amended, or the law of a third country that imposes equivalent requirements to those laid down in the Directive (EU) 2015/849 or equivalent rules

According to CSSF Regulation No 12-02, the professional should verify the quality of a third-party introducer by requesting documentation prior to the introducer's intervention. Responsibility remains ultimately with the professional using a third-party introducer.

Entities must assess the equivalence of third countries' AML/CFT requirements and establish their own risk-based approach.

In practice, this means that the Entity must perform due diligence on the countries of the distributor/investors to assess the equivalence of each third country's AML/CFT requirements and keep their knowledge of the third countries' AML/CFT requirements up to date.

Such assessment should be updated, in particular when relevant new information becomes available on the country in question.

The third party must be in a position to provide immediately, upon request, relevant copies of identification and verification data and other relevant documentation on the identity of the customer or the beneficial owner.

The Entity may be guided by information contained in official reports on corruption and AML/CFT published by the FATF, the Organization for Economic Co-operation and Development (OECD), the World Bank and the International Monetary Fund, as well as lists of countries quoted in CSSF Circulars.

Entities are also referred to the *Common Understanding between Member States on third country equivalence under the Anti-Money Laundering Directive (Directive 2005/60/EC)* published by the European Commission.

The agreement between the UCI and the intermediary must include an AML/CFT provision requiring the intermediary to perform due diligence measures from the beginning of the relationship, towards underlying investors, so that the UCI obtains the necessary assurance that documents and information have been obtained towards investors and are available upon request.

Where shares or units of UCIs are subscribed by intermediaries acting on behalf of clients, the UCI, its management company or AIFM, or its representative is required to apply enhanced due diligence to the intermediary in order to ensure that the intermediary applies AML/CFT measures that can be considered as equivalent to Luxembourg's (see Section 8.8.4.4.6.). This check must be documented and the record kept.

<sup>7</sup> | 4<sup>th</sup> EU AML Directive.

Lastly, when the third-party introducer is part of the same group, the professional should ensure that any risk related to a high-risk third country is efficiently mitigated and that the group applies customer due diligence measures, rules relating to the preservation of documents and exhibits and AML/CTF programs in accordance with consolidated 4<sup>th</sup> EU AML Directive (as of 30/06/2021) or equivalent rules and that the effective implementation of these obligations is monitored at group level by a supervisory authority, a self-regulatory body or one of their foreign counterparts.

### C. Performed by a third-party delegate

Entities may under certain conditions, contractually outsource the execution of the identification requirements to national or foreign firms subject to equivalent identification requirements. The Entity remains, however, responsible for compliance with the identification requirements.

The following conditions must be met when the material process of identifying customers is outsourced:

- ▶ The delegation must be formalized in an agreement
- ▶ The contract must precisely define the delegated tasks and list in detail the documents and information to be requested and verified by the delegate
- ▶ The delegation agreement should foresee that at least a copy of the identification documents be transmitted to the Entity each time
- ▶ Copies have to be duly certified by the delegates or authorized persons in case of a client who is not physically present for identification purposes (see Section 8.8.4.4.6.A.). The professional cannot rely on a certificate issued by a third party that confirms that it knows the client, has verified the client's identity and has received the required documentation
- ▶ The contract grants the Entity the right to access at any time the identification documents during a defined period
- ▶ Entities must have a monitoring framework to ensure that delegates comply with AML/CFT terms of contracts

The board of directors of the UCI and the IFM should ensure that the relevant contracts include (i) detailed clauses specifying the roles and responsibilities of each party as well as (ii) the conditions relating to the transmission of information to the professional, notably to make available immediately, regardless of confidentiality or professional secrecy rules or any other obstacle, the information gathered while fulfilling the customer due diligence obligations. In addition, a process should be put in place to transmit, upon request and without delay, a copy of the original supporting evidence received.

Policies and internal procedures relating to outsourcing and agency relationships should include detailed provisions (due diligence requirements) on the process for the selection and evaluation of third-party delegates and sub-delegates.

Third-party delegates (most notably transfer agents, portfolio managers to which the IFM outsources the management and investment advisors) are monitored on a regular and *ad hoc* basis (e.g., through on-site visits from the delegating entity), in accordance with the risk-based approach. The delegating entity should verify (e.g., through sampling) the compliance obligations incumbent upon the third-party delegate.

Entities cannot outsource identification to delegates in "FATF-identified" countries (see Section 8.8.4.4.6.E.).

The *Practices and Recommendations for the Luxembourg Fund Industry* (see Section 8.8.4.2.) provide guidance on the respective roles and responsibilities of the transfer agent and global distributor in terms of customer due diligence (KYC obligations):

#### ▶ *Role and responsibilities of the transfer agent*

Where the UCI's transfer agent and the global distributor are different entities, the KYC obligations of the transfer agent are limited to the verification of the identity of the investors whose instructions (subscription forms, transfer and redemption orders) have not been submitted by a regulated and supervised financial professional subject to equivalent AML/CFT obligations.

While transfer agents have no responsibility over the due diligence process to be performed on appointed distributors, they are obligated to identify the distributor to ensure that the distributor is subject to equivalent AML/CFT obligations.

#### ▶ *Role and responsibilities of the global distributor*

The global distributor is responsible for developing and maintaining a distribution network that complies with Luxembourg and FATF standards. It should be responsible for the due diligence process at both the country and distributor level.

#### ▶ *Role and responsibilities of the board of directors of the UCI or of its management company*

The board of directors of the UCI or of its management company is responsible for monitoring the distributors and should take all appropriate measures to ensure compliance with Luxembourg AML/CFT obligations and standards.

CSSF Circular 18/698 sets out the general framework and obligations applicable to each investment fund manager (IFM)<sup>8</sup> as well as the detailed obligations applicable to IFMs and registrar agents which include, *inter alia*:

- ▶ IFMs must comply with AML/CFT legislation in force including the Law of 12 November 2004, as amended, CSSF Regulation No 12-02 and the CSSF Circulars on AML/CFT
- ▶ The IFM is also subject to the Law of 16 July 2021 implementing Regulation (EU) 2018/1672 on controls on cash entering or leaving the EU and repealing the Law of 27 October 2010 on this aspect. The goal of the Law is to update the existing regime deploying FATF recommendations in Luxembourg
- ▶ The Law of 27 October 2010 enhancing the AML/CTF legal framework; organizing the controls of physical transport of cash entering, transiting through or leaving the Grand Duchy of Luxembourg; implementing United Nations Security Council resolutions as well as acts adopted by the European Union concerning prohibitions and restrictive measures in financial matters in respect of certain persons, entities and groups in the context of the combat against terrorist financing
- ▶ EU regulations directly applicable in national law or via the adoption of ministerial regulations also apply to every IFM
- ▶ IFMs must follow *Guidance for the Securities Sector* issued by the FATF (released in October 2018). Additionally, they are urged to follow other publications of the FATF. Furthermore, they must comply with CSSF Circular 21/782 adopting the revised EBA guidelines
- ▶ Every IFM must take appropriate measures to identify, assess and mitigate ML/FT risks using risk factors, including those linked to customers, countries or geographical areas, products, services and transactions or delivery channels
- ▶ IFMs are required to implement due diligence measures in particular, on clients, initiators of UCIs, portfolio managers to whom it delegates the management and on investment advisors including due diligence on the assets of the UCIs it manages
- ▶ The UCI, its IFM or, where appropriate, the respective proxies of these professionals, must put in place enhanced due diligence measures on intermediaries subscribing units on behalf of clients (nominees and other intermediaries)
- ▶ An IFM will not be exempt from its AML/CFT responsibility when it delegates its tasks

The Circular sets out four scenarios, linked to the 4<sup>th</sup> EU AML Directive and the respective IFM obligations depending on the manner in which the relationships with the marketing intermediaries and the registrar agent are organized:

- i. The IFM is in a direct relationship with the intermediaries conducting marketing and which act on behalf of clients and/or with direct investors and ensures by itself the function of registrar agent:
  - a. Implements and performs due diligence measures on those intermediaries and/or direct investors
  - b. Enters into a written agreement to establish responsibilities
  - c. Provides a list of all intermediaries to the CSSF on an annual basis
  - d. Creates and establishes measures to ensure that their intermediaries comply with the rules set out
  - e. Conducts Know Your Intermediary (KYI)/KYC
    - i. Initial due diligence
    - ii. Ongoing monitoring of the delegates
  - f. The IFM must establish internal policies, controls and procedures
- ii. The IFM is in a direct relationship with the intermediaries conducting marketing and which act on behalf of clients and/or with direct investors and the function of registrar agent has been delegated to one or more registrar agent(s):
  - a. A written contract between the IFM and the registrar agent to provide for the registrar agents obligation to make available to the IFM any information necessary for the performance by the IFM of its initial due diligence and ongoing monitoring of this registrar agent as well as complying with all their AML/CFT obligations
  - b. The contract must allow the IFM and registrar agent to determine their respective responsibilities with respect to AML/CFT obligations including those mentioned in (i) above
  - c. The IFM must ensure it also complies with the requirements set out in CSSF Circular 18/698 with respect to specific organizational provisions, obligations to conclude a contract, initial due diligence and ongoing monitoring obligations
- iii. The IFM is not in a direct relationship with the intermediaries conducting marketing and which act on behalf of clients and/or with direct investors and the function of registrar agent has been delegated to one or more registrar agent(s):
  - a. An agreement between the IFM and the registrar agent must, most notably, allow the IFM and registrar agent to determine their respective responsibilities with regard to AML/CFT obligations including those mentioned in relevant points of (i) above
  - b. The IFM must ensure it also complies with the requirements set out in CSSF Circular 18/698 with respect to specific organizational provisions, obligations to conclude a contract, initial due diligence and ongoing monitoring obligations
- iv. The AIFM performs neither an additional function of marketing of UCIs under its management nor the function of registrar agent:
  - a. The AIFM must implement procedures to meet its responsibility in the context of AML/CFT
  - b. The members of the board of directors or the members of any other managing body, respectively, which represent the UCI pursuant to the instruments of incorporation must make available any necessary information to the AIFM so that the later can comply with its AML/CFT obligations outlined in (i)

<sup>8</sup> | CSSF Circular 18/698 defines investment fund managers (IFMs) as: Chapter 15 and 16 management companies set up under the 2010 Law, Luxembourg branches subject to Chapter 17 of the 2010 Law, self-managed UCITS, AIFMs and internally managed AIFs.

#### 8.8.4.4.5. Simplified customer due diligence (SDD)

Entities may, in certain cases and taking into consideration Appendix III of the Law of 12 November 2004, as amended, apply simplified due diligence measures when the customer is:

- ▶ A public company listed on a stock exchange and subject to disclosure requirements (either by stock exchange rules or through law or enforceable means), which impose to ensure adequate transparency of beneficial ownership
- ▶ Public administration or enterprises from country or territory having a low level of corruption
- ▶ Resident in geographical areas of lower risks

The factors to take into account when assessing the risks of ML/TF include types of customers, geographic areas and particular products, services, transactions or delivery channel. These factors need to be understood as potential factors of lower risk and not to be understood as a blanket approach to apply a lower risk regime. However, in any case, it is not mandatory to apply the simplified customer due diligence regime.

Before implementing simplified due diligence and before relying on performance of client due diligence by third parties, Entities are required to perform a risk assessment of the country in question (be it an EU Member State or a third country) and document, at the time when the decision is taken, the reasons justifying why they deem the country's AML/CFT regime to be equivalent to Luxembourg's. Such decisions must be based on relevant and up-to-date information. This country risk assessment must be updated on a regular basis and should, at least, take into consideration the list of high-risk third countries set out by the EU, countries designated as presenting a higher risk by the International FATF as well as any other higher risk identified by the CSSF or Financial Intelligence Unit (FIU). Additionally, the professional must take into consideration reports established in the area by international organizations and standard-setting bodies responsible for AML/CFT, with regard to the risks certain countries hold.

However, even where an EU Member State or a third country has a regime equivalent to Luxembourg's, this does not free Entities from the obligation to apply enhanced due diligence measures in situations that, by their nature, can present high ML/TF risks. Enhanced due diligence must be applied in any business relationship and transaction where the client, representative or beneficial owner is a resident of a country which is deemed higher risk as per the professional's evaluation of the country.

Entities are required to ensure that simplified due diligence requirements continue to be fulfilled by the customers on an ongoing basis. This entails that, outside the customer review periods, professionals need to ensure that the criterion and reasons for performing simplified due diligence are still valid. Furthermore, when applying simplified due diligence, other obligations such as monitoring of clients and transactions must still be performed by Entities.

In situations where Simplified Due diligence measures are justified, Entities may reduce their due diligence measures to the business relationship in one or more of the following ways (non-exhaustive):

- ▶ For customers subject to a compulsory authorization or registration regime for AML/CFT purposes, the verification that the customer is subject to for this regime should consist of, for example, performing a search on the official website of the regulator and documenting the results of the search
- ▶ The exceptional acceptance of other types of ID documents which meet the criteria of reliable and independent sources (e.g., a letter addressed to the customer by a governmental body or other reliable public body). This is only possible where the customer cannot provide the usual identification documents and, insofar as there are no grounds for suspicion
- ▶ Due diligence can be updated only upon certain trigger events (e.g., riskier product, relocated to different country, changes in the transaction behaviour or profile or any other trigger event which seems to indicate that the risk is no longer low), instead of being updated on a regular basis
- ▶ For persons purporting to act on behalf of a customer, initiator, or promoter who launched an investment fund, obtaining information on the country of residence of these persons instead of asking for the full postal address
- ▶ For persons purporting to act on behalf of a customer where a customer is a regulated credit or financial institution, instead of requesting the complete identification of these persons, obtaining a letter confirming that the institution applied due diligence measures to these persons and that it carried out regular controls of these persons with respect to the applicable lists of restrictive measures in financial matters
- ▶ For customers subject to a compulsory authorization or registration regime for AML/CFT purposes, the verification that the customer is subject to this regime by performing, for example, a search on the official website of the regulator and documenting the results of the search
- ▶ The acceptance of a customer with a low risk profile, according to the risk-based approach of the professional, can be automated. This allows the professional to have a different option for the acceptance of low-risk customers. The process should be tested before its utilization and should be updated on a regular basis. The process should be in line with the professional's procedures and CSSF requirements

In practice, comfort letters provided by parent companies subject to equivalent AML/CFT requirements are used by branches and subsidiaries in relation to the implementation of customer identification requirements. Comfort letters enable Entities to apply simplified due diligence to their subsidiaries located in non-equivalent countries and subsidiaries in equivalent countries that are not regulated.

#### 8.8.4.4.6. Enhanced customer due diligence (EDD)

Enhanced vigilance and due diligence measures have to be applied in situations considered to be higher risk, including non-face-to-face relationships without certain safeguards, PEPs, transactions with entities holding third-party funds and any business relationship or transaction where the client, directors or beneficial owner lives in a high-risk third country.

The Annex IV of the AML Law provides a non-exhaustive list of factors and types of potential higher risks. The 1<sup>st</sup> Law of 25 March 2020 introduced two new factors:

- ▶ A third-country national customer applying for residence rights or citizenship through capital transfers, the purchase of property or government bonds, or investments in private companies
- ▶ Transactions relating to petroleum, arms, precious metals, tobacco products, cultural goods and other objects of value archaeological, historical, cultural and religious, or of rare scientific value, as well as ivory and protected species

##### A. *Non-face-to-face relationships*

Where a client is not physically present for identification purposes, the Entity must take the specific and additional verification measures necessary to be able to effectively face the higher risks of ML/TF. When there are no certain safeguards such as electronic identification means, relevant trust services as defined in Regulation (EU) No 910/2014 or any other secure, remote or electronic, identification process which is regulated, recognized, approved or accepted by the relevant national authorities, additional measures have to be taken, most notably:

- ▶ Measures ensuring that the customer's identity is established by additional identification documents, data or information
- ▶ Measures ensuring the verification or certification by a public authority of the provided documents
- ▶ Confirmatory certification by a credit institution or a financial institution subject to the AML Law or subject to equivalent professional obligations as regards the fight against ML/TF
- ▶ Measures ensuring that the first payment of the transactions is carried out via an account opened in the customer's name with a credit institution or a financial institution subject to the AML Law or subject to equivalent professional obligations as regards the fight against ML/TF

The Entity must choose between the following types of additional verification measures to be applied before entering into a business relationship, but may decide, based on its risk assessment of the customer, to apply several of them:

- ▶ Scrutiny of the most recent management report and of the most recent accounts, as the case may be, certified by an authorized auditor
- ▶ Verification, after consultation of the trade and companies register or any other source of professional data, that the company has not been, or is not in the process of being, dissolved, removed from the register, in bankruptcy proceedings or liquidated
- ▶ Verification of information gathered from independent and reliable sources, such as notable public and private databanks
- ▶ Electronic signatures within the legal framework
- ▶ A visit to the company, to the extent possible, or via contact with the company, notably by registered letter with acknowledgement of receipt

On 10 December 2021, the EBA published a *Consultation Paper on the Draft Guidelines on the use of Remote Customer Onboarding Solutions* under Article 13(1) of Directive (EU) 2015/849.

The document sets out a strategic objective for digital finance in the EU and identifies priorities and related actions to enable consumers and businesses to benefit from digital finance while also mitigating risks.

The Consultation confirmed that Member States have taken different views on what is permissible in relation to remote customer onboarding (some more restrictive, some less). EBA considers that the identification of common criteria to assess whether innovative technology is acceptable in a remote onboarding context will help align different interpretations by Member States.

The Guidelines set:

- ▶ Common EU standards on the development and implementation of a risk-sensitive initial CDD process in the remote customer onboarding context
- ▶ The steps that financial sector operators should follow when choosing remote customer onboarding tools and what financial sector operators should do to satisfy themselves that the chosen tool is adequate and reliable on an ongoing basis and allows them to comply effectively with their initial CDD obligations

While these Guidelines address initial CDD obligations, they do not prevent financial sector operators from gathering all information needed to perform all CDD obligations at the same time as they are performing initial CDD remotely.

## B. Politically exposed persons (PEPs)

Enhanced customer due diligence must be carried out on PEPs. PEPs are individuals who hold or have been appointed to prominent public functions, their family members and close associates.

The Law of 25 March 2020 removes the concept of automatic exclusion of PEPs who do not have public mandates for more than one year. Instead, it is required to perform a risk-based approach for each such PEP and evaluate the risk of that person in relation to his/her PEP function and continue to apply such scrutiny until that particular person no longer poses a risk in relation to that function. In any case, professionals will need to keep treating a person as a PEP for a minimum period of twelve months after the date the person leaves his PEP position.

PEPs include:

- ▶ Heads of State or of government, ministers and deputy and assistant ministers
- ▶ Members of Parliament or of similar legislative bodies
- ▶ Members of supreme courts, of constitutional courts or of other high-level judicial bodies whose decisions are not subject to further appeal except in exceptional circumstances
- ▶ Members of courts of auditors or of the boards of central banks
- ▶ Ambassadors, *chargés d'affaires* and high-ranking officers in the armed forces
- ▶ Members of the administrative, management or supervisory bodies of State-owned enterprises
- ▶ Important political party officials and members of their governing bodies
- ▶ Directors, deputy directors and the board members of an international organization or persons who occupy a similar position within the organization
- ▶ Natural persons exercising the functions appearing on the list published by the European Commission

People holding an intermediate or lower function within the above categories are not considered to be PEPs.

PEPs also include such positions at European Community and international levels.

Immediate family members of PEPs who should also be treated as if they were PEPs include all the following individuals:

- ▶ The spouse
- ▶ Any partner considered by national law as equivalent to the spouse
- ▶ The children and their spouses or partners or persons considered by domestic law as the equivalent of a spouse
- ▶ The parents
- ▶ Their brothers and sisters

Persons known to be close associates who should be treated as if they were PEPs include the following:

- ▶ Any individual who is known to have joint beneficial ownership of legal entities or legal arrangements, or any other close business relations, with a PEP
- ▶ Any individual who has sole beneficial ownership of a legal entity or legal arrangement which is known to have been set up for the benefit, *de facto*, of the PEP

Specific attention must be paid by Entities when seeking to enter into a business relationship with, or accepting custody of assets belonging to PEPs residing abroad, whether directly or indirectly.

In addition to normal due diligence measures, Entities are required to:

- ▶ Implement appropriate procedures to determine whether the investor or the beneficial owner is a PEP (foreign or local)
- ▶ Take all appropriate measures to verify the source of funds and the origin of the assets regarding the business relationship or the transaction and request documentary evidence if there is the slightest doubt
- ▶ Involve the compliance officer in the acceptance process and, obtain authorization of one of the authorized executive managers (or equivalent at a senior level in the Entity) before entering into a business relationship or, where justified, maintaining a business relationship with a PEP. The business relationship must continue to be closely monitored

Where a customer has been accepted and the customer or beneficial owner is subsequently found to be, or subsequently becomes a PEP, Entities must obtain approval to continue the business relationship from senior management. The identification of a PEP during the business relationship should be carried out at least every six months.

Enhanced due diligence must be applied not only when the client is a PEP, but also when the effective beneficial owner is such a person. Finally, enhanced due diligence must be applied to clients, transactions and beneficial owners when they later become PEPs. The first Law of 25 March 2020 extended the definition of PEPs to include natural persons appearing on the list published by the European Commission (the "EU PEP List"). This list has not yet been published. Institutions will thus be obligated to include this new EU PEP List in their customer screening processes, once it is published.



### C. Transactions with Entities holding third-party funds

For clients having a professional activity that implies the transfer of third-party funds (e.g., lawyers and notaries), the Entity must determine whether the relevant client acts for its own account or on behalf of third-party clients. In the latter case, the Entity must identify not only his client but also the beneficial owner for whom such client acts and request as such all the required identification documents of the ultimate beneficial owner(s).

### D. Clients or transactions involving high-risk countries

Any client or transaction from a jurisdiction identified by the European Commission, the FATF or by the supervisory authorities or professionals as part of their AML/CTF risk assessment (8.8.4.4.7.F.) must be subject to enhanced due diligence at the time the relationship is entered into and throughout the relationship.

For each country considered as high risk, enhanced due diligence measures should be applied which include, at least:

1. Obtaining additional information on the beneficial owner(s) and more frequent updating of the identification data
2. Obtaining additional information on the envisaged nature of the business relationship
3. Obtaining information on the origin of funds/assets of the client and beneficial owner
4. Senior management authorization
5. Obtaining information on the reasons for planned or already performed transactions
6. Enhanced monitoring of the business relationship (incl. increasing number and frequency of checks and determining transaction patterns that require further examination)

The Law also foresees that professionals apply to persons and entities that execute transactions involving high-risk countries, where appropriate, a series of enhanced countermeasures. CSSF Circular 22/815 issued on 22 June 2022 gives a list of high-risk jurisdictions for which an enhanced due diligence is required and a list of jurisdictions for which increased monitoring is performed by the FATF.

Following the initial customer due diligence, professionals should perform ongoing due diligence on several aspects, notably in the case where complex and unusual transactions are identified (analysis of the funds involved in transactions presenting a higher risk of ML/TF due to the complexity of the transaction, unusual amount or pattern).

Professionals should analyse the risk of ML/TF related to the investment and take due diligence measures in accordance with their risk assessment. These measures should be documented. The risk analysis should be reviewed annually and when a particular event requires it.

## 8.8.4.4.7. Other professional AML/CFT obligations

### A. Monitoring of client relationship and transactions

Blacklists, sanctions, PEPs and country screening need to be performed for all clients, their directors, authorized signatories, beneficial owners, proxies for all accounts and all transactions. In the case of legal persons or arrangements (for example a trust) that exist between the customer (legal owner - for example, the trustee in the case of a trust) and the natural person (beneficial owner - for example, trust beneficiaries), the directors and names of these companies will need to be screened.

Transaction monitoring must be performed on all investors with a view to detecting unusual transactions that must be investigated for potential suspicion of ML/FT. Where the monitoring is delegated, the delegating professional, who retains responsibility, must conduct appropriate oversight.

Professionals are required to examine, as far as is reasonable, the context and the purpose of any transaction which fulfills at least one of the following conditions:

- a) It is a complex transaction
- b) It is an unusually large transaction
- c) It is operated according to an unusual scheme
- d) It has no apparent economic or apparent lawful objective

Any transaction which meets the criteria set out above must be subject to enhanced due diligence by the professional.

The screening must cover all accounts and transactions.

Entities are required to monitor the payer for incoming transfers and the payee for outgoing transfers. Monitoring of transfers implies monitoring the recipient of the funds; this control is currently limited to the screening of names against the official blacklists.

It is expected that the obligation to monitor payments will be extended to require the detection of PEPs (for the payee). Entities should take adequate measures to cover such risks.

In case of payments made by financial institutions, the screening of the signatories of orders is not required.

The Entity must have a complete overview of its business. Based on its risk-based approach, the Entity may reduce the monitoring of certain operations if it considers that the risk of ML/TF is low, however, the monitoring should remain sufficient in order to detect all unusual or suspicious transactions.

All results of these controls must be evidenced and documented, whether the result is positive or negative.

The entity must ensure that the internal system or system made available by an external service provider, used for the detection of persons, entities or groups involved in a transaction or a business relationship subject to restrictive measures in financial matters is adapted without delay to the latest blacklists.

In case of positive sanction screening, the case must be reported to the Luxembourg prosecutor and to the CSSF.

CSSF Circular 20/740 sets out the following emerging ML/TF threats and vulnerabilities for the financial sector in the context of the COVID-19 pandemic and lockdown:

1. Online payment services
2. Clients in financial distress due to the possibility to create opportunities for them to be exploited by criminals seeking to launder illicit proceeds
3. Mortgages and other forms of collateralized lending (same type of risk as for 2)
4. Credit backed by government guarantees (misuse of those schemes by criminals)
5. Distressed investment products (opportunity for criminals offering to purchase or re-finance such distressed assets using the backing of illicit funds)
6. Delivery of aid through non-profit organizations: As there are increased financial flows through NPOs to higher risk countries, there may be an increased risk of illicit activity and special attention should be paid to the risks of terrorist financing. There may also remain the potential for tax advantages afforded by charitable donations to be misused by those seeking to launder illicit funds

CSSF Circular 20/740 highlights three key points regarding the transaction monitoring during the COVID-19 pandemic:

1. Professionals should continue to monitor transactions with particular attention to unusual or suspicious transactions (pattern does not match with the customer's usual transactions)
2. Professionals should pay attention to transaction monitoring systems and should be prepared to adapt their models and to increase manual checks
3. Professionals should also confirm the adequacy of third party outsourcing related to transaction monitoring

Ongoing due diligence obligations require Entities to:

- Verify and update, if necessary, the documents, data or information of the customer
- Verify annually if the conditions of a simplified due diligence are still met
- When reviewing and the updating the documents, data and information of the customer, to check different sources of information:
  - Public data
  - National ML/TF risk assessment of the customer's country
  - Mutual evaluation report related to ML/TF of the customer's country
  - Other information from reliable and independent sources

#### B. *Obligation in relation to transfers of funds*

The name or account number of the transferor must be incorporated in the fund transfer and associated messages, as required by the EU Regulation (EU) 2015/847, as amended.

The name of the beneficiary must be mentioned along with the name of the customer in any transaction document.

Entities must have automatic controls to detect incomplete incoming or outgoing payments, for which information required by EU Regulation (EU) 2015/847 is missing, unless Entities can evidence that automatic systems are not compulsory based on the volume of business of the Entities.

#### C. *Obligation to assess ML/TF risks posed by investments*

CSSF Regulation 20-05 introduced the duty that Entities have to carry out an analysis of the ML/TF risk posed by the investments and take due diligence measures adapted to the risks assessed and documented. Such analyses must be formalized. The risk analysis on investments should be reviewed annually and when particular events require it.

On 15 March 2022, the CSSF clarified its expectations in terms of ML/TF risk assessment for virtual assets. When computing an ML/TF risk scoring of a virtual asset, the professional is encouraged to take into account the Vertical Risk Assessment on Virtual Assets Service Providers published in December 2020.

Depending on the type of investment (direct or indirect), the type of virtual asset (e.g., cryptocurrency, utility token) and the way of acquisition (e.g., exchange platform, initial token offering, initial coin offering), the level of ML/TF risk as well as the due diligence will vary.

The key outcome of the due diligence on virtual assets is to understand where the virtual assets are coming from and/or where they are going to (buy/sell side) in order to mitigate the risk of the investment fund being abused by money launderers or terrorist financing.

#### D. Obligation to keep certain documents

Documents relating to identification and transactions must be kept by the Entity:

- ▶ Identification documents must be kept for five years from the end of the business relationship with the customer
- ▶ Transaction documents must be kept for five years following the carrying-out of the transaction; the different components of transaction records must, when brought together, provide, at least, the following information: customer's and beneficiary's name, address or other identification information normally recorded by the intermediary, the nature and date of the transaction, the type and amount of currency involved and the type and number of any account involved in the transaction

Personal data can be held for an additional five years if necessary to effectively implement internal measures for the prevention or detection of money laundering or to counter terrorist financing.

Without prejudice to longer retention periods prescribed by other laws, professionals must delete the personal data at the end of the retention period.

Records can be kept on any medium, as long as the documents meet the criteria allowing them to serve as evidence in the context of a judicial procedure or of an investigation on ML/TF.

#### E. Obligation to co-operate with the authorities and obligation to inform

The Luxembourg Financial Investigation Unit (*Cellule de Renseignement Financier* – FIU) is the direct contact partner of Entities on AML/CFT matters.

Entities must inform the FIU, on their own initiative, of any suspicion or proof of ML/TF. Declarations of suspicion must be made even when the person who is suspicious is not able to identify an underlying offence. Prior formal consent must be obtained from the FIU before a professional can report the existence of a freezing order to the clients, in order to justify the non-execution of a transaction.

The initial duration of the freezing order of three months to six months can be extended; extensions are granted for each additional month up to a maximum of six months.

The no “tipping-off” rule does not prohibit communication of information on suspicious cases with other Entities of the financial sector; under certain specific conditions, Entities are authorized to communicate to other Entities information on suspicious cases notified to the authorities.

Entities must document the procedures, conditions, deadlines and steps for the communication of reports of potential suspicious transactions or facts in relation to their clients to the AML/CFT officer. The analysis of these reports and the decision taken by the AML/CFT officer on whether or not to inform, on his own initiative, the State Prosecutor of the Court of Luxembourg of a suspicion or certitude of ML/TF must be documented.

In case of a business relationship for which a declaration to the authorities has already been made, a complementary declaration must be made in case of new evidence of ML/TF.

The disclosure to the FIU does not constitute a breach of any restriction on disclosure of information imposed by contract, by professional secrecy or a legislative, regulatory or administrative provision and should not involve such persons in liability of any kind.

Entities, their directors and employees are obliged to respond and co-operate as comprehensively as possible in response to any legal request received from the FIU. Professionals must be registered on the “goAML” Platform of the Ministry of Justice to be able to comply with their obligation to communicate without delay their suspicions of ML/TF to the FIU.

The FIU may order systematically and at any time the total or partial withdrawal of the order not to carry out the operations of declared entities or persons.

#### F. Obligation to establish a written AML/CFT risk analysis report

Entities are required to perform an analysis of the AML/CFT risks inherent to their business activities and the functioning of the AML/CFT officer and to document the findings of this analysis. This implies:

- ▶ Identifying the AML/CFT risks to which it is exposed: the features to be considered in order to identify the AML/CFT risks, with regard to and with respect to the nature of:
  - ▶ The clients of the Entity including, *inter alia*:
    - ▶ Geographical origin of customers (residential/non-residential customers, customers coming from countries that do not or insufficiently apply AML/CFT measures, customers coming from countries subject to international sanctions)
    - ▶ Activity sector/customers' profession
    - ▶ Means of entering into business relationship with the customer (business providers, non-face-to-face entry into business relationships, execution of customer due diligence by third parties, etc.)
    - ▶ Degree of complexity of the structure implemented for the benefit of a customer (use of shell companies, trusts, etc.)
    - ▶ Customers who require the application of enhanced due diligence measures, notably in case of PEPs

- ▶ The products and services offered, including, *inter alia*:
  - ▶ Volume and frequency of transactions, application or non-application of relevant limits
  - ▶ Transfers from or to countries that do not or insufficiently apply AML/CFT measures and/or are subject to international financial sanctions
  - ▶ Product/service offers facilitating anonymity (holding numbered accounts)
- ▶ Classify the risks according to its own methodology: the importance given to each type of risk (individually or in combination) will be different for every institution. Each institution must carry out the identification and categorization of ML/TF risks to which it considers itself to be exposed according to its own methodology
- ▶ Define and implement measures to mitigate the identified risks: the description must include, *inter alia*, the following features:
  - ▶ Number of clients to which SDD is applied
  - ▶ Number of clients to which EDD is applied
  - ▶ Process of client acceptance
  - ▶ Process of completion of incomplete client files
  - ▶ System of identification of complex, unusual and suspicious transactions
  - ▶ System of name and country matching
  - ▶ Employee training process
  - ▶ Corporate governance measures

The AML/CFT risk analysis report must be prepared at least annually.

Where statistics are presented, the statistics must be accompanied by analysis.

In order to help Entities to set up their own risk-based approach, Entities are referred to the *FATF Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing - High Level Principles and Procedures*.

#### G. AML/CFT requirements in relation to hiring

Entities are required to implement appropriate screening procedures to ensure that all employees have the necessary honorability and appropriate experience of AML/CFT for the tasks and functions. In particular, the AML/CFT officer must have the necessary experience and appropriate honorability according to the AML/CFT risk depending of the tasks and function to exercise.

For management, information regarding the judicial past of the persons must be obtained by requesting an extract of the criminal record or equivalent document.

#### H. AML/CFT requirements in relation to training

All the employees must be provided with AML/CFT training, at least once per year, tailored to the specificities of their functions and the business operations of the entity. Training materials must be provided and the implementation of the training program must be documented.

All employees must receive ongoing training and staff in direct contact with the customer must also attend specific training.

When they are hired, new employees must follow an AML/CFT training course that makes them aware of AML/CFT policies and requirements.

Training must take into account the evolution of AML/CFT techniques including business specific examples and reflect the latest AML/CFT legal and regulatory requirements.

#### I. Internal audit

The review of the AML/CFT policy must be part of the tasks of the internal audit function. The internal audit function is required to report at least annually on whether the AML/CFT policy has been respected.

#### J. External audit

CSSF Circular 21/788 introduced the requirement for an AML/CFT external report – Please refer to Section 8.8.4.1.

#### K. Whistleblowing

Persons, including employees and representatives of the professional, having reported to the FIU suspicions of ML/TF must not be the subject of threats, reprisals or hostile acts and in particular harmful or discriminatory measures in matters of employment.

Furthermore, any contractual stipulation which would enable threats, reprisals, hostile acts or harmful or discriminatory employment measures or, explicitly any termination of contract against people reporting suspected ML/TF to the FIU, is automatically void.

On 5 May 2020, the CSSF issued an FAQ related to Whistleblowing. The FAQ contains clarifications regarding steps to follow to inform the CSSF and how it is actioned by the CSSF.

#### 8.8.4.4.8. Sanctions

Laundering money from, or linked to, any of the underlying criminal activities (see Section 8.8.4.3.A.) is punishable by one to five years of imprisonment and/or a fine of up to EUR 1,250,000.

The 6<sup>th</sup> EU AML Directive foresees the increase in penalties for ML offences by, *inter alia*, increasing the maximum term of imprisonment to at least four years.

### 8.8.5. Protection against late trading and market timing practices

#### 8.8.5.1. Introduction

On 17 June 2004, the CSSF issued Circular 04/146 on the *Protection of UCIs and their investors against Late Trading and Market Timing practices*. The Circular:

- Clarifies the protective measures to be adopted by UCIs and certain of their service providers
- Fixes more general rules of conduct to be complied with by all professionals subject to the supervision of the CSSF

The separate report procedures required to be performed by the independent auditor of the UCI as requested by CSSF Circular 21/790 include procedures relating to the requirements of CSSF Circular 04/146 and the procedures and controls established by the UCI to protect it against late trade and market timing.

Following the Circular, ALFI issued in 2004 its report entitled *Fair Value Pricing & Arbitrage Protection*. The report aims to provide a reference document collating the reports and recommendations that emerged following accusations of late trading and market timing in the international mutual fund industry. This includes the Guidelines issued by ALFI to its members and the complete Report of the ALFI Working Group on fair value pricing and arbitrage protection.

#### 8.8.5.2. Definitions

##### A. Late trading

Late trading is the acceptance of a subscription, conversion or redemption order after the time limit fixed for accepting orders (cut-off time) on the relevant day and the execution of such order at the price based on the NAV applicable to such same day.

Through late trading, an investor may take advantage of knowledge of events or information published after the cut-off time that are not yet reflected in the price that will be applied to such an investor. This investor is therefore privileged compared to the other investors who have complied with the official cut-off time. The advantage of this practice to the investor is increased even more if he is able to combine late trading with market timing.

The late trading practice is not acceptable as it violates the prospectuses of the UCIs, which include provisions that an order received after the cut-off time is dealt with at a price based on the next applicable NAV.

The acceptance of an order is not considered as a late trading transaction where the intermediary in charge of the marketing of the UCI transmits to the transfer agent after the official cut-off time an order to be dealt at the NAV applicable on such day if the order has been issued by the investor before the cut-off time. To limit the risk of abuse, the transfer agent of the UCI must ensure that such an order is transmitted to him within a reasonable timeframe.

The acceptance of an order dealt with or corrected after the cut-off time, by applying the NAV applicable on such day, is also not considered as a late trading transaction if such order has been issued by the investor before the cut-off time.

##### B. Market timing

Market timing is an arbitrage method through which an investor systematically subscribes and redeems or converts shares or units of the same UCI within a short time period, by taking advantage of time differences and/or imperfections or deficiencies in the method of determining the NAV of the UCI.

Opportunities arise for the market timer either if the NAV of the UCI is calculated on the basis of market prices that are no longer up-to-date ("stale prices") or if the UCI is already calculating the NAV when it is still possible to issue orders.

The practice of market timing is not acceptable as it may affect the performance of the UCI through an increase in the costs and/or entail a dilution of the profit.

#### C. Master-feeder UCITS

In case of master-feeder structures, the master and the feeder UCITS are required to take appropriate measures to coordinate the timing of their NAV calculation and publication, in order to avoid market timing in their shares or units, preventing arbitrage opportunities.

### 8.8.5.3. Prevention of late trading and market timing practices

As late trading and market timing practices are likely to affect the performance of the UCI and are likely to harm investors, the preventive measures presented hereafter should be applied with great care.

The board of directors should analyze such solutions with care and is responsible for implementing them or making certain that they are implemented.

#### 8.8.5.3.1. Protective measures to be adopted by the UCI and by certain of its service providers

##### A. Late trading

The investor must, in principle, subscribe, redeem or convert the shares or units of a UCI at an unknown NAV. This implies that the cut-off time must be fixed in a manner to precede or to be simultaneous to the moment when the NAV, on which the applicable price is based, is calculated ("forward pricing"). A non-precise cut-off time such as, for example, "until the close of business" is to be avoided. The prospectus must specifically mention that subscriptions, redemptions and conversions are dealt with at an unknown NAV and must indicate the cut-off time.

The transfer agent of the UCI is required to ensure that subscription, redemption and conversion orders are received before the cut-off time as set forth in the UCI's prospectus in order to process them at the price based on the NAV applicable on that day. In respect of orders received after such cut-off time, the transfer agent applies the price based on the next applicable NAV. The transfer agent is required to ensure that it receives within a reasonable time period the orders that have been issued by investors before the cut-off time but have been forwarded to the transfer agent by intermediaries in charge of the marketing of the UCI only after such time limit.

In order to be able to ensure the compliance with the cut-off time, the transfer agent of the UCI must adopt appropriate procedures and undertake to perform the necessary controls. The transfer agent undertakes either to provide the UCI on an annual basis with a confirmation from its auditor on its compliance with the cut-off time or to authorize the independent auditor of the UCI to perform a review of the transfer agent's controls on the compliance of the cut-off time.

If intermediaries in charge of marketing the UCI have been appointed by the UCI to ensure the collection of orders and to control the cut-off time with regard to the acceptance of the orders, the UCI must ensure that it obtains from each intermediary concerned a contractual undertaking pursuant to which the intermediaries undertake towards the UCI to transmit to the transfer agent of the UCI, for the processing at the NAV applicable on such day, only such orders that it has received before such cut-off time.

The cut-off time, the time at which the prices of securities are taken into account for the calculation of the NAV and the time at which the NAV is calculated must be combined in a manner so as to minimize any arbitrage possibilities arising from time differences and/or imperfections/deficiencies in the method of determining the NAV of the UCI.

##### B. Market timing

UCIs that, due to their structure, are exposed to market timing practices must put in place adequate measures of protection and/or control to prevent and avoid such practices. The introduction of appropriate subscription, redemption and conversion charges, increased monitoring of dealing transactions and the valuation of the portfolio securities at "fair value" (see Section 7.6.) may constitute possible solutions for such UCIs.

The UCI should ensure that transactions it knows to be, or it has reasons to believe to be, related to market timing are not permitted and use its best available means to avoid such practices.

If formal contractual relationships exist between the UCI and intermediaries in charge of its marketing, the UCI should ensure it obtains from each intermediary a contractual undertaking not to permit transactions that the intermediary knows to be, or has reasons to believe to be, related to market timing.

The prospectus of the UCIs concerned must include a statement indicating that the UCI does not permit practices related to market timing and that the UCI reserves the right to reject subscription, conversion and redemption<sup>9</sup> orders from an investor who the UCI suspects of using such practices and to take, if appropriate, the necessary measures to protect the other investors of the UCI.

Particular attention has to be paid to subscription, conversion or redemption orders from employees of the service providers to the UCI or from any person who holds or is likely to hold privileged information (e.g., knowledge on the exact composition of the portfolio of the UCI). Accordingly, adequate measures must be taken by the service providers of the UCIs to avoid the risk that any such person could take advantage of his privileged situation either directly or through another person.

<sup>9</sup> | Redemptions are not specifically mentioned in the Circular in this context, but, in practice, the measures should also cover redemptions.

### 8.8.5.3.2. Rules of conduct to be followed by all professionals subject to the supervision of the CSSF

The CSSF prohibits any express or tacit agreement that permits certain investors to undertake late trading or market timing practices.

The CSSF requires that any professional subject to its supervision refrains from using late trading or market timing practices when investing in a UCI or from processing a subscription, conversion or redemption<sup>10</sup> order of shares or units of a UCI that he knows to be, or has reasons to believe to be, related to late trading or market timing.

The CSSF requires that any professional subject to its supervision that detects or is aware of a case of late trading or market timing informs, as soon as possible, the CSSF by providing to the latter the necessary information to enable it to make a judgment on the situation.

### 8.8.5.4. Compensation and sanctions

Any person who is guilty of knowingly undertaking or supporting late trading or market timing practices as defined by CSSF Circular 04/146 exposes himself to sanctions and, in addition, to the obligation of repairing the damage caused to the UCI.

## 8.8.6. Payment of dividends

There are no restrictions on distributions made by UCIs except that the net assets of the UCI after distribution must exceed the minimum capital of EUR 1,250,000. However, many UCIs or their management companies may choose to include additional restrictions with respect to distributions; any such restrictions including, if relevant, the fact that capital may be used to pay dividends, should be prominently disclosed in the offering document.

A SICAF, however, is subject to the normal authorization procedures for paying interim dividends and is also required to create a legal reserve. The interim dividend authorization procedures include specific authorization in the articles of association and the preparation of interim financial statements. The independent auditor must issue a report stating whether the conditions relating to the payment of interim dividends outlined in Article 461-3 of the Law of 1915, as amended, have been satisfied. SICAFs are also subject to the legal reserve requirement, which is 5% of net profit until the accumulated reserve equals 10% of subscribed capital. The legal reserve cannot be distributed.

## 8.9. Errors, materiality and compensation to investors

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### 8.9.1. Introduction

This section covers the treatment of NAV computation errors and compensation of losses arising from non-compliance with applicable investment restrictions.

CSSF Circular 02/77, entitled *Protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment*, establishes guidelines for the Luxembourg fund industry when dealing with errors. It introduced a simplified reporting procedure for material errors and active breaches (i.e., breaches for reasons that are not beyond the control of the UCITS) where the total compensation does not exceed EUR 25,000 and the amount payable to a single investor does not exceed EUR 2,500.

Errors generally relate to NAV errors or instances of breaches of the investment policy on investment or borrowing limits as specified in either the prospectus or the law.

It is the responsibility of the sponsor or promoter of the UCI to ensure that any errors are properly dealt with in accordance with the Circular.

The Circular distinguishes the procedures to be followed between NAV computation errors and breaches of investment restrictions, as outlined in Sections 8.9.2. and 8.9.3.

<sup>10</sup> | Idem.

On 7 July 2020, the CSSF issued an FAQ to assist IFMs with the application of CSSF Circular 02/77 requirements.

The FAQ clarifies the scope of application of the Circular, the process to select the method of correction for NAV errors and the circumstances in which tolerance thresholds are applicable.

General clarifications on the scope of the Circular:

- ▶ In the case of an active investment breach that corrects itself through market evolution or new subscriptions, the unrealized loss generated by the holding of the excess security position during the breach period should be compensated to the UCI
- ▶ Intraday active investment breaches and breaches that occur between two official NAVs should be notified to the CSSF and compensated in accordance with the provisions of the Circular
- ▶ CSSF notification or remedial action plans are not required in case of investment breaches beyond the control of the UCI ("passive breaches") but the remediation of the investment breach should be a priority for the IFM
- ▶ In cases where (i) there are no subscriptions and redemptions occurring during the NAV error period, or (ii) the corrective action resulted in a gain for the UCI, only a notification including the financial impact calculation and not a Remedial Action Plan, is required to be sent to the CSSF. However, the notification should include corrective measures to avoid the recurrence of the same type of error/breach and the external auditor of the UCI should review the correction in the context of its separate report procedures required by CSSF Circular 71/790
- ▶ In case of an active investment breach where the compensation amount for the UCI exceeds EUR 25,000 and no compensation is due to investors, both the notification and the remedial action plan are required. The external auditor of the UCI has to report on the remedial action plan pursuant to the Circular
- ▶ When the UCI makes use of the *de minimis* amount for compensating the investors which are financially impacted by a material NAV error calculation, prior approval from the CSSF is not required but the CSSF may request the UCI, on an *ex-post* basis, to provide documentary evidence that such amount represented the bank charges necessary to transfer the compensation amount to investors (notably where the "*de minimis*" amount exceeds EUR 25). The IFM's internal policy should provide for the use and the level of the "*de minimis*" amount
- ▶ The FAQ clarifies that the CSSF will not confirm in writing closure of an incident based on the action taken as disclosed in the notification, but may, on an *ex-post* basis, raise additional questions or require further remedial action if the corrective actions are not deemed sufficient or compliant with the Circular
- ▶ The FAQ also clarifies that a breach of UCITS and AIFs leverage limits does not need to be notified to the CSSF in the context of the Circular. However, adequate monitoring and correction in accordance with applicable internal procedures is expected
- ▶ The CSSF clarifies that SIFs may either opt for the application of the Circular or set specific internal rules. In the absence of specific internal rules, the Circular applies. All material NAV errors and active investment breaches have to be notified to the CSSF, whether the SIF applies the Circular or specific internal rules. When SIFs opt for the application of the Circular, a remedial action plan is not required but the external auditor should review the correction process and the related compensation and confirm in the management letter that they complied with the provisions of the Circular

Clarification on certain types of investment rules

- ▶ In case of a breach of compliance with the UCITS 5/40% rule, the UCITS does not necessarily have to sell the securities that caused the breach. The FAQ describes three acceptable methods to calculate the impact (impact by reference to security which caused the breach (use of accounting method), impact by reference to other securities sold to correct the breach (use of accounting method) or impact by reference to the performance of the reference portfolio (economic method)). However, where the method is not laid down in writing in the internal policy of the IFM, the impact should be calculated by reference to the security which caused the breach, by applying the accounting method in proportion to the amount in breach
- ▶ A breach of the UCITS 20% deposit limit is considered to be active every time the event which caused the breach, such as a settlement date mismatch (between the capital activity and the portfolio transactions or between several portfolio transactions) or the maturity of security, is predictable and avoidable. The organization of the portfolio management function by the IFM at the level of the UCITS (i.e., the investment operations, the cash management and subscription/redemption flows) should provide for ongoing compliance with the 20% deposit limit
- ▶ Where the UCITS 20% deposit limit is breached and the deposit returns negative interest, the UCITS should be indemnified in relation to the interest rate and other charges borne by the UCITS. Financial impact cannot be derived from a comparison with interest rates between different bank accounts
- ▶ The CSSF also confirmed that the Circular applies in case of breach of the UCITS collateral diversification rules and other criteria that the collateral has to observe, but a financial impact calculation is only necessary in case of a counterparty default



#### Governance and organizational requirements

- ▶ The CSSF considers that the organization of IFMs managing Luxembourg domiciled UCIs should provide for robust policies, processes and procedures governing the treatment of NAV calculation errors and investment breaches and, in particular, a detailed policy approved by the board of directors of the IFM and, if applicable, by the board of directors of the UCI
- ▶ The policy and related procedure should cover, *inter alia*:
  - ▶ The governance process, together with the different stakeholders involved, applied in relation to NAV calculation errors and investment breaches
  - ▶ The oversight of the delegates where NAV calculation and investment compliance are delegated
  - ▶ The definition of active *versus* passive investment breaches and applicable criteria (considering notably which events are or are not beyond the control of the UCI)
  - ▶ The different steps and the timeline in relation to the correction of errors and breaches
  - ▶ The NAV error threshold applicable for each compartment
  - ▶ The use and the level of *de minimis* amounts
  - ▶ The methodology used by the compartment for the financial impact calculation: accounting (e.g., Average Weighted Cost, LIFO, FIFO) *versus* economic method (setting the comparative reference index, etc., to be used by compartment)
  - ▶ The application of the compound or non-compound method used by the compartment for the financial impact calculation
  - ▶ The periodic review of the adequacy and the effectiveness of the policy, processes and procedures
- ▶ SIFs which are not managed by an AIFM should also establish and implement such a policy. The CSSF also recommends UCIs subject to Part II of the Law of 17 December 2010 which are not managed by an AIFM to establish and implement such a policy

#### Conditions required for the application of the economic method to determine the financial impact

- ▶ As per CSSF Circular 02/77, the economic method calculates the compensation by reference to the performance which would have been realized in case the non-compliant investments would have had the same fluctuations as the portfolio invested in compliance with the investment policy and the investment restrictions provided for by law or the prospectus
- ▶ The use of the economic method is only permitted if it is defined in the internal policy that governs the UCI, approved by the board of directors of the IFM and, if applicable, by the board of directors of the UCI. This policy must include the reference benchmark index, etc., used to measure the comparative performance against the non-eligible asset. The reference benchmark index should be a fair representation of the investment policy, or a part thereof laid down in the UCI prospectus. IFMs should be able to demonstrate and to evidence with necessary documentation that the comparative performance and the method does not prejudice the investors and has not been selected with the objective of minimizing compensation payments
- ▶ The CSSF confirmed that it is not acceptable to compare the performance of the non-eligible asset with a corresponding eligible asset having the same characteristics
- ▶ In case of an umbrella fund, the choice of the methodology is possible at the entity level or at compartment level
- ▶ It is possible, within the same UCI, to use different methods (accounting/economic) for different types of active investment breaches if this is formally laid down in the internal policy of the IFM and applied on a consistent basis
- ▶ Any change of the method used to correct investment breaches is only possible if there is an adequate justification and if it has been approved by the board of directors of the IFM and, if applicable, by the board of directors of the UCI. It is in principle not permitted to change the correction method applied when it has been previously determined to use a given method for a certain type of breach. It is only possible, upon approval by the board of directors of the IFM and, if applicable, the board of directors of the UCI, to change the method prospectively, i.e., for the next investment breach of the same type

#### Tolerance thresholds

- ▶ The overcharging of fees/costs to the UCI must be reimbursed to the UCI in all cases, irrespective of the materiality threshold laid down in the Circular. However, the recalculation of NAV is only necessary where the reimbursed fees/costs exceed the materiality threshold
- ▶ Where a zero tolerance threshold is applied by a UCI or the tolerance threshold defined in the internally approved policy is lower than the threshold laid down in the Circular, NAV calculation errors should be notified to the CSSF and all provisions of the Circular apply based on the lower thresholds as determined for the UCI
- ▶ In order to determine the materiality threshold applicable to a fund of funds, an index tracker or a feeder fund, a UCI should consider the investment policy of the target investments on a look-through basis, i.e., the investment policy of the target funds or master fund or the investment policy of the assets/funds in the tracking index

On 18 February 2021, the CSSF updated the notification form to be used for the transmission of notifications of NAV calculation errors or breaches of the investment rules in accordance with CSSF Circular 02/77.

The revised version of the form streamlines the categorization of investment breaches, removes share class specific information and adds data fields, notably on corrective measures implemented for avoiding the recurrence of similar incidents in the future.

The CSSF expects the notification to be completed within four to eight weeks of the detection of the incident and insists on the necessary completeness of the form, except where a pre-notification is made. Such pre-notification can only be used on an exceptional basis where the calculation and compensation processes are particularly complex and time-consuming. It should be submitted within four to eight weeks and the complete notification form, including notably the information on the payment date of compensation, should follow.

The CSSF also clarifies that additional explanations, where necessary and impact calculation files must be attached as separate documents to the notification form.

## 8.9.2. Treatment of NAV computation errors

### 8.9.2.1. Definition of a NAV computation error

A NAV computation error occurs where there are one or more factors or circumstances that lead to the computation process producing an inaccurate result. As a general rule, such factors or circumstances may be put down to inadequate internal control procedures, management deficiencies, failings or shortcomings in computer systems, accounting systems or communication systems, or to non-compliance with the valuation rules laid down in the UCI's constitutional document or prospectus.

### 8.9.2.2. Concept of materiality in the context of NAV computation errors

It is generally acknowledged that the NAV computation process is not an exact process and that the result of the process is the closest possible approximation of the actual market value of a UCI's assets. It is accepted practice in the majority of leading fund administration centers to recognize only those computation errors with a material impact on the NAV.

The Circular introduces the concept of materiality to Luxembourg UCIs and sets the acceptable tolerance limits for the different types of UCIs. This differentiated approach is warranted by the fact that the degree of inaccuracy inherent in a given NAV computation may vary from one type of UCI to another due to external factors, such as market volatility.

The tolerance limits provided for in the Circular for the different types of UCIs are as follows:

	As % of NAV
Money market funds/cash fund	0.25%
Bond funds	0.50%
Equity and other funds	1.00%
Mixed funds	0.50%

In the case of a UCI investing through financial derivative instruments (FDIs), the CSSF has clarified that the tolerance level may be defined according to the underlying assets of FDIs (look-through principle) where the yield of the underlying assets accounts for at least 80% of the performance of the UCI.

The management company, sponsor or promoter of the UCI are free to set lower tolerance levels or even to adopt a policy of zero tolerance. The procedures to be followed in the Circular, however, are only obligatory for material errors using the tolerance levels set out in the Circular. It is a matter for the board of directors of a UCI (or its management company in the case of a common fund) to ensure that where the UCI's shares or units are distributed in a foreign jurisdiction, the proposed tolerance levels do not conflict with local requirements.

A material error may not just be an isolated error but also several errors that in aggregate exceed the materiality limit.

The obligation to compensate losses applies only to those valuation days affected by a material NAV computation error.

The CSSF FAQ of 30 July 2019 on *Swing Pricing Mechanism*, as amended, outlined in Section 8.7.4. clarified that in case of a material NAV error arising as a result of an administrative error (i.e., application of the incorrect swing factor, or the NAV was swung in the wrong direction) in the application of the swing pricing mechanism, the procedures set out in CSSF Circular 02/77 must be followed. If the impact of the error is below the materiality threshold, the CSSF considers that the UCI should still be compensated when it was not protected from the level of dilution it should have been, had the swing pricing mechanism policy been applied properly. The FAQ provides illustrative examples of such types or errors.

The same applies within the context of investment or disinvestment operations in underlying or related UCIs where the UCI experienced duplication of certain fees while the sales prospectus specifically excludes such duplication.

### 8.9.2.3. Corrective action for material NAV computation errors

#### 8.9.2.3.1. Reporting to the management company, sponsor or promoter, depositary, CSSF and independent auditor

The UCI's administrator must notify, immediately upon discovery of a material error, the management company, its sponsor or promoter, the depositary, the CSSF and the independent auditor and must submit to the management company, sponsor or promoter and the supervisory authority a remedial action plan dealing with the corrective action proposed or already taken to resolve the problems that caused the error and must make appropriate improvements to existing administrative and control structures to avoid a recurrence of the failure. The remedial action plan should further detail the action proposed or already taken in order to:

- ▶ Determine categories of investors affected by the error
- ▶ Recompute NAVs used for subscriptions and redemptions during the period the error became material and the date of correction ("error period")
- ▶ Determine on the basis of the recomputed NAVs the amounts to be paid as compensation to the UCI and to the investors
- ▶ Notify the supervisory authorities in those foreign jurisdictions where the shares or units are sold, where so required by such authorities
- ▶ Advise impacted investors of the error and the arrangements for compensation

However, a "simplified procedure" may be adopted where the amount of compensation does not exceed EUR 25,000 or the amount payable to an investor does not exceed EUR 2,500. Such a procedure requires that the administrator notifies the CSSF; however, no remedial action plan needs to be prepared.

In the case of nominee accounts the determination of the amount payable to an investor not exceeding EUR 2,500 remains at the level of the beneficial owner and not at the level of the nominee account.

The limit of EUR 25,000 is an aggregate compensation amount due to investors and due to the UCI.

#### 8.9.2.3.2. Quantifying the financial impact of a computation error

The administration must remedy the error as swiftly as possible.

For the purpose of quantifying the financial impact of a computation error, the UCI's administrator should make a distinction between:

- ▶ Investors existing prior to the error period who redeemed during the error period
- ▶ New investors during the error period who held their shares or units beyond the end of the error period

The following gives an overview of the position of a UCI and its investors where the NAV is understated or overstated:

##### A. NAV understated

- ▶ Investors existing before the error period who redeemed their shares or units during the error period must be compensated for the difference between the recomputed NAV and the original understated NAV used as the basis for their redemption transaction
- ▶ The UCI must be compensated for the difference between the recomputed NAV and the original understated NAV as applied to shares or units subscribed during the error period and still held beyond the end of the error period

## B. NAV overstated

- ▶ The UCI must be compensated for the difference between the original overstated NAV as applied to shares or units held prior to the error period and redeemed during the error period and the recomputed NAV
- ▶ New investors during the error period who held their shares or units beyond the end of the error period must be compensated for the difference between the original overstated NAV as applied to such subscriptions and the recomputed NAV

Investors incurring a loss as a result of an error may be compensated out of the assets of the UCI where such payments represent the refund of excess receipts by the UCI. Alternatively, the management company, its sponsor, or the UCI's promoter or administrator may, as appropriate, elect to bear the cost of such compensation.

A question arises as to whether a UCI which has sustained a loss as a result of a computation error has the right to look to investors who have unknowingly benefited from the error to compensate any underpayment for a subscription based on an understated NAV or any excess receipt from a redemption based on an overstated NAV. As this is a somewhat controversial issue to which no clear answer may be given in the absence of a judicial ruling on the matter, the Circular does not advocate recourse to investors for compensation of losses sustained by the UCI, except where institutional or other expert investors are concerned and where such investors have explicitly and knowingly agreed to indemnify the UCI for such losses.

In principle, the administrator or, as appropriate, the management company, its sponsor, or the UCI's promoter compensates the UCI for any loss.

As soon as the misstated NAVs have been recomputed, the appropriate accounting entries to record the compensation payments receivable and/or payable must be entered in the UCI's accounting records.

### 8.9.2.3.3. Payment of compensation for losses incurred

The obligation to compensate losses incurred by the UCI and/or its investors applies only to those valuation days affected by a material NAV computation error.

The UCI's administrator must expedite the compensation payments to the UCI and/or the impacted investors subject to completion of the independent auditor's review (see Section 8.9.2.3.4.). In order to speed up the correction process, the UCI's administrator may begin work on the various steps involved without prior authorization from the CSSF who may be informed of action taken after the event.

Where, as a result of a NAV computation error, the amount of compensation does not exceed EUR 25,000 and the amount payable to an investor does not exceed EUR 2,500, the administrator must expedite the release of the amounts of compensation due to the UCI and/or impacted investors as soon as such amounts of compensation have been quantified.

The CSSF may, however, intervene if it deems appropriate.

In the majority of leading investment fund centers, fund managers are permitted by the supervisory authority to apply *de minimis* (minimum amount) rules to compensation amounts due to individual investors. This procedure avoids the situation of investors who are entitled to relatively modest amounts of compensation seeing the payment effectively nullified by bank and other expenses incurred by them. Luxembourg UCIs are permitted to apply *de minimis* rules. The CSSF has not set a fixed *de minimis* as the appropriate amount may vary from UCI to UCI depending on where its shares or units are sold. It is for each UCI to set its proposed *de minimis*. The CSSF may request from the UCI, on an *ex-post* basis, documentary evidence to support the *de minimis* amount. The *de minimis* rule may not be used to refuse compensation to investors who have specifically requested compensation.

In the case of investors who still hold shares or units in the UCI, the UCI may elect to credit them (without charge) with new shares or units rather than by payment. In such circumstances, there is no justification to apply a *de minimis*.

Where impacted investors subscribed via a nominee, the investor compensation will be remitted to the nominee, who must give an undertaking to the UCI's administrator to forward the amounts to the beneficial owner.

The CSSF's position is that the UCI must be reimbursed for losses incurred due to fees charged incorrectly to the UCI, even when such fees may not be considered to be material.

#### 8.9.2.3.4. The role of the independent auditor in reviewing the correction process

As stated in Section 8.9.2.3.1., when notifying the management company, its sponsor or promoter, the depositary and the CSSF of the occurrence of a material computation error, the UCI's administrator must also advise the UCI's independent auditor and, if the simplified procedure cannot be applied, commission a (first) special report on the appropriateness of the methods intended to be used in order to:

- Determine in the most appropriate manner which categories of investors are affected by the error
- Recompute the NAVs used as the basis for subscription and redemption orders received during the period between the date at which the error became material and the date at which it was corrected
- Determine on the basis of the recomputed NAVs the amounts to be paid to the UCI and to investors by way of compensation for losses sustained as a result of the error

The conclusions of the independent auditor on the proposed methods should be attached to the compensation arrangements document referred to in Section 8.9.2.3.1.

Where the calculation error is detected by the independent auditor, it should be reported to the UCI's administrator immediately together with a request that the management company, sponsor or promoter, depositary and the CSSF be notified forthwith. Where the independent auditor finds that the administration has failed to comply with this request, the CSSF should be advised accordingly.

Once the UCI's administrator has completed the correction process to the extent of making the appropriate entries in the UCI's accounting records, the independent auditor should carry out procedures and produce a (second) special report stating whether, in their opinion, the correction process is appropriate and reasonable in the circumstances. The report should deal with:

- The methods referred to in the first paragraph of this section
- The recomputed NAVs as originally misstated
- The loss sustained by the UCI and/or its investors

The administrator should forward a copy of the (second) special report of the independent auditor to the CSSF and, if requested, to the supervisory authorities of those jurisdictions in which the UCI's shares or units are registered for distribution.

The independent auditor should issue a final (third) special report certifying that the amounts of compensation due to the UCI and/or impacted investors have been effectively paid.

A copy of this (third) special report should also be forwarded to the CSSF and, where applicable, to the authorities of foreign jurisdictions where the shares or units are sold.

In practice, the three special reports may be combined into one or two reports.

Under the simplified procedure, the independent auditor is required to review the correction process in the context of its separate report procedures required by CSSF Circular 21/790.

#### 8.9.2.3.5. Communicating with impacted investors entitled to compensation

Material computation errors must be reported to investors entitled to compensation.

This may be either by individual notification or announcement in the press, giving particulars of the computation error and the action taken to correct the error and compensate the UCI and/or investors affected.

#### 8.9.2.3.6. Liability for expenses incurred in remedying a computation error

Expenses incurred as a result of remedial action taken to correct a computation error, including the cost of the special report(s) of the independent auditor, must not be borne by the UCI. In practice they are borne by the party responsible for the investment breach/NAV calculation error.

It is the duty of the independent auditor to ensure, as part of his statutory review of the accounting information contained in the UCI's annual report, that such expenses have not been met out of the assets of the UCI.

#### 8.9.2.4. Master-feeder UCITS

For master-feeder UCITS, NAV computation errors detected that may have a negative impact on the feeder UCITS include, but are not limited to:

- ▶ Errors in the NAV calculation of the master UCITS
- ▶ Errors in transactions for or settlement of subscription or redemption by the feeder UCITS of shares or units in the master UCITS
- ▶ Errors in the payment or capitalization of income arising from the master UCITS or in the calculation of any related withholding tax

### 8.9.3. Compensation for losses arising from non-compliance with investment restrictions

#### 8.9.3.1. Rectification of non-compliance

Immediately upon discovery of an instance of non-compliance with applicable investment restrictions, the management of the UCI should take all appropriate measures to rectify the situation in which the UCI finds itself as a consequence of the non-compliance. In particular:

- ▶ Where the nature of the non-compliance is the making of investments in contravention of the investment policy stated in the UCI's prospectus, the UCI should arrange to dispose of such investments
- ▶ Where the investment limits stipulated by law or by the UCI's prospectus have been breached in circumstances other than those provided for by Article 49 of the 2010 Law, as amended (see Section 4.2.2.8.1.V.), the UCI should arrange to dispose of the excess positions. However, where there is a breach of Article 43(2) of the 2010 Law, as amended (see Section 4.2.2.8.1.I.(2)), the UCI may also dispose of a position other than those that caused the breach
- ▶ Where the borrowing limits stipulated by the law or by the UCI's prospectus have been breached, the UCI should arrange to reduce the excess borrowing within the applicable limit

On 16 April 2020, the CSSF published its *FAQ - COVID-19* and provided the following clarifications on passive investment breaches and breaches of the Value at Risk (VaR) limits for UCITS:

- ▶ Passive investment breaches of the global exposure limit (and more generally of applicable investment restrictions) do not need to be notified to the CSSF
- ▶ The CSSF considers that breaches of the VaR limit (either the maximum limit laid down in regulation (20% for absolute VaR or 200% for relative VaR as the case may be) or any other more restrictive internal limit set below the above regulatory thresholds, as laid down in the sales prospectus) by UCITS as a result of the increase of volatility in financial markets (in the absence of any new positions increasing the risk of the portfolio) may be considered as passive breaches
- ▶ Upon occurrence of a passive breach, any subsequent additional risk exposure taken by the UCITS increasing the overall level of risk of the portfolio (i.e., VaR usage increasing) should be viewed as an active investment breach
- ▶ Investment fund managers should take reasonable steps to meet the limit within a reasonable time period, thereby taking due account of the prevailing market conditions and the best interests of investors. For that purpose, they have to closely monitor the situation of the UCITS as well as the defined remediation plan
- ▶ Question 16.D) of the FAQ also clarifies the content of the notification to the CSSF in relation to an active breach of the VaR limit

#### 8.9.3.2. Calculation of compensation

In the three cases referred to in Section 8.9.3.1., the UCI should seek compensation for any loss sustained by it.

The CSSF FAQ on CSSF Circular 02/77, mentioned in Section 8.9.1., clarifies certain elements of the compensation calculations applicable to the above scenarios.

Where multiple investment restriction compliance failures occur, compensation should be sought for any aggregate net loss arising as a result of the rectifications as a whole.

Where such rectifying transactions produce an aggregate net profit to the UCI, the UCI should be entitled to recognize and retain such profit. In these circumstances, the UCI's administrator only needs to notify the CSSF and the independent auditor.

By way of exception, where warranted in all the circumstances, alternative methods other than those outlined may be adopted to determine the amount of the loss, including, in particular, the so-called "economic" method whereby the loss is quantifiable in terms of the performance differential had the unauthorized investments sustained the same movements as the authorized portfolio invested in accordance with the investment policy and investment limits stipulated by the law or by the prospectus.

### 8.9.3.3. Application of materiality levels

In July 2004, the CSSF clarified the applicability of the materiality levels (see Section 8.9.2.2.) in the case of non-compliance with investment restrictions, as follows:

- ▶ The UCI must always be compensated for losses resulting from selling the unauthorized investment or the excess position of this investment or the expenses attributable to the unauthorized portion of the borrowing, whatever the impact of the breach; no materiality levels may be applied to these situations
- ▶ If the realized loss shows that the impact on the NAV exceeds the materiality levels, the NAV must be recomputed for the breach period and the UCI and its investors that have suffered a loss must be compensated

The impact on the UCI and/or underlying investors during the breach period may also have to be considered.

### 8.9.3.4. Responsibility for compensation

It is the responsibility of the party that caused the breach through a failure to fulfill its obligations to compensate the loss. In all other circumstances, the management company, its sponsor or the UCI's promoter should be responsible for rectifying the loss.

### 8.9.3.5. Remedial action procedures

The same procedure for determining what remedial action is required in cases of NAV computation error should apply, as is appropriate in the circumstances, to cases of non-compliance with investment restrictions (see Section 8.9.2.). Specific reference is made in this context to the mandatory procedures that deal with:

- ▶ Reporting to the management company, sponsor or promoter and the depositary of the UCI and to the CSSF
- ▶ Determining which categories of investor have been impacted by the loss sustained by the UCI
- ▶ Quantifying the financial impact of the loss for individual investors and making arrangements for their compensation
- ▶ The role of the independent auditor in reviewing the correction process
- ▶ Communicating with impacted investors entitled to compensation
- ▶ With respect to investor compensation arrangements, the procedure set out in Section 8.9.2.3.3. applies

### 8.9.3.6. Master-feeder UCITS

For master-feeder UCITS, a non-compliance with investment restrictions detected that may have a negative impact on the feeder UCITS includes, *inter alia*:

- Breaches of the investment objectives, policy or strategy of the master UCITS, as described in its fund rules or instrument of incorporation, prospectus or KIID
- Breaches of investment and borrowing limits set out in national law or in the fund rules or instruments of incorporation, prospectus or KIID

### 8.9.4. Applicability to SIFs

The CSSF FAQ on CSSF Circular 02/77 mentioned in Section 8.9.1. clarifies that SIFs may either opt to apply CSSF Circular 02/77 or set other specific internal rules in the context of NAV calculation errors and active investment breaches.

In the absence of specific internal rules, the Circular applies. All material NAV errors and active investment breaches have to be notified to the CSSF, whether the SIF applies the Circular or specific internal rules. When SIFs opt for the application of the Circular, a remedial action plan is not required but the external auditor has to review the correction process and the related compensation and confirm in the management letter that they complied with the provisions of the Circular.

When applying internal rules, SIFs must apply appropriate thresholds taking into due account the investment policy of the SIF.



# 09

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# DEPOSITARY

EY supports depositaries in the following tasks:

- ▶ Definition and review of operating models and business plans
- ▶ Application for authorization as a depositary
- ▶ Process design and documentation
- ▶ Compliance solution and support
- ▶ Selection and due diligence support of delegates and outsourcing agents
- ▶ Review of fee structures and benchmarking
- ▶ Assurance reporting on depositary controls (e.g., ISAE 3402, US Attestation Standard AT-C section 320)



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## 9.1. Introduction

This Chapter summarizes key points related to the depositary function of Luxembourg based Undertakings for Collective Investment (UCIs). It covers:

- ▶ The qualifications of the depositary
- ▶ The duties of the depositary
- ▶ Conduct of business rules
- ▶ Depositary liability
- ▶ Delegation by the depositary to third parties

In this Chapter, the term:

- ▶ “Full AIFM regime AIFs” refers to Alternative Investment Funds (AIFs) managed by authorized Alternative Investment Fund Managers (AIFMs) and internally managed AIFs that are subject to the AIFM Law. If the term AIF is used in this Chapter and not further specified, reference is made to full AIFM regime AIFs
- ▶ “Simplified AIFM registration regime AIFs” means AIFs whose manager is not subject to the full provisions of the AIFM Law (or the AIFM Directive) and internally managed AIFs that are not subject to the full provisions of the AIFM Law

In the context of this Chapter, the term “full AIFM regime AIFs” includes reserved alternative investment funds (RAIFs) subject to the Law of 23 July 2016, as amended. Article 5 of the Law of 23 July 2016 requires depositaries of RAIFs to comply with the depositary regime in accordance with the AIFM Law.

The regulatory regime applicable to depositaries in Luxembourg has been subject to significant change originated by the AIFMD and the UCITS V Directive. The most recent, ongoing and future regulatory changes impacting depositaries are summarized below:

1. The Law of 12 July 2013, as amended, (the “2013 Law”) transposed the Directive 2011/61/UE and established the general regime applicable to the depositaries of full AIFM regime in Chapter 3, Section 4. Section 3 of the Delegated Regulation 231/2013, as amended, provides further details as to the requirements for depositaries including, *inter alia*, due diligence duties and asset segregation obligations.
2. The EU UCITS V Directive (UCITS V) aligned, in general, the regime applicable to the depositaries of UCITS with the regime applicable to the depositaries of full AIFM regime AIFs. The UCITS V Directive (2014/91/EU) amending Directive 2009/65/EC was transposed into Luxembourg Law effective 1 June 2016 by amending the Luxembourg Law of 17 December 2010 (the “2010 Law”). The adopted law is, with respect to the depositary rules, mainly a transposition of the text of the UCITS V Directive. The UCITS V delegated act (Delegated Regulation 2016/438) was published in the official journal of the EU on 24 March 2016 and has been applicable since 13 October 2016.
3. In October 2016, the CSSF issued Circular 16/644 which repealed and replaced CSSF Circular 14/587 as amended by CSSF Circular 15/608. Circular 16/644 closely aligned the previous requirements of CSSF Circular 14/587 to the requirements of UCITS V as well as the related Delegated Regulation 2016/438 and provides further clarifications and additional information regarding obligations applicable to depositaries of UCITS in Luxembourg. Overall, the Circular is broadly aligned with the provisions of the AIFM Law and related delegated acts, as well as UCITS V and its delegated acts. However, there are some important differences between the various texts.
4. The Law of 27 February 2018 introduced important changes to UCIs governed by Part II of the 2010 Law (2010 Law Part II UCIs). Since transposition of the UCITS V Directive into Luxembourg Law, 2010 Law Part II UCIs were subject to the more stringent depositary rules as defined by UCITS V. The Law of 27 February 2018 amends the 2010 Law and the Law of 12 July 2013 on AIFMs and introduces different depositary regimes (UCITS V, AIFM and the depositary regime defined by the Law of 13 February 2007 on specialized investment funds) for 2010 Law Part II UCIs, subject to certain conditions. The Law of 27 February 2018 entered into force on 5 March 2018.
5. On 23 August 2018, the CSSF issued CSSF Circular 18/697 clarifying the requirements applicable to depositaries of UCIs which are not subject to Part I of the 2010 Law relating to undertakings for collective investment and, where appropriate, to their branches.

This Circular provides, *inter alia*, additional clarifications regarding the admission criteria and process for depositaries of non-UCITS, specific requirements for non-bank depositaries (investment firms within the meaning of the 1993 Law, as amended, and professional depositaries of assets other than financial instruments in accordance with Article 26-1 of the 1993 Law, as amended), eligibility criteria, additional guidance as to the application of safeguarding, due diligence and oversight principles for specific asset classes and clarifications on record keeping, asset valuation and segregation rules.

6. Delegated Regulation (EU) 2018/1618 of 12 July 2018 amending Delegated Regulation (EU) No 231/2013 related to safe-keeping duties of depositaries of AIFs and Delegated Regulation (EU) 2018/1619 of 12 July 2018 amending Delegated Regulation (EU) 2016/438 related to safe-keeping duties of depositaries of UCITS (the “Revised UCITS V and AIFMD regulations”). Guided by the ESMA opinion to the EU Parliament published on 20 July 2017 on clarifications of legislative provisions under the AIFMD and UCITS Directive regarding asset segregation and the application of depositary delegation rules to CSDs, the Revised UCITS V and AIFMD regulations implemented a number of new requirements to foster asset protection, including for example, the requirements related to the reconciliation process, the books and records to be kept by depositaries and the identification of all the parties included in the custody chain (refer also to Section 9.7.2.A.). The revised UCITS V and AIFMD regulations were published on 30 October 2018 in the Official Journal of the EU and have been applicable since 1 April 2020.

7. Another European regulatory development impacting depositaries is the Regulation on securities settlement and on central securities depositaries<sup>1</sup> (CSDs). The CSD Regulation is designed to increase the safety and efficiency of securities settlement in the EU, promote greater choice for issuers and users by enhancing the single market and harmonizing settlement periods for transferable securities traded on EU markets. The CSD Regulation, as amended, provides, *inter alia*, for shorter settlement periods, measures to promote settlement discipline, access rights requirements for CSD services, prudential and conduct of business rules for CSDs and increased prudential and supervisory requirements for CSDs and other institutions providing banking services ancillary to securities settlement.

The CSD Regulation No. 909/2014, as amended by EU Regulation 2016/1033 (CSDR), entered into force in September 2014, with staged implementation from 1 January 2015 and full implementation by 1 January 2025. The EU Commission published on 10 March 2017 Commission Delegated Regulations 2017/389, 2017/390, 2017/391, 2017/392, 2017/393 of 11 November 2016 amending the Regulation and providing Regulatory and Implementing Technical Standards, complementing the obligations defined under the Regulation. The RTS have been effective since 10 March 2019.

ESMA issued a Question and Answer (Q&A) document on the *Implementation of EU Regulation 909/2014 on improving securities settlement in the EU and on central security depositaries*, as amended, providing guidance on central security depositaries, settlement discipline and internalized settlement.

On 17 December 2021, ESMA issued a public statement regarding the supervisory approach on the implementation of the CSDR buy-in provisions which highlighted that ESMA called the European Commission (EC) for an urgent change in CSDR to allow postponing the application date of the buy-in regime, while noting the importance of the entry into force of the rest of the settlement discipline regime measures (settlement fails reporting and cash penalties) on 1 February 2022 as planned. The co-legislators agreed on an amendment to CSDR that will allow ESMA to develop draft technical standards proposing to postpone the date of application of the buy-in regime while keeping the date of application of the penalties and reporting requirements unchanged. The revised legislative proposal that amends Regulation (EU) No 909/2014 was issued on 18 March 2022.

On 10 January 2022, the CSSF issued Circular 22/792 informing Central Security Depositaries that the CSSF, in its capacity as a competent authority, applies the *Guidelines on Settlement Fails Reporting under Article 7 of CSDR*<sup>1</sup> (ESMA70-156-4717) (the "Guidelines"), published on 8 December 2021.

8. ESMA issued Q&A documents on the Application of the UCITS Directive and the AIFMD Directive, which clarify certain aspects of UCITS V and AIFMD. In addition, the CSSF Press Release 16/10 of 2 March 2016 addresses *Practical issues in relation to the UCITS V regime*.
9. On 26 November 2021, the EC provided legislative proposal amending Directives 2011/61/EU and 2009/65/EC addressing the following elements with regards to the provision of depositary and custody services:
  - CSD will be included in the custody chain when they provide custody services to ensure that depositaries have access to the information needed to carry out their duties
  - National Supervisors will be permitted to allow AIFs established in their jurisdictions to select a depositary established in another Member State
10. On 4 January 2022, the CSSF published the most recent version of guidelines on virtual assets for credit institutions and UCIs in the form of FAQs, addressing the notification and organizational requirements that have to be fulfilled in the event that depositaries want to engage in the safekeeping of virtual assets
11. To the extent that their operating model involves outsourcing, depositaries are also subject to the provisions of the new outsourcing CSSF Circular 22/806 (please refer to Section 8.4.8.)
12. The ABBL/ALFI Depositary Bank Forum has issued several important guidelines for depositaries:
  - *ABBL/ALFI Guidelines on financial instruments held in custody* issued in January 2020: These guidelines summarize key responsibilities for depositaries of custodial assets, obligations in relation to the set-up of accounts and segregation obligations, the appointment and monitoring of sub-custodians, considerations in relation to target funds, collateral arrangements and relationships with prime brokers
  - *ABBL/ALFI Guidelines on look through and control* issued in March 2020: These guidelines provide an overview of the application of the look through approach with respect to cash and ownership verification depending on various situations of control
  - *ABBL/ALFI Guidelines on the new AIFM/UCITS CDRs on delegated regulation*: These guidelines include an impact assessment and recommendations for implementation following the changes introduced by the Delegated Regulations (EU) 2018/1618 and 2018/1619 related to safekeeping duties of depositaries of AIFs and UCITS (refer to point 6 above)
  - *ABBL/ALFI Guidelines and recommendations for depositaries on safekeeping of other assets*: These guidelines provide an overview of common principles and practices for depositaries regarding, *inter alia*, the verification of ownership and recordkeeping with respect to assets which do not fall within the definition of financial instruments held in custody (other assets). The guidelines walk through processes and procedures specific to various other asset classes (e.g., derivatives, real estate, private equity and loans)

<sup>1</sup> Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositaries and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012.

## 9.2. Appointment

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A single depositary must be appointed for each Luxembourg UCI. The appointment and any replacement of the depositary must be approved by the CSSF (except for RAIFs).

There is no specific “depositary banking license” to be obtained to operate as a depositary. However, CSSF Circulars 16/644, as amended, and 18/697 provide detailed rules regarding the content of an application file to be submitted, the conditions to be met and the procedures to be put in place by the depositary in order to be granted approval to act as depositary by the CSSF. The information to be provided to the CSSF is described in Section 9.9. *Other reporting and disclosure obligations*.

The appointment of the depositary must be evidenced by a written contract. CSSF Circular 16/644 makes reference to the requirements of Chapter 1 of the UCITS V Delegated Regulation which includes in Article 2.2 a detailed list of the points which must be addressed in the written contract. The content of the written contract is very much aligned with the depositary contract requirements of the AIFMD and its delegated acts and CSSF Circular 18/697. The written contract should, *inter alia*, regulate the flow of information deemed necessary to allow the depositary to perform its function for the UCITS and/or AIF to which it has been appointed.

The minimum content of the depositary contracts for UCITS and AIFs is covered in Section 6.3.5.1. Neither a management company nor an AIFM can act as depositary.

## 9.3. Eligible entities

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The entities eligible to act as a depositary depend on the regime applicable to the UCI.

### 9.3.1. Depositary of UCITS and 2010 Law Part II UCIs

The depositary of a UCITS must be a credit institution with its registered office in Luxembourg or a branch of a credit institution established in Luxembourg with its registered office in another EU/EEA Member State.

The UCITS V Directive, as amended, in principle also allows national central banks and other legal entities authorized by the competent authority under the laws of the Member State to carry on depositary activities under the UCITS Directive, subject to specific conditions (*inter alia*, meeting certain capital adequacy requirements).

According to the rules applied in Luxembourg, a Luxembourg branch of a non-EU/EEA credit institution may not act as depositary of a UCITS.

The Law of 10 May 2016 implementing UCITS V into Luxembourg law extended the UCITS V depositary regime to 2010 Law Part II UCIs, thus, superseding the rules on depositaries provided for under the AIFM Law applicable to 2010 Law Part II UCIs. The Law of 27 February 2018, however, changed that approach and allows the application of different depositary regimes under certain conditions. In summary, the various depositary regimes introduced by the Law of 27 February 2018 for 2010 Law Part II UCIs can be summarized as follows:

- ▶ 2010 Law Part II UCIs marketed to retail investors in Luxembourg are subject to the UCITS depositary regime (irrespective of whether they are managed by an EU authorized/registered AIFM<sup>2</sup> or by a non-EU AIFM)
- ▶ 2010 Law Part II UCIs where the offering documents do not allow marketing to retail investors in Luxembourg and which are managed by an authorized AIFM are subject to the AIFMD depositary regime
- ▶ 2010 Law Part II UCIs where the offering documents do not allow marketing to retail investors in Luxembourg and which are managed by a registered AIFM or by a non-EU AIFM are subject to the SIF depositary regime<sup>3</sup>

### 9.3.2. Depositary of AIFs (according to the AIFM Law)

The depositary of an AIF subject to the AIFM Law must, in general, be a credit institution or an investment firm (often referred to as a MiFID<sup>4</sup> firm). The depositary must either have its registered office in Luxembourg or have a branch established in Luxembourg with its registered office in another EU/EEA<sup>5</sup> Member State.

Under certain conditions as described in Section 9.3.2.2., a specialized professional of the financial sector (PSF) qualifying as “Professional depositary of assets other than financial instruments” may act as depositary of a full AIFM regime AIF or a simplified AIFM registration regime AIF.

Reference is made to Section 9.3.1. relating to depositaries applicable to 2010 Law Part II UCIs.

<sup>2</sup> AIFMs which benefit and use the exemption of Article 3 (2) of the AIFM Law, as amended.

<sup>3</sup> The depositary regime defined by the Law of 13 February 2007 on specialized investment funds, as amended.

<sup>4</sup> Markets in Financial Instruments Directive (MiFID), Directive 2004/39/EC, repealed by Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, as amended (MiFID II).

<sup>5</sup> European Union (EU) Member States plus Iceland, Liechtenstein and Norway.

### 9.3.2.1. Investment firms as depositaries

Where an investment firm wishes to act as depositary, it must notify the CSSF prior to commencing depositary activities. The CSSF may object within a period of up to two months, explaining its reasons. An investment firm that intends to act as depositary must, *inter alia*:

- ▶ Be authorized to provide the ancillary service of safekeeping and administration of financial instruments for the account of clients
- ▶ Have minimum capital of EUR 730,000
- ▶ Have an internal governance structure, including an organizational, administrative and internal control structure that is appropriate for the activity of a depositary

Subject to obtaining the required authorizations, investment firms may also act as:

- ▶ Agent for the reception and transmission of orders relating to one or more financial instruments
- ▶ Collateral agent
- ▶ Collateral manager
- ▶ External valuer

An investment firm acting as the single depositary of an AIF must appoint a delegate to safekeep assets other than financial instruments. In such case, the first accounts relating to the assets to be held in custody with the delegate must be opened in the name of each client (or, where applicable, of each AIF compartment) at the level of the delegate.

Also, investment firms which act as depositaries must ensure the appointment of one or more entities with which all cash of the AIF should be monitored and booked in cash accounts in accordance with Article 19(7) of the 2013 Law, as amended.

### 9.3.2.2. Professional depositaries of assets other than financial instruments (PDAOIFs)

A specialized PSF “Professional depositary of assets other than financial instruments” must obtain authorization from the CSSF prior to starting its activities. It must have minimum capital of EUR 500,000.

Also, the specialized PSF must have an appropriate administrative and accounting organization in place and dispose of effective internal procedures and controls. The organization and internal procedures and controls need to be complete and reflect the nature, scale and complexity of the operations of the specialized PSF.

PDAOIFs can only act as depositaries for AIFs, SIFs and SICARs (which do not qualify as AIFs) with no exercisable redemptions rights for a period of five years from the date of the initial investment and which, pursuant to their main investment policy, generally do not invest in assets which must be held in custody.

Also, PDAOIFs cannot act as depositary for entities with an investment policy to invest in issuers of non-listed companies in order to acquire control thereof.

A PDAOIF cannot act as custodian of cash deposits or of financial instruments to be held in custody. In case a PDAOIF acts as the single depositary of an AIF, it must appoint a delegate to maintain cash deposits or safekeep financial instruments to be held in custody on its behalf (“mandatory delegate”).

### 9.3.2.3. Virtual asset service providers

A depositary providing administrative and depositary services to a UCI investing in virtual assets triggers an obligation to register as a virtual asset service provider within the meaning of the *Law of 12 November 2004 on the fight against money laundering and terrorist financing*, as amended, if the depositary directly provides services related to the safekeeping or the administration of virtual assets, including the custodian wallet service, to its client.

Under this set-up, virtual assets are recognized off-balance sheet and the depositary has an obligation of restitution for the loss or theft of said assets within the meaning of the civil law. UCI depositaries that envisage directly safeguarding virtual assets are required to inform the CSSF of such plans in a timely manner. This requirement is in addition to the registration as a virtual asset service provider.

### 9.3.3. Summary of qualifications

The eligibility of depositaries for UCITS, other UCIs and SIFs can be summarized in the following table:

Entities eligible to act as depositaries by UCI regime

	UCITS/2010 Law Part II UCIs <sup>6</sup>	Full AIFM regime AIFs		Simplified AIFM registration regime AIFs
		AIFs/SIFs/ 2010 Law Part II UCIs <sup>7</sup>	RAIFs	AIFs/SIFs/ 2010 Law Part II UCIs <sup>8</sup>
Luxembourg credit institution	Yes	Yes	Yes	Yes
Luxembourg branch of an EU/EEA credit institution	Yes	Yes	Yes	Yes
Luxembourg branch of a non-EU credit institution	No	No	No	Yes
Luxembourg investment firm	No	Yes	Yes	Yes
Luxembourg branch of an EU/EEA credit institution	No	Yes	Yes	Yes
Luxembourg branch of a non-EEA investment firm	No	No	No	Yes
Professional depositaries of assets other than financial instruments	No	Yes	Yes	Yes
Applicable core regulations	UCITS V  CSSF Circular 16/644	AIFMD  CSSF Circular 18/697	AIFMD  CSSF Circular 18/697	SIF Law  CSSF Circular 18/697 Part I Chapter V

## 9.4. Duties

### 9.4.1. General

In general, the depositary of a UCI should perform the following duties:

- The safekeeping of financial instruments and other assets belonging to the UCI
- Cash flow monitoring
- Carrying out a number of other monitoring and oversight duties

There are currently certain differences between the duties of the depositary of a UCITS, a full AIFM regime AIF and a simplified AIFM registration regime. UCITS V, AIFMD and CSSF Circulars 16/644 and 18/697 have extensively harmonized the existing differences in duties as described hereafter and have, in particular, addressed the differences in depositary duties in relation to common funds and investment companies.

<sup>6</sup> 2010 Law Part II UCIs marketed to retail investors in Luxembourg are subject to the depositary regime of the UCITS V Directive (irrespective of whether they are managed by an EU authorized/registered AIFM or by a non-EU AIFM).

<sup>7</sup> 2010 Law Part II UCIs where the offering documents do not allow marketing to retail investors in Luxembourg and which are managed by an authorized AIFM are subject to the AIFMD depositary regime.

<sup>8</sup> 2010 Law Part II UCIs where the offering documents do not allow marketing to retail investors in Luxembourg which are managed by a registered AIFM or by a non-EU AIFM are subject to the depositary regime for SIFs.

The duties of the depositary in relation to the applicable depositary regimes can be summarized as follows:

### Overview of depositary duties

	UCITS		Full AIFM regime AIFs						Simplified AIFM registration regime AIFs			
			AIF		SIF		RAIF		AIF		SIF	
	Common fund	Investment company	Common fund	Investment company	Common fund	Investment company	Common fund	Investment company	Common fund	Investment company	Common fund	Investment company
Safekeeping of the UCI's assets	X	X	X	X	X	X	X	X	X	X	X	X
Cash flow monitoring	X	X	X	X	X	X	X	X	X	X		
Oversight duties	Ensuring that the subscription and redemption of shares or units of the UCI are carried out in accordance with the law and the constitutional document											
	Ensuring that the value of the shares or units is calculated in accordance with the law and the constitutional document											
	Carrying out the instructions of the management company or AIFM, unless they conflict with the constitutional document											
	Ensuring that for transactions involving the UCI's assets, any consideration is remitted to it within the usual time limits											
	Ensuring that the UCI's income is applied in accordance with the constitutional document											

The depositary regime applicable to a 2010 Law Part II UCI will depend on various factors such as its targeted distribution and the qualification of the entity which manages it. As to the applicable depositary regime, please refer to Section 9.3.1.

The depositary is also required to provide the CSSF, on request, with all the information that it has obtained in the exercise of its duties and that is necessary to enable the CSSF to monitor compliance by the UCI with the law.

## 9.4.2. Safekeeping

The depositary's safekeeping duties may be summarized as follows:

▶ Custodial assets:

- ▶ All financial instruments belonging to the UCI, that may be registered in a financial instruments account, are to be maintained in segregated accounts (i.e., separately from the depositary's own assets) opened in the name of the UCI (or of the management company acting on behalf of the UCI), so that they can at all times be clearly identified as belonging to the UCI or the respective compartment, if applicable

Financial instruments are generally held in custody through a custody network. They may include, for example, listed equities, bonds and selected money market instruments.

- ▶ All financial instruments that can be physically delivered to the depositary

▶ Other assets:

- ▶ For all other assets of the UCI, the safekeeping duties include the verification of ownership and keeping of records of such other assets for which the depositary is satisfied that they belong to the UCI. The assessment of ownership is determined on the basis of information and documentation provided by the UCI or on behalf of the UCI, or any other evidence the depositary can rely on

Other assets not held in custody may include, for example, over-the-counter (OTC) derivatives, foreign exchange derivatives, equities in non-listed companies, real estate, physical assets, ownership rights and intellectual property.

For virtual assets that qualify as "other assets", depositary's liability is limited to safekeeping duties regarding ownership verification and record-keeping.

The depositary is permitted to delegate its safekeeping duties under certain conditions (see Section 9.7.).

### 9.4.2.1. Safekeeping of UCITS, 2010 Law Part II UCI and AIF assets

For UCITS, 2010 Law Part II UCIs and full AIFM regime AIFs, a distinction is made between the depositary's safekeeping duties relating to financial instruments that can be held in custody and those relating to other assets. The requirements for UCITS, 2010 Law Part II UCIs and AIFs are largely identical, however certain differences exist.

### A.1. Assets held in custody - UCITS, 2010 Law Part II UCIs and AIFs

The depositary must hold in custody:

- ▶ All financial instruments belonging to the UCITS, 2010 Law Part II UCI, or AIF where both of the following requirements are met:
  - ▶ They are transferable securities, including those that embed derivatives (see Section 4.2.2.7.3.), money market instruments, or units of UCIs<sup>9</sup>
  - ▶ They are capable of being registered or held in an account directly or indirectly in the name of the depositary

Financial instruments that, in accordance with applicable national law, are only directly registered in the name of the UCITS, 2010 Law Part II UCI, or AIF with the issuer itself or its agent, such as a registrar or a transfer agent, are not considered to be held in custody.

The CSSF's FAQ on Luxembourg's AIFM Law and on Commission Delegated Regulation (EU) No 231/2013 ("Level 2") (the FAQ on AIFMs) clarifies that financial instruments can be directly registered in the name of the AIF, or the AIFM on behalf of the AIF, with the issuer or an agent of the issuer in the following circumstances:

- ▶ When the law applicable to the issuer explicitly requires those financial instruments to be registered directly in the name of the AIF, or the AIFM on behalf of the AIF, with the issuer or an agent of the issuer
- ▶ When the law applicable to the issuer does not prohibit an AIF to register its investment directly in the name of the AIF, or the AIFM on behalf of the AIF, with the issuer or an agent of the issuer, provided that the AIF or the AIFM and the depositary agree to register the financial instruments in the name of the AIF or the AIFM on behalf of the AIF

- ▶ All financial instruments that can be physically delivered to the depositary

In order to comply with its safekeeping duties with respect to financial instruments held in custody, the depositary must at least ensure that:

- (1) The financial instruments are properly registered in the depositary's books by means of segregated accounts, opened in the name of the UCITS, 2010 Law Part II UCI, the AIF and the respective compartments, where applicable, so that they can be clearly identified at all times, in accordance with the applicable law, as belonging to the UCITS, 2010 Law Part II UCI, the AIF and respective compartments, where applicable
- (2) Records and segregated accounts are maintained in a way that ensures their accuracy and in particular record the correspondence with the financial instruments and cash held for UCITS, 2010 Law Part II UCIs, the AIFs and for each compartment, where applicable
- (3) Reconciliations are conducted on a regular basis between the depositary's internal accounts and records and those of any third party to whom custody functions may be delegated
- (4) Due care is exercised in relation to the financial instruments held in custody in order to ensure a high standard of investor protection
- (5) All relevant custody risks throughout the custody chain are assessed and monitored and the management company, investment company, or AIFM is informed of any material risk identified
- (6) Adequate organizational arrangements are introduced to minimize the risk of loss or diminution of the financial instruments or of rights in connection with those financial instruments as a result of fraud, poor administration, inadequate registering, or negligence
- (7) The UCITS', 2010 Law Part II UCI's, or AIF's ownership right or the ownership right of the management company, investment company, or AIFM acting on behalf of the AIF over the assets is verified

Where a UCITS, 2010 Law Part II UCI, or AIF provides its assets as collateral to a collateral taker, these assets must be kept in custody by the depositary as long as the UCITS, 2010 Law Part II UCI, or AIF retains property title of the financial instruments. In these circumstances, custody can be arranged in one of the following ways:

- ▶ The collateral taker is the depositary of the UCITS, 2010 Law Part II UCI, or AIF or is appointed by the UCITS, 2010 Law Part II UCI, or AIF's depositary as sub-custodian of the collateral
- ▶ The UCITS, 2010 Law Part II UCI, or AIF's depositary appoints a sub-custodian which acts for the account of the collateral taker
- ▶ The assets subject to collateral arrangements remain with the UCITS, 2010 Law Part II UCI, or AIF's depositary and are "earmarked" in favor of the collateral taker

For further information about collateral arrangements refer to the *ABBL/ALFI Guidelines on financial instruments held in custody*, January 2020 version.

<sup>9</sup> According to the AIFMD, UCITS V, CSSF Circulars 16/644 and 18/697, investments in UCIs (underlying funds) are considered to be held in custody if registered or held in an account directly or indirectly in the name of the depositary. Investments in UCIs may also be directly registered in the name of the UCITS, 2010 Law Part II UCI, or AIF with the issuer or registrar of the UCITS, 2010 Law Part II UCI, or AIF when the law applicable to the issuer does not prohibit such a registration.



## A.2. Custody considerations specific to AIFs

The AIFMD foresees for AIFs (full AIFM regime AIFs) additional depositary requirements with respect to multi-layer holding structures. The depositary's safekeeping duties apply on a look through basis to underlying assets held by financial or legal structures controlled directly or indirectly by the AIF.

This requirement does not, however, apply to fund of funds structures or master-feeder structures where the underlying funds have a depositary that keeps in custody the assets of these funds.

Financial instruments owned by the AIF (or by the AIFM on behalf of the AIF) for which the AIF (or the AIFM on behalf of the AIF) has given its consent to be reused by the depositary remain in custody as long as the right of reuse has not been exercised.

## A.3. Custody considerations specific to UCITS and 2010 Law Part II UCIs marketed to retail investors

UCITS V defines tighter rules compared to AIFMD concerning the reuse of assets. The assets held in custody by the depositary are allowed to be reused only where:

- (a) The reuse of the assets is executed for the account of the UCITS
- (b) The depositary is carrying out the instructions of the management company on behalf of the UCITS
- (c) The reuse is for the benefit of the UCITS and in the interest of the unitholders
- (d) The transaction is covered by high-quality and liquid collateral received by the UCITS under a title transfer arrangement

It is important to note that as stated under (d) the collateral is received under a title transfer arrangement, not a pledge arrangement.

CSSF Circular 16/644, as amended, contains additional requirements for UCITS and depositaries in relation to collateral handling. As such, depositaries must, in-line with the AIFMD rules, be in a position to determine whether collateral provided to or by a third party for the benefit of the UCITS is the property of the UCITS. The assessment by the depositary must take into consideration the legal nature and the legal and regulatory or contractual provisions applicable to the relevant transaction which is at the origin of the collateral. The assessment should, *inter alia*, allow the depositary to determine the nature of the collateral in order to determine the safekeeping obligations in relation to such assets (refer to Section 9.4.2.1.A.1.).

Regarding collateral, the depositary needs to further take into account the ESMA *Guidelines on ETF and other UCITS issues* as implemented in Luxembourg by CSSF Circular 14/592 where a UCITS enters into OTC transactions or when it engages in effective portfolio management techniques. The duties of the depositary include in this respect, *inter alia*, (see also CSSF Circular 08/356):

- ▶ To ensure that the collateral to be received by the UCITS in the context of securities lending transactions is effectively received prior to, or at the same time as, the transfer of the securities
- ▶ To verify that collateral received complies with the legal and regulatory provisions in force also considering the rules of CSSF Circular 14/592

Specific obligations in case of delegation of custody activities to third-party sub-custodians are described in Section 9.7.

## B.1. Other assets - UCITS, 2010 Law Part II UCIs and AIFs

For other assets, the depositary is required to verify the ownership of the UCITS, 2010 Law Part II UCI, or AIF of such assets and maintain a record of those assets for which it is satisfied that the UCITS, 2010 Law Part II UCI, or AIF holds the ownership.

In general, ownership implies the lawful right, title or claim over an asset and the right to dispose thereof. The ownership itself may be established in various forms depending upon the type of the asset and is typically based on one or several documents by which title to such asset is acquired, e.g., by means of registration or physical transfer or delivery. In summary, the depositary will need to obtain comfort of the existence of such asset and that the UCITS, 2010 Law Part II UCI, or AIF is considered the owner thereof<sup>10</sup>.

The assessment of whether the UCITS, 2010 Law Part II UCI, or AIF holds the ownership must be based on information or documents provided by the management company, investment company or the AIFM and, where available, on external evidence.

<sup>10</sup> | Refer to ALFI and ABBL Guidelines and recommendations for depositaries - Safekeeping of other assets, Chapter III, Section 2, p. 7.

In order to comply with its obligations in relation to safekeeping of other assets, the depository must at least:

- ▶ Have access without undue delay to all relevant information required to perform its ownership verification and record-keeping duties, including relevant information to be provided to the depository by third parties
- ▶ Possess sufficient and reliable information for it to be satisfied of the UCITS, 2010 Law Part II UCI, or AIF's ownership right over the assets

The legal documentation of the investment must clearly indicate and establish whether the UCI is the direct owner of the assets or alternatively, whether the AIFM/management company or, where applicable, the delegated investment manager, is the registered owner acting on behalf of the UCI.

- ▶ Maintain a record of those assets for which it is satisfied that the UCITS, 2010 Law Part II UCI, or AIF holds the ownership. In order to comply with this obligation, the depository must register in its record, in the name of the UCITS, 2010 Law Part II UCI, or AIF, such other assets, including the respective notional amounts, for which it is satisfied that the UCITS, 2010 Law Part II UCI, or AIF holds the ownership.  
For such record to represent a complete overview of such assets, this implies that:
  - ▶ The depository has procedures in place so that registered assets cannot be assigned, transferred, exchanged, or delivered without the depository or its delegate having been informed of such transactions
  - ▶ The depository shall have access without undue delay to documentary evidence of each transaction and position from the relevant third party. Therefore the management companies, investment companies, or AIFMs are required to ensure that the relevant third parties provide the depository without undue delay with certificates or other documentary evidence every time there is a purchase or sale of other assets, or a corporate action. Accordingly, it is recommended that the management company or investment company create, whenever possible and feasible, a direct communication link between the target asset or entity, maintaining the register of such target asset and the UCI's depository<sup>11</sup>
- ▶ Be in a position at any time to provide a complete overview of the UCITS, 2010 Law Part II UCI, or AIF related assets, including the others assets and cash
- ▶ Perform independent reconciliations of its other asset records or books against ownership evidence it receives from the management/investment company, its agents or any other third party, at least annually or more frequently depending on the type of asset and the NAV frequency of the UCI
- ▶ Set up and implement an escalation procedure for situations where an anomaly is detected including notification of the management company, investment company, or AIFM and of the competent authorities if the situation cannot be clarified and, as the case may be, corrected

The CSSF's FAQ on AIFMs clarifies that the depository can maintain its record based on its own systems or based on records of third parties provided that the depository performs ongoing due diligence on the third party and has access to all information required by the depository in order to comply with its obligations.

The concept of third party in this context also includes other divisions or services of the depository, provided that a functional and hierarchical separation of the performance of the depository functions is ensured.

In practice, depositories are very dependent on the interactions with the management/investment company to perform their verification duties. The different forms of documentary evidence that may serve the depository's purposes as well as differences linked to the jurisdiction of target investments may require a significant degree of flexibility from both parties to discharge their information and verification duties. The depository or its agent may consider proceeding with on-site inspections where the nature of the asset does not allow for a verification based on documentary evidence<sup>12</sup>.

CSSF Circular 16/644, as amended, provides additional clarifications for UCITS regarding the possibility by the depository to rely on other parties in order to comply with its record-keeping responsibilities. E.g., depositories can rely on records of the fund accounting agent or statements from other third parties under the following conditions:

- ▶ It has access to the accounting information of the UCITS to allow it to identify at any moment the detailed assets which are reflected in the books of the UCITS
- ▶ Execution of due diligence by the depository on the accounting agent or other third party which covers the accounting system and which allows the depository to conclude that accounting transactions are accurately and exhaustively recorded by the fund accounting agent or other third party, or alternatively, that the accounting system is subject to a ISAE 3402 or US Attestation Standard AT-C section 320 report

<sup>11</sup> Refer to ALFI and ABBL Guidelines and recommendations for depositories - Safekeeping of other assets, Chapter III, Section 4, p. 9.

<sup>12</sup> Idem.

In anticipation of its oversight duty regarding “timely settlement of transactions”, the depositary may also request, to be provided with some contractual documents *ex ante*, in particular for less liquid assets.

The *ALFI and ABBL Guidelines and recommendations for depositaries on safekeeping of other assets* include considerations with respect to ownership verification and record-keeping for each of the following specific asset classes<sup>13</sup>:

- ▶ Private equity/venture capital
- ▶ Real estate
- ▶ Infrastructure
- ▶ Loans, including private debt and syndicated loans
- ▶ Time deposits
- ▶ Undertakings for collective investment
- ▶ Repurchase agreement and securities lending contracts
- ▶ Derivatives
- ▶ To be announced contracts
- ▶ Non-financial assets

## B.2. Other assets - considerations specific to AIFs

Most key asset categories of private equity funds or real estate funds represent other assets. In general, these other assets may be held either directly or indirectly through legal structures which raises a number of questions as to the scope depositaries are expected to apply when executing their depositary duties in relation to such structures including investments held through them.

The depositary’s safekeeping duties apply on a look through basis to underlying assets held by financial and/or legal structures established by the AIF (or by the AIFM acting on behalf of the AIF) for the purpose of investing in the underlying assets and that are controlled directly or indirectly by the AIF (or by the AIFM acting on behalf of the AIF). This requirement does not apply to fund of fund structures and master-feeder structures where the underlying funds have a depositary that provides ownership verification and record-keeping functions for the underlying fund’s assets.

Given that the depositary of an AIF neither physically holds custody of, nor has direct access to the AIF’s “other assets”, it may experience certain challenges in applying a “look through” principle when performing its ownership verification duties. In such instances, the depositary is required to rely on the AIF or the AIFM acting on behalf of the AIF to ensure that the necessary information and documentation is provided to it.

The CSSF FAQ on AIFMs clarifies that the definition of a controlled entity is a matter of professional judgment and will depend on the specific structure in question. The AIF or the AIFM should provide the depositary with all the required information to confirm whether the underlying entity is directly or indirectly controlled or not.

Further clarification on the definition and determination of control is provided in the *ABBL/ALFI Depositary Bank Guidelines on Look Through and Control* published in March 2020.

The depositary is required to assess, on an independent basis and in the interest of the investors, and decide together with the AIF or the AIFM whether or not control exists. In case of disagreement, the depositary should use an appropriate escalation procedure to ensure that the right documentation and information is provided to it.

Exclusive control should be assumed and look-through applied in cases of:

- ▶ *De jure* control:  
The AIF or the AIFM on behalf of the AIF holds:
  - ▶ The majority of ownership or voting rights, either directly or through a shareholder agreement
  - ▶ The right to appoint or remove the majority of the members of the management body of the underlying structure
  - ▶ The contractual right to exercise dominant influence
- ▶ *De facto* control:  
The AIF or the AIFM on behalf of the AIF holds less than 50% of the voting rights but there is no other shareholder in the structure with more voting rights and it can be demonstrated that the AIF or the AIFM on behalf of the AIF exercises a dominant influence, notably on the basis of the investment chart the AIF needs to provide as required by CSSF Circular 18/697.

<sup>13</sup> | Refer to ALFI and ABBL Guidelines and recommendations for depositaries - Safekeeping of other assets, Chapter III, Section 4, p. 11-29.

In all other cases with less clear ownership and control scenarios such as for example, cases of joint control via joint agreement and/or co-ownership agreement, the depositary will need to determine whether or not to apply “look through” in light of the risk-based approach it applies. When applying professional judgement, the depositary may take into consideration the type of underlying assets, how the AIFM conducts its duties, the parties involved in administering or managing the assets of the AIF including other matters such as the onboarding of such assets and the process of ownership monitoring.

The depositary needs to be granted an inspection right in relation to tangible assets even where such assets are held through a chain of controlled entities of an ownership structure.

The ABBL/ALFI *Depositary Bank Guidelines on Look Through and Control* provide detailed recommendations for depositaries related to cash deposits, ownership verification procedures and application of the look through principle, monitoring procedures and information to be requested from AIFs. Also, the Guidelines include concrete examples of ownership scenarios.

CSSF Circular 18/697 provides in Part III, section 5.3.3. additional requirements and guidance for depositaries when executing their safekeeping functions with respect to selected asset classes, such as:

- Real estate
- Target funds
- Investments in issuers or non-listed companies
- Intangible rights
- Financial derivative instruments
- Movable property

#### 9.4.2.2. Other safekeeping duties

Specific Luxembourg requirements may apply in addition to the safekeeping requirements applicable to the depositaries of UCIs.

If the Luxembourg depositary itself holds the securities of the UCI in custody, then it is required to respect the Luxembourg legal requirements on deposits, including those of the Luxembourg Civil Code (in particular Title XI) and the Law of 1 August 2001 concerning the circulation of securities and other fungible financial instruments, as amended. The Law of 1 August 2001 requires, *inter alia*, that fungible securities and other financial instruments received on deposit or held in an account must be booked in an account with the depositary opened in the name of the depositor, separate from its own assets and off-balance sheet.

In respect of financial collateral of UCITS, additional requirements apply on how collateral and assets acquired upon reinvestment of cash collateral must be safekept (refer to Section 4.2.2.10.(6) and (7)).

In addition, the depositary may also be required to comply with the Luxembourg Law of 5 August 2005 on financial collateral arrangements, as amended, which implements Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

CSSF Circulars 16/644 and 18/697 specify that the depositary must be in a position to produce a comprehensive inventory/statement of all the asset positions of a UCITS/AIF or respective compartment. This requirement must be specifically met at the end of each financial year of the UCITS/AIF or respective compartment in view of the audit of the UCI's annual accounts.

The CSSF Circular Letter dated 16 December 2020 clarified that the inventory of all asset positions must differentiate between financial instruments that can be registered in a financial instrument account (custodial assets) and “other assets” such as derivatives, repurchase agreements and securities lending contracts, time deposits, target funds registered in the name of the UCI, loans, private equity, real estate, infrastructure, contracts and other non-financial assets.

It is expected that such inventory of asset positions is exhaustive and no general or specific disclaimers are allowed in relation to the inventory of financial instruments that can be registered in a financial instrument account. In-line with the general safekeeping requirement, the depositary must list all other assets in the inventory list, for which ownership verifications have been completed in accordance with applicable legal provisions.

Additional guidance is provided below:

- ▶ Financial instruments that can be registered in a financial instrument account  
The confirmation must be exhaustive and disclaimers are not permissible in relation to these assets subject to strict restitution liability.
- ▶ Other assets  
In relation to the confirmation of other assets, which are subject to standard negligence liability, adequate ownership verification of sale and purchase agreements, subscription or similar documents, should be performed in accordance with the applicable legislation.  
The depository can state that the confirmation has been established on the basis of information provided by the IFM, the UCI or any third party appointed by either of them, or any other third parties involved in the holding chain. Further disclaimers may also be included in relation to certain other assets for which the depository considers necessary to qualify the result of its ownership verification.  
Where a depository has applied ownership verifications on a look through basis, inventories should disclose the chain of ownership verified by the depository consisting of the entities directly or indirectly controlled by the UCIs.
- ▶ Liabilities  
Current, future and contingent liabilities of the UCI, including capital commitments are excluded from the scope of the inventory requirements.
- ▶ Guarantees and securities  
Guarantees and securities received or provided as collateral belonging to the UCI in the form of financial instruments or cash should be included in the confirmation and identified as such. The confirmation should mention assets which have been received, pledged or given as collateral and rights associated to assets given under title transfer can be disclosed and described as such in the inventory.

### 9.4.3. Day-to-day administration of the assets of the UCI

The depository should carry out all operations related to the day-to-day administration of the UCI's assets held in custody, e.g., the collection of dividends, interest and matured securities, the exercise of securities rights and, more generally, any other operation in relation to the day-to-day administration of securities and liquid assets belonging to the UCI.

Income from securities and related tax reclaims are expected to be accurately and completely identified, processed and credited to the UCI accounts on a timely basis. Therefore, the depository should have sound internal processes and controls in place related to income collection and corporate action processing, ensuring that:

- ▶ Income event data is monitored and respective amounts credited to the UCI account on a timely basis. Where safekeeping of securities is delegated, the depository should ensure that income is credited to the respective accounts of the delegates
- ▶ Income event data and holding entitlements are matched with pre-advice from the delegate, where possible
- ▶ Event notifications are generated and transmitted to UCIs
- ▶ Voluntary or optional corporate actions are identified and processed in accordance with robust procedures
- ▶ Income entitlements are reconciled against settled transactions and amounts and that unusual transactions or un-reconciled differences are investigated and resolved on a timely basis
- ▶ Tax reclaims receivable are monitored until the outstanding receivables are paid

In general, the depository is the last party in the chain of intermediaries providing securities accounts to UCIs. As such, the depository is responsible for the swift, complete and standardized transmission of the following information if it is available at the level of the depository<sup>14</sup>:

- ▶ Information considered as mandatory and designed for shareholder identity disclosure
- ▶ General meetings and corporate event notifications to the UCI

Additional related announcements to UCIs should be delivered on a best effort basis without undue delay.

Depositories of UCIs investing directly in virtual assets must put in place adequate organizational arrangements and an appropriate operational model, considering the specific risks related to the safekeeping of virtual assets.

Depositories should avoid that operational disruptions and failures of virtual asset service providers spread to their regulated financial activities and ultimately result in financial losses harming their stakeholders. They should also manage their concentration risk on such providers.

Moreover, depositories must notify the CSSF beforehand when they intend to act as depository for a UCI investing directly in virtual assets.

<sup>14</sup> | Within the time limits defined in the SRDII Commission Implementing Regulation (EU) 2018/1212 of 3 September 2018.

## 9.4.4. Cash flow monitoring

CSSF Circulars 16/644 and 18/697, UCITS V and AIFMD, as well as the UCITS V and AIFMD delegated acts, are largely aligned with respect to cash flow monitoring.

The aligned cash flow monitoring rules implemented under UCITS V, CSSF Circular 16/644 as well as AIFMD and CSSF Circular 18/697 are as follows:

For UCITS, 2010 Law Part II UCIs and full AIFM regime AIFs, the depositary must ensure that cash flows are properly monitored and in particular that all payments made by or on behalf of investors upon the subscription of units or shares of a UCITS, 2010 Law Part II UCI, or AIF have been received and that all cash has been booked in cash accounts opened in the name of the respective UCITS, 2010 Law Part II UCI, or AIF, or in the name of the management company or AIFM or depositary acting on behalf of the UCITS, 2010 Law Part II UCI, or AIF.

The management company, investment company, or AIFM is required to ensure that the depositary is provided, upon commencement of its duties and on an ongoing basis, with all information it needs to comply with its cash flow monitoring obligations. In order to have access to all information regarding the UCITS, 2010 Law Part II UCI and AIF's cash accounts and cash flows, the depositary must at least be:

- ▶ Informed, upon its appointment, of all existing cash accounts opened in the name of the UCITS, 2010 Law Part II UCI, or AIF
- ▶ Informed of the opening of any new cash accounts by the UCITS, 2010 Law Part II UCI, or AIF
- ▶ Provided with all information related to the cash accounts opened at the third-party entity, directly by those third parties

The depositary is required to perform the following cash flow monitoring duties:

- ▶ Ensure that all cash of the UCITS, 2010 Law Part II UCI, or AIF is booked in accounts opened with a central bank, an authorized EU credit institution, or a bank authorized in a third country, or another entity of the same nature, in the relevant market where cash accounts are required, provided that such entity is subject to effective prudential regulation and supervision that has the same effect as European Union law and is effectively enforced. Where the cash accounts are opened in the name of the depositary acting on behalf of the UCITS, 2010 Law Part II UCI, or AIF, no cash of the entity at which the cash accounts are opened and none of the depositary's own cash can be booked on such accounts
- ▶ Implement effective and proper procedures to reconcile all cash flow movements and perform such reconciliations on a daily basis or, in case of infrequent cash movements, when such cash flow movements occur
- ▶ Implement appropriate procedures to identify at the close of each business day significant cash flows and in particular those that could be inconsistent with the UCITS, 2010 Law Part II UCI, or AIF's operations
- ▶ Review periodically the adequacy of those procedures, including a full review of the reconciliation process at least once a year and ensure that the cash accounts opened in the name of the UCITS, 2010 Law Part II UCI, or AIF, in the name of the management company, or AIFM or depositary acting on behalf of the UCITS, 2010 Law Part II UCI, or AIF are included in the reconciliation process
- ▶ Monitor on an on-going basis the outcomes of the reconciliations and actions taken as a result of any discrepancies identified by the reconciliation procedures and notify the management company, investment company, or AIFM if an irregularity has not been corrected without undue delay and also the competent authorities if the situation cannot be clarified and/or corrected
- ▶ Check the consistency of its own records of cash positions with those of the management company, investment company, or AIFM

With respect to subscriptions, the management company, investment company, or AIFM must ensure that the depositary is provided with information about payments made by or on behalf of investors upon the subscription of shares or units of a UCITS, 2010 Law Part II UCI, or AIF at the close of each business day when the management company, or AIFM, the UCITS, 2010 Law Part II UCI, or AIF or a party acting on behalf of it, such as a transfer agent, receives such payments or an order from the investor. The management company, investment company, or AIFM must ensure that the depositary receives all other relevant information it needs to ensure that the payments are then booked in cash accounts of the UCITS, 2010 Law Part II UCI, or AIF.

For AIFs, the following additional clarifications are provided:

The CSSF's FAQ on AIFMs clarifies that the depositary may rely on material tasks executed by a third party with respect to cash flow monitoring for the execution of its own obligations or may use information received with respect to cash flow reconciliations performed by a third party, provided that the depositary obtains all information it needs to comply with its own cash monitoring obligations and has performed adequate due diligence of the reconciliation processes performed by the third party. The concept of third party in this context also includes other divisions or services of the entity appointed as depositary of an AIF, provided that a functional and hierarchical separation of the performance of the depositary functions is ensured.

While the safekeeping duties related to financial instruments and other assets are subject to a look through obligation with respect to ownership verification for assets held by an ownership structure that is directly or indirectly controlled by the AIFM, the CSSF's FAQ on AIFMs clarifies that the Level 2 Regulation requires effective and proper monitoring of cash accounts to be executed solely at the level of the AIFs.

The depositary may want to expand the monitoring of cash flows related to investments/disinvestments at the level of the ownership structures (e.g., SPV) to identify relevant cash balances within the AIF, to monitor the ownership structure and the investment activity of the AIF (at the level of the ownership structure), which is not under the direct control of the depositary bank.

Further clarification on the cash flow monitoring provisions and guidance on controls is provided in the *ABBL/ALFI Guidelines and Recommendations for Depositaries – Oversight Duties and Cash Monitoring* for AIFs & UCITS.

## 9.4.5. Oversight duties

### 9.4.5.1. General requirements

The depositary is required to perform defined oversight duties. Among others, they aim to verify whether the UCI is managed in accordance with the provisions of its constitutional documents, its prospectus or issuing document.

In carrying out its oversight duties, the depositary is not required to re-perform the tasks itself, but rather to ensure that they are correctly executed.

General rules to be followed by the depositary have been defined under UCITS V and AIFMD and related delegated acts as described below.

These general oversight rules for UCITS, 2010 Law Part II UCIs and AIFs are as follows:

- ▶ Risk assessment: the depositary must at the time of its appointment, assess the risks associated with the nature, scale and complexity of the UCITS, 2010 Law Part II UCI, or AIF's strategy and the management company, investment company, or AIFM's organization in order to devise oversight procedures that are appropriate to the UCITS, 2010 Law Part II UCI, or AIF and the assets in which it invests and that are then implemented and applied. Such procedures must be regularly reviewed and updated  
Depositaries should pay specific attention to certain types of UCIs, namely real estate, private equity, as well as infrastructure UCIs, known for the complexity of their set-up which often includes several layers of SPVs and holding structures  
With regard to "other assets", the depositary needs to ensure it has a proper understanding of the UCI's investment strategy as well as the geographic focus and sufficient expertise, tools, systems, resources and, where necessary, local networks, to ensure it has the capability to collect the documents required to perform its ownership verification duties
- ▶ Procedures review: the depositary must perform *ex-post* controls and verifications of processes and procedures that are under the responsibility of the management company or AIFM, the UCITS, 2010 Law Part II UCI, or AIF or an appointed third party. The depositary must in all circumstances ensure that appropriate verification and reconciliation procedure exist and that they are implemented, applied and frequently reviewed  
The management company, investment company, or AIFM must ensure that its internal procedures foresee that all instructions related to the UCITS, 2010 Law Part II UCI, or AIF's assets and operations are sent to the depositary, so that the depositary is able to perform its own verification and reconciliation procedures

The *ALFI and ABBL Guidelines and recommendations for depositaries on safekeeping of other assets* clarify that:

- ▶ Where assets are held through intermediary structures or SPVs, IFMs/UCIs need to ensure that reconciliations are performed on a look-through basis. Where a gap exists due to the limitation of scope in engagement of the administrative agents performing reconciliations (e.g., at fund level or for certain SPVs), IFMs/UCIs should implement their own reconciliation on a look through basis
  - ▶ The depositary needs to make its records available to the IFM/UCI or its agents. Any inconsistency detected should be escalated to the depositary who should investigate whether they are due to clerical errors or gaps in the communication between the depositary, the IFM/UCI and the portfolio manager
  - ▶ Where required, the depositary may ask an SPV to reissue or rectify statements until the reconciliation mismatch has been resolved and will communicate its corrected records to the management/investment company or its agents. If the reconciliation issue cannot be resolved, the depositary will escalate the issue or any weakness in the communication process to the compliance officer and conducting officers or any other appropriate approved senior person of the management/investment company in charge of these tasks or associated controls
- ▶ Escalation procedure: the depositary must establish a clear and comprehensive escalation procedure to deal with situations where potential irregularities are detected in the course of its oversight duties, the details of which should be made available, upon request, to the competent authorities of the management company, investment company, or AIFM
  - ▶ Access to information: the management company, investment company, or AIFM must provide the depositary, upon commencement of its duties and on an on-going basis, with all relevant information it needs to perform the oversight duties including information to be provided to the depositary by third parties. The management company, investment company, or AIFM must, in particular, ensure that the depositary can access the books and perform on-site visits on the premises of the management company, or AIFM and any service provider appointed by the UCITS, 2010 Law Part II UCI and AIF or the management company or AIFM, such as administrators or external valuers and/or review reports and statements of recognized external certifications by qualified independent auditors or other experts to ensure the adequacy and relevance of the procedures in place

Further clarification on the oversight duties and guidance on controls are provided in the *ABBL/ALFI Guidelines and Recommendations for Depositaries – Oversight Duties and Cash Monitoring for AIFs & UCITS*. The Guidelines provide a list of proposed oversight activities and controls in relation to, *inter alia*, subscriptions and redemptions, the valuation of shares/units, carrying out the UCI's instructions, the timely settlement of transactions and the UCI's income distribution.

### 9.4.5.2. Subscriptions and redemptions

The oversight duties regarding subscriptions and redemptions apply to all UCITS, 2010 Law Part II UCIs and all full AIFM regime AIFs.

The depositary is required to ensure that the sale, issue, repurchase and cancellation of shares or units of the UCITS, 2010 Law Part II UCI, or AIF are carried out in accordance with the law and the constitutional document.

More detailed requirements are:

- ▶ The depositary must ensure that the UCITS, 2010 Law Part II UCI, or AIF, the management company or AIFM or the designated entity has established, implemented and applied an appropriate and consistent procedure to:
  - ▶ Reconcile the subscription orders with the subscription proceeds and the number of shares or units issued with the subscription proceeds received by the UCITS, 2010 Law Part II UCI, or AIF
  - ▶ Reconcile the redemption orders with the redemptions paid and the number of shares or units cancelled with the redemptions paid by the UCITS, 2010 Law Part II UCI, or AIF
  - ▶ Verify on a regular basis that the reconciliation procedure is appropriate
- ▶ In particular, the depositary must regularly check the consistency between the total number of shares or units in the UCITS, 2010 Law Part II UCI, or AIF's accounts and the total number of outstanding shares or units that appear in the UCITS, 2010 Law Part II UCI, or AIF's register
- ▶ A depositary must ensure and regularly check that the procedures regarding the sale, issue, repurchase, redemption and cancellation of shares or units of the UCITS, 2010 Law Part II UCI, or AIF comply with the applicable national law and with the UCITS, 2010 Law Part II UCI, or AIF rules or instruments of incorporation and verify that these procedures are effectively implemented
- ▶ The frequency of the depositary's checks must be consistent with the frequency of subscriptions and redemptions

Subscriptions and redemptions are covered in Section 8.8.

### 9.4.5.3. Valuation of shares or units

The oversight duties regarding the valuation of shares or units apply to all UCITS, 2010 Law Part II UCIs and all full AIFM regime AIFs.

The depositary is required to ensure that the value of the shares or units is calculated in accordance with the law and the constitutional document.

More specifically, the depositary must:

- ▶ Verify on an on-going basis that appropriate and consistent procedures are established and applied for the valuation of the assets of the UCITS, 2010 Law Part II UCI, or AIF in compliance with the relevant UCI law, the AIFM Law, UCITS V Directive or AIFM Directive and related implementing measures and with the UCITS, 2010 Law Part II UCI, or AIF constitutional document
- ▶ Ensure that the valuation policies and procedures are effectively implemented, for example, by the performance of sample checks or by comparing the consistency of the change in the NAV calculation over time with that of a benchmark
- ▶ Ensure that the valuation policies and procedures are periodically reviewed
- ▶ Ensure its procedures are conducted at a frequency that is consistent with the UCITS, 2010 Law Part II UCI, or AIF's valuation policy as defined in the UCI Law or AIFM Law or UCITS V Directive or AIFM Directive and related implementing measures
- ▶ Where it considers that the calculation of the value of the shares or units of the UCITS, 2010 Law Part II UCI, or AIF has not been performed in compliance with applicable law or the UCITS, 2010 Law Part II UCI, or AIF rules or with the relevant UCI law and AIFM Law valuation requirements, it must notify the management company or AIFM and/or the UCITS, 2010 Law Part II UCI, or AIF and ensure that timely remedial action is taken in the best interest of the investors in the UCITS, 2010 Law Part II UCI, or AIF
- ▶ Where an external valuer has been appointed, the depositary must check that the external valuer's appointment is in accordance with the AIFM Law or AIFM Directive and its implementing measures

Valuation requirements are covered in Chapter 7.



#### 9.4.5.4. Carrying out the manager's instructions

The oversight duties regarding the carrying out of the manager's instructions apply to all UCITS, 2010 Law Part II UCIs and all full AIFM regime AIFs.

The depositary is required to carry out the instructions of the management company, investment company, or AIFM, unless they conflict with the constitutional document.

More detailed requirements of the depositary include the obligation to implement:

- ▶ Appropriate procedures to verify that the UCITS, 2010 Law Part II UCI, or AIF and management company or AIFM comply with applicable laws and regulations and with the UCITS, 2010 Law Part II UCI, or AIF's constitutional document. In particular, the depositary must monitor the UCITS, UCI or AIF's compliance with investment restrictions and leverage limits laid down in the UCITS, 2010 Law Part II UCI, or AIF's offering documents. Those procedures should be proportionate to the nature, scale and complexity of the UCITS, 2010 Law Part II UCI, or AIF
- ▶ An escalation procedure for situations where the UCITS, 2010 Law Part II UCI, or AIF has breached one of the aforementioned limits or restrictions

#### 9.4.5.5. Timely settlement of transactions

The oversight duties regarding the timely settlement of transactions apply to all UCITS, 2010 Law Part II UCIs and all full AIFM regime AIFs.

More detailed requirements include the following:

- ▶ The depositary must set up a procedure to detect any situation where a consideration related to the operations involving the assets of the UCITS, 2010 Law Part II UCI, or AIF is not remitted to the UCITS, 2010 Law Part II UCI, or AIF within the usual time limits, notify the management company, investment company, or AIFM and, when the situation has not been remedied, request the restitution of the financial instruments from the counterparty, when possible
- ▶ Where transactions do not take place on a regulated market, the usual time limits must be assessed with regard to the conditions attached to the transactions (OTC derivative contracts or investments in real estate assets or in privately held companies for AIFs)

The Delegated Regulation 2018/1229 ("RTS on settlement discipline") was expected to come into force as from 1 February 2021. On 27 January 2021, the Commission Delegated Regulation (EU) 2021/70 postponed the application of the RTS on settlement discipline until 1 February 2022.

The RTS on settlement discipline will apply primarily to investment firms and will impact all parties in the settlement chain involved in transactions in European securities, affecting both the receiving and delivering parties in a failing transaction.

Measures to prevent settlement fails include:

- ▶ Flows of contractual written allocations and confirmations between the investment firm and its client
- ▶ Functionalities and tools to assist matching and settlement

Measures to address settlement fails include:

- ▶ Cash penalties for late matching and failed settlement (applicable as from 1 February 2022)
- ▶ On 11 July 2022, ESMA published a consultation paper to seek stakeholder views on simplifying the process of collection and distribution of cash penalties for settlement fails relating to cleared transactions. ESMA's proposals would change the existing practice by allowing the CSD to collect and distribute all types of penalties, including those for settlement fails relating to cleared transactions. Currently, central counterparties (CCPs) are responsible for the collection and distribution of cash penalties for settlement fails on cleared transactions
- ▶ Mandatory buy-in and cash compensation: in the event of a settlement fail, a buyer of securities has the right to source the securities from another counterparty, cancel the original transaction and settle any additional costs incurred by the new transaction between the two original counterparties. However, due to some uncertainties about the implementation of such regime, ESMA issued a draft on 2 June 2022 amending the RTS, proposing to postpone its application for three years. Furthermore, the EC issued a proposal for a regulation on 18 March 2022 amending the CSDR which foresees a more proportionate mechanism. In this proposal, the EC would be empowered to decide to apply mandatory buy-ins to certain categories of financial instruments or transactions on the basis of the level of settlement fails. The pass-on mechanism which aims at avoiding a cascade of settlement fails each requiring a separate buy-in process is also further clarified. The proposal would also introduce the symmetry of payments between the buyer and the seller, in case the economic terms of the transaction at execution of the buy-in differ from the original transaction, to ensure that the buy-in restores the parties to the same economic position had the original transaction taken place

In December 2021, ALFI issued considerations on certain implications of the settlement discipline regime, covering both penalties and buy-in regimes.

### 9.4.5.6. Distribution of the UCI's income

The oversight duties regarding the distribution of income apply to all UCITS, 2010 Law Part II UCIs and all full AIFM regime AIFs.

More detailed requirements for depositaries include the following:

- ▶ Ensure that the net income calculation, once declared by the management company, investment company, or AIFM, is applied in accordance with the UCITS, 2010 Law Part II UCI, or AIF constitutional document and applicable national law
- ▶ Ensure that appropriate measures are taken where the UCITS, 2010 Law Part II UCI, or AIF's auditors have expressed reservations on the annual financial statements. The UCITS, 2010 Law Part II UCI, or AIF must provide the depositary with all information on the reservations expressed on the financial statements
- ▶ Check the completeness and accuracy of dividend payments, once they are declared by the management company, investment company, or AIFM, and, where relevant, of the carried interest for AIF

Where a depositary of a UCITS, 2010 Law Part II UCI, or AIF considers that the income calculation has not been performed in compliance with applicable law or with the UCITS, 2010 Law Part II UCI, or AIF rules or instruments of incorporation, it must notify the management company, investment company, or AIFM and/or the UCITS, 2010 Law Part II UCI, or AIF and ensure that timely remedial action has been taken in the best interest of the UCITS, UCI's or AIF's investors.

## 9.4.6. Other specific duties in relation to UCITS

### 9.4.6.1. Luxembourg UCITS managed cross-border

In the case of Luxembourg UCITS that are managed by a management company in another EU Member State (i.e., the management company passport regime - refer to Section 6.3.4.), the depositary and management company must sign a written agreement regulating the flow of information deemed necessary to allow it to perform its depositary functions (refer to Section 6.3.5.1.).

### 9.4.6.2. Master-feeder UCITS

In the case of master-feeder UCITS (refer to Section 2.3.4.1.), if the master and feeder UCITS have different depositaries, those depositaries must enter into an information-sharing agreement in order to ensure the fulfillment of the duties of both depositaries. The agreement must cover, *inter alia*:

- ▶ The documents and information that are to be routinely shared between both depositaries
- ▶ The manner and timing of the transmission of information by the depositary of the master UCITS to the depositary of the feeder UCITS
- ▶ The coordination of the involvement of both depositaries, to the extent appropriate in view of their respective duties under national law, in relation to operational matters, including:
  - ▶ The procedure for calculating the NAV of each UCITS, including any measures appropriate to protect against the activities of market timing
  - ▶ The processing of the feeder UCITS' subscription and redemption orders for shares or units in the master UCITS and the settlement of such transactions, including any arrangement to transfer assets in kind
- ▶ The coordination of accounting year-end procedures
- ▶ Information to be provided by the depositary of the master UCITS to the depositary of the feeder UCITS on breaches by the master UCITS of the law and the constitutional document
- ▶ The procedure for handling *ad hoc* requests for assistance from one depositary to the other
- ▶ Identification of particular contingent events in relation to which the depositaries need to notify each other on an *ad hoc* basis and the manner and timing of notification

The depositary of the master UCITS is required to immediately inform the competent authorities of the master UCITS home Member State, the feeder UCITS, or, where applicable, the management company and the depositary of the feeder UCITS about any irregularities that it detects with regard to the master UCITS and that are deemed to have a negative impact on the feeder UCITS. Such irregularities include:

- ▶ Errors in the NAV calculation of the master UCITS
- ▶ Errors in transactions or settlement of feeder UCITS' subscription or redemption orders for shares or units in the master UCITS
- ▶ Errors in the payment or capitalization of income arising from the master UCITS or in the calculation of any related withholding tax
- ▶ Breaches of the investment objectives, policy, or strategy of the master UCITS, as described in its constitutional document, prospectus, or Key Investor Information Document (KIID)
- ▶ Breaches of investment and borrowing limits set out in national law or in the management regulations, instruments of incorporation, prospectus, or KIID

### 9.4.6.3. Mergers of UCITS

Where two UCITS merge (see Section 3.7.), the depositaries of the merging and receiving UCITS that are established in Luxembourg are required to verify compliance of certain particulars of the common draft terms of the merger with the requirements of the 2010 Law and the constitutional document of their respective UCITS and to issue a statement to the CSSF confirming that they have performed the verification. The particulars to be verified include the rules applicable to the transfer of assets and the exchange of shares or units.

## 9.5. Conduct of business and conflicts of interest rules

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### 9.5.1. Conduct of business and conflicts of interest

The depositary is expected to act honestly, fairly, professionally and independently, solely in the interest of the UCI and its investors.

The directors of the depositary should be of good repute and sufficiently experienced in relation to the UCI.

The depositary of UCITS, 2010 Law Part II UCIs and full AIFM regime AIFs is not permitted to carry out activities for the UCITS, 2010 Law Part II UCI, or AIF that may create conflicts of interest between the UCITS, 2010 Law Part II UCI, or AIF, the investors in the AIF, the management company or AIFM and the depositary, unless the depositary has functionally and hierarchically separated the performance of its depositary tasks from its other potentially conflicting tasks and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the UCITS, 2010 Law Part II UCI and AIF.

The relationship between the depositary and prime broker is covered in Section 9.8.

The assets of the AIF cannot be reused by the depositary without the prior consent of the AIF (or the AIFM acting on behalf of the AIF) (see also Sections 10.3.5. and 10.4.2.3.). The constraints concerning the reuse of assets as defined under UCITS V go even further as described in Section 9.4.2.1.A3.

Additional governance rules for UCITS, 2010 Law Part II UCIs and AIFs include:

- ▶ No delegation of the principal function of investment management can be made to the depositary or to any entity in the custody chain. The delegation to an entity linked to the depositary by common control is not prohibited
- ▶ Neither the depositary nor an entity in the custody chain can be entrusted with the risk management function. However, certain operational tasks linked to the risk management function can be delegated to a depositary or any entity within the custody chain
- ▶ The depositary may hold a direct or indirect shareholding in the management company appointing it, under certain conditions
- ▶ No person employed by the depositary can act as a director of a UCITS, 2010 Law Part II UCI and AIF appointing it

UCITS V has defined rules concerning independence requirements between the management company or investment company and the depositary.

**Common management or supervision:** The UCITS V delegated acts require that the board of directors of the management company (one tier governance) should not comprise any member of the board of directors or any employee of the depositary and vice versa. Where the management company has a supervisory body complementary to the board of directors (two tier governance), only one third of the members of the supervisory body of the management company may be at the same time members of the supervisory body, member of the management body or an employee of the depositary and vice versa.

**Existence of link or group link:** In case a link or group link exists between the management company or the investment company and the depositary of a UCITS, the concerned entities need to ensure that they have conflict of interest policies and procedures in place which:

- ▶ Identify all conflicts of interest from that link
- ▶ Take all reasonable steps to avoid those conflicts of interest

**Existence of group link:** In case a group link exists between the management company or the investment company and the depositary of a UCITS, the concerned entities need to comply with the following requirements:

- ▶ One tier governance entities should make sure that one third of the members of the board of directors or two persons (whichever is lower) are independent
- ▶ Two tier governance entities should make sure that one third of the members of the supervisory body or two persons (whichever is lower) are independent

Members of the above mentioned bodies are deemed independent as long as:

- ▶ They are neither members of the management body or the body in charge of the supervisory functions nor employees of any of the other undertakings between which a group link exists
- ▶ They are free of any business, family, or other relationship with the management company or the investment company, the depositary and any other undertaking within the group that gives rise to a conflict of interest such as to impair their judgment

In the context of independence requirements, UCITS V further imposes specific requirements concerning the appointment of the depositary.

In general, all management or investment companies should select and appoint the depositary following a documented decision-making process based on objective and pre-defined criteria.

In case the management company or the investment company and the appointed depositary are linked entities (including a group link), an assessment comparing the merits of appointing a linked depositary with the merits of appointing an unrelated depositary is to be performed. This assessment must at a minimum cover the costs, expertise, financial standing and the quality of services provided by all depositaries assessed. A report on this assessment including a description of the extent to which the appointment meets the pre-defined criteria and the extent to which it is made in the sole interest of the UCITS and its investors must be prepared.

The management company or the investment company must demonstrate to the competent authority of the UCITS home Member State that it is satisfied with the appointment of the depositary and that the appointment is in the sole interest of the UCITS and its investors. The management company or the investment company must make the report and documentary evidence referred to above available to the competent authority of the UCITS home Member State.

The management company or the investment company must justify to investors of the UCITS, upon request, the choice of the depositary.

## 9.5.2. Organization (internal procedures)

The UCITS V delegated acts, CSSF Circular 16/644 as well as the AIFMD and CSSF Circular 18/697 provide specific requirements concerning internal procedures of the depositary and written procedures or contracts with external parties.

Internal written procedures must be established for accepting new depositary mandates and executing the depositary function and must describe the type of UCI (legal nature and investment strategies) that the depositary may serve. The procedures must foresee controls during the acceptance process which ensure that legal and operational risks are appropriately assessed.

The internal procedures need to clearly define the persons in-charge of the depositary function. The depositary further needs to describe the human and technical resources put in place for the performance of the duties and to describe in detail how the depositary function is exercised for the different types of investment funds with due consideration of the respective investment policies and take into account operational specificities of certain families of funds. Also, the procedures are required to address the due diligence criteria applied by the depositary.

In addition to the internal procedures, the depositary must also establish written procedures with the external persons who have not been appointed by the depositary itself, such as, for example, the administration agent or transfer agent of a UCITS, or contracts with the external persons who have been appointed by the depositary itself, such as, for example, a delegate of the depositary. The objective of the written procedures that may be completed by operating memoranda or service level agreements is to document the operational procedures between the depositary and the third parties.

The depositary acting on behalf of a UCITS common fund is not permitted to grant loans or act as a guarantor on behalf of third parties nor carry out uncovered sales of transferable securities, money market instruments, or other financial instruments.

The depositary acting on behalf of a 2010 Law Part II common fund is not permitted to grant loans to purchasers and unitholders of the common fund with a view to the acquisition or subscription of units.

## 9.6. Liability

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The liability regime applicable to the depositary of UCITS, 2010 Law Part II UCIs and full AIFM regime AIFs has been largely aligned with the implementation of UCITS V.

The sole, yet significant, difference in the depositary's liability between AIFMD and UCITS V concerns the case of delegation (see Section 9.7.3.). UCITS V foresees, under no circumstances, a discharge of liability. It further requires that the liability of the depositary shall not be excluded or limited by agreement.

CSSF Circular 16/644 does not address the liability of the depositary.

### 9.6.1. UCITS, 2010 Law Part II UCIs and full AIFM regime AIFs

#### 9.6.1.1. Loss of financial instruments held in custody

As a general rule, the depositary is liable to a UCITS, 2010 Law Part II UCI, or AIF or its investors for the loss of financial instruments held in custody by the depositary itself or by a third party to whom custody had been delegated (the sub-custodian<sup>15</sup>). In case of such loss, the depositary is required to return to the UCITS, 2010 Law Part II UCI, or AIF (or the management company or AIFM acting on behalf of the UCITS, 2010 Law Part II UCI, or AIF) a financial instrument of identical type or the corresponding amount, without undue delay.

A loss of a financial instrument held in custody is deemed to have taken place when, in relation to a financial instrument held in custody by the depositary or by a third party to whom the custody of financial instruments held in custody has been delegated, any of the following conditions is met:

- ▶ A stated right of ownership of the UCITS, 2010 Law Part II UCI, or AIF is demonstrated not to be valid because it either ceased to exist or never existed
- ▶ The UCITS, 2010 Law Part II UCI, or AIF has definitively been deprived of its right of ownership over the financial instrument
- ▶ The UCITS, 2010 Law Part II UCI, or AIF is definitively unable to directly or indirectly sell the financial instrument

The ascertainment by the management company, investment company, or AIFM of the loss of a financial instrument must follow a documented process readily available to the competent authorities. Once a loss is ascertained, it must be notified immediately to investors in a durable medium.

A financial instrument held in custody is not deemed to be lost where a UCITS, 2010 Law Part II UCI, or AIF is definitively deprived of its right of ownership in respect of a particular instrument, but this instrument is substituted by or converted into another financial instrument or instruments.

In the event of insolvency of the third party to whom the custody of financial instruments held in custody has been delegated, the loss of a financial instrument held in custody must be established by the management company, investment company, or AIFM as soon as one of the abovementioned conditions is met with certainty. There is certainty as to whether any of the conditions is fulfilled at the latest at the end of the insolvency proceedings. The management company, investment company, or AIFM and the depositary must closely monitor the insolvency proceedings to determine whether all or some of the financial instruments entrusted to the third party to whom the custody of financial instruments held in custody has been delegated are effectively lost.

However, the depositary is not liable if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

The notion of "external event beyond reasonable control" covers all events that are not related to the depositary and its sub-custodians.

Therefore, events that occur within the "chain of custody" would not be deemed "external", irrespective of whether these events happened at the level of an affiliated sub-custodian or at the level of a sub-custodian that does not belong to the same corporate group as the depositary.

Any natural disasters, acts of state, or government measures (e.g., market closures) would be classified as being "external events beyond reasonable control".

Liability in the case of delegation is covered in Section 9.7.4.

#### 9.6.1.2. Other losses

The depositary is also liable to the UCITS, 2010 Law Part II UCI, or AIF or its investors for all other losses suffered by them as a result of negligent or intentional failure to properly perform its depositary duties (e.g., oversight duties, cash flow monitoring).

<sup>15</sup> | Liability in the case of delegation is covered in Section 9.7.4.

Within the meaning of the civil law, a credit institution holding its customers' virtual assets as an off-balance sheet item would be required to compensate its customers in case of loss or theft of the virtual assets. Today, the CSSF observes that such assets are generally kept at external exchange or custody platforms. The corresponding counterparty risk of credit institutions towards the specialized virtual asset service providers may contractually be transferred to their customers. To be effective from a risk perspective, such transfer of counterparty risk would require customers to directly contract with the virtual asset service provider. A credit institution that does not effectively transfer the counterparty risk to its customers has to comply with the large exposure limits framework provided in the Capital Requirements Regulation (CRR) for the counterparty risk it incurs on custody or exchange platforms. Depositories should discuss with CSSF the approach they intend to choose when determining the exposure value and the concentration measure under the large exposure framework.

## 9.6.2. Simplified AIFM registration regime AIFs

The depository is liable in accordance with Luxembourg law to the management company and the share/unitholders for any losses suffered by them as a result of its wrongful failure to perform its obligations or its wrongful improper performance thereof (also in case of delegation of safekeeping tasks).

The liability to share/unitholders is invoked indirectly through the management company. Should the management company fail to act despite a written notice to that effect from a share/unitholder within a period of three months following receipt of such a notice, such share/unitholder may directly invoke the liability of the depository.

Those who have suffered damages should prove the depository's negligence in respect of its duty of supervision and the link between cause and effect.

On the extent of the duty of supervision of the depository, the depository may be considered to have performed its duty of supervision when it is satisfied from the outset and during the entire duration of the contract that the third parties with whom the assets of the simplified AIFM registration regime AIF are held in deposit are reputable and competent and have sufficient financial resources.

## 9.7. Delegation

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The UCI depository is in principle authorized to delegate to a third party certain functions or certain tasks related to its different functions in accordance with the defined rules. As to the core function of the depository as a general rule, the depository is permitted to delegate the safekeeping of financial instruments to be held in custody to a third party, however, cannot delegate its general safekeeping duty, oversight duties or cash flow monitoring obligations.

A depository can appoint and entrust a third party to effectively execute certain safekeeping functions after performing a due diligence on such third party covering, *inter alia*, the good repute, effective prudential regulation and supervision, as well as expertise and effective segregation of assets.

UCITS V and CSSF Circular 16/644 as well as the AIFMD and CSSF Circular 18/697 define procedures and criteria that need to be followed upon appointment of a third party (initial due diligence) and that need to be re-performed on a regular basis, at least annually (ongoing due diligence). The rules summarized below regarding UCITS according to the Circulars, UCITS V and AIFMD are largely aligned with respect to delegation of safekeeping tasks and due diligence activities to be performed. The existing differences as well as the general delegation principles defined by the Circular with respect to UCITS, e.g., concerning IT outsourcing or intra-group delegation, are highlighted below.

A key matter for consideration in the context of the safekeeping delegation rules relates to asset segregation which is further addressed in Section 9.7.3.

To the extent that their operating model involves outsourcing, depositories are also subject to the provisions of the new outsourcing CSSF Circular 22/806. See Section 8.4.8.

### 9.7.1. General delegation requirements for UCITS, 2010 Law Part II UCIs and AIFs

The depository is permitted to delegate safekeeping duties to a third party, but not its oversight and cash flow monitoring duties.

The depository may delegate safekeeping duties to a third party if it can demonstrate that:

- The tasks are delegated for a demonstrable, objective reason and not with the intention of avoiding the AIFMD and UCITS V requirements
- It has exercised all due skill, care and diligence in the selection, appointment, periodic review and ongoing monitoring of:
  - The third party to whom it has delegated its tasks
  - The arrangements of the third party in respect of the matters delegated

The depositary is required to implement and apply an appropriate, documented due diligence procedure for the selection and ongoing monitoring of the delegate. The due diligence must be reviewed regularly, at least once a year, and made available upon request to competent authorities.

When selecting and appointing a third party to whom safekeeping functions are delegated, the depositary must exercise all due skill, care and diligence to ensure that entrusting financial instruments to this third party provides an adequate standard of protection, including at least:

- ▶ Assessing the regulatory and legal framework, including country risk, custody risk and the enforceability of the third party's contracts. The assessment must enable the depositary to determine the potential implication of insolvency of the third party on the assets and rights of the UCITS, 2010 Law Part II UCI and AIF. If a depositary becomes aware that the segregation of assets is not sufficient to ensure protection from insolvency because of the law of the country where the third party is located, it must immediately inform the management company, investment company, or AIFM (see also Section 9.7.3.)
- ▶ Assessing whether the third party's practice, procedures and internal controls are adequate to ensure that the financial instruments of the UCITS, 2010 Law Part II UCI and AIF are subject to a high standard of care and protection
- ▶ Assessing whether the third party's financial strength and reputation are consistent with the tasks delegated. That assessment must be based on information provided by the third party as well as other available information
- ▶ Ensuring that the third party has the operational and technological capabilities to perform the delegated custody tasks with a satisfactory degree of protection and security

The depositary must exercise all due skill, care and diligence in the periodic review and ongoing monitoring to ensure that the third party continues to comply with the aforementioned criteria. To this end the depositary must at least:

- ▶ Monitor the third party's performance and its compliance with the depositary's standards
- ▶ Ensure that the third party exercises a high standard of care, prudence and diligence in the performance of its custody tasks and in particular that it effectively segregates the financial instruments in line with the requirements (see Section 9.7.3.)
- ▶ Review the custody risks associated with the decision to entrust the assets to the third party and without undue delay notify the management company, investment company, or AIFM of any change in those risks. That assessment must be based on information provided by the third party and other available information. During market turmoil or when a risk has been identified, the frequency and the scope of the review must be increased. If the depositary becomes aware that the segregation of assets is no longer sufficient to ensure protection from insolvency because of the law of the country where the third party is located, it must immediately inform the management company, investment company, or AIFM

The depositary is required to ensure that, at all times during the performance of the tasks delegated to it, the third party:

- (1) Has the structure and expertise that are adequate and proportionate to the nature and complexity of the assets that have been entrusted to it
- (2) As far as the delegation of safekeeping of financial instruments is concerned, is subject to effective prudential regulation, including minimum capital requirements and supervision in the jurisdiction concerned and to periodic external audit to ensure that the financial instruments are in its possession
- (3) Segregates the assets of the depositary's clients from its own assets and from the assets of the depositary so that they can at any time be clearly identified as belonging to clients of the depositary (see Section 9.7.3.)
- (4) Does not make use of the assets without prior consent of the AIF (or the AIFM acting on behalf of the AIF) and prior notification of the depositary
- (5) Complies with the same general custody obligations and prohibitions applicable to the depositary

In case of delegation of safekeeping of financial instruments held in custody, the depositary remains subject to requirements on records and segregated accounts, reconciliations, due care and custody risks (see Points (2) to (5) of Section 9.4.2.1.A1.).

In addition, the depositary is required to ensure that the third-party delegate complies with these requirements and, in addition, those on adequate organizational arrangements and right of ownership (see Points (2) to (7) of Section 9.4.2.1.A1.).

The depositary is required to monitor compliance with the management company, investment company and AIFM requirements in relation to conflicts of interest, as applicable.

The depositary is required to devise contingency plans for each market it appoints a third party to perform safekeeping duties. Such a contingency plan must include the identification of an alternative provider, if any.

The depositary is required to take measures, including termination of the contract, that are in the best interest of the UCI and its investors where the delegate no longer complies with the requirements.

A third party delegate may in turn sub-delegate these tasks, provided that the same conditions are met.

Management companies, investment companies and AIFMs are required to make available to investors, before they invest in the UCI, information on any safekeeping function delegated by the depositary, the identification of the delegate and any conflicts of interest that may arise from such delegation, as well as any material changes thereto (refer to Section 10.3.5.).

An area of intense debate has been the question of the extent to which CSDs are subject to the AIFMD and UCITS V delegation requirements. On 20 July 2017, ESMA published an opinion to the EU Parliament, the Council and Commission (the EU institutions) proposing clarifications on the legislative provisions under the AIFMD and UCITS Directive regarding, *inter alia*, the application of depositary delegation rules to CSDs.

ESMA undertook a detailed review of both directives including feedback from the industry and taking into account the CSDR regulatory framework. Based on its review, ESMA recommended certain changes to the AIFMD and UCITS frameworks by introducing a distinction between issuer CSDs (CSD providing the core service of “initial recording of securities in a book-entry system “notary service” or central maintenance services) and investor CSDs (CSD that is either a participant in the securities settlement system operated by another CSD or that uses a third party or an intermediary that is a participant in the securities settlement system operated by another CSD in relation to a securities issue).

ESMA suggested that issuer CSDs would not be subject to any depositary delegation rules of the AIFMD and UCITS V because the use of such issuer CSDs is mandatory for the holding of securities in certain jurisdictions. Alternatively, investor CSDs, would be subject to the delegation provisions.

On 26 November 2021, the EC provided a legislative proposal amending Directives 2011/61/EU and 2009/65/EC stating that CSD will be included in the custody chain when they provide custody services to ensure that depositaries have access to the information needed to carry out their duties. It was considered whether depositaries delegating custody of AIFs or UCITS assets to CSDs should perform due diligence. It was decided that this would be excessive, given that authorized CSDs are already subject to stringent sectorial requirements and supervision. Therefore, the proposal focuses on including the CSDs in the custody chain without imposing superfluous due diligence requirements on depositaries.

CSSF Circulars 16/644 and 18/697 provide additional general rules for UCITS, Part II funds and AIFs with respect to the outsourcing of functions, which include, *inter alia*, the following:

- ▶ It is the responsibility of UCITS depositaries to ensure that appropriate risk management policies and procedures are in place addressing the identification and management of risks linked to the delegation and outsourcing of functions
- ▶ Every delegation and outsourcing relationship by the depositary must be recorded in contractual documentation between the depositary and the delegate or outsourcing agent
- ▶ With respect to the delegation of safekeeping functions, the Circulars make reference to the respective articles of the 2010 Law and the UCITS V Delegated Regulation defining the applicable rules of such delegations. The Circulars make reference to the requirement that all delegates of a depositary are required to be included in a list which is to be submitted to the CSSF on an annual basis
- ▶ Each outsourcing with external parties is subject to the requirements outlined in CSSF Circular 12/552, as amended and in CSSF Circular 17/654, as amended
- ▶ Also, each outsourcing of an essential or important function of a depositary is subject to prior approval by the CSSF. A notification explaining the outsourcing rationale with specific reference to the 2010 Law, the UCITS V Delegated Regulation and CSSF Circular 12/552 as amended may be sufficient, where the outsourcing is contracted either with a Luxembourg credit institution or with specific PSFs

The CSSF’s FAQ on UCIs clarifies that in case of data transfer to another service provider, depositaries of UCIs must obtain consent from the board of directors of an investment company or management company of a common fund for the services outsourced, the type of information transmitted and the country of establishment of the entities providing the outsourced services.

Boards of directors should inform and obtain consent from investors to the transfer of their personal and confidential data through:

- (1) A letter with a possibility to object
- (2) Immediate change of the subscription form to seek consent from future investors
- (3) A modification of the prospectus

Before outsourcing the services in scope, a depositary should obtain the commitment of the board of directors of the SICAV, or the IFM for common funds that investors have been informed and consented to the transfer of their personal and confidential data.

## 9.7.2. Delegation considerations specific to AIFs

### A. Considerations for assets to be held in custody

The CDR 2018/1618 amending AIFM CDR 231/2013 and CDR 2018/1619 amending UCITS CDR 438/2016 (the “CDRs”) were both published on 30 October 2018 and have introduced a number of important changes to selected delegation requirements involving the delegation of safekeeping of assets to be held in custody. The introduced changes are equally applicable for UCITS and AIFM and are applicable from 1 April 2020 onwards.



The main amendments introduced by the CDRs can be summarized as follows:

- ▶ Reconciliations: Prior to implementation of the CDRs, reconciliations between the depositary and the third-party delegates had to be done “on a regular basis”. The CDRs now require reconciliations to be performed “as frequently as necessary”. The CDRs provides further guidance on which factors to consider by depositaries in determining the frequency of the reconciliations

On 20 July 2022, ESMA clarified, that for a UCI with a weekly dealing frequency which trades on a daily basis, daily reconciliation are required.

In case of use of a tri-party collateral manager which is not the depositary, the tri-party collateral manager is required to transmit the end-of-day positions on a fund-by-fund basis or, if applicable, on a compartment-by-compartment basis. The information provided allows the depositary (for both Regulations) to verify that the quantity of the identified financial instruments recorded in the financial instruments accounts opened in its books matches the quantity of the identified financial instruments held in custody by the third party.

- ▶ Maintaining books and records: An important amendment is the requirement for depositaries to maintain a record in financial instruments accounts opened in the name of an AIF/UCITS or in the name of the AIFM/management company acting on behalf of the AIF/UCITS showing that the assets kept in custody by a third party belong to a particular AIF/UCITS client. The requirements imply that such accounts reflect the underlying activity in such accounts leading to the balances of assets to be held in custody belonging to the respective AIF/UCITS
- ▶ Identification of all third-party delegates in the custody chain: The depositary must identify all entities which constitute the custody chain and secure access to all relevant information with third parties to verify the quantity of the identified financial instruments kept in custody by the third party. The binding arrangement between the depositary and any third party to whom custody functions are delegated (including prime brokers or collateral agents) should reflect that the financial instruments owned by the AIF/UCITS are held in custody by the third party under a delegation arrangement with the depositary bank
- ▶ Maintaining omnibus accounts at the level of the delegated third party: A custodian can hold assets of UCITS, AIFs and other clients of the same depositary in one omnibus account, provided that the segregation requirements with respect to its own assets, the own assets of the depositary and the assets of the other clients of the third party are kept in segregated financial instruments accounts
- ▶ Supervision over the custody chain: The CDRs introduce amendments for depositaries delegating the custody of assets to third-party delegates located outside the EU. In such instances, depositaries are required to obtain independent legal advice on the legal framework of the third country insolvency rules. The new requirements for AIFs shift the obligation to the depositary against its delegate, whereas for UCITS the obligation remains with the delegate against its depositary. In addition, the depositary has to upgrade its supervision and due diligence to comply with the enhanced provisions of the CDRs

A key aspect resulting from the AIFM CDR 2018/1618 and UCITS CDR 2018/1619 relates to the maintenance of records and accounts for custodial assets, where the safekeeping is delegated to third-party delegates. The wording of the EU Delegated Regulations 213/2013 for AIFMs and 438/2016 for UCITS was such to leave room for interpretation among practitioners whether such records had to be compiled on the basis of individual transactions or whether they could be “registered” in the books of the depositary on the basis of end-of-day statements provided by the third-party delegate. Where a depositary has delegated its custody functions to a third party, both EU Delegated Regulations now clearly refer to the requirement to ensure that the financial instruments are properly registered in accordance with Article 21(8)(a)(ii) of Directive 2011/61/EU, as amended, and accordingly, are registered in financial instruments accounts in the depositary’s books and in the name of the AIF or the AIFM acting on behalf of the AIF, “so that they can be clearly identified as belonging to the AIF in accordance with the applicable law at all times”. Therefore, where safekeeping is delegated to third parties, depositaries must ensure that the movements of assets held in custody by a third-party delegate are reflected in the depositary’s books and records, and that the depositary’s books and records are distinct from those of the third-party delegate, or put otherwise: the delegation of safekeeping to a third-party delegate does not dispense depositaries from registering such financial instruments in its own books.

The above represents a significant challenge where AIFs/UCITS involve either prime brokers or collateral agents acting as sub-custodians of AIF/UCITS assets. For these specific circumstances, the ABBL/ALFI Depositary Bank Forum has developed an alternative approach for a depositary to construct the books and records from the end-of-day settled positions information as sourced from the third-party delegate itself or another source deemed appropriate, subject to certain conditions. Reference is made to the ABBL/ALFI *Guideline on the implementation of New AIFM/UCITS CDRs on delegated safekeeping* issued in September 2019.

#### B. Consideration for delegation of safekeeping of other assets for AIFs

The delegation of the custody functions related to assets which are not held in custody is possible, provided that the depositary has executed an appropriate and documented due diligence procedure in relation to the delegate. The purpose of the due diligence is to ensure that the process of ownership verification, the registration of other assets, for which the ownership has been verified and record-keeping obligations are met by the delegate.

In order to achieve an appropriate level of certainty that an AIF is the owner of an asset not held in custody, the depositary must receive all necessary information for that purpose. The nature of such information is dependent upon the nature of the underlying assets and the approach applied to any such investments. Irrespective of the AIF's investment strategy, the depositary remains responsible to ensure that compliance with the provisions in relation to ownership verifications and record keeping are met.

Currently Luxembourg depositaries do not directly safeguard the virtual assets themselves, but usually rely on an external virtual assets custodian. Credit institutions that envisage to directly safeguard virtual assets are required to inform the CSSF of such plans in a timely manner.

## 9.7.3. General segregation obligation for - UCITS, 2010 Law Part II UCIs and AIFs

### 9.7.3.1. General requirements

The segregation requirements of UCITS, 2010 Law Part II UCIs and AIFs are largely aligned. Some differences exist. The common segregation requirements are described in this section; specific considerations are described in the subsequent sections.

The concept of asset segregation implies that the depositary maintains records and accounts which enable it at any time and without delay to identify the assets of its UCITS, 2010 Law Part II UCI or AIF clients. In order to achieve this objective, certain requirements need to be met at the level of depositary itself and at the level of each third party to which safekeeping functions are delegated.

- ▶ At the level of the depositary, accounts and records need to be opened and maintained in the name of each individual UCITS, 2010 Law Part II UCI, AIF and for each compartment, where applicable. This implies that the depositary must be in a position to segregate the assets of each UCITS, 2010 Law Part II UCI or AIF from the assets of its other clients and the assets held for its own account
- ▶ At the level of the third party to which safekeeping functions are delegated, the concept of asset segregation is assured by means of separate accounts to be opened with such third party for the depositary's client assets (including UCITS, 2010 Law Part II UCIs and AIFs), for its own assets and by ensuring that the third party has implemented procedures which ensure compliance with minimum asset segregation requirements at its level and, where such third party has further sub-delegated safekeeping functions, at the various levels of the custody chain

More specifically, the depositary must ensure that the third party acts in accordance with the segregation obligations by verifying that the third party:

- ▶ Keeps such records and accounts necessary to enable it at any time and without delay to distinguish the assets of the depositary's clients (including UCITS, 2010 Law Part II UCI or AIF clients) from the depositary's own assets, the assets of the third party's other clients and the assets of the third party's own account

The *ABBL/ALFI Guidelines on the implementation of the new AIFM/UCITS CDRs on delegated safekeeping* were published on 30 September 2019 and proposed, *inter alia*, a list of acceptable principles underlying the creation and reconciliation of the depositary's records.

Whilst custody books and records are traditionally built from transactions instructed by an independent party from the delegate and settlement agents, the depositary may, as an alternative option and for some specific transaction activities, construct its records from the end-of-day settled positions information, provided that the depositary:

- ▶ Receives and/or accesses via an online platform the necessary information with regard to the underlying activity on the accounts
  - ▶ Has performed a satisfactory due diligence on the processes and associated control environment
  - ▶ Has ensured that an effective reconciliation process exists between the records from the source at the origin of the creation of the depositary's records and those from a relevant party independent from that source
- ▶ Maintains records and accounts in a manner that ensures their accuracy and in particular their correspondence to the assets safekept for the depositary's clients
  - ▶ Conducts, as frequently as necessary, reconciliations between its internal accounts and records and those of the third party to whom it has delegated safekeeping functions. The frequency of reconciliations should be determined on the basis of criteria described in Section 9.7.3.2.
  - ▶ Introduces adequate organizational arrangements to minimize the risk of loss or diminution of financial instruments or of rights in connection with those financial instruments as a result of misuse of the financial instruments, fraud, poor administration, inadequate record-keeping, or negligence
  - ▶ Where the third party is a central bank, an authorized EU credit institution, or a bank authorized in a third country that is subject to effective prudential regulation and supervision that has the same effect as European Union law and is effectively enforced, the depositary must take the necessary steps to ensure that the UCITS, 2010 Law Part II UCIs or AIF's cash is held in an account or accounts in accordance with the cash flow monitoring requirements applicable to the depositary (refer to Section 9.4.4.)

Where a depositary has delegated its custody functions to a third party in accordance with the delegation requirements, the monitoring of the third party's compliance with its segregation obligations must ensure that the financial instruments belonging to its clients are protected from any insolvency of that third party.

If, according to the applicable law, including in particular the law relating to property or insolvency, the requirements laid down in the previous paragraph are not sufficient to achieve that objective, the depositary is required to assess what additional arrangements are needed to minimize the risk of loss and maintain an adequate standard of protection.

The same requirements apply when the third-party delegate further sub-delegates its safekeeping tasks.

### 9.7.3.2. Developments related to segregation considerations

The topic of asset segregation is subject to continued discussions as different interpretations and models are applied in different jurisdictions and by different players. A key point relates to the account structure to be applied at the level of delegates and sub-delegates.

Important developments were introduced by the publication on 20 July 2017 of an ESMA opinion on asset segregation. In its opinion, ESMA concluded that for the purpose of asset segregation, depositaries needed to ensure that without prejudice to any additional EU or national segregation rule and to the extent applicable, delegates open at least three accounts per depositary: one account for the delegate's own assets, one account for the own assets of each delegating depositary and one account for the assets of the depositary's clients, which may include UCITS, AIFs and other clients. Additional accounts will need to be opened for each direct client of the delegate. Accordingly, ESMA did not consider the opening of separate accounts for each asset class (UCITS, AIFs, other clients) to be a mandatory requirement of the UCITS V Directive and the AIFMD.

ESMA's opinion was followed on 29 May 2018 by the publication of two draft amendments to the Delegated Regulations No 231/2013 and 2016/648 addressing, *inter alia*, asset segregation. They led to the release on 30 October 2018 by the European Commission of Delegated Regulation (EU) 2018/1618 of 12 July 2018 amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries of AIFs and of Delegated Regulation (EU) 2018/1619 of 12 July 2018 amending Delegated Regulation (EU) 2016/438 as regards safe-keeping duties of depositaries of UCITS which are applicable since 1 April 2020.

These two Delegated Regulations allowed depositaries the use of omnibus accounts at the level of their delegates (custodians can hold assets of UCITS, AIFs and other clients of a given depositary in the same omnibus account, provided its own assets, the proprietary assets of the depositary and the assets belonging to other clients of the third party are held in segregated financial instruments accounts), as long as they do not include any own assets of the depositary and of the delegate.

In addition, the use of omnibus accounts is subject to the following:

- 1) Depositaries need to ensure that assets are not available for distribution to creditors of a failed delegate
- 2) There are accounting and reconciliation systems in place allowing the depositary to accurately verify the existence of UCITS, AIF or client assets in the accounts opened with the delegate

Whilst custody books and records are traditionally reconciled back to the agents involved in the settlement chain, the depositary should be permitted, for the specific transaction activities, to leverage existing reconciliation processes in place and associated reporting made available at the level of the delegate itself and/or any relevant third parties provided that the depositary:

- Receives and/or accesses via an online platform the necessary information
  - Has performed satisfactory due diligence on the processes and associated control environment
  - Implements or oversees an effective reconciliation process between the custody function records and records from the UCI or a third party acting on behalf of the UCI
- 3) Depositaries need to ensure that the reconciliation measures described in 2) are conducted as often as necessary and in line with the nature, scope and volume of transactions. The frequency of the reconciliations shall be determined on the basis of:
    - The normal trading activity of the UCITS
    - Any trade occurring outside the normal trading activity
    - Any trade occurring on behalf of any other client whose assets are held by the third party in the same financial instruments account as the assets of the UCITS
  - 4) Processes foreseeing the reuse of securities are only allowed if foreseen in the relevant contracts and permitted by relevant legislation
  - 5) The relationship between the depositary and its delegate is subject to a written contract
  - 6) The contract between the depositary and the delegate includes sufficient information, access and inspection rights for the depositary at the level of the delegate and sub-delegate

- 7) Depositories of AIFs must obtain a legal opinion on the insolvency laws of any third-country delegate. This requirement was already applicable to depositaries of UCITS. The depositaries are required to monitor that their third-country delegates comply with national laws securing the benefits of asset segregation and keep them informed about any changes to the insolvency laws they are subject to. In addition, the depository will have to upgrade its supervision program (e.g., due diligence reviews) to comply with the enhanced provisions of the new regulation (refer to AIFM-CDR 231/2013; UCITS CDR 438/2016; ABBL/ALFI *Guidelines on the implementation of new AIFM/UCITS CDRs on delegated safekeeping*)

By way of a derogation, the accounts of an investment firm or a PDAOIF acting as an AIF depository at the level of its delegate, to either hold cash deposits or to maintain accounts for financial instruments in custody, must be opened in the name of each individual AIF or compartment, if applicable (refer also to Sections 9.3.2.1. and 9.3.2.2.).

## 9.7.4. Liability in the case of delegation

The UCITS V and AIFMD liability regimes are aligned with one important exception outlined in Section 9.7.4.1. and share the following key elements:

- ▶ The depository is liable to the UCITS, 2010 Law Part II UCI and AIF and to the investors for the loss by the depository or a third party to whom the custody of financial instruments held in custody has been delegated
- ▶ In case of loss of a financial instrument held in custody, the depository must return a financial instrument of identical type or the corresponding amount without undue delay
- ▶ The depository is not liable if it can prove that the loss of the financial instrument is a result of an external event beyond its reasonable control (e.g., natural disaster, state act)
- ▶ The depository is also liable to the UCITS, 2010 Law Part II UCI and AIF for all other losses suffered by them as a result of the depository's negligent or intentional failure to properly fulfill its obligations pursuant to the UCITS V Directive and AIFMD
- ▶ The liability of the depository is not affected by any delegation
- ▶ The share/unitholder in the UCITS, 2010 Law Part II UCI and AIF may invoke the liability of the depository directly, or indirectly through the management company, as applicable, provided that this does not lead to a duplication of redress or to unequal treatment of share/unitholders

### 9.7.4.1 Liability in the case of delegation - considerations specific to AIFs

Unlike for UCITS, the liability for loss of financial instruments of an AIF held in custody can be transferred from the depository to the third party if the delegation complies with the delegation requirements and the following conditions are met:

- ▶ There is a written contract between the depository and the AIF (or the AIFM acting on behalf of the AIF) that establishes the objective reason to contract such a discharge of liability

The objective reasons to contract a discharge of liability must be:

- ▶ Limited to precise and concrete circumstances characterizing a given activity
- ▶ Consistent with the depository's policies and decisions

The objective reasons must be established each time the depository intends to discharge itself of liability. The depository is considered to have objective reasons for contracting the discharge of its liability when the depository can demonstrate that it had no other option but to delegate its custody duties to a third party. This is the case where:

- ▶ The law of a third country requires that certain financial instruments be held in custody by a local entity and local entities exist that satisfy the delegation requirements
- ▶ The AIFM insists on maintaining an investment in a particular jurisdiction despite warnings by the depository as to the increased risk this presents

The CSSF's FAQ on AIFMs clarifies that the definition of objective reasons for discharge of liability is a matter of professional judgment, based on the aforementioned criteria, and the facts of the specific case in question. The objective reasons could, for example, be related to:

- ▶ The investment policy and strategy of the AIF
- ▶ The types of counterparties used by the AIFM on behalf of the AIF
- ▶ The sub-custody network used for safekeeping of the financial instruments

- ▶ There is a written contract between the depository and the third party that explicitly provides for the transfer of liability from the depository to the third party and makes it possible for the AIF, the AIFM, or the depository acting on their behalf to make a claim against the third party in respect of the loss of financial instruments
- ▶ The arrangement is disclosed to investors before they invest (see Sections 10.3.5. and 10.4.2.5.)

Further, where the delegation requirements with regard to financial instruments held in custody cannot be met in a certain country (Point (2) of the sixth paragraph of Section 9.7.1.) because there are no such entities, the depositary can discharge itself of its liability provided that the following conditions are fulfilled:

- ▶ The constitutional document expressly allows for such discharge
- ▶ The investors in the AIF have been duly informed, prior to their investment, of the discharge and the reasons justifying the discharge
- ▶ The AIF (or AIFM acting on behalf of the AIF) instructed the depositary to delegate the custody of such financial instruments
- ▶ There is a written contract between the depositary and AIF (or the AIFM acting on behalf the AIF) that expressly allows such a discharge
- ▶ There is a written contract between the depositary and the third party that explicitly transfers the liability of the depositary to that local entity and makes it possible for the AIF, the AIFM acting on behalf of the AIF, or the depositary acting on their behalf to make a claim against that local entity in respect of the loss of financial instruments

## 9.8. Prime broker

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A prime broker is an entity subject to prudential regulation and ongoing supervision that:

- ▶ Offers to professional investors one or more services primarily to finance or execute transactions in financial instruments as counterparty
- ▶ May also provide other services such as clearing and settlement of trades, custodial services, securities lending, customized technology and operational support facilities<sup>16</sup>

The selection and appointment of the prime broker is generally the responsibility of:

- ▶ The board of directors of the UCI, in the case of an investment company
- ▶ The management company or AIFM, in the case of a common fund

For full AIFM regime AIFs, where a prime broker is appointed, the depositary, if separate from the prime broker, must be informed of the contract with the prime broker. The appointment of the prime broker is covered in Section 6.3.5.2. The prime broker is required to report information to the depositary on a daily basis (see Section 9.8.1.). If the depositary entrusts the safekeeping of the assets of the AIF to the prime broker, the prime broker must be appointed by the depositary as a sub-custodian and all the requirements applicable to delegation of safekeeping must be met (see Section 9.8.2.). A prime broker may also act as depositary, if certain conditions are met (see Section 9.8.3.).

The models possible where an AIF provides its assets as collateral to a collateral taker are outlined in Section 9.4.2.1.A.1.

The contract with the prime broker must cover the terms under which the prime broker may transfer and reuse the AIF's assets (see Section 6.3.5.2.).

Information that must be disclosed to investors before they invest in the AIF is the following:

- ▶ The identity of one or more prime broker(s)
- ▶ A description of any material arrangements of the AIF with the prime broker(s)
- ▶ The way conflicts of interest thereto are handled
- ▶ The provisions in the contract with the depositary on the possibility of a transfer of assets
- ▶ The provisions in the contract with the depositary on the possibility of reuse of assets
- ▶ Information about any transfer of liability to the prime broker

### 9.8.1. Reporting obligations

Where a prime broker has been appointed, the AIFM is required to ensure that from the date of that appointment, an agreement is in place pursuant to which the prime broker is required to make available to the depositary a statement in a durable medium that contains the following information at the close of each business day:

- ▶ The total value of assets held by the prime broker for the AIF, where safekeeping functions are delegated (see also Section 9.8.2.) and the value of each of the following:
  - ▶ Cash loans made to the AIF and accrued interest
  - ▶ Securities to be redelivered by the AIF under open short positions entered into on behalf of the AIF
  - ▶ Current settlement amounts to be paid by the AIF under any futures contracts
  - ▶ Short sale cash proceeds held by the prime broker in respect of short positions entered into on behalf of the AIF
  - ▶ Cash margins held by the prime broker in respect of open futures contracts entered into on behalf of the AIF. This obligation is in addition to the cash flow monitoring obligations
  - ▶ Mark-to-market close-out exposures of any OTC transaction entered into on behalf of the AIF
  - ▶ Total secured obligations of the AIF against the prime broker
  - ▶ All other assets relating to the AIF

<sup>16</sup> | AIFM Law definition.

- ▶ The value of other assets held as collateral by the prime broker in respect of secured transactions entered into under a prime brokerage agreement
- ▶ The value of the assets where the prime broker has exercised a right of use in respect of the AIF's assets
- ▶ A list of all the institutions at which the prime broker holds or may hold cash of the AIF in an account opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF

The statement must be made available to the depository of the AIF no later than the close of the next business day to which it relates.

The prime broker is also required to make available to the depository details of any other matters necessary to ensure that the depository of the AIF has up-to-date and accurate information about the value of assets the safekeeping of which has been delegated.

## 9.8.2. Delegation to prime brokers

Delegation of custody tasks by the depository to a prime broker is permitted provided the delegation conditions are met (see Section 9.7.).

## 9.8.3. Prime broker acting as depository

A prime broker can also act as a depository only if:

- ▶ It has functionally and hierarchically separated the performance of its depository functions from its tasks as a prime broker
- ▶ The requirements on delegation of custody tasks by the depository to a third party are met (see Section 9.7.)
- ▶ The potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF (see also Section 10.3.5. for more information on AIF disclosure requirements)

## 9.9. Other reporting and disclosure obligations

In addition to the aforementioned disclosure requirements, UCITS V and AIFMD define some general requirements with regard to disclosure to investors. Both UCITS V and AIFMD require, in addition to the identity of the depository, a description in the prospectus of any safekeeping function delegated by the depository, the identification of the delegate and any conflicts of interest that may arise from such delegations.

UCITS V goes even further and requires a disclosure of sub-delegates and potential conflicts of interest arising from the sub-delegation. UCITS V states further that up-to-date information regarding the above disclosures needs to be made available to investors on request.

The CSSF clarified in its Press Release 16/10 of 2 March 2016 that the requirement to include a list of the delegates and sub-delegates of the depository in the prospectus can be fulfilled by including a reference to a website where the list is available to investors.

CSSF Circulars 16/644 and 18/697 requires new depositaries to provide comprehensive information. The information needs to be kept up-to-date and to be delivered to the CSSF on an annual basis at the latest six months after the closure of the financial accounts of the depository. This information includes, *inter alia*, the following elements (additional elements can be required upon request of the CSSF):

- ▶ Name and title of the person(s) in charge of the depository bank business
- ▶ Organization chart, especially of the departments that intervene and work on the various functions of a depository bank
- ▶ Number of employees of the depository bank business
- ▶ CV detailing background and experience of the person(s) in charge
- ▶ Detailed description of the technical resources, for example, IT infrastructure and systems
- ▶ List of the sub-custodians or information on the website on which such an up-to-date list is available
- ▶ List of the delegates assisting the depository, including a description of the links with each delegate and the mode of operation with them
- ▶ Description of the links with the transfer agent and the fund administrator, including the elements assuring the segregation of the duties, if they belong to the same legal entity
- ▶ The contract of designation of the depository accompanied by a matrix indicating where the different elements of the Delegated Regulation are covered
- ▶ List of operational procedures indicating the date of their latest update
- ▶ Description of the type of funds the depository wishes to include in its service portfolio

# 10

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## FUND DOCUMENTATION AND REPORTING

EY supports asset managers, traditional and alternative investment fund houses with fund documentation preparation including prospectuses, KIID or KID and other investor information, financial reports (Luxembourg GAAP, IFRS and US GAAP) and other periodic regulatory reporting to the CSSF and foreign supervisory authorities.



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## 10.1. Introduction

This Chapter covers:

- ▶ The content of the initial disclosures to investors to be included in the:
  - ▶ Prospectus (for 2010 Law UCIs)
  - ▶ Key Investor Information Document (KIID) applicable for:
    - ▶ Retail investor share classes of UCITS until 31 December 2022
    - ▶ Professional investor share classes (not required if a PRIIP KID is available)
    - ▶ AIFs, where the KIID was made available before 31 December 2017
  - ▶ Key Information Document for Packaged Retail and Insurance-based Investment Products (PRIIP KID) applicable for:
    - ▶ AIFs, which cannot use the UCITS derogation of the CSSF (i.e., where the KIID was prepared by the end of 2017) and are marketed to retail investors (may also include informed investors)
    - ▶ Retail investor share classes of UCITS from 1 January 2023 (will replace UCITS KIID)
    - ▶ (Optionally) professional investors share classes (as an alternative to UCITS KIID)
  - ▶ Initial disclosures to investors in AIFs, as required by the AIFM Law
  - ▶ Offering documents (for SIFs, RAIFs, EuVECAs, EuSEFs and ELTIFs)
- ▶ Periodic investor disclosures and updates
- ▶ Financial reporting: The annual, semi-annual, quarterly and interim reporting requirements and audit requirements
- ▶ General meetings
- ▶ Submission of periodic reports to the Trade and Companies Register
- ▶ Information to be sent to the authorities responsible for the collection of such information, including monthly, quarterly, semi-annual and annual financial information as well as financial reports and prospectuses or offering documents

AIFM reporting to the CSSF is covered in Section 6.5.1.

Marketing of UCIs to investors is covered in Chapter 12.

Additional reporting requirements for UCIs admitted to trading on a securities market of the Luxembourg Stock Exchange (LuxSE) are set out in Section 13.4.2.

In this Chapter, the term “AIFs” is used to refer to both AIFs managed by authorized AIFMs and internally managed AIFs that are subject to the AIFM Law (“Full AIFM regime AIF”).

The term “management company” is used to refer to both management companies and AIFM where the AIFM fulfils management company activities.

### 10.1.1. Investor information for 2010 Law UCIs

A 2010 Law investment company, or a management company for each of the 2010 Law common funds that it manages, is required to publish:

- ▶ A prospectus  
The prospectus must include the information necessary for investors to be able to make an informed judgment of the investment proposed to them, and, in particular, of the associated risk. The essential elements of the prospectus must be kept up-to-date.  
The prospectus must meet UCI-specific requirements covered in Section 10.3.1. If a closed-ended UCI applies for admission to a securities market, the prospectus will, in addition, be required to meet the Prospectus Regulation<sup>1</sup> requirements (see also Chapter 13).
- ▶ A KIID, for UCITS  
The KIID is designed to provide investors with information on the essential characteristics of the UCITS, so that investors are reasonably able to understand, before they invest, the nature and the risks of the investment product that is being offered to them. The essential elements of the KIID must be kept up-to-date.

It is expected that the UCITS directive will be amended to reflect that the KIID is no longer required once a PRIIP KID is produced.

- ▶ An annual report for each financial year:
  - ▶ For UCITS: Within four months of the end of the period to which it relates
  - ▶ For 2010 Law Part II UCIs: Within six months of the end of the period to which it relates or four months when the UCI is admitted to trading on a regulated market (see Section 13.4.1.)

<sup>1</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.



- ▶ A semi-annual report covering the first six months of the financial year:
  - ▶ For UCITS: Within two months of the end of the period to which it relates
  - ▶ For 2010 Law Part II UCIs: Within three months of the end of the period to which it relates
- ▶ Subscription and redemption price (see Sections 8.7. and 8.8.)

The prospectus and the latest published annual and semi-annual reports must be provided to investors on request and free of charge. For UCITS, the KIID must be provided to investors free of charge; in general, the KIID must be provided to investors before they invest (see Section 12.2.). The prospectus and, for UCITS, KIID may be provided to investors in a durable medium or by means of a website. A paper copy of the prospectus, the latest published annual and semi-annual reports and, for UCITS, the KIID must be delivered to the investors upon request and free of charge.

For UCITS, an up-to-date version of the KIID must be made available on the website of the investment company or management company.

Updated KIIDs must be made available within 35 business days counting from 31 December each year, to investors and to the CSSF via e-filing of the documents. There is a divergence between the UCITS Directive and the PRIIP Regulation. In the PRIIP Regulation, the KID must be updated at least annually on the basis of the PRIIP KID published during the previous year.

The annual and semi-annual reports must be available to investors in the manner specified in the prospectus and, for UCITS, in the KIID.

All marketing communications to investors (e.g., factsheets) must meet certain requirements. The marketing of UCITS, including provision of fund information to investors, is covered in Chapter 12.

Updates to existing UCIs may entail amendments to the prospectus and, for UCITS, the KIID; the procedure to be followed is outlined in Section 3.4.

The management company or investment company that has not appointed a management company is also required to disclose information on the exercise of voting rights and may be required to disclose information in relation to conflicts of interest (see Sections 10.4. and 5.1.3.B. for further information on disclosures).

### 10.1.2. Investor information for SIFs

A SIF investment company and a management company for each of the SIF common funds that it manages must establish:

- ▶ An offering document
  - The offering document must include the information necessary for investors to be able to make an informed judgment of the investment proposed to them and, in particular, of the associated risks.
- ▶ An annual report for each financial year, which must be available to investors within six months of the end of the period to which it relates or four months when the SIF is admitted to trading on a regulated market (see Section 13.4.1.)

The offering document and the latest annual report must be provided to investors on request, free of charge.

### 10.1.3. Investor information for RAIFs

A RAIF, and the management company for each of the RAIF common funds it manages, must establish:

- ▶ An offering document
- ▶ An annual report for each financial year, which must be available to investors within six months of the end of the period to which it relates or four months when the RAIF is admitted to trading on a regulated market (see Section 13.4.1.)

If a prospectus has been prepared to meet the requirements of the Law of 16 July 2019 which transposes the Prospectus Regulation<sup>2</sup>, there is no obligation to establish an offering document.

### 10.1.4. Investor information for full AIFM regime AIFs

Full AIFM regime AIFs are required to meet AIFM investor information requirements on:

- ▶ Information that must be provided to investors before they invest. This information must be disclosed in the prospectus or the offering document or as supplementary information
- ▶ Periodic and regular disclosures to investors, for example on leverage and liquidity
- ▶ Annual report

<sup>2</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

## 10.1.5. Investor information for ELTIFs

ELTIFs are required to publish:

- ▶ A prospectus containing all information required to be disclosed by closed-ended UCIs in accordance with the Prospectus Regulation<sup>3</sup> and Commission Delegated Regulation (EU) 2020/1273<sup>4</sup>
- ▶ An annual report

## 10.1.6. Financial reporting standards

Most UCIs prepare their financial statements under Luxembourg generally accepted accounting principles (Lux GAAP). However, UCIs created as investment companies may prepare their financial statements under International Financial Reporting Standards (IFRS) as long as this is disclosed in the prospectus or offering document. UCIs created as common funds should seek pre-approval, on a case-by-case basis, from the CSSF, to prepare their financial statements under IFRS.

In any case, the accounting principles to be applied should be disclosed in the prospectus or similar offering document of the UCI.

On 30 June 2021, the CSSF published the updated *FAQ on Alternative Investment Fund Managers* to state that Section 14, L2 with regard to the accounting standards which are accepted under Article 20(3) of the Law of 2013, as amended, for preparing the accounting information in the annual report of an AIF managed by an Authorised AIFM established in Luxembourg is no longer applicable.

This amendment is to be read in light of the Law of 21 July 2021 specifying the accounting standards that AIFs in the form of *sociétés en commandite spéciale* and falling outside the scope of application of Chapter II of the Law of 19 December 2002 *on register of commerce and companies and the accounting and annual accounts of undertakings*, as amended, may use in order to comply with Article 20(3) of the Law of 2013, as amended. The amendment enshrines the principle that those AIFs may use either LUX GAAP, IFRS or the equivalent accounting standards of certain third countries, which include, in particular, US GAAP.

## 10.2. Constitutional documents

### 10.2.1. Management regulations of a common fund

The management company is required to draw up the management regulations for a common fund. The provisions of the management regulations are deemed to be accepted by unitholders who acquire units of the common fund.

The management regulations of a common fund are subject to Luxembourg Law and must contain provisions at least on the following:

- ▶ The name and duration of the common fund, the name of the management company and of the depositary
- ▶ The investment policy, elaborated in line with the specific objectives and criteria of the UCI
- ▶ The distribution policy
- ▶ The remuneration and expenses that the management company is entitled to charge to the common fund and the method of calculation of that remuneration
- ▶ The provisions as to publications
- ▶ The date of the closing of the accounts of the common fund
- ▶ Subscriptions and redemptions:
  - ▶ The procedure for the issue of units
  - ▶ In the case of a 2010 Law common fund, the procedure for the repurchase of units and the conditions under which repurchases are carried out and may be suspended
  - ▶ In the case of a SIF or RAIF common fund, the procedure for the redemption of units, where relevant
- ▶ The procedures for amendment of the management regulations
- ▶ The cases where, without prejudice to legal grounds, the common fund shall be dissolved
- ▶ In the case of a RAIF common fund, the rules applicable to the valuation and the calculation of the net asset value per unit

<sup>3</sup> Regulation (EU) 2017/1129 *on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market*, as amended.

<sup>4</sup> Commission Delegated Regulation (EU) 2020/1273 of 4 June 2020 amending and correcting Delegated Regulation (EU) 2019/980 supplementing Regulation (EU) 2017/1129 of the European Parliament and of the Council *as regards the format, content, scrutiny and approval of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market*.

Where applicable, the management regulations of a common fund must expressly provide that the common fund may comprise multiple compartments, each compartment corresponding to a distinct part of the assets and liabilities of the common fund, and the applicable operational rules (see Section 2.3.2.).

The management regulations must be lodged with the Trade and Companies Register and their publication in the *Recueil électronique des sociétés et associations* will be made by way of a notice advising of the deposit of the document.

All publications regarding Luxembourg companies and associations appear in electronic format (.pdf) in the electronic gazette RESA (*Recueil Electronique des Sociétés et Associations*) hosted on the Trade and Companies Register (*Registre de Commerce et des Sociétés*, Luxembourg - RCS) website.

## 10.2.2. Articles of incorporation of an investment company

The articles of incorporation of an investment company, and any amendment to them, must be recorded in a special notarial deed drawn up in French, German or English. Where the notarial deed is drawn up in English, translation into one of the official languages is not required. The articles of incorporation of an investment company generally contain provisions on the following:

- ▶ The name, registered office, duration, and object/purpose of the investment company
- ▶ The share capital and characteristics of shares
- ▶ The governing body and management of the investment company and its administration
- ▶ Expenses to be borne by the investment company
- ▶ The financial year
- ▶ General meetings of the investment company
- ▶ The distribution policy
- ▶ Valuation policy for the underlying assets
- ▶ Subscriptions and redemptions: The issue and repurchase of shares including, *inter alia*, time limits for issue and repurchase payments, the frequency of calculation of the issue and repurchase price, and the conditions under which the issues and repurchases are carried out and the conditions under which the issues and repurchases may be suspended
- ▶ The procedure to amend the articles of incorporation
- ▶ In case of a multiple compartment investment company, the possibility to liquidate or merge compartments
- ▶ The cases where, without prejudice to legal grounds, the investment company shall be liquidated

Where applicable, the articles of incorporation of an investment company must expressly provide that the investment company may comprise multiple compartments, each compartment corresponding to a distinct part of the assets and liabilities of the investment company, and the applicable operational rules (see Section 2.3.2.).

Where other deeds recorded in notarial form are drawn up in English, such as notarial deeds drawing-up reports of shareholders' meetings of an investment company or recording a merger project regarding an investment company, translation into one of the official languages is not required.

The rules or instruments of incorporation of an ELTIF should specifically disclose:

- ▶ A specific date for the end of the life of the ELTIF. It may also provide for the right to temporarily extend the life of the ELTIF and the conditions for exercising such a right
- ▶ The procedures for the redemption of shares or units and the disposal of assets, and state clearly that redemptions to investors will commence on the day following the date of the end of the life of the ELTIF. Should the ELTIF provide the possibility to redeem before the end of its life, the rules or instruments of incorporation must state this fact along with the conditions required to be met for such redemptions to be possible, being:
  - ▶ Redemptions are not granted before the date the ELTIF invests at least 70% of its capital in eligible investment assets
  - ▶ The manager is able to demonstrate that an appropriate liquidity management system and effective procedures for monitoring the liquidity risk of the ELTIF are in place
  - ▶ The manager sets out a defined redemption policy which clearly indicates when investors may request redemptions
  - ▶ The redemption policy ensures that the overall amount of redemptions within any given period is limited to a percentage of UCITS' eligible assets invested in
  - ▶ The redemption policy ensures that investors are treated fairly and redemptions are granted on a *pro rata* basis if the total amounts of redemption requests exceed the limit in the previous bullet point
- ▶ The distribution policy the ELTIF will apply during its life

The rules or instruments of incorporation of an ELTIF marketed to retail investors should provide that all investors benefit from equal treatment and no preferential treatment or economic benefits are granted to individual, or groups of, investors.

## 10.3. Initial disclosures to investors

### 10.3.1. Prospectus of 2010 Law UCIs

The principal contents of the prospectus are set out in Schedule A of Annex I to the 2010 Law, as supplemented by the Law of 10 May 2016, and in Chapter L of IML Circular 91/75 as amended. The prospectus, and any amendments thereto, must be approved by the CSSF before the prospectus is used (see Chapter 3). The essential elements of the prospectus must be kept up-to-date.

*Commission Regulation (EU) No 583/2010* outlines the conditions that apply when providing a prospectus to investors in a “durable medium” other than paper or by means of a website.

The prospectus, in general, must be clear and easily understandable and must include the information necessary for investors to be able to make an informed judgment of the investment proposed to them, and, in particular, of the risks attached thereto.

The information required may be summarized as follows:

#### A. Information concerning the UCI and its management company, if applicable

	Common fund	Investment company	Management company
Name	X	X	X
Legal form		X	X
Registered and head office (if different)		X	X
Date of establishment/incorporation	X	X	X
Other UCIs managed by management company			X
For umbrella funds, the name of the compartments <sup>5</sup>	X	X	
Place where constitutional document may be obtained (see Section 10.2.)	X	X	
Brief description of tax system including details of whether deductions from the income and capital gains paid by the shareholders or unitholders are made at source	X	X	
Accounting and distribution dates	X	X	
Name of auditor	X	X	
Names and positions of management and their outside activities		X	X
Capital		X	X
Details of types and characteristics of shares or units (for each compartment, if applicable)	X	X	
Stock exchanges on which shares or units are listed (for each compartment, if applicable)	X	X	
Procedures and conditions for issuing shares or units (for each compartment, if applicable)	X	X	
Procedures and conditions for repurchasing and switching of shares or units (for each compartment, if applicable)	X	X	
Circumstances for suspending subscriptions and redemptions	X	X	
Rules for determining and applying income	X	X	
Description of the investment objectives (for each compartment, if applicable), including its financial objectives (e.g., capital growth or income), investment policy (e.g., specialization in geographical or industrial sectors), any limitations on that investment policy, and an indication of any techniques and instruments or borrowing powers that may be used in the management of the UCI, or each compartment of a multiple compartment UCI <sup>6</sup>	X	X	

<sup>5</sup> Unlaunched compartments and compartments awaiting reactivation for more than 18 months must be removed from the prospectus (see Section 3.11.).

<sup>6</sup> See Section O.

	Common fund	Investment company	Management company
Description of the risks (for each compartment, if applicable <sup>7</sup> )	X	X	
Rules for valuing assets	X	X	
Frequency of the NAV calculation (for each compartment, if applicable <sup>8</sup> )	X	X	
Determination of subscription and redemption price (method and frequency of calculation, charges, places, and frequency of publication) (for each compartment, if applicable)	X	X	
Information on remuneration paid by the UCI to the management company, depositary or third parties (for each compartment, if applicable) <sup>9</sup>	X	X	

#### B. Information concerning the depositary

The Law of 10 May 2016 implementing UCITS V slightly enhanced the information to be provided on the depositary:

- ▶ Identity of the depositary of the UCI, the description of its duties and the conflicts of interests that might arise
- ▶ A description of any safekeeping functions delegated by the depositary, the list of the delegates and sub-delegates and the conflicts of interests that might arise from such delegation
- ▶ A declaration indicating that updated information on the above sections will be made available to investors upon request

#### C. Information concerning investment advisors (for each compartment, if applicable)

- ▶ Name
- ▶ Material provisions of the contract, excluding remuneration
- ▶ Other significant activities

#### D. Investor redemption arrangements and investor information

Information concerning arrangements for making payments to shareholders or unitholders and repurchasing shares or units and making available information on the UCI; such information is to be given in Luxembourg and other countries where the prospectus is to be circulated.

#### E. Other information (to be provided for all compartments in the case of multiple compartment UCIs)

- ▶ Historical performance of the UCI (where applicable): Such information may be either included in or attached to the prospectus and should be updated on an annual basis
- ▶ Profile of the typical investor

#### F. Fees and expenses

Possible expenses or fees, other than charges relating to the subscription or redemption of shares or units, distinguishing between those to be paid directly by the shareholder or unitholder and those to be borne by the UCI.

As per the CSSF's *Frequently Asked Questions concerning the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment*:

- ▶ Where a service fee is directly paid out of the assets of the UCITS to the investment manager(s), and possibly to any investment advisor(s) contractually linked to the UCITS, the method of calculation or the rate of the fee to each recipient must be disclosed in the prospectus
- ▶ The investment manager's fee and/or the investment advisor's fee should only pay for investment management and investment advice respectively. As a general rule, the investment advisor's fee is expected to be at a lower level than the investment manager's fee
- ▶ When other expenses or fees for activities beyond the direct scope of investment management or advice are payable out of the assets of the UCITS to the investment manager(s) or investment advisor(s), such expenses or fees must be disclosed separately from the investment manager's and investment advisor's fee respectively, in a way that clearly informs investors about the nature of such expenses or fees
- ▶ In cases where the option of an "all-in" fee is proposed, which implies that only one compensation amount is paid out of the assets of the UCITS to a recipient (typically the management company) who will remunerate the other service providers to the UCITS, the prospectus must clearly state the scope and nature of such "all-in" fee. Each contractual recipient of this all-in fee should be specified
- ▶ In case of a performance fee, both the performance fee model and the investment manager as the recipient of the performance fee must be disclosed in the prospectus. Should a sharing arrangement be in place for the performance fee with any investment advisor(s) contractually linked to the UCITS, the prospectus must disclose this arrangement

<sup>7</sup> Required in practice.

<sup>8</sup> Idem.

<sup>9</sup> Where a "substantial proportion" of net assets of a UCITS is invested in other UCIs that are linked to the investing UCITS, the prospectus must disclose the maximum level of management fees that may be charged both to the UCITS itself and to the other UCIs in which it intends to invest (see Section 4.2.2.8.1.III.(3)).

CSSF Circular 20/764 implemented the ESMA's *Guidelines on performance fees in UCITS and certain types of AIFs* which include a certain number of disclosure requirements in the prospectus:

- ▶ Investors should be adequately informed about the performance fees and their impact on return
- ▶ All *ex-ante* documents (prospectus, KIID, marketing documents) should clearly set out all information necessary to understand the performance fee model and the computation methodology, including the main elements and parameters, the payment date. Concrete computation examples should be included in the prospectus
- ▶ Where a performance fee model uses a different but consistent benchmark, the explanation of the choice of benchmark should be included in the prospectus
- ▶ Where a performance fee is payable in times of overall negative performance, a prominent warning must be included in the KIID
- ▶ Where applicable, the KIID and the prospectus should display the name of the benchmark index and disclose past performance of the UCI against the benchmark index

#### G. Date

The prospectus must be dated and may only be used as long as the information in it is accurate.

#### H. Delegation of management company functions

The prospectus of a UCITS must list the functions delegated by the management company, including name of the delegate, legal form and material provisions of the contract.

#### I. Risk management disclosures for UCITS (see also Section 7.2.6.)

The UCITS should disclose in its prospectus the method used to calculate the global exposure (i.e., commitment approach, relative VaR or absolute VaR).

UCITS using VaR approaches should disclose in the prospectus the expected level of leverage and the possibility of higher leverage levels. CSSF Circular 11/512, as amended, provides further clarification on the assessment and disclosure of the expected level of leverage.

CSSF *Communiqué* 12/29 clarifies that, as regards the publication of leverage in the prospectus, the CSSF considers that newly created UCITS (including UCITS compartments) must, from the date of launch, base the disclosure of leverage in the prospectus on the sum of notionals approach. This information may be complemented with the leverage determined based on the commitment approach (provided that the underlying calculation method is clearly and precisely indicated for every mentioned figure) or with other additional explanations.

Where financial derivative instruments (FDIs) are used and benefit only specific share or unit classes (e.g., hedging, leverage), it is good practice to disclose global risk exposure (market risk) and leverage at share or unit class level, although there are no specific requirements on disclosures at share or unit class level.

When using the relative VaR approach, information on the reference portfolio should be disclosed in the prospectus. CSSF Circular 11/512, as amended, provides further clarification on the content of the information to be disclosed.

For structured, passively managed UCITS where the commitment approach is used for the calculation of global exposure, the prospectus should:

- ▶ Contain full disclosure regarding the investment policy, underlying exposure, and payoff *formulae* in clear language that can be easily understood by the retail investor
- ▶ Include a prominent risk warning informing investors who redeem their investment prior to maturity that they do not benefit from the predefined payoff and may suffer significant losses

#### J. Prospectus of a feeder UCITS

In addition to the information required by Schedule A of Annex I of the 2010 Law, as amended, the prospectus of a feeder UCITS must contain the following:

- ▶ A declaration that the feeder UCITS is a feeder of a particular master UCITS and as such permanently invests 85% or more of its assets in shares or units of that master UCITS
- ▶ The investment objectives and policies of both the master and the feeder UCITS
- ▶ A brief description of the master UCITS, its organization, its investment objective and policy, including the risk profile, and an indication on how the prospectus of the master UCITS may be obtained
- ▶ Details of where to obtain the prospectus of the master UCITS
- ▶ A summary of the agreement (or internal conduct of business rules) between master and feeder UCITS
- ▶ Details of how the shareholders or unitholders may obtain further information on the master UCITS and on the agreement entered into between the master and feeder UCITS
- ▶ A description of all remuneration and reimbursement of costs payable by the feeder UCITS by virtue of its investment in units of the master UCITS, as well as the aggregate charges of the feeder UCITS and the master UCITS
- ▶ The tax implications of the chosen structure

### K. Investor rights

The CSSF's Newsletter of November 2011 introduced the requirement to include a paragraph on investor rights in the prospectuses of 2010 Law UCIs.

The paragraph draws attention to the fact that investors will only be able to fully exercise their investor rights directly against the UCI (including the right to participate in general shareholders' meetings in the case of investment companies) if the investor is registered in the shareholders' or unitholders' register. It also advises investors to take advice on their rights.

The text of the paragraph must follow the model provided by CSSF Newsletter No. 130 of November 2011.

### L. Remuneration

The Law of 10 May 2016 implementing UCITS V amended the 2010 Law and requires the prospectus of a UCITS to include either:

- ▶ The details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identities of persons responsible for awarding the remuneration and benefits including the composition of the remuneration committee; or
- ▶ A summary of the remuneration policy and a statement to the effect that the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identity of persons responsible for awarding the remuneration and benefits, including the composition of the remuneration committee where such committee exists, are available by means of a website, including a reference to that website, and that a paper copy will be made available free of charge upon request

### M. Share classes

Following ESMA's *opinion on share classes of UCITS of 30 January 2017*, and the *CSSF's Frequently Asked Questions concerning the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment*, to ensure transparency, the prospectus should:

- ▶ Provide the details of the types and main characteristics of the share classes such as, *inter alia*, fee structure, dividend policy, investor type, currency or currency risk hedging  
However, it does not have to provide an exhaustive list of all individual share classes together with all their individual characteristics. Additional information on share classes issued (such as, e.g., list of all the share classes offered to investors or effectively launched classes) should be available to investors either on request and free of charge, or through a reference in the prospectus to an internet website, where such information can be found
- ▶ The information related to share classes with contagion risk can be addressed by means of a website publication if the prospectus includes a link to the relevant website of the management company/UCITS

### N. Benchmarks

When an index is used to measure the UCI's performance with the purpose of tracking the return of such index, or of defining the asset allocation of a portfolio, or of computing the performance fees, a 2010 Law UCI falls under the scope of the Regulation (EU) 2016/1011 on *indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds*, as amended (the "Benchmark Regulation").

As per the Benchmark Regulation<sup>10</sup>, a prospectus issued under the Prospectus Regulation<sup>11</sup> or the UCITS Directive<sup>12</sup> should include clear and prominent information stating whether the benchmark is provided by an administrator included in the register referred to in Article 36 of the Benchmark Regulation.

<sup>10</sup> Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, as amended.

<sup>11</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

<sup>12</sup> Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended.

In its *Questions and Answers on the Benchmarks Regulation*, ESMA considers that prospectuses should include reference to ESMA's register of administrators and benchmarks ("the register") as follows:

In relation to prospectuses approved on or after 1 January 2018:

- Where the register already includes the relevant administrator by the time a prospectus under the Prospectus Regulation<sup>13</sup> or the UCITS Directive<sup>14</sup> is published, ESMA considers that the prospectus should include a reference to the fact that the administrator is listed in the register
- Where the register does not include the relevant administrator by the time a prospectus is published, ESMA considers that the prospectus should include a statement to that effect

Additionally:

- Prospectuses published under the UCITS Directive<sup>15</sup> should be updated once the relevant administrator is included in the register, the next time prospectus updates are made
- Prospectuses approved under the Prospectus Regulation<sup>16</sup> are not required under the Benchmark Regulation<sup>17</sup> to be systematically updated by means of a supplement once the relevant administrator is included in the register

In relation to prospectuses approved prior to 1 January 2018:

- For prospectuses approved under the UCITS Directive<sup>18</sup>, if by 1 January 2019 the relevant administrator was not included in the register, ESMA considers that these prospectuses should be updated to include a statement to that effect
- Prospectuses approved under the Prospectus Regulation<sup>19</sup> are not required under the Benchmark Regulation<sup>20</sup> to be systematically updated by means of a supplement once the relevant administrator is included in the register

#### O. Additional prospectus disclosures

The prospectus of a UCITS must indicate the categories of assets in which the UCITS is authorized to invest (see Section 4.2.2.3.) and prominently indicate its policy in relation to financial derivative instruments (FDIs). UCITS that use FDIs for purposes other than hedging should include in their prospectus a description of the risks (including, if appropriate, an indication of the leverage and market risk).

Where the UCITS is authorized to invest up to 100% of its net assets in at least six different transferable securities issued or guaranteed by an EU Member State, its local authorities, a non-Member State of the EU or public international bodies of which one or more EU Member States are members (see Section 4.2.2.8.1.II.(2)), this must be explicitly stated in the prospectus.

When a UCITS invests principally in any category of assets other than transferable securities and money market instruments or replicates a stock or debt securities index, the prospectus must include a prominent statement drawing attention to its investment policy. When the NAV of a UCITS is likely to have a high volatility due to its portfolio composition or the portfolio management techniques that may be used, the prospectus must include a prominent statement drawing attention to this characteristic of the UCITS.

Where a UCI intends to use techniques and instruments relating to transferable securities and money market instruments (see Section 4.2.2.6.), it must clearly indicate in its prospectus:

- That it intends to enter into such techniques and use such instruments
- The types of transaction considered and purpose thereof
- The conditions and limits of such transactions
- The conditions and limits of cash collateral reinvestment if the UCI intends to reinvest the collateral
- A description of the risks inherent in such transactions

Depending on the risk of investment in, specificities and magnitude of certain types of assets within a portfolio, the CSSF may request disclosures to be made in the UCI's prospectus. For example:

- If a UCITS invests more than 20% of its net assets in Mortgage Backed Securities (MBS) or Asset Backed Securities (ABS), the prospectus must provide explicit information on such investments, in particular the risks associated with investing in such securities

<sup>13</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

<sup>14</sup> Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended.

<sup>15</sup> Idem.

<sup>16</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

<sup>17</sup> Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, as amended.

<sup>18</sup> Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended.

<sup>19</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

<sup>20</sup> Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, as amended.



ESMA's *Guidelines on ETFs and other UCITS issues*, as amended, require disclosure of the following information in the prospectus:

- ▶ Efficient Portfolio Management (EPM) techniques:
  - ▶ Techniques and instruments to be employed, the risks involved including counterparty risk, potential conflicts of interest, and the impact on the performance of the UCITS
  - ▶ A policy relating to the treatment of direct and indirect operational costs and fees arising from EPM, the identity of entities to which such costs and fees are paid, and any relationship with the management company or depositary
- ▶ Financial Derivative Instruments (FDIs):
  - ▶ UCITS entering into total return swaps (TRS) or similar derivative instruments: the underlying strategy and composition of the investment portfolio or index, information on counterparties, their risk of default and the potential effect on investor returns, the extent to which the counterparties assume any discretion over the UCITS' portfolio or over the underlying of the FDIs and whether the approval of the counterparty is required in relation to any UCITS investment portfolio transaction, and, where relevant, identification of the counterparty as investment manager
- ▶ Management of collateral:
  - ▶ UCITS' collateral policy covering permitted types of collateral, level of collateral required, haircut policy, and, in the case of cash collateral, reinvestment policy
  - ▶ Clear information to investors on the collateral policy
  - ▶ UCITS that intend to be fully collateralized in securities issued or guaranteed by a Member State should disclose this fact in the prospectus
- ▶ UCITS ETFs:
  - ▶ Use of the "UCITS ETF" identifier in the name and prospectus; this English identifier should be used independently of the language of the document; the identifiers "UCITS ETF", "ETF" or "exchange-traded fund" cannot be used by other UCITS
  - ▶ The policy on portfolio transparency and where information on the portfolio can be obtained, including the indicative net asset value (iNAV)
  - ▶ How the iNAV is calculated and the frequency of calculation
  - ▶ For an actively-managed UCITS ETF:
    - ▶ That it is actively-managed
    - ▶ Strategy to meet the stated investment policy, including any intention to outperform an index
  - ▶ Treatment of secondary market investors: inclusion of a warning in the prospectus and marketing communications to the effect that shares or units purchased on the secondary market, if applicable, are generally not redeemable from the ETF, as well as the procedure and costs for direct redemptions in exceptional circumstances
- ▶ Index-tracking UCITS:
  - ▶ Description of the index, including information on its underlying components (or a website link to such information), how the index will be tracked and implications in terms of exposure to the underlying index and counterparty risk, anticipated tracking error (in normal market conditions), and factors impacting the ability of the UCITS to track the performance of the index
  - ▶ Index-tracking leveraged UCITS: Leverage policy, associated costs and risks, impact on returns, impact of any reverse leverage (short exposure), and a description of how the performance may differ significantly from the multiple of the index over the medium to long term
- ▶ Financial indices:
  - ▶ When a UCITS intends to make use of the increased diversification limits for financial indices referred to in Article 53 of the UCITS Directive<sup>21</sup> (see Section 4.2.2.7.7.), this should be disclosed clearly in the prospectus, together with a description of the exceptional market conditions that justify this investment
  - ▶ Rebalancing frequency and its effects on the costs within the strategy

For structured UCITS where the commitment approach is used for the calculation of global exposure, additional disclosures are required (see Section 10.3.1.1.).

Regulation EU 2015/2365 on *transparency of securities financing transactions and of reuse* requires that a UCITS prospectus specifies the securities financing transactions (SFTs) and total return swaps which UCITS management companies, or self-managed UCITS, are authorized to use, and includes a clear statement that those transactions and instruments are used.

The prospectus must include the following data:

- ▶ General description of the SFTs and total return swaps used by the UCITS and the rationale for use
- ▶ Overall data to be reported for each type of SFT and total return swaps:
  - ▶ Types of assets that can be subject to them
  - ▶ Maximum proportion of assets under management that can be subject to them
  - ▶ Expected proportion of assets under management that will be subject to each of them

<sup>21</sup> Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended.

- ▶ Criteria used to select counterparties (including legal status, country of origin, minimum credit rating)
- ▶ Acceptable collateral: Description of acceptable collateral with regard to asset types, issuer, maturity, liquidity as well as the collateral diversification and correlation policies
- ▶ Collateral valuation: Description of the collateral valuation methodology used and its rationale, and whether daily mark-to-market and daily variation margins are used
- ▶ Risk management: Description of the risks linked to SFTs and total return swaps as well as risks linked to collateral management, such as operational, liquidity, counterparty, custody and legal risks and, where applicable, the risks arising from its reuse
- ▶ Specification of how assets subject to SFTs and total return swaps and collateral received are safe-kept (e.g., with the UCITS custodian)
- ▶ Specification of any restrictions (regulatory or self-imposed) on the reuse of collateral
- ▶ Policy on sharing or return generated by SFTs and total return swaps: Description of the proportions of the revenue generated by SFTs and total return swaps that is returned to the UCITS and of the costs and fees assigned to the manager or third parties (e.g., the agent lender). The prospectus should also indicate if these are related parties to the manager

On 18 December 2020, the CSSF issued an FAQ to clarify certain requirements in terms of prospectus disclosures, revenues and costs/fees, conflicts of interest and best execution applicable to securities financing transactions (SFTs):

- ▶ General disclosures  
The prospectus of a UCITS which intends to use SFTs should, *inter alia*, confirm whether SFTs will be used on a continuous or temporary basis and provide the expected and maximum proportion of the assets under management that can be subject to SFTs.
- ▶ Risk disclosures  
The prospectus should describe the risks linked to each individual SFT and to collateral management.
- ▶ Costs/Fees disclosures  
The prospectus should also disclose the portion, after deduction of direct and indirect operational costs/fees, of gross revenues generated by the use of SFTs on the basis of arm's length transactions, which is returned to the UCITS.
- ▶ Conflicts of interest disclosures  
Any material conflict of interest that may arise, notably from SFTs with related parties, should be appropriately disclosed in the prospectus.

CSSF Circular 14/591 clarifies that the minimum notification period to notify investors of a significant change to the UCI they are invested in should be one month. During this one-month period before the entry into force of the significant change, investors have the right to request, without any repurchase or redemption charge, the repurchase or redemption of their shares/units. In addition to the possibility to redeem shares/units free of charge, the UCI may also (but is not obliged to) offer the option to investors to convert their shares/units into shares/units in another UCI (or, in case the change affects only one compartment, into shares/units of another compartment of the same UCI) without any conversion charges. The CSSF may nevertheless agree, through a duly supported request for derogation made in advance, to not impose such a notification period with the ability for investors to redeem or convert their holdings free of charge (for example, in cases where all the investors in the relevant UCI agree with the contemplated change). Similarly, the CSSF may agree to only impose a notification period to duly inform the investors of the relevant change before it becomes effective, but without the ability for investors to redeem or convert their holdings free of charge. It should be noted that where the UCI is registered for cross-border distribution, the regulators in the host countries may impose a notification period exceeding one month.

Following ESMA's *opinion on share classes* of UCITS of 30 January 2017, information about existing share or unit classes should be provided via the UCITS prospectus as part of the details of the types and main characteristics of the shares or units. See also Section 2.3.3.

Prospectuses of closed-ended UCIs whose shares/units are listed on the *Bourse de Luxembourg* are required to comply with the requirements of the Prospectus Regulation<sup>22</sup>. CSSF Circular 16/636 implemented ESMA's *Guidelines on Alternative Performance Measures*. These Guidelines aim at promoting the usefulness and transparency of Alternative Performance Measures (APMs) disclosed by issuers or the person responsible for the prospectus prepared in accordance with the Prospectus Regulation<sup>23</sup>.

Regulation EU 2019/2088 *on sustainability-related disclosures in the financial services sector*, as amended, requires management companies of UCITS to include in the UCITS prospectus a description of the following:

- ▶ Transparency of the integration of sustainability risks
- ▶ Transparency of adverse sustainability impacts at financial product level
- ▶ Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures
- ▶ Transparency of sustainable investments in pre-contractual disclosures

See Chapter 14 for the details of the required disclosures.

<sup>22</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

<sup>23</sup> *Idem*.

### 10.3.1.1. Hedge funds

As laid down in CSSF Circular 02/80, the prospectus of a 2010 Law Part II UCI pursuing alternative investment strategies, akin to those pursued by hedge funds must contain a description of the investment strategy and the inherent risks and make reference to the fact that:

- ▶ Potential losses from short selling differ from those where securities are acquired for cash
- ▶ The leverage effect creates an opportunity for increased yield, but at the same time increases volatility and the risk of capital loss. Borrowings involve an interest cost that may exceed income or gains
- ▶ Low liquidity may mean investors' redemption requests cannot be met

The prospectus must indicate that investing in the UCI in question entails a higher than average risk and is only suitable for investors prepared to lose the total value of their investment.

Where applicable, the prospectus must contain a description of the dealing strategy as regards futures and options, making reference to their volatility.

### 10.3.1.2. Venture capital UCIs

As laid down in Chapter I.I of IML Circular 91/75, as amended, the prospectus of a 2010 Law Part II UCI making venture capital investments should contain a detailed description of investment risk inherent to the policy of the UCI and of the type of conflict of interest that could arise between the interests of the directors of the portfolio management and advisory bodies and the interests of the UCI.

The prospectus must contain a statement indicating that an investment in such a UCI represents an above average risk, is only suitable for persons who can afford to take such a risk, and that investors are advised to invest only a part of their savings in such long-term investments.

Where investors have the right to present their shares or units for redemption, the UCI may provide for certain restrictions to this right. Any such restrictions should be stated in the prospectus.

If the remuneration of the portfolio management and advisory bodies is higher than that usually applicable to UCIs, the prospectus should state whether the additional remuneration is also payable on assets not invested in venture capital.

### 10.3.1.3. Futures contracts and/or options UCIs

As laid down in Chapter I.II of IML Circular 91/75, as amended, the prospectus of a 2010 Law Part II UCI investing in futures contracts and options should contain a detailed description of the trading strategy with regard to futures contracts and options, as well as the inherent investment risk and the high risk of loss.

The prospectus should include a statement indicating that the UCI is only suitable for persons who can afford to take such a risk.

If the remuneration of the portfolio management and advisory bodies is higher than that usually applicable to UCIs, the prospectus should state whether the additional remuneration is also payable on assets not invested in futures contracts and options.

### 10.3.1.4. Real estate UCIs

As laid down in Chapter I.III of Circular IML 91/75, as amended, the prospectus of a 2010 Law Part II UCI investing in real estate should include a description of the inherent risks.

It should also provide details of the type of commissions, expenses and charges to be borne by the UCI, together with the method of calculation and accounting treatment.

If the remuneration of the portfolio management and advisory bodies is higher than that usually applicable to UCIs, the prospectus must state whether the additional remuneration is also payable on assets not invested in real estate.

## 10.3.2. Key Investor Information (KIID) document of UCITS

Key Investor Information Documents (KIIDs) must be produced for every share or unit class of every compartment of a UCITS. The KIID must include appropriate information about the essential characteristics of the UCITS concerned. It must be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, make informed investment choices.

### 10.3.2.1. Content and layout of the KIID

The KIID must be presented and laid out in a way that is easy to read. It must contain fair, clear and understandable information about the UCITS. It must be brief and non-technical. It must be consistent with the relevant parts of the prospectus. It should be drawn up in a common format, allowing for comparison and be presented in a way that is likely to be understood by retail investors.

The form, presentation and content of the sections of the KIID has been laid down in *Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards Key Investor Information and conditions to be met when providing Key Investor Information or the prospectus in a durable medium other than paper or by means of a website* and the 2010 Law, as amended. The KIID must include:

- ▶ Title
- ▶ The required explanatory statement, *inter alia*, advising the client to read it in order to make an informed decision about whether to invest
- ▶ Name (of compartment or share or unit class followed by name of UCITS) and identifier of the share or unit class (commonly the International Securities Identification Number (ISIN) of the share or unit class) and the reference that the CSSF is the competent authority for the supervision of the UCITS pursuant to the 2010 Law
- ▶ Name of the management company and group, if relevant
- ▶ A description of objectives and investment policy covering, *inter alia*:
  - ▶ Main categories of eligible financial instruments
  - ▶ Targets of the UCITS in relation to industrial, geographical or other market sectors, or specific asset classes
  - ▶ Whether the UCITS allows for discretionary choice with regard to particular investments
  - ▶ Reference to a benchmark, if relevant

ESMA clarified in its *Questions and Answers on the Application of the UCITS Directive*, that a UCITS must clearly indicate in the objectives and investment policy section of the KIID whether it has an index tracking objective or alternatively allows for discretionary choices. ESMA recommends using the terms “passive” or “passively managed” in addition to “index-tracking”, and “active” or “actively managed” to assist investor understanding. ESMA’s Q&A also provide clarifications on the meaning of the terms “whether this approach includes or implies a reference to a benchmark” and “the degree of freedom from the benchmark” from Article 7(1)(d) of the Regulation<sup>24</sup>.

- ▶ Possibility to redeem shares or units on demand and dealing frequency
- ▶ Whether dividend income is distributed or reinvested
- ▶ Risk and reward profile, including guidance on the associated risks; this will take the form of:
  - ▶ A synthetic risk and reward indicator (SRRI) following ESMA’s *Guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document*, published in July 2010

The SRRI aims to provide potential investors with an indication of the overall risk and reward profile of a UCITS. The SRRI corresponds to an integer number designed to rank the UCITS, according to its increasing level of volatility, on a scale from 1 to 7. The methodology is tailored to cover the particular features of the different types of UCITS. It must be based on the estimated volatility using weekly past returns of the UCITS or, if not otherwise possible, using monthly returns. The returns relevant for the computation of volatility must be gathered from a sample period covering the last five years of the life of the UCITS and, in case of distribution of income, must be measured taking into account the relevant earnings or dividend payoffs.

There are specific rules on application of the methodology to absolute return UCITS, total return UCITS, life cycle UCITS, and structured UCITS. In the case of structured UCITS, the SRRI should be calculated on the basis of the annualized volatility corresponding to the 99% Value at Risk (VaR) at maturity.

- ▶ A narrative explanation of the main limitations of the SRRI
- ▶ A narrative presentation of the material risks that are not fully captured by the methodology of the SRRI
- ▶ Charges: following the standard presentation format, including narrative explanations. Ongoing charges should be calculated according to ESMA’s<sup>25</sup> *guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document*, published in July 2010
- ▶ Past performance for the last ten years; for any years for which data is not available, the year must be shown as blank; for UCITS that do not yet have past performance data for a complete calendar year, a statement must be provided explaining that there is insufficient data to provide a useful indication of past performance

ESMA clarified in its *Questions and Answers on the Application of the UCITS Directive* that where a UCITS refers to an index in its investment objectives and policy as a benchmark and will measure performance against that index, but does not intend to track the index, the performance of the benchmark index must be shown in the past performance section of the KIID.

<sup>24</sup> Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website.

<sup>25</sup> The Committee of European Securities Regulators (CESR) became the ESMA on 1 January 2011.

The requirement to disclose a bar showing the performance of the benchmark index equally applies to total return/ absolute return UCITS if the investment objectives and policy clearly mention that the UCITS will aim to outperform an index.

UCITS management companies should ensure that the KIID is updated to include this latest ESMA clarification as soon as practicable and that performance disclosed in the KIID regarding a benchmark index is consistent with performance disclosure in other investor communications including:

- ▶ Across offering documents and marketing material, including the prospectus
- ▶ Across distribution channels
- ▶ Across investor types
- ▶ Practical information including:
  - ▶ Name of depositary
  - ▶ Where and how to obtain further information about the UCITS, including where and how to obtain, free of charge, the prospectus and annual and semi-annual reports
  - ▶ Where and how to obtain other practical information, including latest prices of shares or units
  - ▶ A statement regarding the tax impact on the investor
  - ▶ A statement regarding the liability of the investment company or management company in relation to the KIID
  - ▶ Authorization details
  - ▶ Date of publication
- ▶ Statement to the effect that the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identity of the persons responsible for awarding the remuneration and benefits including the composition of the remuneration committee, where such a committee exists, are available by means of a website and that a paper copy will be made available free of charge upon request

In accordance with the EU Sustainable Finance Disclosure Regulation (SFDR)<sup>26</sup>, a UCITS classified as Article 8 (“Light Green”) or Article 9 (“Dark Green”) should amend the KIID’s “Objectives and Investment Policy” section in order to include sustainability disclosure to investors.

In addition, a management company, for all UCITS considering sustainability risks, should review the UCITS KIID’s “Risk and Reward” section to ensure that any sustainability risks that may not be captured by the SRRI are disclosed.

The KIID must not exceed two pages of A4-sized paper when printed, or three pages in the case of structured UCITS.

Specific provisions of *Commission Regulation (EU) No 583/2010* cover compartments, share or unit classes, funds of funds, feeder UCITS, and structured UCITS.

In December 2010, ESMA issued various guidelines on the KIID including:

- ▶ ESMA’s *template for the Key Investor Information Document* showing the type of contents and layout of a KIID for a standard UCITS
- ▶ ESMA’s *guide to clear language and layout for the Key Investor Information Document (KIID)*, which is intended as a statement of good practice. It covers:
  - ▶ Using plain language: What is meant by plain language and how to deal with barriers to clear language
  - ▶ Designing a clear KIID: Covering, *inter alia*, font, layout and colors
  - ▶ Specific guidance on key sections of the KIID
- ▶ Guidelines on the *Selection and presentation of performance scenarios in the Key Investor Information Document (KIID) for structured UCITS*: For structured UCITS, the objective and investment policy section of the KIID must include an explanation of how the formula works or how the pay-off is calculated, accompanied by an illustration showing at least three scenarios of the UCITS potential performance. The guidelines indicate that the scenarios to illustrate how the pay-off works under the different market conditions should include an unfavorable outcome, a favorable outcome, and a medium outcome, and specific features of the formula. They also provide examples of scenario selection and presentation

<sup>26</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, as amended.

The Association of the Luxembourg Fund Industry (ALFI) has issued a *Key Investor Information Document Q&A*. The Q&A, which represents the view of the ALFI working group on KIID, cover questions relating to Commission Regulation (EU) No 583/2010, ESMA's guidelines, and using the KIID in distribution networks.

The Q&A have been updated a number of times and cover:

- The form and presentation of the KIID including:
  - The title of the document, order of contents, and headings of sections
  - Language, length, and presentation
- The content of sections of the KIID addressing:
  - The objectives and investment policy
  - The risk and reward profile
  - Charges
  - Past performance
  - Practical information and cross references
  - The review and revision of the KIID
- Particular UCITS structures including:
  - Investment compartments
  - Share or unit classes
- Issues in relation to "durable medium"
- ESMA's *Guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document*
- ESMA's *Guidelines on the methodology for the calculation of the ongoing charges figure in the Key Investor Information Document*
- Using KIID in distribution networks

In May 2012, the CSSF issued a *Key Investor Information Document - Frequently Asked Questions* document (the CSSF KIID FAQ), updated in July 2012, covering, *inter alia*:

- Minimum regulatory documents to be taken into consideration for drafting a KIID
- Procedure to file the final version of a KIID with the CSSF
- In the context of a request for authorization of a UCITS or compartment thereof:
  - Procedure when submitting a draft of the KIID to the CSSF
  - Requirement to submit a draft of the KIID of at least the share or unit class deemed to be the most relevant per compartment
- Responsibility for the content of the KIID
- Formal CSSF approval (or visa stamping) - none is provided for KIID
- Requirements to be met before issuing a share or unit class (including filing the KIID with the CSSF)
- Impact of temporary suspension of subscriptions and redemptions on requirement to keep KIID up-to-date
- Provision of translations of the KIID to the CSSF
- Requirements to be met in relation to the publication of KIID on a website

In March 2015, ESMA published an updated Q&A - *Key Investor Information Document for UCITS (2015/ESMA/631)* covering, *inter alia*:

- Preparation of KIID by UCITS that are no longer marketed to the public or by UCITS in liquidation
- Communication of KIID to investors
- Treatment of UCITS with share or unit classes
- Past performance
- Clear language
- Identification of the UCITS

ESMA's *Guidelines on ETFs and other UCITS issues*, as amended, require disclosure of the following information in the KIID:

- ▶ UCITS ETF:
  - ▶ Use of the "UCITS ETF" identifier in the name and KIID; this English identifier should be used independently of the language of the document; the identifiers "UCITS ETF", "ETF" or "exchange-traded fund" cannot be used by other UCITS
  - ▶ The policy on portfolio transparency and where information on the portfolio can be obtained, including the indicative net asset value (iNAV)
  - ▶ Actively managed UCITS ETF:
    - ▶ That it is actively managed
    - ▶ Strategy to meet the stated investment policy, including any intention to outperform an index
- ▶ Index-tracking UCITS:
  - ▶ How the index will be tracked and implications in terms of exposure to the underlying index and counterparty risk, in summary form
  - ▶ Index-tracking leveraged UCITS: Leverage policy, associated costs and risks, impact on returns, impact of any reverse leverage (short exposure), and description of how the performance may differ significantly from the multiple of the index over the medium to long term in summary form

On 26 November 2014, Regulation (EU) 1286/2014, *on key information documents for packaged retail and insurance-based investment products (PRIIPs)* was adopted and entered into force on 1 January 2018, following its amendment on 14 December 2016 by Regulation (EU) 2016/2340. On 8 March 2017, the European Commission (EC) adopted the Delegated Regulation (EU) 2017/653 supplementing the PRIIPs regulation and laying down regulatory technical standards specifying the content and underlying methodology of the KID that will have to be provided to retail consumers when they buy certain investment products.

The CSSF clarified in its *Frequently Asked Questions concerning the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment* that manufacturers of Luxembourg UCITS need to have in place a PRIIP KID as of 1 January 2022. In May 2021, the EC announced that the new PRIIPs RTS requirements will come into force on 1 July 2022, hence putting an end to the exemption for UCITS and granting them 6 months to transition from the UCITS KIID to the PRIIPs KID. In September 2021, the EC adopted the Delegated Regulation (new RTS) amending the RTS laid out in the Delegated Regulation (EU) 2017/653 regarding the methodology and presentation of performance scenarios and summary risk indicator (SRI), as well as calculation and presentation of costs. In order to ensure that management companies have sufficient time to prepare and meet the obligation, the UCITS KIID exemption has been extended until 31 December 2022. Until this date, UCITS will be exempt from the obligations of the PRIIPs Regulation in conformity with Article 32(1) of the Delegated Regulation (EU) 2017/653. UCITS will be required to replace UCITS KIIDs with PRIIP KIDs by 1 January 2023.

On 3 April 2020, ESMA issued its *Guidelines on performance fees in UCITS and certain types of AIFs* which include a certain number of disclosure requirements in the KIID, *inter alia*:

- ▶ Investors should be adequately informed about the performance fees and their impact on return
- ▶ All *ex-ante* documents (prospectus, KIID, marketing documents) should clearly set out all information necessary to understand the performance fee model and the computation methodology, including the main elements and parameters, the payment date
- ▶ Where a performance fee is payable in times of overall negative performance, a prominent warning must be included in the KIID
- ▶ Where applicable, the KIID and the prospectus should display the name of the benchmark

For more information on ESMA Guidelines, see Section 10.3.1.F.

### 10.3.2.2. Production of the KIID

KIIDs must be drawn up for every UCITS. In the case of umbrella UCITS, a separate KIID must be produced for each compartment. In the case of multiple share or unit classes, a separate KIID must be produced for each share or unit class, except where a share or unit class can be selected to represent other share or unit classes and certain conditions are met. In the case of master-feeder structures, a separate KIID must be produced for each feeder UCITS.

Where a UCITS consists of more than one class of shares or units, the ALFI working group on KIID considers that there may be three options:

- ▶ Single share or unit class KIIDs: Separate KIIDs are prepared for each class of shares or units
- ▶ A representative share or unit class KIID: In case of multiple share or unit classes, one share or unit class may be selected to represent one or more other classes of the UCITS
- ▶ A multiple share or unit class KIID: Information on multiple share or unit classes is provided on a single KIID

KIIDs must be submitted to the CSSF in English, French, German or Luxembourgish.

Where the UCITS is distributed in other Member States, KIIDs must be translated into the official language or one of the languages of the UCITS host Member State or into a language approved by the competent authorities of that Member State (see Section 12.3.6.).

### 10.3.2.3. Update of the KIID

The investment company or, in the case of common funds, the management company must ensure that the KIID is up-to-date. The KIID must be updated annually and reviewed prior to or following any changes regarded as material to the information contained in the KIID:

- ▶ *Ex-ante* material changes: The KIID must be reviewed prior to any change to the prospectus, constitutional document or any other material change. In general, before a material change is implemented by the investment company or, in the case of common funds, the management company, a draft update to the authorization file, including draft updated KIIDs, are communicated to the CSSF (see Section 3.4.)
  - ▶ SRRI: the KIID must be updated when either of the following occurs:
    - ▶ Changes to the risk and reward section of the KIID are the result of a decision by the management company or self-managed UCITS regarding the investment policy or strategy of the UCITS
    - ▶ The relevant volatility of the UCITS has fallen outside the bucket corresponding to its previous risk category on each weekly or monthly data reference point over the preceding four months
- ▶ Other *ex-post* material changes: It is up to the board of directors of the investment company, or, in the case of common funds, the management company to define a frequency for identification of material changes. Thresholds and procedures need to be implemented to identify material changes in the composition of the charges and material changes to the ongoing charges
- ▶ Annual updates: The KIID must be updated annually. Updated KIIDs must be made available and distributed no later than 35 business days after 31 December

As a matter of good practice, management companies and UCITS may also choose to review the KIID before entering into any initiative that is likely to result in a significant number of new investors acquiring shares or units in the UCITS.

### 10.3.2.4. Distribution and publication of KIID

New and updated KIIDs need to be communicated to:

- ▶ The CSSF (see Sections 3.2., 3.3., and 10.9.)
- ▶ Each host Member State competent authority where the UCITS is registered for public distribution (the "written notice" - see Section 12.3.4.)

The KIID must be used without alterations or supplements, except translation, in all Member States where the UCITS is notified to be marketed to the public.

Communication of the KIID to investors and distributors is covered in Section 12.2.1.

An up-to-date version of the KIID must be made available on the website of the investment company or management company.

According to the CSSF KIID FAQ, the UCITS may rely on a third-party website, which is not the website of the UCITS or its management company, to make available its KIIDs, only when the third-party website allows unconditional access that fulfills the following principles:

- ▶ The internet address of the location where the KIID must be made available is disclosed in the prospectus and KIID
- ▶ Access to the KIID must be available to the general public (with no registration needed) and free of charge
- ▶ Public access to the KIID must not be restricted in time
- ▶ Public access to the KIID must be straightforward and dedicated to the UCITS
- ▶ When a UCITS publishes its KIIDs and other data and information on the internet, all information must be contained within one single website

### 10.3.2.5. Record-keeping

UCITS or their management companies are required to keep a record of certain information including, *inter alia*:

- ▶ The choice of a representative share or unit class
- ▶ Calculations (e.g., SRRI, simulated data for past performance, charges)

In practice, UCITS or their management companies may choose to keep records of much more of the KIID process from underlying data to KIID distribution.



### 10.3.2.6. Responsibility for KIID

The KIID constitutes pre-contractual information. The KIID must be drawn up and made available by the investment company or, in the case of common funds, the management company in accordance with the EU regulatory requirements concerning format, content and publication. The board of directors of the investment company or management company is accountable for the content of KIIDs. The investment company or management company may be held liable solely on the basis of any statement contained in the KIID (including any translation thereof) that is misleading, inaccurate or inconsistent with the relevant parts of the prospectus.

## 10.3.3. PRIIP Key Information Document (PRIIP KID)

### 10.3.3.1. Content and layout of the KID

The form, presentation and content of the sections of the KID has been laid down in Commission Regulation (EU) No 1286/2014 of 26 November 2014 on *key information documents for packaged retail and insurance-based investment product (PRIIPs)* following its amendment on 14 December 2016 by Regulation (EU) 2016/2340. The Regulation is supplemented by the Delegated Regulation (EU) 2017/653 of 8 March 2017 laying down regulatory technical standards (RTS) with regards to the presentation, content, review and revision of KIDs. After the acceptance of a revised PRIIPs RTS by ESMA and EBA in July 2020, EIOPA has also confirmed the acceptance of the new RTS as of 3 February 2021. The revised PRIIPs RTS has been submitted to the EU Commission for adoption and in December 2021, the EC and Parliament issued the following legal texts:

1. *Regulation (EU) 2021/2259 amending Regulation (EU) 1286/2014 with regard to the extension of the transitional arrangement for management companies, investment companies and persons advising on, or selling, units of UCITS and non-UCITS*
2. *Directive (EU) 2021/2261 amending Directive 2009/65/EC with regard to the use of key information documents by management companies of UCITS*
3. *Commission Delegated Regulation (EU) 2021/2268 amending the RTS laid out in the Commission Delegated Regulation (EU) 2017/653, with which UCITS will have to comply starting from 1 January 2023*

To ensure a smooth transition from UCITS KIIDs, the revised RTS implies a significant number of changes to the existing PRIIP KIDs, mainly:

- ▶ Change in the calculation model for unfavorable, favorable and moderate performance scenarios
- ▶ New historical data requirements of a minimum of ten years
- ▶ New benchmark requirements
- ▶ Change in the cost illustration following the recent consumer testing
- ▶ Past performance as per UCITS KIIDs to be disclosed on a website or on a separate document
- ▶ New website disclosure requirements for performance scenario calculation results

Additionally to the above, the narrative information provided in a PRIIP KID will be adapted to allow the transition so that UCITS can reuse UCITS KIIDs narratives for investment objectives, risk description and other relevant information.

The revised PRIIPs RTS also allow the production of one single PRIIP KID for the representative class of the UCITS.

The KID must be presented and laid out in a way that is easy to read. KID must be fair, clear, and not misleading. It must be brief and non-technical. It must be consistent with the relevant parts of the offering documents and with the terms and conditions of the PRIIP. It should be written in a concise manner and of maximum three sides of A4-sized paper, allowing for comparison and focus on key information that retail investors need and be presented in a way that is likely to be understood by retail investors.

The information contained in the document should be capable of being relied on by a retail investor when making an investment decision, even in the months and years following the initial preparation of the key information document, for those PRIIPs that remain available to retail investor. Standards should therefore be laid down to ensure timely and appropriate review and revision of key information document, so that those documents remain accurate, fair and clear.

The KID must at least include :

- ▶ Title
- ▶ Sections containing the following information:
  - A. Description of the purpose of the key information document with the required explanatory statement, *inter alia*, advising the client to read it in order to make an informed decision about whether to invest
  - B. "General Information" section containing:
    - ▶ Name of the PRIIP assigned by the PRIIP manufacturer and, where applicable, the PRIIP's identifier (e.g., ISIN of the fund/share class)
    - ▶ Identity and contact details of the PRIIP manufacturer, such as manufacturer specific website and telephone number, providing retail investors with information on how to get in contact with the PRIIP manufacturer
    - ▶ When the manufacturer forms part of a bigger group, the name of that group should be mentioned in the Product section of the KID
    - ▶ Name of the competent authority responsible for the supervision of the PRIIP manufacturer

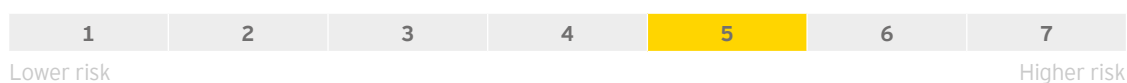
- ▶ The date of the document (the date of the production or, if the document has been recently revised, the date of the revision)
- ▶ A comprehension alert for complex PRIIPs
- ▶ With the entering into force of the new PRIIPs RTS, additional information would be disclosed in this section, such as the Member State in which the PRIIP is authorized. When the PRIIP takes the form of a UCITS or of an AIF, the Member State and National Competent Authority under which the management company or the AIFM are authorized should be disclosed

C. “What is this product” section describing the nature and main features of the PRIIP including, *inter alia*:

- ▶ Type of the PRIIP (description of legal form)
- ▶ Its objectives (markets, including where applicable specific environmental and social objectives targeted) and means for achieving them and, in particular, whether they are achieved with direct or indirect investments including underlying instruments. Additional information should be disclosed in the objectives according to the new PRIIPs RTS, when the PRIIP takes the form of a UCITS or an AIF, such as:
  - ▶ The main categories of eligible financial instruments, with specific indication where the UCITS or AIF invests in debt securities
  - ▶ The possibility for the investor to redeem units of the UCITS or AIF on demand
  - ▶ Any specific geographical focus of investments
  - ▶ Whether the UCITS or AIF allows for discretionary choices with respect to investments made
  - ▶ Information on distribution policy
- ▶ Description of the type of intended retail investor to whom the PRIIP is intended to be marketed. The MiFID II target market definition can be used as a reference to describe the various target market dimensions such as the recommended holding period/investment horizon or the ability to bear losses. Where the PRIIP takes the form of a UCITS or an AIF, the section “What is this product?” should contain information on the depositary entity, how to obtain further information about the UCITS or AIF, copies of the UCITS prospectus or copies of the description of the investment strategy and objectives of the AIF, the latest annual report and any half-yearly report of the UCITS, for every Member State in which the UCITS or AIF is marketed

D. “What are the risks and what could I get in return” section relating to the risk-reward profile of the PRIIP, consisting of all technical aspects for the methodology and the presentation of the summary risk indicator, as set out in Annex III and the methodology and format for the presentation of performance scenarios, as set out in Annex IV and V of the Regulation comprising, *inter alia*:

- ▶ The level of risk of the PRIIP in the form of a risk class by using a summary risk indicator having a numerical scale from 1 to 7



- ▶ A narrative explanation of that indicator, the main limitations of the indicator and a standard and free-text narrative presentation of the material risks that are not fully captured by the summary risk indicator. The narrative should include an indication of the possible maximum loss, information that the investment may be lost if it is not protected or where the PRIIP manufacturer is unable to pay out, that necessary additional investment payments to the initial investment may be required, and that the total loss may significantly exceed the total initial investment
- ▶ Appropriate performance scenarios, as set out in Annex V of the Regulation. These scenarios are built, in most cases, on historical data and are aimed at projecting future performance of the PRIIP. The performance scenarios are as follows:
  - ▶ Unfavorable scenario
  - ▶ Moderate scenario
  - ▶ Favorable scenario
  - ▶ Stress scenario

According to the new PRIIPs RTS, the calculation model has changed for unfavorable, moderate and favorable scenarios, while for the stress scenario the same Cornish-Fisher model is applicable for PRIIPs Category 2.

A minimum of data equal to the maximum between ten years and recommended holding period plus five years is introduced for the new model. In case the PRIIP does not have sufficient NAV history, new benchmark requirements are introduced in the new RTS when selecting the benchmark to backfill the missing NAV history.

The new model requires to calculate the historical performance of sub-intervals of the 10+ years' data sample and rank them from the best to the worst performing in order to determine the scenarios. The best, the median and the worst performing sub-intervals will determine the favorable, moderate and unfavorable scenario respectively.

- ▶ The four performance scenarios under the Regulation need to show a range of possible returns. Depending on the recommended holding period of the PRIIP, performance should be displayed at:
  - ▶ The end of the first year
  - ▶ The end of the recommended holding period
  - ▶ If applicable, after half of the recommended holding period rounded upwards

The new RTS introduces a layout change in the performance scenarios table. For PRIIPs with a recommended holding period lower than ten years, the intermediate holding period is no longer shown in the KID, only the values at the end of the first year of investment and at the end of the recommended holding period should be displayed.

- ▶ The performance should be shown in monetary units (including the relevant currency). In addition, performance should be presented in percentage terms, as the average annual rate of return on the investment. According to the new PRIIPs RTS, performance amounts should be rounded to the nearest EUR 10, while percentages should be rounded to the first decimal place
  - ▶ Standard narratives to describe the product/fund performance scenario presentation
- E. “What happens if (the name of the PRIIP manufacturer) is unable to pay out?” section containing information about whether the related loss is covered by an investor compensation or guarantee scheme and if so, which scheme it is, the name of the guarantor and which risks are covered and not covered by the scheme
- F. “What are the costs?” section describing the costs associated with an investment in the PRIIP, comprising both direct and indirect costs to be borne by the retail investor, including one-off and recurring costs presented by means of summary indicators of these costs and, to ensure comparability, total aggregate costs expressed in monetary and percentage terms, to show the compound effects of the total costs on the investment
- ▶ Costs over time are presented as an impact on return (Annual cost impact) per year in percentage terms. The Annual cost impact shows what impact the total costs paid will have on the investment return. The cost should be shown as a cumulative cost of the PRIIP. The figure should assume an investment of EUR 10,000 at:
    - ▶ The end of the first year
    - ▶ The end of the recommended holding period
    - ▶ If applicable, after half of the recommended holding period rounded upwards

Similar to the performance scenarios table, the new PRIIPs RTS require that the intermediate holding period values are not displayed on the cost over time table if the recommended holding period of the PRIIP is lower than ten years.

- ▶ A breakdown of the costs should be disclosed. The composition of costs should include the impact of costs in percentage terms each year, of the different types of costs on the investment return. In addition, the meaning of the different cost categories should be provided as follows:
  - ▶ One-off costs such as entry or exit costs borne by the retail investor, not deducted from the assets of the UCI, such as upfront subscription fees
  - ▶ Recurring costs
    - ▶ Portfolio transaction costs - the impact of the costs of buying and selling
    - ▶ Other recurring costs - the impact of the costs incurred in operations, *inter alia*, management company fees, depositary fees, professional fees
  - ▶ Incidental costs
    - ▶ Performance fees - the impact of the performance fee
    - ▶ Carried interest - the impact of carried interest

As a result of the recent consumer testing on PRIIP KIDs, the new RTS require the “Composition of costs” table to show values in monetary units at the end of the first year of investment. This will be a divergence point with the PRIIP KID for insurance-based investment products, where the values will continue to be shown as annualized percentages over the recommended holding period.

- G. “How long should I hold it and can I take money out early?” section describing:
- ▶ Where applicable, whether there is a cooling off period or cancellation period for the PRIIP
  - ▶ An indication of the recommended and, where applicable, required minimum holding period
  - ▶ The ability and conditions for any divestments before maturity or any other specified date other than the recommended holding period, including all applicable fees and penalties.
 

Information about potential consequences of cashing in before the end of the term of the recommended holding period such as the loss of capital protection or additional contingent fees
- H. “How can I complain?” section containing all the information about how and to whom a retail investor can make a complaint about the product, the conduct of the PRIIP manufacturer, or a person advising on, or selling, the product. A link to the relevant website for such complaints and an up-to-date postal address and email address to which such complaints may be submitted should also be included
- I. “Other relevant information” section describing any additional information documents that may be provided to the retail investor at the pre-contractual and/or post-contractual stage. The revised PRIIPs RTS introduces a requirement to disclose specific information separately from the PRIIP KID. A past performance graph as per the UCITS KIID (Section 10.3.2.1.) should either be disclosed in a separate document or on a website for PRIIPs taking the form of UCITS, AIFs or unit-linked vehicles, while for all PRIIPs Category 2 that are open-ended UCIs or open to subscriptions, previous performance scenario calculations should be published on a monthly basis on a website. The section “Other relevant information” should state where past performance and previously calculated performance scenarios can be found

### 10.3.3.2. Production of and responsibility for the KID

Since 1 January 2018, existing AIFs which utilized the CSSF's UCITS derogation (see Section 12.5.2.1.1.) currently ending in December 2022 and all new AIFs sold to retail investors (may also include informed investors) need to have a PRIIP KID as a pre-contractual document. As a result, investment companies need to identify which entity is the PRIIP manufacturer and hence must assume the responsibility for preparing, providing and publishing the KID for retail investors.

PRIIP KIDs need to be available for retail share classes of UCITS funds by 1 January 2023 according to the draft version of the new PRIIPs RTS. The industry needs to prepare for this production. Distributors will need the PRIIP KIDs well in advance. Regulators may also request KIDs in advance.

As the PRIIP manufacturer (investment company/management company) is held accountable for the content and accuracy of the KID, it may be held liable for a violation of the PRIIP Regulation where a retail investor suffers damage merely on the basis of any statement contained in the KID:

- That is misleading or inaccurate (also applying to translations of the content)
- That is inconsistent with the relevant parts of the prospectus
- That is not compliant with the prescribed format and content requirements of the KID

Each KID should be produced and updated by the PRIIP manufacturer.

The PRIIP KID needs to be provided as a pre-contractual document and therefore must be prepared and be available well in advance of any sale to a retail investor or to an intermediary distributing the PRIIP to retail investors.

### 10.3.3.3. Update of the KID

PRIIP manufacturers must establish and maintain adequate processes throughout the life of the PRIIP where it remains available to retail investors to identify without undue delay any circumstances which might result in a change that affects or is likely to affect the accuracy, fairness or clarity of the information contained in the KID.

PRIIP manufacturers must review the information contained in the key information document every time there is a change that significantly affects or is likely to significantly affect the information contained in the KID and, at least, every 12 months following the date of the initial publication of the KID.

The review must verify whether the information contained in the KID remains accurate, fair, clear, and non-misleading. In particular, it must verify the following:

- a) Whether the information contained in the KID is compliant with the general form and content requirements under the Regulation and Delegated Regulation
- b) Whether the PRIIP's market risk or credit risk measures have changed, where such a change has the combined effect that necessitates the PRIIP's move to a different class of the summary risk indicator from that attributed in the KID subject to review
- c) Whether the mean return for the PRIIP's moderate performance scenario, expressed as an annualized percentage return, has changed by more than five percentage points

### 10.3.3.4. Record-keeping for KID

PRIIP manufacturers or their management companies are required to keep a record of certain information including, *inter alia*, each published PRIIP KID for a period of ten years.

In practice, PRIIP manufacturers or their management companies may choose to keep records of much more of the PRIIPs process, such as underlying data used and calculations.

## 10.3.4. UK post-Brexit divergence on PRIIP Key Information Document (PRIIP KID)

In July 2021, the Financial Conduct Authority (FCA) issued a Consultation Paper (CP21/23) concerning PRIIPs - *Proposed scope rules and amendments to Regulatory Technical Standards* proposing the following amendments to the public:

1. Introduction of rules to clarify the scope of the PRIIPs Regulation in relation to corporate bonds, making it clearer that certain common features of these instruments do not make them qualify as PRIIPs
2. Introduction of interpretative guidance to clarify what it means for a PRIIP to be 'made available' to retail investors
3. Amendment to the PRIIPs RTS to:
  - a. Replace the performance scenarios calculation requirement with a requirement for narrative information on performance
  - b. Introduce the possibility to increase the SRI class for some PRIIPs
  - c. Address concerns on the slippage methodology to calculate transaction costs

This proposal resulted in the issuance of a new Policy Statement (PS22/2) on *PRIPs - Scope Rules and amendments to Regulatory Technical Standards* where the following amendments were confirmed:

1. Clarification of the scope of the PRIPs Regulation for corporate bonds, making it clearer that certain common features of these instruments do not make them into a PRIP
2. Clarification on what it means for a PRIP to be “made available” to retail investors
3. Changes in the summary risk indicator disclosure:
  - a. PRIPs issued by Venture Capital Trusts must be assigned a summary risk indicator of 6 or 7
  - b. When assessing the SRI with the calculation methodology prescribed by the Regulation, manufacturers must ensure that the assigned class is not lower than the actual risk of the PRIP by increasing the reported SRI if required
4. Changes in the performance scenarios disclosure:
  - a. Performance scenario results are removed from the PRIP KID
  - b. Instead, a narrative explanation of the drivers of investment performance is added, including as a minimum:
    - i. A description of the main factors likely to affect future returns for the investors
    - ii. Identification of the most relevant index, benchmark, target, or proxy along with an explanation of how the PRIP is likely to compare in terms of performance and volatility
    - iii. Under a sub-heading “what could affect my return positively?”, an explanation of the conditions that would be conducive to the PRIP generating higher returns
    - iv. Under a sub-heading “what could affect my return negatively?”, an explanation of the conditions that would be conducive to the PRIP generating lower returns or losses
    - v. A brief description of what outcome the investor may expect where the PRIP matures or is redeemed or encashed under severely adverse market conditions
5. Changes to the slippage methodology for calculating transaction costs primarily on:
  - a. How to calculate the costs associated with non-financial assets transactions
  - b. How to calculate the costs when a low number of trades is available
  - c. Possibility to use estimate methodology for UCITS or AIFs, as well as for insurance-based investment products investing in UCITS or AIFs, until 31 December 2029

A UCITS management company is exempt from the PRIPs Regulation until 31 December 2026. These firms should continue to publish a KIID until that date. This means that, in the context of Luxembourg UCITS distributed in the UK, a UCITS KIID should still be produced, alongside the PRIP KID, for marketing in the UK.

PS22/2 is applicable from 25 March 2022, however, firms are granted a transitional period which will end on 31 December 2022. By this date, firms must apply the new requirements when distributing and marketing PRIPs in the UK.

### 10.3.5. AIFs

The following information must be disclosed to investors before they invest in an AIF:

- ▶ A description of the investment strategy and objectives of the AIF
- ▶ Information on where any master AIF is established and where the underlying funds are established if the AIF is a fund of funds
- ▶ A description of the types of assets in which the AIF may invest
- ▶ The techniques it may employ and all associated risks (see Section 7.3.)
- ▶ Any applicable investment restrictions
- ▶ Leverage (see also Section 7.3.6.A.):
  - ▶ The circumstances in which the AIF may use leverage
  - ▶ The types and sources of leverage permitted and the associated risks
  - ▶ Any restrictions to the use of leverage and any collateral and asset reuse arrangements
  - ▶ Information on the maximum level of leverage that the AIFM may employ on behalf of the AIF

Where FDIs are used and benefit only specific share or unit classes (e.g., hedging, leverage), it is good practice to disclose leverage at share or unit class level, although there are no specific requirements on disclosures at share or unit class level.

- ▶ A description of the procedures by which the AIF may change its investment strategy or investment policy, or both
- ▶ A description of the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, on the applicable law, and on the existence or not of any legal instruments providing for the recognition and enforcement of judgments in the territory where the AIF is established
- ▶ The identity of the AIFM, the AIF's depositary, auditor and any other service providers and a description of their duties, and the investors' rights
- ▶ A description of how the AIFM is complying with the professional liability cover requirements (see Section 6.2.3.2.D.)
- ▶ A description of any delegated management function (see Section 6.3.3.) and of any safekeeping function delegated by the depositary (see Section 9.7.), the identification of the delegate and any conflicts of interest that may arise from such delegations (see also Section 9.8.)
- ▶ Information about any arrangement made by the depositary to contractually discharge itself of liability (see Section 9.7.4. and 10.4.2.5.)
- ▶ A description of the AIF's valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets (see Section 7.6.2.)
- ▶ A description of the AIF's liquidity risk management, including the redemption rights both in normal and in exceptional circumstances, and the existing redemption arrangements with investors (see Section 7.3.6.C.)
- ▶ A description of all fees, charges, and expenses and of the maximum amounts thereof that are directly or indirectly borne by investors (see Section 11.2.)
- ▶ A description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment, and, where relevant, their legal or economic links with the AIF or AIFM (see Section 6.4.2.)
- ▶ The latest annual report (see Section 10.5.2.)
- ▶ The procedure and conditions for the issue and sale of shares or units (see Section 8.8.)
- ▶ The latest net asset value of the AIF or the latest market price of the share or unit of the AIF
- ▶ Where available, the historical performance of the AIF
- ▶ Prime broker (see Section 6.3.5.2.):
  - ▶ Identity of the prime broker
  - ▶ A description of any material arrangements of the AIF with its prime brokers and the way the conflicts of interest in relation thereto are managed
  - ▶ The provision in the contract with the depositary on the possibility of transfer and reuse of AIF assets
  - ▶ Information about any transfer of liability to the prime broker that may exist
- ▶ A description of how and when the periodic disclosures on liquidity and the regular disclosures on leverage will be provided to investors (see Section 10.4.2.)

Where the AIF is required to publish a prospectus and not all of the aforementioned information is included in the prospectus, the additional information needs to be disclosed separately or as additional information in the prospectus.

Prospectuses of closed-ended AIFs whose shares/units are listed on the *Bourse de Luxembourg* are required to comply with the requirements of the Prospectus Regulation<sup>27</sup>. CSSF Circular 16/636 implemented ESMA's *Guidelines on Alternative Performance Measures*. These Guidelines aim at promoting the usefulness and transparency of Alternative Performance Measures (APMs) disclosed by issuers or the person responsible for the prospectus prepared in accordance with the Prospectus Regulation<sup>28</sup>.

Investors must also be informed of any material changes to the information provided to them. Any material changes to the information disclosed to investors before they invest and not already present in the financial statements must be disclosed in the report on the activities for the financial year (see Section 10.5.2.).

Regulation (EU) 2015/2365 on *transparency of securities financing transactions and of reuse* (SFTR) requires that disclosures by AIFMs, or internally managed AIFs, to investors specify the securities financing transactions (SFTs) and total return swaps which AIFMs, or internally managed AIFs, are authorized to use, and include a clear statement that those transactions and instruments are used.

The disclosures to investors must include the following data:

- ▶ General description of the SFTs and total return swaps used by the AIF and the rationale for use
- ▶ Overall data to be reported for each type of SFTs and total return swaps:
  - ▶ Types of assets that can be subject to them
  - ▶ Maximum proportion of assets under management that can be subject to them
  - ▶ Expected proportion of assets under management that will be subject to each of them
- ▶ Criteria used to select counterparties (including legal status, country of origin, minimum credit rating)
- ▶ Acceptable collateral: Description of acceptable collateral with regard to asset types, issuer, maturity, liquidity as well as the collateral diversification and correlation policies
- ▶ Collateral valuation: Description of the collateral valuation methodology used and its rationale, and whether daily mark-to-market and daily variation margins are used

<sup>27</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

<sup>28</sup> Idem.

- ▶ Risk management: Description of the risks linked to SFTs and total return swaps as well as risks linked to collateral management, such as operational, liquidity, counterparty, custody and legal risks and, where applicable, the risks arising from its reuse
- ▶ Specification of how assets subject to SFTs and total return swaps and collateral received are safe-kept (e.g., with the AIF custodian)
- ▶ Specification of any restrictions (regulatory or self-imposed) on the reuse of collateral
- ▶ Policy on sharing or return generated by SFTs and total return swaps: Description of the proportions of the revenue generated by SFTs and total return swaps that is returned to the AIF, and of the costs and fees assigned to the manager or third parties (e.g., the agent lender). The disclosures should also indicate if these are related parties to the manager

ESMA's *Guidelines on performance fees in UCITS and certain types of AIFs* include a certain number of disclosure requirements to be made to investors, see Section 10.3.1.F.

An AIF falls under the scope of the Benchmark Regulation<sup>29</sup> when an index is used to measure its performance with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees.

As per the Benchmark Regulation<sup>30</sup>, a prospectus issued under the Prospectus Regulation<sup>31</sup> or the UCITS Directive<sup>32</sup> should include clear and prominent information stating whether the benchmark is provided by an administrator included in the register referred to in Article 36 of the Benchmark Regulation.

In its *Questions and Answers on the Benchmarks Regulation*, ESMA considers that prospectuses should include reference to ESMA's register of administrators and benchmarks ("the register") as described in Section 10.3.1.N.

Regulation EU 2019/2088 on *sustainability-related disclosures in the financial services sector*, as amended, requires AIFMs to disclose to investors a description of the following:

- ▶ Transparency of the integration of sustainability risks
- ▶ Transparency of adverse sustainability impacts at financial product level
- ▶ Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures
- ▶ Transparency of sustainable investments in pre-contractual disclosures

Refer to Chapter 14 for the details of the required disclosures.

### 10.3.6. Offering document of SIFs

A SIF, or its management company, must establish an offering document. The offering document may be labeled as a private placement memorandum, offering memorandum, issuing document or prospectus, as the case may be. The document must include the information necessary for investors to be able to make an informed judgment of the investment proposed to them and, in particular, of the associated risks.

Generally, the offering document of a SIF contains most of the information required for 2010 Law UCIs (see Section 10.3.1.).

The offering document of a SIF should also provide details on how the principle of risk diversification will be implemented, including quantifiable investment limits.

The offering document should also list the delegated functions.

The essential elements of the offering document must be up-to-date when new shares or units are issued to new investors.

### 10.3.7. Offering documents of RAIFs

The offering document of a RAIF must include information necessary for investors to be able to make an informed judgment of the investment proposed to them and, in particular, of the risks attached thereto.

It must also contain a clearly visible statement on its cover page stating that the RAIF is not subject to supervision by a Luxembourg supervisory authority.

The essential elements of the offering document must be up-to-date when new shares or units are issued to new investors.

Information to be provided to investors of a RAIF is consistent with the requirements of the AIFM Law.

<sup>29</sup> Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, as amended.

<sup>30</sup> Idem.

<sup>31</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

<sup>32</sup> Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended.

## 10.3.8. EuVECAs and EuSEFs

The managers of qualifying European Venture Capital Funds (EuVECA) and of qualifying European Social Entrepreneurship Funds (EuSEFs) are, for each qualifying European fund they manage, required to provide investors before they invest with information in a clear and understandable manner, including:

- ▶ The identity of the manager and any other service providers and a description of their duties
- ▶ The amount of own funds of the manager and a detailed statement as to why the manager considers that amount to be sufficient for maintaining the adequate human and technical resources
- ▶ A description of the investment strategy and objectives of the qualifying European fund, including a description of the types of the qualifying portfolio undertakings, other qualifying European funds and non-qualifying investments in which the qualifying European fund intends to invest, the techniques it may employ, and any applicable investment restrictions
- ▶ In the case of EuSEFs:
  - (i) The positive social impact being targeted by the investment policy of the EuSEF, including where relevant, projections of such outcomes and information on past performance in this area
  - (ii) The methodologies to be used to measure social impacts
  - (iii) A description of the assets other than qualifying portfolio undertakings and the process and criteria that are used for selecting these assets (other than cash or cash equivalents)
- ▶ A description of the risk profile of the qualifying European fund and any risks associated with the assets in which the fund may invest or investment techniques that may be employed
- ▶ A description of the qualifying European fund's valuation procedure and pricing methodology for the valuation of assets
- ▶ A description of how the remuneration of the manager is calculated
- ▶ A description of all relevant costs and the maximum amounts thereof
- ▶ Where available, the historical performance
- ▶ The business support services and the other support activities the manager is providing or arranging in order to facilitate the development, growth or, in some other respect, the ongoing operations of the qualifying portfolio undertakings, or explanation of the fact that such services or activities are not provided
- ▶ A description of the procedures by which the qualifying European fund may change its investment strategy or investment policy, or both

The EuVECA and EuSEF regimes are introduced in Section 2.4.4.3.

## 10.3.9. ELTIFs

The prospectus of an ELTIF should include all information necessary to enable investors to make an informed assessment regarding the investment proposed to them and, in particular, the risks attached thereto.

The prospectus should contain at least the following:

- ▶ A statement setting out how the ELTIF's investment objectives and strategy for achieving the objectives qualify the fund as long-term in nature
- ▶ Information to be disclosed by closed-end UCIs in accordance with the Prospectus Regulation<sup>33</sup> and Commission Delegated Regulation (EU) 2020/1273<sup>34</sup>
- ▶ Information to be disclosed to investors required by Directive 2011/61/EU of the *European Parliament and of the Council with regard to regulatory technical standards determining types of alternative investment fund managers as supplemented by the Delegated Regulation (EU) 694/2014 of the European Commission*
- ▶ A prominent indication of the categories of assets in which the ELTIF is allowed to invest
- ▶ A prominent indication of the jurisdictions in which the ELTIF is allowed to invest
- ▶ Information about the illiquid nature of the ELTIF, in particular, clearly:
  - ▶ Informing investors about the long-term nature of the ELTIF's investments
  - ▶ Informing investors about the end of the life of the ELTIF as well as the option to extend the life, where provided for and conditions relating thereto
  - ▶ Stating whether the ELTIF is intended to be marketed to retail investors
  - ▶ Explaining the rights of investors to redeem
  - ▶ Stating the frequency and timing of distributions of proceeds, if any
  - ▶ Advising investors that only a small overall proportion of their overall investment portfolio should be invested in an ELTIF

<sup>33</sup> Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended.

<sup>34</sup> Commission Delegated Regulation (EU) 2020/1273 of 4 June 2020 amending and correcting Delegated Regulation (EU) 2019/980 supplementing Regulation (EU) 2017/1129 of the European Parliament and of the Council as regards the format, content, scrutiny and approval of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.



- ▶ Describing the hedging policy, including an indication that financial derivative instruments may only be used for hedging and the possible impact on the risk profile of the ELTIF as a result thereof
- ▶ Informing investors about the risks related to investing in real assets, including infrastructure
- ▶ Informing investors regularly, at least once a year, of the jurisdictions in which the ELTIF has invested
- ▶ The level of costs borne directly or indirectly by the investors, grouped using the headings of (i) costs of set up, (ii) costs related to the acquisition of assets, (iii) management and performance related fees, (iv) distribution costs and (v) other costs including administrative, regulatory, depositary, custodial, professional services and audit costs
- ▶ An overall ratio of the costs to the capital of the ELTIF
- ▶ Any other information requested by the competent authorities

Regulation EU 2019/2088 on *sustainability-related disclosures in the financial services sector*, as amended, requires AIFMs of ELTIFs to include in the ELTIF prospectus a description of the following:

- ▶ Transparency of the integration of sustainability risks
- ▶ Transparency of adverse sustainability impacts at financial product level
- ▶ Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures
- ▶ Transparency of sustainable investments in pre-contractual disclosures

Refer to Chapter 14 for the details of the required disclosures.

## 10.4. Periodic investor disclosures and updates

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The management company or investment company that has not appointed a management company may be required to periodically disclose information, including in relation to conflicts of interest, on the exercise of voting rights, and, in the case of AIF, on liquidity, leverage, and remuneration.

### 10.4.1. UCITS

#### 10.4.1.1. Conflicts of interest

Self-managed UCITS investment companies and UCITS management companies must inform investors about the situations where organization or administrative arrangements made by the management company or the investment company to manage conflicts of interest have not been sufficient to ensure, with reasonable confidence, that risks of damage to the interests of the UCITS it manages or its shareholders or unitholders will be prevented. Such information must be transmitted in a durable medium (see also Section 6.4.1.).

#### 10.4.1.2. Voting rights

A summary of the strategies for determining when and how voting rights attached to instruments held in the managed portfolios will be exercised to the exclusive benefit of the UCITS it manages has to be made available to investors, in particular, by way of a website. Details of the actions taken on the basis of those strategies have to be made available to investors upon request (see also Section 5.1.3.B.).

#### 10.4.1.3. Share classes

The CSSF's *Frequently Asked Questions concerning the Luxembourg Law of 17 December 2010* relating to undertakings for collective investment, stipulates that a notice to existing investors about the update of the prospectus is required if the update of the prospectus includes changes to the rights/interests of the investors.

### 10.4.2. AIFs

#### 10.4.2.1. Conflicts of interest

Where organizational arrangements made by AIFMs and internally managed AIFs in relation to conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to investors' interests will be prevented, AIFMs and internally managed AIFs must disclose information on the conflicts of interest to the investors. This disclosure must be provided in a durable medium or by means of a website, to investors before undertaking business on their behalf (see also Section 6.4.1. for SIFs, Section 2.4.2.3. and, for ELTIFs, see Section 2.4.5.).

### 10.4.2.2. Liquidity risk

AIFMs and internally managed AIFs are required to periodically disclose to investors:

- ▶ The percentage of the AIF's assets that are subject to special arrangements due to their illiquid nature, providing an overview of such special arrangements in place, including whether they relate to side pockets, gates or other similar arrangements, the valuation methodology applied to assets that are subject to such arrangements, and how management and performance fees apply to these assets
- ▶ The current risk profile of the AIF including:
  - (i) Measures to assess the sensitivity of the AIF's portfolio to the most relevant risks to which the AIF is or could be exposed
  - (ii) If risk limits set by the AIFM and internally managed AIF have been or are likely to be exceeded and where these risk limits have been exceeded, a description of the circumstances and the remedial measures taken
- ▶ The risk management systems employed by the AIFM outlining the main features of the risk management systems to manage the risks to which each AIF it manages is or may be exposed. In the case of a change, the disclosure shall include the information relating to the change and its anticipated impact on the AIF and its investors

This information must be provided as part of the AIF's periodic reporting to investors or at the same time as the prospectus or offering document and, as a minimum, at the same time as the annual report is made available.

AIFMs and internally managed AIFs are also required to:

- ▶ Notify investors of any material changes to liquidity management systems and procedures
- ▶ Immediately notify investors where they activate gates, side pockets or similar special arrangements or where they decide to suspend redemptions
- ▶ Provide an overview of any changes to liquidity arrangements, including special arrangements

See also Section 7.3.6.

### 10.4.2.3. Leverage

The following information must be disclosed to investors on a regular basis:

- ▶ The original and revised maximum level of leverage that the AIFM, on behalf of the AIF, or the internally managed AIF may employ, calculated according to the gross method and the commitment method
- ▶ The nature of the rights granted for the reuse of collateral
- ▶ The nature of any guarantees granted under the leveraging arrangement
- ▶ Details of any changes in service providers relating to one of the previous bullet points
- ▶ The total amount of leverage employed by that AIF

The information must be disclosed as part of the AIF's periodic reporting to investors, or at the same time as the prospectus or offering document and, at a minimum, at the same time as the annual report is made available.

Where FDIs are used and benefit only specific share or unit classes (e.g., hedging, leverage), it is good practice to disclose leverage at share or unit class level, although there are no specific requirements on disclosures at share or unit class level.

See also Section 7.3.6.

### 10.4.2.4. Voting rights

A summary description of the effective strategies for determining when and how any voting rights held in the AIF portfolios it manages will be exercised and details of the actions taken on the basis of those strategies must be made available to the investors on their request. See also Section 5.1.3.B.

### 10.4.2.5. Depository liability

The AIFM or internally managed AIF must inform investors of any changes with respect to depository liability without delay (see Section 9.6.).

## 10.4.3. Remuneration disclosures

A management company, self-managed UCITS or internally managed AIF should disclose relevant information on the remuneration policy and any updates in case of policy changes in a clear and easily understandable way to relevant stakeholders. Such disclosure may take the form of an independent remuneration policy statement, a periodic disclosure in annual financial statements or any other form.

The information disclosed should include:

- The decision-making process used for determining the remuneration policy
- Linkage between pay and performance
- The criteria used for performance measurement and the risk adjustment
- Performance criteria on which the entitlement to shares, options or variable components of remuneration are based
- The main parameters and rationale for any annual bonus scheme and any other non-cash benefits

Remuneration requirements are covered in Section 6.4.3.

UCITS annual report remuneration disclosures by UCITS management companies are covered in Section 10.5.1. and AIF annual report remuneration disclosures by AIFM are covered in Section 10.5.2.

## 10.4.4. SIFs

### 10.4.4.1. Conflicts of interest

Where the organizational and administrative arrangements made by a SIF to manage conflicts of interest are not sufficient to guarantee, with reasonable confidence, that risks of damage to the interests of the SIF or its investors will be prevented, the SIF is required to inform the investors of such conflicts of interest and explain the measures adopted by the SIF in relation to those conflicts of interest (see Section 2.4.2.3.). The information must be provided in a durable medium.

## 10.4.5. ELTIFs

An ELTIF is required to include in its periodical reports, the market value of its listed units or shares along with the NAV per unit or share.

Any material change to the value of an asset is also required to be disclosed in the periodical reports.

## 10.4.6 Money Market Funds

On 30 June 2017, Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on *money market funds* (MMF) was published in the Official Journal of the European Union. On 10 April 2018, Commission Delegated Regulation (EU) 2018/990 amended and supplemented Regulation (EU) 2017/1131. The Regulation, as amended, applies to all UCIs and compartments that qualify as MMFs as per the definition set out in Article 1 of the Regulation.

An MMF must indicate clearly which type of MMF it is in accordance with Article 3(1) of the Regulation, and whether it is a short-term or standard MMF in any external document, report, statement, advertisement, letter or any other written evidence issued by it or by the manager of the MMF, addressed to or intended for distribution to prospective investors, unitholders, or shareholders.

The manager of an MMF must, at least weekly, make all of the following information available to the MMF's investors:

- (a) The maturity breakdown of the portfolio of the MMF
- (b) The credit profile of the MMF
- (c) The Weighted Average Maturity (WAM) and Weighted Average Life (WAL) of the MMF
- (d) Details of the 10 largest holdings of the MMF, including the name, country, maturity and asset type, and the counterparty in the case of repurchase and reverse repurchase agreements
- (e) The total value of the assets of the MMF
- (f) The net yield of the MMF

The CSSF's *Frequently Asked Questions concerning Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds* clarify that:

- (a) to (f) above may be provided by means of a website indicated in the MMF's offering document
- The MMF or its manager may decide at its discretion the timing of the weekly disclosures
- The MMF or its manager should provide information relating to the internal credit quality assessment. This information may be complemented by external ratings provided by a registered and certified credit rating agency

Any document of an MMF used for marketing purposes shall clearly include all of the following statements:

- (a) That the MMF is not a guaranteed investment
- (b) That an investment in MMFs is different from an investment in deposits, with particular reference to the risk that the principal invested in an MMF is capable of fluctuation
- (c) That the MMF does not rely on external support for guaranteeing the liquidity of the MMF or stabilizing the NAV per unit or share
- (d) That the risk of loss of the principal is to be borne by the investor

No communication by the MMF or by the manager of an MMF to investors or potential investors shall in any way suggest that an investment in the units or shares of the MMF is guaranteed.

Investors in an MMF shall be clearly informed of the method or methods used by the MMF to value the assets of the MMF and calculate the NAV.

Public debt constant net asset value (CNAV) MMFs and low volatility net asset value (LVNAV) MMFs should explain clearly to investors and potential investors any use of the amortized cost method or of rounding or both.

## 10.5. Financial reporting

This section covers the financial reporting requirements for UCIs. The reporting requirements apply as follows:

- UCITS: The 2010 Law requirements
- 2010 Law Part II UCIs subject to full AIFM regime: The 2010 Law requirements and the AIF requirements
- 2010 Law Part II UCIs subject to simplified AIFM registration regime: The 2010 Law requirements
- SIFs subject to full AIFM regime: The SIF requirements and the AIF requirements
- SIFs subject to simplified AIFM registration regime: The SIF requirements
- ELTIFs
- RAIFs: The RAIF requirements and the AIF requirements

It also covers multiple compartment UCIs and audit requirements.

The CSSF expects that the financial statements of a UCI will be drawn up from:

- For an investment company - the date of incorporation
- For a common fund (FCP) - the date of constitution (which is not necessarily the date of launch of the UCI)

### 10.5.1. Annual report of 2010 Law UCIs

An annual report including the audited financial statements (often referred to as the short form report) is to be published:

- For UCITS: Within four months of the end of the period to which it relates
- For 2010 Law Part II UCIs: Within six months of the end of the period to which it relates or four months when the UCI is admitted to trading on a regulated market (see Section 13.4.1.)

The annual report must be communicated to the CSSF (see Section 10.9.). The annual report must also be available eight days prior to the annual general meeting of shareholders, where applicable.

The annual report must include information specified in Schedule B of Annex I to the 2010 Law, as amended, as well as any significant information which will enable investors to make an informed judgement on the development of the activities and the results of the UCI.

Schedule B of Annex I to the 2010 Law, as amended, includes:

- I. Statement of assets and liabilities:
  - Transferable securities
  - Bank balances
  - Other assets
  - Total assets
  - Liabilities
  - Net asset value (NAV)
- II. Number of shares or units in circulation
- III. NAV per share or unit
- IV. Portfolio, distinguishing between:
  - a) Transferable securities and money market instruments (MMIs) admitted to official stock exchange listing
  - b) Transferable securities and MMIs dealt in on another regulated market
  - c) Recently issued transferable securities and MMIs
  - d) Other transferable securities and MMIs (see Section 4.2.2.3.)

The portfolio should be analyzed in accordance with the most appropriate criteria in light of the investment policy of the UCI (e.g., in accordance with economic, geographical or currency criteria) as a percentage of net assets; for each of the above investments, the proportion it represents of the total net assets of the UCI should be stated.

Statement of changes in the composition of the portfolio during the reference period.

The CSSF may permit that this statement be omitted from the annual report, provided that it is made available free of charge to shareholders or unitholders and that this is clearly stated in the annual report.

- V. Statement of the developments (generally known as the “statement(s) of operations and changes in net assets”) concerning the assets of the UCI during the reference period including the following:
- Income from investments
  - Other income
  - Management charges
  - Depository’s charges
  - Other charges and taxes
  - Net income
  - Distributions and income reinvested
  - Increases or decreases of the capital account
  - Appreciation or depreciation of investments
  - Any other changes affecting the assets and liabilities of the UCI
  - Transaction costs

Transaction costs must be disclosed on a compartment basis.

Transaction costs are all costs incurred by a UCI in connection with investment transactions, including those charged by the depository for the execution of the UCI’s transactions.

Transaction costs may be disclosed either under a specific heading “transaction costs” in the statement of operations or in the notes to the financial statements.

- VI. A comparative table covering the last three financial years and including, for each financial year, at the end of the financial year:
- The total NAV
  - The NAV per share or unit
- VII. Details of FDI transactions and techniques and instruments employed, by category of transaction, carried out by the UCI during the reference period, and of the resulting amount of commitments (i.e., transactions within the meaning of Article 42 of the 2010 Law, as amended)

A statement of changes in the number of shares or units outstanding is also normally included. It is not required to disclose the individual and total cost of the investments. Comparative figures are also not, in practice, disclosed.

The Law of 10 May 2016 implementing UCITS V supplemented the 2010 Law annual report disclosure requirements to include:

- The total amount of remuneration for the financial year, split into fixed and variable remuneration paid by the management company and by the investment company to its staff, and the number of beneficiaries, and where relevant, any amount paid directly by the UCITS itself, including any performance fee
- The aggregate amount of remuneration broken down by categories of employees or other members of staff of the management company whose actions have a material impact on the risk profile of the UCITS
- A description of how the remuneration and benefits have been calculated
- The outcome of the reviews of the remuneration policy, including any irregularities that have occurred
- Material changes to the remuneration policy

ESMA’s *Questions and Answers on the Application of the UCITS Directive* indicate that the remuneration-related disclosure requirements under Article 69(3)(a) of the UCITS Directive<sup>35</sup> also apply to the staff of the delegate of a management company to whom investment management functions (including risk management) have been delegated.

Management companies can ensure compliance in one of the following two ways:

- (i) Where the delegate is subject to regulatory requirements on remuneration disclosure for its staff to whom investment management (including risk management) activities have been delegated that are equally as effective as those under Article 69(3)(a) of the UCITS Directive<sup>36</sup>, the management company should use the information disclosed by the delegate for the purposes of fulfilling its obligations under Article 69(3)(a) of the UCITS Directive<sup>37</sup>
- (ii) In other cases, appropriate contractual arrangements should be put in place with the delegate allowing the management company to receive (and disclose in the annual report for the relevant UCITS that it manages) at least information on the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the management company, the investment company and, where relevant the UCITS itself to the identified staff of the delegate – and number of beneficiaries, and, where relevant, performance fee – which is linked to the delegated portfolio. This means that the disclosure should be done on a prorated basis for the part of the UCITS’ assets which are managed by the identified staff within the delegate

In both situations set out above, the disclosure may be provided on an aggregate basis, i.e., by means of a total amount for all the delegates of the management company in relation to the relevant UCITS.

Where a UCITS invests a substantial proportion of its assets in other UCITS and/or other UCIs that are linked to the investing UCITS (see Section 4.2.2.8.1.III.(3)), the 2010 Law, as amended, requires disclosure of the maximum proportion of management fees charged both to the UCITS itself and to the UCITS and/or other UCIs in which it invests.

<sup>35</sup> Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended.

<sup>36</sup> Idem.

<sup>37</sup> Idem.

CSSF Circulars 14/592 and 13/559 implementing ESMA's *Guidelines on ETFs and other UCITS issues* require disclosure of the following information in the annual report of the UCITS:

- ▶ Efficient Portfolio Management (EPM) techniques:
  - (i) The exposure gained through EPM techniques
  - (ii) The identity of the counterparties to these EPM techniques
  - (iii) The type and amount of collateral received to reduce counterparty exposure
  - (iv) The revenues arising from EPM techniques for the entire reporting period together with the direct and indirect operational costs and fees incurred
- ▶ FDIs: UCITS entering into total return swaps (TRS) or similar derivative instruments:
  - (i) The underlying exposure obtained through FDIs
  - (ii) The identity of the counterparties to these FDI transactions
  - (iii) The type and amount of collateral received to reduce counterparty exposure
- ▶ Index-tracking UCITS: Size of the tracking error at the end of the period under review, explanation of any divergence between the anticipated and realized tracking error for the relevant period and an explanation of the annual tracking difference between the performance of the UCITS and the performance of the index tracked

According to CSSF Circular 08/356, where the UCI employs certain techniques and instruments relating to transferable securities and MMIs (see Section 4.2.2.6.), the annual report of the UCI must disclose the:

- ▶ Global valuation of securities lent at the year-end date
- ▶ Total amount of open transactions related to securities purchased with a repurchase option at the year-end date
- ▶ Total amount of open transactions related to securities sold with a repurchase option at the year-end date
- ▶ Total amount of open reverse repurchase agreements at the year-end date
- ▶ Total amount of open repurchase agreements at the year-end date

If cash collateral received has been reinvested, reinvestments must be specified, with their values given, in an appendix to the annual report of the UCI.

ESMA's *Revision of the provisions on diversification of collateral in ESMA's Guidelines on ETFs and other UCITS issues* requires that the UCITS' annual report should contain details of the following in the context of OTC FDI transactions and EPM techniques (see also Sections 4.2.2.8. and 4.2.2.10.):

- ▶ Where collateral received from an issuer has exceeded 20% of the NAV of the UCITS, the identity of that issuer
- ▶ Whether the UCITS has been fully collateralized in securities issued or guaranteed by a Member State

Section I of Chapter H of IML Circular 91/75, as amended, requires that the financial statements of a UCITS identify the securities that are the subject of an option and individually indicate the writing of call options on securities that are not held in the portfolio. The financial statements should also breakdown, by category of options, the aggregate of the exercise (strike) prices of options outstanding as at the year-end date.

Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on *the transparency of securities financing transactions and of reuse* (the SFT Regulation) requires the following disclosures to be made in the semi-annual and annual reports of UCITS:

#### *Global data*

- ▶ The amount of securities and commodities on loan as proportion of total lendable assets defined as excluding cash and cash equivalents
- ▶ The amount of assets engaged in each type of SFTs and total return swaps expressed as an absolute amount (in the base currency of the UCITS) and as a proportion of the UCITS' assets under management

#### *Concentration data*

- ▶ Ten largest collateral issuers across all SFTs and total return swaps (breakdown of volumes of the collateral securities and commodities received per issuer's name)
- ▶ Top 10 counterparties of each type of SFTs and total return swaps separately (name of counterparty and gross volume of outstanding transactions)

*Aggregate transaction data for each type of SFT and total return swap separately to be broken down according to the below categories*

- ▶ Type and quality of collateral
- ▶ Maturity tenor of the collateral broken down in the following maturity buckets: less than one day, one day to one week, one week to one month, one to three months, three months to one year, above one year, open maturity
- ▶ Currency of the collateral
- ▶ Maturity tenor of the SFTs and total return swaps broken down in the following maturity buckets: less than one day, one day to one week, one week to one month, one to three months, three months to one year, above one year, open transactions
- ▶ Country in which the counterparties are established
- ▶ Settlement and clearing (e.g., tri-party, central counterparty, bilateral)

#### *Data on reuse of collateral*

- ▶ Share of collateral received that is reused, compared to the maximum amount specified in the prospectus
- ▶ Cash collateral reinvestment returns to the UCITS\*

#### *Safekeeping of collateral received by the UCITS as part of SFTs and total return swaps*

- ▶ Number and names of custodians and the amount of collateral assets safe-kept by each of the custodians

#### *Safekeeping of collateral granted by the UCITS as part of SFTs and total return swaps*

- ▶ The proportion of collateral held in segregated accounts or in pooled accounts, or in any other accounts

#### *Data on return on cost for each type of SFTs and total return swaps*

- ▶ Broken down between the UCITS, the manager of the UCITS and third parties (e.g., agent lender) in absolute terms and as a percentage of overall returns generated by that type of SFT and total return swaps\*

ESMA's *Questions and Answers on the Application of the UCITS Directive* provides clarification on data to be reported under the SFT Regulation in the semi-annual and annual reports of UCITS. ESMA clarified that all items except those marked with an \* above should be reported on a snapshot basis. Items marked with an \* should be disclosed on an aggregate basis.

In the case of a UCITS master/feeder structure, in addition to the information provided for in Schedule B of Annex I to the 2010 Law, as amended, the annual report of the feeder UCITS must include a statement on the aggregate charges of the feeder UCITS and the master UCITS. The annual and semi-annual reports of the feeder UCITS must also indicate how the annual and the semi-annual reports of the master UCITS can be obtained.

In practice, the financial statements of a feeder UCITS should include the following:

- ▶ The position held by the feeder UCITS in the master UCITS, shown in the statement of investments of the feeder UCITS. The value of the master UCITS should be based on its NAV as of the year-end of the feeder UCITS
- ▶ Indication of where the annual report and semi-annual report of the master UCITS can be obtained. The language in which the annual report and semi-annual report of the master UCITS must be prepared must be a language commonly used in Luxembourg (English, French or German)
- ▶ A note covering the following information:
  - (i) General description of the master and feeder structure
  - (ii) The investment objective and policy of the master UCITS
  - (iii) The feeder UCITS percentage ownership share of the master UCITS at the year-end date of the feeder UCITS
- ▶ Aggregate charges disclosed in both of the following ways:
  - (i) Monetary terms (expressed in the fund currency of the feeder UCITS) by applying a look-through approach
  - (ii) By adding total charges expressed as a percentage of the average NAV of the master UCITS and feeder UCITS

If aggregate charges cannot be disclosed in monetary terms, as a transitional measure, the aggregate charges of the master UCITS and feeder UCITS may only be disclosed by adding total charges expressed as a percentage of their average NAVs.

Both aggregate charges disclosures must be given in the annual report. This information may be presented in the notes to the financial statements of the feeder UCITS or in a section providing other information.

The charges-related information regarding the master UCITS should be presented, in principle, for the same accounting period of the feeder UCITS. However, if this information cannot be obtained without undue costs, the information may be provided for the last audited period of the master UCITS, where all of the following conditions are met:

- ▶ Aggregate charges of the feeder UCITS and master UCITS are expressed in monetary terms and as a percentage of the average NAVs
- ▶ These main charges applicable for the master UCITS have not changed significantly since its last year-end (i.e., no change in the fee rates applicable to, for example, portfolio management, administration, depositary, distribution)
- ▶ There were no significant subscriptions/redemptions at the level of the master UCITS that could have a significant impact on the total of charges expressed in monetary terms and as a percentage of the average NAV due to dilution of fixed charges (charges not linked to the NAV such as audit fees and legal fees)
- ▶ It is clearly mentioned in the annual report that total charges of the master UCITS do not cover the entire financial period of the feeder UCITS

CSSF Circular 11/512, as amended, and ESMA's *Guidelines on risk measurement and the calculation of Global Exposure and Counterparty Risk for UCITS* require disclosure of the following information in the annual report of UCITS (see also Section 7.2.6.):

- ▶ The method used to calculate global exposure, making a distinction between the commitment approach, the relative VaR or the absolute VaR approach
- ▶ Information on the reference portfolio for UCITS using the relative VaR approach. CSSF Circular 11/512, as amended, provides further clarification on the content of the information to be disclosed
- ▶ The utilization of the VaR limit of the UCITS, where applicable. The information provided should at least include the lowest, the highest and the average utilization of the VaR limit calculated during the financial year; this is further clarified in CSSF Circular 11/512, as amended
- ▶ The VaR model and parameters used for calculation (confidence interval, holding period, length of data history), where applicable
- ▶ The level of leverage employed during the relevant period for UCITS using VaR approaches. CSSF Circular 11/512, as amended, provides further clarification on the disclosure of the expected level of leverage

CSSF *Communiqué 12/29* clarifies that, as regards the publication of leverage in the annual report, the CSSF considers that the leverage information to be included in the annual report must be based on the sum of notionals approach.

This information may be complemented with the leverage determined based on the commitment approach (provided that the underlying calculation method is clearly and precisely indicated for every mentioned figure) or with other additional information.

The annual report must be available to investors in the manner specified in the prospectus as well as in the KIID. A paper copy of the annual report must, in any case, be delivered to investors on request and free of charge. An abridged annual report (comprising a report on activities, independent auditor's report, statements of net assets, operations and changes in net assets) may also be prepared. Only the full annual report is required to be filed with the CSSF.

For UCIs marketing their shares or units in foreign countries, specific additional reporting requirements may have to be included in the annual report. Additional reporting requirements vary from one country to another (e.g., number of shares or units issued and redeemed, Total Expense Ratio (TER), performance of share or unit classes, portfolio turnover) and may in some cases have to be audited.

The annual report of a Luxembourg UCI admitted to trading on the *Bourse de Luxembourg* must be made public within four months of each financial year-end and comprise financial statements, the related audit report, a management report and a corporate governance statement.

UCIs admitted to the Euro MTF must make available to the public financial statements prepared in accordance with the UCI's national legislation, related audit report thereon, and management report (see also Section 13.4.1.).

Other disclosures to be made include:

- ▶ Period end exchange rates
- ▶ If mergers have occurred during the period (between compartments, with compartments of other entities), the merger share/unit exchange ratios should be disclosed
- ▶ Cross-investments (investing and investee compartments, amount invested, expressed as an absolute value and as a percentage of the NAV of the investing compartment)

ESMA's *Guidelines on performance fees in UCITS and certain types of AIFs* requires that the annual and semi-annual reports and any other *ex-post* information should indicate for each relevant share class the amount of performance fees and the percentage of the share class NAV they represent.

Regulation EU 2019/2088 on *sustainability-related disclosures in the financial services sector*, as amended, requires management companies of UCITS to describe transparency of the promotion of environmental or social characteristics and of sustainable investments in the annual report of the UCITS.

Refer to Chapter 14 for the details of the required disclosures.



### 10.5.1.1. Venture capital UCIs

In addition to the requirements described previously, the annual and semi-annual reports of venture capital UCIs must contain information on the development of the companies in which the UCI has invested and disclose separately the profit or loss on investments sold.

Specific instances where potential conflicts of interest could arise between the interests of a director of the portfolio management or advisory bodies and the interests of the UCI must be indicated in the financial statements.

### 10.5.1.2. Futures contracts and/or options UCIs

In addition to the requirements described previously, the annual and semi-annual reports of futures contracts and/or options UCIs must disclose the profit or loss for each category of closed contract.

Commissions paid to brokers and fees paid to the portfolio management and advisory bodies must be quantified in the financial statements.

### 10.5.1.3. Real estate UCIs

In addition to the requirements described previously, the independent auditor of a real estate UCI and its affiliated real estate companies, which are 50% or more funded by the UCI, must be the same.

The accounts of the UCI and its affiliated companies, which should in principle be drawn up at the same date, must be consolidated semi-annually, disclosing the accounting principles applied for the consolidation.

Minority unlisted shareholdings in real estate must be either partially consolidated at the year-end or valued based on the probable realizable value. The value of minority listed shareholdings in real estate companies should be based on the stock exchange value or market value.

The portfolio of properties in the annual and semi-annual reports must show, for each class of properties, the cost, insured value, and valuation. Properties must be shown at their valuation in the financial statements.

## 10.5.2. Annual report of AIFs

AIF are required to produce an annual report that must be made available to investors within six months of the end of the financial year or within four months when the AIF is admitted to trading on a regulated market (see Section 13.4.1.). The annual report must be made available to the competent authorities of the home Member State of the AIFM and, where applicable, the home Member State of the AIF.

The annual report of the AIF must at least contain a balance sheet or a statement of assets and liabilities, an income and expenditure account for the financial year, a report on the activities of the financial year, and any material changes in the disclosures to investors (see Section 10.3.3.) during the year, including the following elements and underlying line items:

I. Balance sheet or statement of assets and liabilities:

- Investments
- Cash and cash equivalents
- Receivables

Total assets

- Payables
- Borrowings
- Other liabilities

Total liabilities

Net assets

II. Income and expenditure account:

- |   |                                   |
|---|-----------------------------------|
| ▸ Investment income (dividend income, interest income, and rental income) | ▸ Unrealized gains on investments |
| ▸ Realized gains on investments   | ▸ Other income                    |

Total income

- |  |                                  |
|--|----------------------------------|
| ▸ Investment advisory or management fees | ▸ Realized loss on investments   |
| ▸ Other expenses                         | ▸ Unrealized loss on investments |

Total expenses

Net income or expenditure

The annual report of the AIF must also:

- ▶ Disclose the total amount of remuneration paid by the AIFM to its staff for the financial year, split into fixed and variable remuneration, number of beneficiaries, and, where relevant, carried interest paid by the AIF
- ▶ Disclose the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF
- ▶ State which of the following the total remuneration disclosure relates to:
  - (i) The total remuneration of the entire staff of the AIFM
  - (ii) The total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF
  - (iii) The proportion of the total remuneration of the staff of the AIFM attributable to the AIF
- ▶ Indicate the number of beneficiaries
- ▶ Include an allocation or breakdown in relation to each AIF, where the information is disclosed at the level of the AIFM
- ▶ Provide information on the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created, including the information necessary to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interest

ESMA's *Questions and Answers on the Application of the AIFMD* indicates that the remuneration-related disclosure requirements under Article 22(2)(e) of the AIFMD also apply to the staff of the delegate of an AIFM to whom portfolio management or risk management activities have been delegated. AIFMs can ensure compliance in one of the following two ways:

- (i) Where the delegate is subject to regulatory requirements on remuneration disclosure for its staff to whom portfolio management or risk management activities have been delegated that are equally as effective as those under Article 22(2)(e) of the AIFMD, the AIFM should use the information disclosed by the delegate for the purposes of fulfilling its obligations under Article 22(e) of the AIFMD and Article 107 of the AIFMD Level 2 Regulation; or
- (ii) In other cases, appropriate contractual arrangements should be put in place with the delegate allowing the AIFM to receive (and disclose in the annual report for the relevant AIF(s) that it manages) at least information on the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIF and/or the AIFM to the identified staff of the delegate - and number of beneficiaries, and, where relevant, carried interest - which is linked to the delegated portfolio. This means that the disclosure should be done on a prorated basis for the part of the AIF's assets which are managed by the identified staff within the delegate

In both situations set out above, the disclosure may be provided on an aggregate basis, i.e., by means of a total amount for all the delegates of the AIFM in relation to the relevant AIF.

- ▶ The information prescribed by Article 22(2)(e) and (f) of the AIFMD (quantitative information on remuneration) should be included in the annual report and cannot be disclosed in the annual report by the way of a link to a document where the relevant information is available

Periodic remuneration disclosures are covered in Section 10.4.3.

When an AIF acquires, individually or jointly, control over a non-listed company, the AIFM is required, *inter alia*, to either:

- ▶ Make the information in the annual report of the non-listed company available to the investors of each such AIF at the latest when the annual report of the non-listed company is made available
- ▶ Include in the annual report of each such AIF information relating to the relevant non-listed company

The requirements on acquisitions of major holdings and control over non-listed companies, including the minimum amount of information to be disclosed in the annual report of the non-listed company or of the AIF are covered in Section 4.6.

*Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on the transparency of securities financing transactions and of reuse* (the SFT Regulation) requires the following disclosures to be made in the annual reports of AIFs:

#### *Global data*

- ▶ The amount of securities and commodities on loan as proportion of total lendable assets defined as excluding cash and cash equivalents
- ▶ The amount of assets engaged in each type of SFTs and total return swaps expressed as an absolute amount (in the base currency of the AIF) and as a proportion of the AIF's assets under management

#### *Concentration data*

- ▶ Ten largest collateral issuers across all SFTs and total return swaps (breakdown of volumes of the collateral securities and commodities received per issuer's name)
- ▶ Top 10 counterparties of each type of SFTs and total return swaps separately (name of counterparty and gross volume of outstanding transactions)

Aggregate transaction data for each type of SFT and total return swap separately to be broken down according to the below categories

- Type and quality of collateral
- Maturity tenor of the collateral broken down in the following maturity buckets: less than one day, one day to one week, one week to one month, one to three months, three months to one year, above one year, open maturity
- Currency of the collateral
- Maturity tenor of the SFTs and total return swaps broken down in the following maturity buckets: less than one day, one day to one week, one week to one month, one to three months, three months to one year, above one year, open transactions
- Country in which the counterparties are established
- Settlement and clearing (e.g., tri-party, central counterparty, bilateral)

Data on reuse of collateral

- Share of collateral received that is reused, compared to the maximum amount specified in the disclosures to investors
- Cash collateral reinvestment returns to the AIF\*

Safekeeping of collateral received by the AIF as part of SFTs and total return swaps

- Number and names of custodians and the amount of collateral assets safe-kept by each of the custodians

Safekeeping of collateral granted by the AIF as part of SFTs and total return swaps

- The proportion of collateral held in segregated accounts or in pooled accounts, or in any other accounts

Data on return on cost for each type of SFTs and total return swaps

- Broken down between the AIF, the manager of the AIF and third parties (e.g., agent lender) in absolute terms and as a percentage of overall returns generated by that type of SFT and total return swap\*

ESMA's *Questions and Answers on the Application of the AIFMD* provides clarification on data to be reported under the SFT Regulation in the annual reports of AIFs. ESMA clarified that all items except those marked with an \* above should be reported on a snapshot basis. Items marked with an \* should be disclosed on an aggregate basis.

A 2010 Law Part II UCI must also include the information specified in Schedule B of Annex 1 to the 2010 Law, as amended, (see Section 10.5.1.). A SIF must also include the information specified in the Annex to the SIF Law<sup>38</sup> (see Section 10.5.3.). A RAIF must also include the information specified in the Annex to the RAIF Law<sup>39</sup> (see Section 10.5.6.).

Where the AIF is required to make public an annual report in accordance with the Transparency Directive<sup>40</sup>, only additional information must be provided to investors on request. This information must be provided either separately or as an additional part of the annual report. In the latter case, the annual report must be made public no later than four months following the end of the financial year to which it refers.

The layout, nomenclature, and terminology of line items must be consistent with the accounting standards applicable to or the rules adopted by the AIF and must comply with legislation applicable where the AIF is established. Such line items may be amended or extended to ensure compliance with the above.

The report on the activities to be included in the annual report of the AIF must contain at least an overview of investment activities, an overview of the AIF's portfolio at year-end or period-end, AIF performance over the year or period, a description of the principal risks and investment or economic uncertainties that the AIF might face, and any material changes to the information disclosed to investors.

The information in the report on the activities of the AIF shall form part of the directors or investment managers' report.

Any changes in the disclosures to investors (see Section 10.3.3.) are deemed material if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, *inter alia*, because such information could impact an investor's ability to exercise its rights in relation to its investment or otherwise prejudice the interests of one or more investors in the AIF.

ESMA's *Guidelines on performance fees in UCITS and certain types of AIFs* require that the annual and semi-annual reports and any other *ex-post* information should indicate for each relevant share class the amount of performance fees and the percentage of the share class NAV they represent.

Regulation EU 2019/2088 on *sustainability-related disclosures in the financial services sector*, as amended, requires AIFMs to describe transparency of the promotion of environmental or social characteristics and of sustainable investments in the annual report of the AIF.

Refer to Chapter 14 for the details of the required disclosures.

<sup>38</sup> Law of 13 February 2007, as amended.

<sup>39</sup> Law of 23 July 2016, as amended.

<sup>40</sup> Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, as amended (the Transparency Directive - see also Chapter 13).

### 10.5.3. Annual report of SIFs

SIFs are required to produce an annual report that must be made available to investors within six months of the end of the financial year or within four months for closed-ended funds admitted to trading on the Luxembourg Stock Exchange's (LuxSE) regulated market (see Section 13.4.1.). The annual report of a SIF must also be communicated to the CSSF (see Section 10.9.).

SIFs that are managed by authorized AIFM as well as internally managed SIFs subject to AIFM Law (see Chapter 6) are subject to AIF reporting requirements (see Section 10.5.2.); they are not subject to the following SIF Law-specific reporting requirements.

The annual report must include a report on the SIF's activities, a statement of assets and liabilities, a detailed income and expenditure account, and the information specified in the Annex to the SIF Law<sup>41</sup>, which is set out below.

- I. Statement of assets and liabilities:
  - Investments
  - Bank balances
  - Other assets
  - Total assets
  - Liabilities
  - NAV
- II. Number of shares or units in circulation
- III. NAV per share or unit
- IV. Quantitative and/or qualitative information on the investment portfolio enabling investors to make an informed judgment on the development of the activities and the results of the SIF
- V. Statement of the developments (generally known as the "statement(s) of operations and changes in net assets") concerning the assets of the SIF during the reference period including the following:
  - Income from investments
  - Other income
  - Management charges
  - Depository's charges
  - Other charges and taxes
  - Net income
  - Distributions and income reinvested
  - Increase or decrease of capital accounts
  - Appreciation or depreciation of investments
  - Any other changes affecting the assets and liabilities of the SIF
- VI. A comparative table covering the last three financial years and including, for each financial year, at the end of the financial year:
  - The total NAV
  - The NAV per share or unit

A statement of changes in the number of shares or units outstanding is also normally included. It is not required to disclose the cost of the investments. Comparative figures are also not in practice disclosed.

It is not necessary to disclose details of the portfolio, though sufficient quantitative and/or qualitative information for investors to make an informed judgment on the development of the activities and the results of the SIF should be provided.

SIFs and their subsidiaries are exempt from the obligation under Luxembourg legal and regulatory requirements of consolidating the companies owned for investment purposes.

The annual report of a closed-ended SIF admitted to trading on an EU regulated market must include a management report and a responsibility statement (see Section 13.4.1.).

### 10.5.4. Annual report of EuVECAs and EuSEFs

The managers of qualifying European Venture Capital Funds (EuVECA) and of qualifying European Social Entrepreneurship Funds (EuSEFs) are, for each qualifying European fund they manage, required to make its audited annual report available to the competent authority no later than six months after the end of the financial year and to make it available to investors on request. The report must describe the composition of the portfolio of the qualifying European fund and the activities for the year. Therefore the annual report of a EuSEF must at least include:

- Details of the overall social outcomes achieved by the investment policy and the method used to measure these outcomes
- A statement of any divestments related to qualifying portfolio undertakings
- A description of whether divestments in relation to the other assets of the EuSEF that are not invested into qualifying portfolio undertakings occurred on the basis of processes and criteria that are used for selecting such assets and that were disclosed to investors
- A summary of the activities the EuSEF has undertaken in relation to the qualifying portfolio undertakings in terms of business support services and other support activities
- Information on the nature and purpose of the investments other than qualifying portfolio undertakings

The EuVECA and EuSEF regimes are introduced in Section 2.4.4.3.

<sup>41</sup> | Law of 13 February 2007, as amended.

## 10.5.5. Annual report of ELTIFs

The annual report of an ELTIF should specifically contain the following:

- ▶ A cash flow statement
- ▶ Information on any participation in instruments involving European Union budgetary funds
- ▶ Information on the value of the individual qualifying portfolio undertakings (see Section 2.4.4.) and the value of other assets in which the ELTIF has invested, including the value of financial derivative instruments used
- ▶ Information on the jurisdictions in which the assets of the ELTIF are located

## 10.5.6. Annual report of RAIFs

The annual report must include the information specified in the Annex to the RAIF Law<sup>42</sup>, which is set out below.

### I. Statement of assets and liabilities:

- |                 |                   |
|-----------------|-------------------|
| ▶ Investments   | ▶ Total assets    |
| ▶ Bank balances | ▶ Liabilities     |
| ▶ Other assets  | ▶ Net asset value |

### II. Number of shares or units in circulation

### III. NAV per share or unit

### IV. Quantitative and/or qualitative information on the investment portfolio enabling investors to make an informed judgment on the development of the activities and the results of the RAIF

### V. Statement of the developments (generally known as the statement(s) of operations and changes in net assets) concerning the assets of the RAIF during the reference period including the following:

- |                           |  |
|---------------------------|--|
| ▶ Income from investments | ▶ Distributions and income reinvested                                |
| ▶ Other income            | ▶ Increase or decrease of capital accounts                           |
| ▶ Management charges      | ▶ Appreciation or depreciation of investments                        |
| ▶ Depositary's charges    | ▶ Any other changes affecting the assets and liabilities of the RAIF |
| ▶ Other charges and taxes |  |
| ▶ Net income              |  |

### VI. A comparative table covering the last three financial years and including, for each financial year, at the end of the financial year:

- ▶ The total NAV
- ▶ The NAV per share or unit

The above requirements from the Annex to the RAIF Law are not applicable to RAIFs which provide in their constitutive documents that their exclusive object is the investment of their funds in assets representing risk capital. Investment in risk capital means the direct or indirect contribution of assets to entities in view of their launch, development or listing on a stock exchange.

As per the Q&A CNC 19/018 of the Commission des Normes Comptables, RAIFs investing in risk capital have the choice to present their annual accounts either following the standard chart of accounts as defined in the Grand-Ducal Regulation of 12 September 2019 or following the format defined in the Appendix to the RAIF Law<sup>43</sup> entitled *Information to be included in the annual report of reserved alternative investment funds other than those subject to Article 48* ("RAIF Law Appendix"). RAIFs and their subsidiaries are exempt from the obligation to consolidate the companies owned for investment purposes.

In addition to being submitted to the Trade Register (see Section 10.7.), annual reports of RAIFs must be sent to the CSSF by the AIFM.

### 10.5.6.1 Annual report of RAIFs with multiple sub-funds

According to Article 49(1) of the RAIF Law<sup>44</sup>, RAIFs may also be constituted with multiple compartments, each sub-fund corresponding to a distinct part of the assets and liabilities of the RAIF.

The RAIF Law does not require the presentation of individual financial statements for each compartment. However, the annual report must include *"any significant information enabling investors to make an informed judgement on the development of the activities and of the results of the RAIF"*.

Consequently, although detailed individual financial statements for each compartment are not explicitly required in the statutory accounts of RAIFs, a sufficient level of information for each compartment, in accordance with the RAIF Law Appendix, should be included in the annual report of the umbrella RAIF.

<sup>42</sup> Law of 23 July 2016, as amended.

<sup>43</sup> Idem.

<sup>44</sup> Idem.

Generally, such information relating to each compartment is presented in a note to the financial statements. However, a multi-column presentation covering each compartment of the statement of net assets and the statement of changes in net assets could also be appropriate.

A separate report may be also established for each or several of the compartments provided it contains, in addition to the information on the compartment(s) concerned, the combined results of all compartments.

### 10.5.6.2 Specific report for RAIFs investing in risk capital

As per the RAIF Law<sup>45</sup>, for a RAIF whose exclusive object is the investment of its funds in assets representing risk capital (direct or indirect contribution of assets to entities in view of their launch, development or listing on a stock exchange), the independent auditor of such RAIF must issue for each financial year a report certifying that, during the past financial year, the RAIF has complied with the policy of investing in risk capital. This report must be transmitted to the Direct Tax Administration (“*Administration des Contributions Directes*”).

## 10.5.7. Semi-annual report of UCIs

For a 2010 Law UCI, an unaudited semi-annual report is to be published (and communicated to the CSSF – see Section 10.1.1.):

- ▶ For UCITS: Within two months of the end of the period to which it relates
- ▶ For Part II UCIs: Within three months of the end of the period to which it relates
- ▶ The semi-annual report must disclose at least the information specified in Sections 10.5.1. I - IV. A statement of income and expenditure is not obligatory

See also Sections 10.5.1.1. to 10.5.1.3. for additional disclosure requirements for specific types of 2010 Law Part II UCIs.

CSSF Circulars 14/592 and 13/559 implementing ESMA's *Guidelines on ETFs and other UCITS issues* require disclosure of the size of the tracking error in the semi-annual report of index-tracking UCITS.

There is no requirement to produce a semi-annual report for SIFs, except for closed-ended SIFs admitted to trading on a regulated market or other trading venue, such as the *Bourse de Luxembourg* or Euro MTF (see also Section 13.4.1.).

The semi-annual report of UCITS also needs to include the disclosures required by the SFT Regulation, as described in Sections 10.5.1. and 10.5.2.

ESMA's *Guidelines on performance fees in UCITS and certain types of AIFs* require that the annual and semi-annual reports and any other *ex-post* information should indicate for each relevant share class the amount of performance fees and the percentage of the share class NAV they represent.

## 10.5.8. Interim management statement of UCIs

An interim management statement must be published for closed-ended UCIs admitted to trading on an EU-regulated market, such as the *Bourse de Luxembourg* (see Section 13.4.1.).

## 10.5.9. Multiple compartment UCIs

In the case of multiple compartment UCIs, all the annual and semi-annual information outlined in Sections 10.5.1. to 10.5.9., where applicable, is required for each compartment. Each compartment may be denominated in different currencies. Combined figures of the financial statements are required to be shown in the currency of the UCI. The notes to the financial statements and semi-annual financial statements (if any) should include the exchange rates between the currency of the combined figures and the currencies of the various compartments.

In addition to the full report, multiple compartment UCIs may provide for the publication of separate financial reports for each of their compartments. Such reports must include either the independent auditor's report or a separate audit report for each compartment.

## 10.5.10. Audit

### 10.5.10.1. General rules

The audit requirements and auditors' responsibilities are covered in Article 154 of the 2010 Law, Article 55 of the SIF Law, Article 20 of the AIFM Law, Article 43 of the RAIF Law and CSSF Circulars 02/77 (on NAV calculation errors and compensation of losses arising from non-compliance with applicable investment restrictions), 21/788 (on the CSSF AML/CFT external report) and 21/790 (on the management letter and the separate report). Auditors are bound by the obligation of professional secrecy.

<sup>45</sup> | *Idem.*

The financial statements included in the annual report must be audited by a Luxembourg independent auditor (*réviseur d'entreprises agréé*), that is approved by the CSSF in accordance with the amended Law of 23 July 2016 on the audit profession and that is also suitably qualified in terms of relevant experience. The audit is conducted in accordance with International Standards on Auditing (ISAs), as adopted for Luxembourg by the CSSF. The audit report is to be reproduced in full in each annual report.

Except for RAIFs which are not under the supervision of the CSSF, the independent auditor must report promptly to the CSSF where information provided to investors or the CSSF does not truly describe the financial situation and any fact or decision, which he has become aware of during the audit of a UCI, that is liable to:

- ▶ Constitute a substantial breach of the Law or regulations
- ▶ Affect the continuous functioning of the UCI
- ▶ Lead to a refusal to certify the accounts or to the expression of qualifications thereon

Following CSSF Circular 21/790, for every audit report drawn up by the independent auditor that includes a modified audit opinion at the level of one or more compartments of a 2010 Law UCI, SIF or SICAR and/or of the 2010 Law UCI, SIF or SICAR as a whole, the 2010 Law UCI's, SIF's or SICAR's *dirigeants*<sup>46</sup> must send a letter to the CSSF, without having been expressly required to do so by the latter, explaining the underlying reasons for the modified audit opinion, its impact on the 2010 Law UCI, SIF or SICAR and its investors as well as the corrective measures, including the timeline for their implementation, taken by the *dirigeants*.

A modified audit opinion refers to qualified opinions, adverse opinions and disclaimer opinions. Emphasis of matter paragraphs and information paragraphs are not concerned by this requirement.

The above-mentioned letter must be validated by the independent auditor and subsequently submitted to the CSSF within one month after the publication of the annual report.

The CSSF may determine rules regarding the scope of the audit and the independent auditor's report and may request auditors to carry out special audits.

In accordance with Article 52(5)b) of the amended Law of 23 July 2016 on the audit profession, Luxembourg UCITS and AIFs are exempt from the requirement to establish an audit committee.

The independent auditor must also intervene and has certain reporting requirements in the case of NAV calculation errors and compensation of losses arising from non-compliance with applicable investment restrictions (see Sections 8.9.2.3.4. and 8.9.3.).

The 2010 Law, as amended, requires that if a master UCITS and a feeder UCITS have different auditors, the auditors should enter into information-sharing agreements in order to ensure the fulfillment of their duties (see also Section 2.3.4.1.).

In kind subscriptions and, in some cases, in kind redemptions (see Sections 8.8. and 3.9.3.), fund mergers (see Section 3.7.), and liquidations (see Section 3.10.) may also require reporting by the independent auditor.

For 2010 Law UCIs and SIFs, the independent auditor will express an opinion covering the financial statements of the UCI and each of its compartments. For RAIFs, the independent auditor will either express an opinion on the financial statements of the RAIF or on the RAIF and each of its compartments.

### 10.5.10.2. Management letter

Following CSSF Circular 21/790, the independent auditor must draw up a management letter for each year or period subject to a statutory audit to the attention of the *dirigeants* of a 2010 Law UCI, SIF or SICAR.

Once finalized by the independent auditor, the *dirigeants* of the 2010 Law UCI, SIF or SICAR must submit the management letter to the CSSF via the eDesk portal.

The management letter must include, at least, the following findings:

- ▶ An important weakness or a point needing improvement communicated to whom it concerns in accordance with:
  - ▶ ISA 260 "Communication with those charged with governance"
  - ▶ ISA 265 "Communicating deficiencies in internal control to those charged with governance and management"
- ▶ Any other weakness or point needing improvement which, based on the professional judgement of the independent auditor, is of sufficient importance to be brought to the attention of the *dirigeants* of the 2010 Law UCI, SIF or SICAR or the CSSF

<sup>46</sup> With respect to 2010 Law UCIs, the term "*dirigeants*" in the context of CSSF Circular 21/790 means those persons, who under law or the instruments of incorporation represent the UCI or the depositary or who effectively determine the conduct of the activity of the UCI. With respect to SIFs, "*dirigeants*" refers to "directors", meaning, in the case of public limited companies and in the case of cooperatives in the form of a public limited company, the members of the board of directors, "in the case of partnerships limited by shares, the managing general partner(s), in case of limited partnerships and special limited partnerships, the manager(s) whether or not it (they) is (are) general partner(s)," in the case of limited companies, the manager(s) and in the case of common funds, the members of the board of directors or the managers of the management company. In the case of SICARs, "*dirigeants*" refers to the directors who are, in the case of "partnerships limited by shares, the managing general partner(s), in case of limited partnerships and special limited partnerships, the manager(s) whether or not it (they) is (are) general partner(s)" and in the case of public limited companies and limited companies, the members of the board of directors and the manager(s), respectively.

The management letter must also include the follow-up of the weaknesses or points needing improvement raised in the management letters issued in preceding financial years and that have not been “closed” in the previous management letter.

Every weakness or point needing improvement raised by the independent auditor must be linked to a topic selected from a list of subjects predefined by the CSSF, included in the management letter form available on the eDesk portal. The independent auditor must also provide additional information by responding to a questionnaire, included in the same management letter form, in order to allow the CSSF to determine the risk level for each weakness or point of improvement. This risk level will be taken into account in the prudential supervisory approach of the CSSF for 2010 Law UCIs, SIFs and SICARs.

Moreover, every weakness or point needing improvement must be accompanied by the comments of the 2010 Law UCI's, SIF's or SICAR's *dirigeants*, which must mandatorily include, *inter alia*, the following information:

- ▶ A detailed explanation of the reasons and circumstances related to the occurrence of the weakness or point needing improvement raised by the independent auditor
- ▶ A detailed explanation of the measures taken or decided in order to remedy the weakness or point needing improvement and to prevent their recurrence in the future. These measures must be accompanied by a detailed remediation plan with a related timetable

If the 2010 Law UCI's, SIF's or SICAR's *dirigeants* do not remedy the weaknesses or points needing improvement raised by the independent auditor in the management letter in a timely manner and within a reasonable time frame, the independent auditor will issue this management letter specifying that no comments have been received by the 2010 Law UCI's, SIF's or SICAR's *dirigeants* on the weaknesses or points raised.

Where the independent auditor did not identify any issue to be included in the management letter, the independent auditor should still validate the form “management letter” via the eDesk portal, specifying that no issue has been raised by using the specific field provided for that purpose in the form (i.e., “No comment ML”).

The management letter must be submitted to the CSSF by the 2010 Law UCI's, SIF's or SICAR's *dirigeants* within four months after the end of the UCITS' financial year and six months after the end of the financial year for 2010 Law Part II UCIs, SIFs and SICARs.

### 10.5.10.3. Self-assessment questionnaire and separate report

CSSF Circular 21/790 also introduced for 2010 Law UCIs, SIFs and SICARs the requirement for the UCI to complete a self-assessment questionnaire subsequent to which the independent auditor should complete a separate report, replacing the “long form report” for financial periods ended on or after 30 June 2022.

#### 10.5.10.3.1 Self-assessment questionnaire

Following CSSF Circular 21/790, a self-assessment questionnaire has to be completed by 2010 Law UCIs, SIFs and SICARs for each year or period in respect of which a statutory audit was carried out.

The self-assessment questionnaire includes questions on predefined topics and takes into account the characteristics of the different types of 2010 Law UCIs, SIFs or SICARs concerned as well as the risks associated with them (e.g., valuation, investment compliance, NAV determination, expenses and income, relationship with the depositary). Its main purpose is to request 2010 Law UCIs, SIFs and SICARs to perform a self-assessment of their compliance with the legal and regulatory requirements.

The 2010 Law UCI's, SIF's and SICAR's *dirigeants* are responsible for the content of the self-assessment questionnaire. For the purpose of filling out the self-assessment questionnaire, the *dirigeants* must put in place adequate organizational processes within the 2010 Law UCI, SIF or SICAR to allow the retrieval of any information needed from the service providers (e.g., the investment fund manager) to provide answers to different questions.

Before submitting the self-assessment questionnaire to the CSSF, the 2010 Law UCI's, SIF's or SICAR's *dirigeants* must review and validate its content.

The self-assessment questionnaire must be submitted to the CSSF within three months after the end of the UCITS' financial year and four months after the end of the financial year for 2010 Law Part II UCIs, SIFs and SICARs.

In case of deregistration of the 2010 Law UCI, SIF or SICAR from the official list, the self-assessment questionnaire covering the period from the last year-end to the date of deregistration is required, in principle, within the same time frames of three months for UCITS and four months for the other types of UCIs.

In a press release published on 22 July 2022, the CSSF provided additional clarifications for the completion/submission of reports of UCIs foreseen by CSSF Circular 21/790 with regard to:

- ▶ Responsibilities of the *dirigeants* and support from service providers
- ▶ Organization of the operational process for the completion of the self-assessment questionnaire and the submission of the reports to the CSSF
- ▶ Access of authorized user(s) to the reports of regulated UCIs in the Collective Investment Sector Reporting Tool (CISERO) module on the CSSF eDesk platform



### 10.5.10.3.2 Separate report

Following CSSF Circular 21/790, a separate report has to be completed by the independent auditor of 2010 Law UCIs, SIFs and SICARs, for each year or period for which a self-assessment questionnaire has been submitted by the 2010 Law UCI, SIF or SICAR. The purpose of this report, which must be filled in via the eDesk portal, is notably to ensure the reliability of the answers provided by the 2010 Law UCI, SIF or SICAR in the self-assessment questionnaire and to provide answers to a set of questions determined by the CSSF.

The drawing-up of a separate report consists of a set of procedures defined by the CSSF to be implemented by the independent auditor, broken down into predefined topics, being valuation, investment compliance, NAV determination, expenses and income, relationship with the depositary and disclosures in the annual report.

These procedures are directly indicated in the separate report.

The results of these procedures are documented in the separate report in the form of answers to a set of mainly closed-ended questions and they do not result in an opinion in accordance with auditing, insurance or any related services standards.

The separate report must be validated by the independent auditor and subsequently submitted by the 2010 Law UCI's, SIF's or SICAR's *dirigeants* to the CSSF within five months after the end of the UCITS' financial year and six months after the end of the financial year for 2010 Law Part II UCIs, SIFs and SICARs.

In case of deregistration of the 2010 Law UCI, SIF or SICAR from the official list, the report covering the period from the last year-end to the date of the deregistration will be required, in principle, within the same time frames of five months for UCITS and of six months for the other types of UCIs.

The provisions concerning the separate report must be complied with by SIFs and SICARs for the financial years closing on or after 30 June 2023.

### 10.5.10.4. CSSF AML/CFT external report

Following CSSF Circular 21/788, a CSSF AML/CFT external report is required from all Luxembourg IFMs including registered AIFMs as well as from all Luxembourg UCIs supervised by the CSSF for AML/CFT purposes.

The CSSF AML/CFT external report is not required from UCIs which have appointed an IFM (established in Luxembourg or abroad).

Refer to Section 6.5.4. for more details.

### 10.5.10.5. Additional provisions regarding late trading and market timing

CSSF Circular 04/146 includes provisions on the role of the independent auditor regarding late trading and market timing (see Section 8.8.5.), which are additional to those of CSSF Circular 21/790.

The independent auditor of the UCI is requested to perform certain checks relating to the procedures and controls put in place by the UCI so as to protect itself from late trading practices in the context of the separate report. For UCIs that, due to their structure, are likely to be subject to market timing practices, the independent auditor is request to perform certain relating to the checks the measures and/or controls put in place by the UCI to protect itself by the best possible means against such practices in the context of the separate report.

If the independent auditor of the UCI, during the performance of its duties, becomes aware of a case of late trading or market timing, it must indicate this in the separate report.

### 10.5.10.6. Additional provisions regarding CSSF Regulation 12-02, as amended

CSSF Regulation No.12-02, as amended, includes provisions on the role of the independent auditor regarding compliance with the legal and regulatory requirements and AML/CFT which are additional to those of CSSF Circular 21/790.

## 10.6. General meetings

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An investment company, or the management company of a common fund, must generally hold at least one general meeting of shareholders each year within six months of the financial year end<sup>47</sup>.

The convocation to the annual general meeting must indicate how to obtain the annual accounts, the independent auditor's report, the management report, and the observations of the supervisory board (if applicable) and state that the investor may request that these documents be sent to him.

The annual accounts, including the report of the independent auditor, must be available at the investment company's registered office eight days before the annual general meeting.

The annual general meeting hears the reports of the directors or of the management board, as well as the independent auditor, before adopting the annual accounts.

The annual general meeting then votes specifically as to whether discharge is given to the directors or members of the management board. Such discharge is only valid, *inter alia*, if the annual accounts contain no omission or false information concealing the true situation of the company.

## 10.7. Submission to the Trade Register

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The annual report of an investment company has to be registered at the Trade and Companies Register (*Registre de Commerce et des Sociétés*, Luxembourg - RCS) in one of the official languages (being French, German and Luxembourgish) or English during the month of its approval by the general meeting of shareholders.

The RCS number of the investment company or the common fund should be disclosed on the cover of the annual report.

The presentation and the form of the documents to be published must meet certain technical standards defined in the amended ministerial regulation of 27 May 2016 (*Règlement ministériel*), including requirements such as:

- ▶ PDF/A format
- ▶ The header must disclose, *inter alia*, the denomination, the legal form, the registered number, and the registered address

The Law of 27 May 2016 has specific implications for common funds (fonds commun de placement – FCP):

- ▶ Common funds must be registered with the Trade and Companies Register
- ▶ The management company must file with the Trade and Companies Register the common fund's management regulation within the common fund's own file under Section K
- ▶ Other documents subject to deposit with the Trade and Companies Register:
  - ▶ The facts leading to the liquidation of the common fund
  - ▶ The injunction to put the common fund into liquidation addressed by the CSSF to the management company

A progressive scale of late filing fees relating to the filing of company annual accounts not performed within the time prescribed by law applies.

The late filing fees are described in Appendix J of the Grand Ducal Regulation of 27 May 2016, as amended.

## 10.8. Financial information reporting to authorities

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### 10.8.1. UCIs

Monthly and annual financial information must be provided in an electronic format to:

- ▶ The CSSF for statistical and supervisory purposes
- ▶ The Luxembourg Central Bank (BCL)

<sup>47</sup> An investment company, or management company, formed as a private limited liability company (S.à r.l.) must hold at least one annual general meeting of shareholders if there are more than 25 shareholders. If there are less than 25 shareholders, there is no obligation to hold general meetings.

The contents of the monthly, semi-annual and annual financial information to be reported to the CSSF are set out:

- ▶ For 2010 Law UCIs, in CSSF Circular 97/136, as amended and CSSF Circular 15/627
- ▶ For SIFs, in CSSF Circular 07/310, as amended and CSSF Circular 15/627. The information must be prepared separately for each compartment. Consolidated information is not required

The CSSF issued *Frequently Asked Questions concerning U1.1 Reporting* on 3 June 2016 clarifying certain requirements of CSSF Circular 15/627.

Report	Reporting deadline (from end of period)
2010 law UCIs:	
▶ Monthly information (Table U 1.1)	10 days
▶ Annual information (Table O 4.1 and O 4.2)	4 months <sup>48</sup>
SIFs:	
▶ Monthly information (Table U 1.1)	10 days
▶ Annual information (Tables O 4.1 and O 4.2)	6 months

Monthly information (Table U 1.1) includes details of:

- I. General information on the report and the sender
- II. General information on the UCI
- III. Financial information on the UCI in the base currency of the UCI
- IV. General information on the unit/share class
- V. Financial information on the unit/share class for the reference month
- VI. Information on investment income and expenses for the reference month in the base currency of the UCI

UCIs that offer a formal guarantee to their investors (guaranteed funds) are also required to complete an additional table of monthly financial information (Table O 1.2).

The reference date for monthly reporting is, in principle, the last day of each month. For UCIs that calculate a weekly NAV, the reference date may be the last NAV calculation day. For UCIs that calculate their NAV on a monthly basis, the reference date is the NAV calculation date closest to the last day of the month. For 2010 Law Part II UCIs that calculate their NAV on a less frequent basis, the reporting should be based on end of month accounting data. For SIFs that calculate their NAV on a less frequent basis, the reporting can be based on the last available NAV; the final NAV per share or unit must be provided to the CSSF when it becomes available.

Annual information to be reported (Table O 4.1) includes detailed breakdowns of:

- I. Net assets
  - ▶ Total assets
  - ▶ Total liabilities
  - ▶ Net assets at the end of the year
- II. Operations
  - ▶ Total income
  - ▶ Total charges
  - ▶ Net investment income
  - ▶ Profit or loss on operations
- III. Changes in net assets
  - ▶ Net assets at the beginning of the year
  - ▶ Net assets at the end of the year
- IV. Changes in the investment portfolio
  - ▶ Total purchases of transferable securities and other investments
  - ▶ Total sales of transferable securities and other investments
- V. Breakdown of the securities portfolio and of liquid assets other than cash at bank
- VI. Countries in which the UCI is marketed

Forward transactions and options data to be reported (Table O 4.2) include detailed breakdowns of:

- I. Commitments at the year end arising in respect of transactions entered into for purposes other than hedging
- II. Premiums received and paid in respect of options contracts in the course of the financial year

The reference date for annual reporting is the year end closing date.

The main circulars covering BCL reporting is BCL Circular 2014/237 and CSSF Circular 14/588 on the statistical data collection for MMFs and investment funds and BCL Circular 2018/241 on the statistical data collection for non-regulated alternative investment funds. The reporting templates, detailed instructions, circulars, circular letters and reporting calendars are available on the BCL website.

<sup>48</sup> The AIFM Law extends the annual reporting deadline for Part II UCIs to six months, but, at the time of writing, no amendment had been made to change the annual reporting deadline.

The BCL reporting requirements distinguish between money market funds<sup>49</sup> and non-monetary investment funds, which are categorized as follows:

- ▶ Equity UCIs
- ▶ Bond UCIs
- ▶ Real estate UCIs
- ▶ Mixed UCIs
- ▶ Other UCIs
- ▶ Alternative UCIs (hedge funds)
- ▶ Non-regulated alternative investment funds

Report	Reporting deadline (from month-end in working days)
Monthly statistical report:	
▶ MMFs: S 1.3. "Monthly statistical balance sheet for MMFs"	10
▶ Non-monetary investment funds and non-regulated alternative investment funds: S 1.6. "Information on valuation effects on the balance sheet of non-MMF investment funds"	20
Quarterly statistical report: S 2.13. "Quarterly statistical balance sheet of non-MMF investment funds"	
	20
Monthly security by security reporting:	
▶ MMFs	10
▶ Investment funds	20

The BCL may grant non-regulated alternative investment funds a derogation from the monthly and quarterly reporting obligations if the total assets (of all compartments) remain below EUR 500 million.

The information to be included in the Monthly statistical balance sheet for MMFs is the same as the information to be included in the Quarterly statistical balance sheet of UCIs. Breakdowns must be provided for the following categories of assets and liabilities:

- ▶ Assets:
  - ▶ Claims
  - ▶ Securities other than shares
  - ▶ Quoted shares
  - ▶ Unquoted shares
  - ▶ Participating interests: quoted shares
  - ▶ Participating interests: unquoted shares
  - ▶ Fixed assets
  - ▶ Accrued interest
  - ▶ Other assets
  - ▶ Financial derivatives
- Total assets
- ▶ Liabilities:
  - ▶ Overnight borrowings
  - ▶ Borrowings with agreed maturity
  - ▶ Borrowings redeemable at notice
  - ▶ Repurchase agreements
  - ▶ Short sale of securities
  - ▶ Shares or units issued
  - ▶ Accrued interest
  - ▶ Debt securities issued
  - ▶ Other liabilities
  - ▶ Financial derivatives
- Total liabilities

The data must be provided according to:

- ▶ Country of counterparty
- ▶ Currency
- ▶ Economic sector of the counterparty
- ▶ Initial maturity

Information on valuation effects on the balance sheet of investment funds includes information on fixed assets and financial derivatives, which must be provided if the amount reported for an item exceeds 5% in terms of total assets.

Monthly security by security reporting must be provided for certain categories of assets and liabilities and includes information on:

- ▶ The balance sheet line
- ▶ The identification code of the security
- ▶ The identification of the issuer
- ▶ The type of holding of securities
- ▶ The quantity of securities
- ▶ Supplementary information for securities not identified by an ISIN code

In practice, monthly, quarterly, semi-annual, and annual financial information is transmitted to the CSSF and the BCL via e-file (see Section 10.9.1.).

In addition, management entities are required to submit to the CSSF on an annual basis a written report of the management on the state of the internal controls (see Section 6.3.2.1.). UCITS management companies are required to transmit their updated risk management process (RMP) to the CSSF (see Section 7.2.8.) on at least an annual basis.

Regulation (EU) 2015/2365 *on transparency of securities financing transactions and of reuse* requires a UCITS management company on behalf of a UCITS, a self-managed UCITS, an AIFM on behalf of an AIF, and an internally managed AIF to report to a registered or recognized trade repository details of any securities financing transaction on a T+1 basis. Securities financing transactions include repurchase transactions, securities or commodities lending and borrowing, buy-sell back transactions and margin lending transactions.

<sup>49</sup> The criteria to be met by MMFs for the purpose of reporting are the same as those to be met for the purpose of utilization of the "money market fund" label under ESMA's guidelines (see Section 2.6.1.). The CSSF establishes a list of MMFs, or compartments of MMFs, that are reported on the list of monetary financial institutions; the BCL submits this list to the European Central Bank (ECB).

## 10.8.2 Specific reporting for MMFs

On 30 June 2017, the Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on *money market funds* (MMF) was published in the Official Journal of the European Union. On 10 April 2018, Commission Delegated Regulation (EU) 2018/990 amended and supplemented Regulation (EU) 2017/1131. The Regulation, as amended, applies to funds and compartments that qualify as MMFs as per the definition set out in Article 1 of the Regulation.

According to the Regulation, for MMFs whose assets under management do not exceed EUR 100,000,000, the manager of the MMF must report to the competent authority of the MMF on at least an annual basis.

The manager of an MMF must also, upon request, provide the information to the competent authority of the manager of an MMF, if different from the competent authority of the MMF.

The information reported must comprise the following points:

- (a) The type and characteristics of the MMF
- (b) Portfolio indicators such as the total value of assets, NAV, WAM, WAL, maturity breakdown, liquidity and yield
- (c) The results of stress tests and, where applicable, the proposed action plan
- (d) Information on the assets held in the portfolio of the MMF, including:
  - (i) The characteristics of each asset, such as name, country, issuer category, risk or maturity, and the outcome of the internal credit quality assessment procedure
  - (ii) The type of asset, including details of the counterparty in the case of derivatives, repurchase agreements or reverse repurchase agreements
- (e) Information on the liabilities of the MMF, including:
  - (i) The country where the investor is established
  - (ii) The investor category
  - (iii) Subscription and redemption activity

If necessary and duly justified, competent authorities may solicit additional information.

In addition to the information referred to in the preceding paragraph, for each LVNAV MMF that it manages, the manager of an MMF must report the following:

- (a) Every event in which the price of an asset valued by using the amortized cost method deviates from the price of that asset calculated using mark-to-market or mark-to-model by more than 10 basis points
- (b) Every event in which the constant NAV per unit or share calculated using the amortized cost method deviates from the NAV per unit or share calculated using mark-to-market or mark-to-model or both by more than 20 basis points
- (c) Every event where the imposed thresholds regarding weekly maturing assets and net daily redemptions on a single working day are breached and details of the course of action decided by the board of directors or equivalent of the MMF in these situations

On 17 April 2018, the European Commission published Commission Implementing Regulation (EU) 2018/708 *laying down implementing standards with regard to the template to be used by managers of money market funds when reporting to competent authorities as stipulated by Article 37 of Regulation (EU) 2017/1131 of the European Parliament and of the Council (the MMF Regulation)*. This implementing Regulation was based on ESMA's *Final Report on technical advice, draft implementing technical standards and guidelines under the MMF Regulation*, issued on 13 November 2017.

On 19 July 2019, ESMA published its *Final Report on Guidelines on the reporting to competent authorities under Article 37 of the MMF Regulation*.

These Guidelines complement the information included in the draft technical standards so that managers of MMFs have all the necessary information to fill in the reporting template they will need to send to the competent authorities of their MMFs.

CSSF Circular 20/736 implemented these Guidelines into Luxembourg regulation applicable to MMFs under the supervision of the CSSF and to the Luxembourg managers of MMFs; and CSSF Circular 20/734 clarifies technical details that managers of MMFs need to take into account in order to fulfil their reporting obligations.

On 4 June 2020, ESMA updated the reporting instructions to be used for reporting under the MMF Regulation.

The CSSF issued the *MMFR Handbook* describing the reporting principles to be used by the MMF managers in order to report activity to the CSSF as the National Competent Authority (NCA) for Luxembourg.

ESMA's *Guidelines on stress test scenarios under the MMF Regulation* establish common reference parameters of the stress test scenarios MMFs or managers of MMFs should include in their stress scenarios. These Guidelines were updated in May 2022.

CSSF Circular 20/735 implemented those Guidelines into Luxembourg regulation applicable to the MMFs under the supervision of the CSSF and to the Luxembourg managers of MMFs.

### 10.8.3. AIFs

Reporting by AIFMs and internally managed AIFs is covered in Section 6.5.1.B.

## 10.9. Electronic transmissions to the CSSF and publication

### 10.9.1. Documents to transmit electronically and to publish

CSSF Circular 03/97 of 28 February 2003 clarifies the procedure for the publication of KIID, prospectuses and annual and semi-annual reports under the 2010 Law. It requires that the KIID, prospectuses as well as the annual and semi-annual reports of 2010 Law UCIs be published in the database of the financial center.

CSSF Circular 19/708, as amended, covers the electronic transmission of the following documents to the CSSF, in their final form, via an electronic communication channel:

- Prospectuses and annual and semi-annual reports of 2010 Law UCIs
- Offering documents, prospectuses and annual reports of SIFs

The electronic filing of these documents is to be completed using a secured system that is accepted by the CSSF.

On 26 February 2021, CSSF Circular 21/766 amended CSSF Circular 19/724 on the technical specifications regarding the submission of documents to the CSSF under the Prospectus Regulation and the Prospectus Law. Refer to Chapter 3.

In practice, prospectuses, offering documents, KID/KIID, annual and semi-annual reports, management letters, separate reports, CSSF AML/CFT external reports and financial information (see Section 10.8.) are transmitted to the CSSF via the eDesk system (see Section 6.5.2.).

According to CSSF Circular 22/799, listed closed-ended UCIs should file all regulated information, including, *inter alia*, annual and semi-annual financial report via the e-RIIS platform. According to the *Commission Delegated Regulation (EU) 2018/815 of 17 December 2018 supplementing Directive 2004/109/EC of the European Parliament and of the Council with regard to regulatory technical standards on the specification of a single electronic reporting format*, annual financial reports should be prepared in XHTML format.

### 10.9.2. Transmission deadlines

A 2010 Law UCI's prospectus and a SIF's offering document or prospectus must be transmitted once they have been approved by the CSSF, or if later than the approval by the CSSF, when the marketing of the UCI begins, or when the activities of the SIF begin.

Annual and semi-annual reports must be transmitted within the deadline for the publication of the reports in the case of 2010 Law UCIs and the deadline for making the report available to investors in the case of SIFs. UCIs do not need to transmit these reports to the CSSF in paper form.

### 10.9.3. Format of transmission

All files must be transmitted to the CSSF in PDF-text format as detailed in CSSF Circular 19/708.

# 11

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## EXPENSES AND TAXATION: STRUCTURING AND REPORTING

EY services include:

- ▶ Review of performance fee models and methodologies
- ▶ Benchmarking of fee structures
- ▶ Advice in relation to:
  - ▶ Tax structuring and restructuring of funds
  - ▶ Tax structuring and restructuring of corporate asset management structures
  - ▶ Transfer pricing for all dealings between related parties
- ▶ Taxation of assets of funds
- ▶ Taxation of fund investors
- ▶ Fund fees
- ▶ FATCA and Common Reporting Standard compliance
- ▶ European tax reporting
- ▶ Fund tax services
- ▶ Mandatory disclosure rules/DAC 6 compliance



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## 11.1. Introduction

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This Chapter covers:

- The formation and operating expenses incurred by Luxembourg undertakings for collective investment (UCIs)
- The taxation of Luxembourg UCIs, the assets of Luxembourg UCIs, investors in Luxembourg UCIs, fees paid by Luxembourg UCIs, and the tax implications of restructuring UCIs
- The VAT regime applicable to services provided to such Luxembourg UCIs and their service providers

## 11.2. Expenses

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This Section covers the types of formation expenses and annual operating expenses of Luxembourg UCIs. Disclosure of fees and expenses is covered in Chapter 10.

### 11.2.1. Formation expenses

Formation expenses include costs incurred to establish a UCI and to enable it to do business, excluding initial capital requirements (see Section 2.5.). A newly established compartment of a UCI may also incur formation expenses. For master-feeder UCI structures, formation expenses may be incurred at the master fund and feeder fund level(s).

Formation expenses are borne by the UCI, unless its management company or general partner agrees to absorb these expenses in full or to absorb a portion of the formation expenses in excess of an amount stated in the UCI's prospectus or offering document. Under Luxembourg generally accepted accounting principles (Lux GAAP), formation expenses may be amortized over a period not exceeding five years.

Formation expenses for a Luxembourg UCI may include the following:

- Notary fees
- Legal fees
- Advisory fees relating to initial structuring
- CSSF initial authorization fee:
  - Single compartment UCI EUR 4,400
  - Multiple compartment UCI EUR 8,800
  - Self-managed UCITS and internally managed UCIs (single or multiple compartment)<sup>1</sup> EUR 16,500
- Printing of prospectus/offering document

Grand-Ducal Regulation of 17 December 2021, as amended, increased the single lump sum fee to EUR 1,000 for each authorization request for a new compartment within an existing multiple compartment structure. A single lump sum fee of EUR 1,100 is also payable for each authorization request of an AIF compartment set-up as an ELTIF where the AIF is not subject to authorization and prudential supervision by an official supervisory authority in Luxembourg.

Formation expenses of a Luxembourg management entity are covered in Section 6.5.3.2.

### 11.2.2. Operating expenses

Luxembourg UCIs incur various expenses in the conduct of their operations.

The management company, AIFM, or general partner will normally be paid a fee by the UCI for its services, when applicable.

The management company, AIFM, or general partner may, subject to the fee arrangements in place, be responsible for paying any appointed delegates, out of the fees it receives from the UCI. Alternatively, the UCI may pay the delegates directly out of its assets.

The most significant expense incurred by a Luxembourg UCI is the fee paid for portfolio management or investment management services. The portfolio management/investment management fee is generally a fixed percentage typically ranging from 0.05% to 2% of net assets. Minimum amounts and reduced fee rates for certain asset levels may be applied. In addition, a performance fee, usually ranging from 5% to 20%, may also be applied. This may incorporate a high watermark, trigger limits and claw back provisions.

CSSF Circular 20/764 implemented ESMA's *Guidelines on performance fees in UCITS and certain types of AIFs* which are prescriptive notably in terms of consistency between the performance fee model used and the UCI's investment objective, where a UCI is managed by reference to a benchmark index, or as regards to the minimum performance reference period.

<sup>1</sup> | See Section 2.3.



All UCITS are in scope of the Guidelines. The Guidelines also apply to open-ended AIFs marketed to retail investors. However, European Venture Capital Funds (EuVECA) or other types of venture capital AIFs, European Social Entrepreneurship Funds (EuSEFs), private equity and real estate AIFs remain out of scope.

ESMA's report comprises five guidelines:

1. The calculation of a performance fee should be verifiable and the method should include at least:

- ▶ A performance reference indicator, i.e., an index, a high-water mark (HWM), a hurdle rate or a combination
- ▶ The crystallization frequency and the crystallization date
- ▶ The performance reference period
- ▶ The performance fee rate
- ▶ The calculation methodology
- ▶ The computation frequency which should match with the net asset value (NAV) calculation frequency

Performance fees should be proportionate to the UCI's performance. Artificial increases arising from new subscriptions should not be taken into account when calculating UCI performance.

Managers should be able to demonstrate that manager's and investor's interests are aligned.

It is permissible to calculate performance fees on a single investor basis.

2. The performance fee model implemented must be, and remain, consistent with the UCI's investment objectives, strategy and policy.

- ▶ The manager should implement and maintain a periodic review process to ensure that the performance fee model is consistent with the UCI's investment objectives, strategy and policy
- ▶ As a general principle, a UCI which is managed by reference to a benchmark, or where the UCI's portfolio does not deviate materially from a benchmark index portfolio, should use the same benchmark in the performance fee model
- ▶ Where the UCI is managed by reference to a benchmark, but the UCI's holdings are not based upon the holdings of the benchmark index, the benchmark used for the calculation of the performance should be consistent with the benchmark used for the portfolio composition, according to a non-exhaustive list of consistency indicators:
  - ▶ Expected return
  - ▶ Investment universe
  - ▶ Beta exposure to an underlying asset class
  - ▶ Geographical exposure
  - ▶ Sector exposure
  - ▶ Income distribution of the UCI
  - ▶ Liquidity measures (e.g., daily trading volumes, bid-ask spreads)
  - ▶ Duration
  - ▶ Credit rating category
  - ▶ Volatility and/or historical volatility
- ▶ Performance should be calculated net of all costs but may be calculated without deducting the performance fee as long as this would be in the investor's best interest
- ▶ If the reference indicator changes during the performance reference period, the performance should be calculated by linking the benchmark index that was previously in force until the date of the change and the new reference indicator used afterwards

3. Crystallization frequency

- ▶ It should allow for the alignment of the manager's and the investor's interests
- ▶ It should not be more than once a year, except for the HWM model or high-on-high model where these cannot be reset during the whole life of the UCI, and fulcrum fee model and other models which provide a symmetrical fee structure
- ▶ It should be the same for all share classes of a UCI with a performance fee
- ▶ Performance fee should crystallize in due proportion in case of closure/merger of UCIs or upon an investor's redemption. However, where both merging and receiving UCIs are managed by the same manager, crystallization should be presumed to be contrary to investors' best interests, unless justified otherwise by the manager
- ▶ Generally, it should coincide with the end of the financial year of the UCI

#### 4. Loss recovery

- ▶ Any loss or underperformance previously incurred during the performance reference period should be recovered before a performance fee becomes payable
- ▶ A performance fee may be payable in the case where the UCI outperformed the benchmark but had negative performance
- ▶ The performance reference period should be, as far as possible, consistent with the recommended investor holding period. Where the performance reference period is shorter than the whole life of the UCI, it should be set equal to at least five years (on a rolling basis)

#### 5. Disclosures

- ▶ Investors should be adequately informed about the performance fees and their impact on return
- ▶ All *ex-ante* documents (prospectus, Key Investor Information Documents (KIIDs), marketing documents) should clearly set out all information necessary to understand the performance fee model and the computation methodology, including the main elements and parameters and the payment date. Concrete computation examples should be included in the prospectus
- ▶ Where a performance fee model uses a different but consistent benchmark, the explanation of the choice of benchmark should be included in the prospectus
- ▶ Where a performance fee is payable in times of negative performance a prominent warning must be included in the KIID
- ▶ Where applicable, the KIID and the prospectus should display the name of the benchmark index and disclose past performance against it
- ▶ The annual and semi-annual reports and any other *ex-post* information should indicate for each relevant share class the amount of performance fees and the percentage of the share class NAV they represent

In its *Q&A on the application of the UCITS Directive* and *Q&A on the application of the AIFMD*, ESMA clarified that:

- ▶ The Guidelines on performance fees do not prevent from paying performance fees during the performance reference period of five years
- ▶ ELTIFs marketed to retail investors that do not have a closed-ended structure within the meaning of Article 1(2) of the Delegated Regulation 694/2014 and are not venture capital/private equity or real estate AIFs are in scope of the Guidelines
- ▶ In the case of a merger where the receiving UCITS or AIF is a newly established UCI with no performance history and the competent authority of the receiving UCITS or AIF assesses that the merger does not substantially change the UCITS' or AIF's investment policy, the performance reference period of the merging UCITS or AIF should continue to apply in the receiving UCITS or AIF
- ▶ The Guidelines on performance fees do not apply to registered AIFMs referred to in Article 3(2) of the Alternative Investment Fund Managers Directive (AIFMD). However, Member States may decide to impose stricter requirements on registered AIFMs and to allow them to market AIFs to retail investors in their territory, in accordance with Articles 3(3) and 43(1) of the AIFMD. In such cases, National Competent Authorities (NCA) may also decide to apply the guidelines to registered AIFMs
- ▶ Where the portfolio management of a sub-fund is delegated to different portfolio managers, performance fees should only be paid in case of a global overperformance of the sub-fund, i.e., in case of global underperformance of the sub-fund, no performance fee should be paid to a portfolio manager that would have overperformed
- ▶ Performance fees should only crystallize after at least 12 months from the creation of a new UCITS/AIF/sub-fund/share class
- ▶ The minimum length of the performance reference period of five years is also applicable to the hurdle rate model

ESMA also provides graphical and numerical examples on how to set the performance reference period of five years for the benchmark model.

On 10 March 2020, the CSSF updated its *FAQ concerning the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment* with respect to disclosure of performance fees, the investment manager's fee and the investment advisor's fee, to investors of a UCITS. In this document, the CSSF clarified the following:

- ▶ Both the fee model and the investment manager as the recipient of a performance fee must be disclosed in the prospectus. In cases where there is a sharing arrangement of the performance fee with any investment advisor(s) contractually linked to the UCITS, the prospectus must inform investors of this arrangement
- ▶ Where a service fee is directly paid out of the assets of the UCITS to the investment manager(s), and to any investment advisor(s) contractually linked to the UCITS, the method of calculation or the rate of the fee to each recipient must be disclosed in the prospectus
- ▶ The investment manager's fee and/or the investment advisor's fee must only pay for investment management and investment advice, respectively. In general, the investment advisor's fee is expected to be lower than that of the investment manager
- ▶ When other expenses or fees for activities beyond the direct scope of investment management or advice are payable out of the assets of the UCITS to the investment manager(s) or investment advisor(s), such expenses or fees must be disclosed separately from the investment manager's fee and investment advisor's fee respectively, in a manner that clearly informs investors about the nature of such expenses or fees
- ▶ Where an "all-in" fee is proposed, which implies that only one compensation amount is paid out of the assets of the UCITS to a recipient (commonly the management company) who will pay the other service providers to the UCITS afterwards, the prospectus must clearly state the scope and nature of such all-in fee. Ideally, each contractual recipient of this all-in fee should be specified

On 26 November 2021, ESMA updated its *Questions and Answers (Q&As) on the application of the UCITS Directive* to increase further transparency on commissions paid to or received from third parties and to ensure a fair treatment of the different groups of unitholders.

ESMA reminds UCITS management companies that Article 29 of Commission Directive 2010/43/EU lays down strict conditions for fees or commissions paid to or received from a third party in relation to the activity of investment management and administration of the UCITS. Management companies should act honestly, fairly and professionally, ensuring UCITS' best interests, investors' fair treatment and the transparency of UCITS' operations.

Since management fee discount arrangements entail payments to certain investors based on the fees charged by the UCITS management companies to remunerate investment management and/or administration activities, ESMA considers that they should be analyzed as payments for the activity of the investment management and administration of the UCITS. The consequence is that management companies should ensure that the following conditions are satisfied:

- ▶ The existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the UCITS in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant service
- ▶ The payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service and not impair compliance with the management company's duty to act in the best interests of the UCITS

Therefore ESMA considers that:

- ▶ Those arrangements should be transparent and meet the above-mentioned conditions
- ▶ Management companies should demonstrate that these arrangements:
  - ▶ Enhance the quality of the relevant service for the UCITS to the benefit of all investors and not only to investors who benefit from those arrangements
  - ▶ Do not impair compliance with the management company's duty to act in the best interests of the UCITS. In particular, management companies are bound to treat all unitholders fairly, act in the best interest of the unitholders and to refrain from placing the interest of any group of unitholders above others. Therefore, management companies should be able to justify that all investors pay their fair share in the UCI's functioning (taking into account management fee discounts) and the UCITS cost structure. These arrangements should not have a negative impact on other investors

Upon NCA request, management companies should be able to provide accurate and documented justifications.

Another significant expense incurred by a Luxembourg UCI is the fee paid for administration (including, *inter alia*, fund accounting and transfer agency – see also Chapter 8). The administration fee is also often based on a specified percentage of net assets, or average net assets, of the UCI. The administration agreement may also provide for minimum fees and/or reduced fee rates on net assets in excess of specified levels of assets under administration.

Other operating expenses incurred by a Luxembourg UCI include:

- ▶ Directors fees, insurance, conducting persons fees (if applicable), and management company fees (if applicable)
- ▶ Depositary fees, transaction fees, and brokerage fees
- ▶ Domiciliation fees

- ▶ Preparation of financial reports (annual and semi-annual reports, where relevant)
- ▶ Annual and semi-annual report printing costs
- ▶ NAV or price publication expenses
- ▶ Independent valuation costs
- ▶ Annual registration duty (if applicable)
- ▶ CSSF annual fee:
  - ▶ Single compartment UCI EUR 4,400
  - ▶ Multiple compartment UCI:
    - ▶ 1 to 5 compartments EUR 8,800
    - ▶ 6 to 20 compartments EUR 16,500
    - ▶ 21 to 50 compartments EUR 26,400
    - ▶ More than 50 compartments EUR 38,500

Grand-Ducal Regulation of 17 December 2021, as amended, introduced a single lump sum fee of EUR 4,400 for each conversion request of a single compartment UCI into a multiple compartment UCI. In addition, any change of legal status of an existing UCI or its conversion into another legal form (for example, a common fund (FCP) into an investment company) is considered as a new examination and will incur CSSF initial authorization fees as set out in Section 11.2.1.

For umbrella UCIs, the amount shall be based on the number of compartments authorized by the CSSF mentioned in the prospectus as at 31 December preceding the billing year. For umbrella UCIs that are authorized by the CSSF in the course of the year, the amount will be based on the number of compartments when registered on the official list. UCIs that are authorized by the CSSF as umbrella structures and that do not yet have active sub-funds will be subject to the annual lump sum of EUR 8,800 listed above.

An annual lump sum of EUR 3,300 is also payable by each UCI in non-judicial liquidation. This lump sum is due for each financial year in which the non-judicial liquidation has not been completed, except for the financial year in which the UCI has been deregistered from the official list.

- ▶ Legal fees
- ▶ Audit fees
- ▶ Stock exchange (fees for Luxembourg and/or EU-domiciled UCIs):
  - ▶ Approval fee (if and as applicable): EUR 1,250
  - ▶ Listing fee EUR 1,250
  - ▶ Maintenance fee (if applicable):
    - ▶ 1<sup>st</sup> quotation line EUR 1,875
    - ▶ 2<sup>nd</sup> quotation line EUR 1,250
    - ▶ 3<sup>rd</sup> quotation line EUR 875
    - ▶ 4<sup>th</sup> and subsequent quotation lines, per line EUR 500
- ▶ Cross-border registration application, authorization, and maintenance fees
- ▶ Tax compliance fees
- ▶ Distribution costs including:
  - ▶ Initial registration costs
  - ▶ Ongoing registration costs
  - ▶ Local representatives costs
  - ▶ Local paying agent and other facilities costs
- ▶ Annual subscription tax for UCIs (see Section 11.3.2.2.)
- ▶ Investor communication costs
- ▶ Marketing costs

Luxembourg UCIs may cap their fees and/or expenses. This may be achieved by:

- ▶ Waive of fees, or a portion of certain expenses/fees
- ▶ Reimbursement by portfolio manager or other party of certain expenses/fees, or a portion of the expenses/fees or assume certain expenses, or a portion of the expenses

Best practice is to disclose, in the annual report, the impact of any waiver/reimbursement on the performance of the UCI's shares/units.

Operating expenses may be paid either directly by the UCI, or by the management company or general partner (when the UCI is not self-managed). When they are paid by the management company or general partner, the UCI is typically charged a fixed service fee covering certain operating expenses incurred on behalf of the UCI.

Ongoing expenses of a Luxembourg management entity are covered in Section 6.5.5.2.

On 4 June 2020, ESMA published a *supervisory briefing on the supervision of costs in UCITS and AIFs*. The briefing is expected to be considered by NCAs.

ESMA has developed criteria to support NCAs in:

- (i) Assessing the notion of “undue costs” and supervising the pricing process of the management company  
The notion of undue costs should be primarily assessed against what should be considered as being in the best interest of the UCI or its share/unitholders.  
NCAs are expected to require management companies to develop and review periodically a structured pricing process.  
NCAs should supervise that the payment of any fee is aimed at remunerating a service provided to the UCI/its investors and does not impair compliance with the management company’s duty to act in the best interests of the share/unitholders.
- (ii) Supervising the obligation to prevent undue costs being charged to investors  
NCAs are expected to review management companies’ pricing processes as part of their supervisory activity to ensure that undue costs are not charged to investors.

NCAs are expected to scrutinize:

1. Whether the costs are necessary for the UCI to operate in line with its investment objective (e.g., portfolio management fees, transaction and settlement fees) or strictly functional to the ordinary activity or to fulfil regulatory requirements (audit fees, taxes, NCA levies)
2. Whether the costs are proportionate to market standards and the type of service provided, notably in the context of potential conflicts of interest where payments are made to third parties, intragroup delegates or depositaries
3. Whether the fees are proportionate to the complexity of assets, strategies and activities performed
4. Whether the fees are sustainable in light of the expected net return of the UCI
5. Whether the costs ensure investors’ equal treatment, except for AIFs not distributed to retail investors disclosing a preferential treatment, where such treatment is allowed under the applicable legislation
6. Whether there is no duplication of costs and costs are properly identified and accounted for
7. Whether a cap on fees, if any, is applied and disclosed to investors
8. Whether the performance fee model and its disclosure are compliant, where applicable, with the ESMA’s *Guidelines on performance fees in UCITS and certain types of AIFs*
9. Whether all costs disclosures to investors comply with applicable EU and national rules
10. Whether the pricing process and all charged costs are based on reliable and documented data and verifiable at a single portfolio level

ESMA expects the outcome of any supervisory action to include an assessment of the possibility of investor compensation, fee reduction, review of disclosure documents and/or communication of good and poor practices by NCAs to the market.

The CSSF issued, on 18 December 2020, FAQs to clarify certain requirements in terms of prospectus disclosures, revenues and costs/fees, conflicts of interest and best execution applicable to securities financing transactions (SFTs), including securities lending transactions, repurchase agreements (repos) and reverse repurchase agreements (reverse repos), buy-sell back and sell-buy back transactions, as well as total return swaps.

Only effective costs/fees corresponding to services rendered to the UCITS in the context of SFTs can be charged to the UCITS. Investment fund managers (IFMs) should perform a comprehensive assessment of the adequacy of the operational costs/fees deducted from gross revenues generated by SFTs. IFMs should notably document, with quantitative information, the relevance of the underlying cost drivers which make up the costs borne by the UCITS in order to demonstrate that these costs do not include any hidden revenues.

Compliance with the clarifications provided for in the FAQ is required by 30 September 2021 at the latest.

On 31 May 2022, ESMA published its report on the Common Supervisory Action (CSA) on costs and fees for investment funds. The CSA was conducted by NCAs in 2021.

Broadly-speaking, the NCAs noted that while they did not identify any regulatory breaches, there is room for improvement in the application and governance of costs and fees. The key findings are as follows:

- Costs continue to be higher for retail as opposed to institutional investors. In addition to smaller entities not being able to enjoy economies of scale, a benefit that can be passed down to investors in the form of lower charges, it was also established that smaller management companies sometimes have less strong pricing processes in place, when compared to entities overseeing larger assets under management (AUM). This could be attributed to these small entities not having the capability to access better, more attractive pricing offers

- ▶ In some cases, delegates have been found to have the final say on the fees and costs charged for fund management, bringing into question i) their compliance with delegation rules and ii) the adequacy of controls of the UCITS manager in setting overall costs and fees
- ▶ Undue costs are not defined at Level 1 and 2 and this has resulted in there being subjectivity on what constitutes an undue cost at Member State level
- ▶ Conflicts of interest at play: Specifically in the context of related-party or intragroup transactions, there have been reported cases of conflict of interest and specific measures to mitigate these conflicts of interests have not been addressed
- ▶ Efficient portfolio management (EPM) processes not clearly outlined: Some of the most common EPM processes and policies include that of securities lending, (reverse) repurchase agreements and buy-sell/sell-buy back transactions. It was reported that some UCITS managers could not furnish the NCA with evidence of their internal policies and procedures for EPM. Further, a lack of detailed information on the EPM in client disclosures - including information on risks, fees and performance - was noted in certain European countries covered in the survey
- ▶ In some circumstances, UCITS managers applied fee splits without sufficient consideration as to whether they are in line with fair market rates or in investors' best interests
- ▶ The report emphasized that where investors have been financially negatively impacted by undue costs, fees or calculation errors, that they be compensated appropriately

## 11.3. Taxation

### 11.3.1. Introduction

This Section covers the taxation of:

- ▶ Luxembourg UCIs
- ▶ The assets of Luxembourg UCIs
- ▶ Investors in Luxembourg UCIs
- ▶ Fees paid by Luxembourg UCIs

This Section also covers taxation impacts of selected restructuring scenarios.

### 11.3.2. Taxation of Luxembourg UCIs

Luxembourg UCIs constituted under the 2010 Law, the SIF Law or the RAIF Law (other than under article 48 of the RAIF Law) are tax exempt in Luxembourg with the exception of the registration duty and annual subscription tax. There is no stamp duty in Luxembourg on share issues or transfers. Most of the UCIs have to register for Luxembourg VAT purposes in order to self-assess the VAT due in Luxembourg on services received from foreign suppliers (unless an exemption is applicable).

Taxation of management companies and AIFMs is covered in Section 6.5.5.4.

#### 11.3.2.1. Registration duty

A registration duty of EUR 75 is levied upon:

- ▶ Incorporation of a UCI in a corporate form with registered office or central administration in Luxembourg
- ▶ Modification of the articles of incorporation of a UCI in a corporate form with registered office or central administration in Luxembourg
- ▶ Transfer to Luxembourg of the registered office or central administration of a UCI in a corporate form

This registration duty is fixed; it does not vary with the number of compartments.

UCIs constituted as common funds are not subject to this registration duty.

#### 11.3.2.2. Annual subscription tax

UCIs that are subject to subscription tax must file tax returns for *taxe d'abonnement* electronically.

### 11.3.2.2.1. General tax rate

2010 Law UCIs are generally subject to an annual subscription tax of 0.05% (a reduced rate of 0.01% may apply in certain circumstances; see Section 11.3.2.2.2.); for SIFs and RAIFs<sup>2</sup>, the rate is 0.01%. This tax is calculated and payable quarterly, based on the total NAV of the UCI on the last day of every calendar quarter.

On incorporation of the UCI, this tax is calculated in proportion to the duration, in days, between the date of incorporation and the end of the following quarter. For each additional compartment incorporated thereafter, the tax base remains the total NAV on the last day of each quarter.

On the dissolution of the UCI, the subscription tax is calculated in proportion to the number of days between the beginning of the last quarter and the dissolution (the appointment of a liquidator). Where a compartment is liquidated but the UCI is not dissolved, there is no subscription tax due for the quarter during which the compartment was liquidated.

### 11.3.2.2.2. Reduced tax rate

For 2010 Law UCIs, a reduced tax rate is applicable in the following cases:

#### A. UCIs investing in money market instruments and deposits

The rate is reduced to 0.01% for UCIs and UCI compartments whose exclusive policy is the investment in money market instruments and the placing of deposits with credit institutions or the collective investment in deposits with credit institutions.

As clarified in the Grand-Ducal Regulation of 14 April 2003, such money market instruments are deemed to include any notes and instruments representing claims, whether or not they may be characterized as securities, including bonds, certificates of deposit, treasury bills, and any other similar instruments, provided that at the time of their acquisition their residual maturity does not exceed twelve months, taking account of any related hedging financial instruments. In addition, floating rate notes with a residual maturity exceeding twelve months are permitted provided the interest rate is adjusted to market conditions at least annually. In certain cases, a UCI whose portfolio has an average remaining maturity not exceeding twelve months may also qualify for the reduced rate.

It should be noted that the definition of “money market instruments” for the purpose of subscription tax is different to the criteria for the purpose of UCITS (see Sections 4.2.2.7.5. and 2.6.1.).

#### B. Institutional investor compartments or share classes

The reduced rate of annual subscription tax of 0.01% also applies to individual compartments of multiple compartment UCIs subject to the 2010 Law, as well as to individual share classes of a UCI or of a compartment of a multiple compartment UCI, if the shares of these compartments or classes of these shares are restricted to one or several institutional investors.

#### C. Sustainable UCIs

As from 1 January 2021, reduced subscription tax rates apply for UCIs or individual compartments of such UCIs that invest a specific portion of their NAV in determined sustainable economic activities, as defined in the EU Taxonomy Regulation<sup>3</sup>.

This only impacts 2010 Law UCIs investing a certain portion of their assets in qualifying sustainable economic activities as follows:

Percentage of the NAV invested in qualifying sustainable economic activities	Subscription tax rate
At least 5%	0.04%
At least 20%	0.03%
At least 35%	0.02%
At least 50%	0.01%

<sup>2</sup> Other than RAIFs investing exclusively in risk capital, which choose to be subject to a regime similar to that of SICARs, per Article 48 of the RAIF Law of 23 July 2016, as amended.

<sup>3</sup> Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

The portion of the net assets invested in sustainable economic activities<sup>4</sup> as of the last day of the UCI's financial year must be audited by an independent auditor as part of the annual audit of the financial statements, or, where applicable, certified by an independent auditor in the context of a reasonable assurance audit according to the international audit standard as adopted by the *Institut des Réviseurs d'Entreprises* (Luxembourg Auditor's Institute). The portion, as well as the percentage this portion represents, of the total net assets of the UCI or of the individual compartment of the UCI shall be included in either the annual report of the UCI, or in a separate assurance report.

An attestation certified by the independent auditor must furthermore be transmitted by the UCI to the tax administration in charge of collecting the subscription tax (*Administration de l'enregistrement, des domaines et de la TVA*). The portion of NAV invested in sustainable economic activities indicated in the attestation will be used as the basis to determine the subscription tax rate applicable to these assets.

### 11.3.2.2.3. Exemption

A subscription tax exemption is applicable in the following cases:

#### A. Investment in other Luxembourg UCIs

In order to avoid double taxation, the value of assets represented by investments in other Luxembourg UCIs (2010 Law UCIs, SIFs and RAIFs) that have already been subject to subscription tax is exempt.

#### B. Institutional cash UCIs

UCIs (2010 Law UCIs, SIFs and RAIFs), compartments of multiple compartment UCIs, and share classes are exempt from the subscription tax provided all the following conditions are cumulatively met:

- ▶ The shares are reserved for institutional investors
- ▶ The exclusive policy is the investment in money market instruments and the placing of deposits with credit institutions
- ▶ The weighted residual portfolio maturity does not exceed 90 days (floating rate notes with a maturity exceeding 90 days but whose interest rate is adjusted at least every 90 days are also permitted)
- ▶ The UCI benefits from the highest possible rating by a recognized rating agency

Where several classes of shares exist within the UCI or the compartment, the exemption only applies to classes whose shares are reserved for institutional investors.

#### C. Pension Fund Pooling Vehicles (PFPVs)

Luxembourg Pension Fund Pooling Vehicles (PFPVs) (whether 2010 Law UCIs, SIFs or RAIFs) are exempt from subscription tax.

#### D. Microfinance UCIs

2010 Law UCIs, SIFs, and RAIFs, or compartments thereof, whose main objective is the investment in microfinance institutions are exempt from subscription tax.

The Grand-Ducal Regulation of 14 July 2010 clarified that UCIs, as well as compartments of umbrella UCIs whose investment policy is to invest at least 50% of their assets in one or several microfinance institutions or that benefit from the microfinance label issued by the Luxembourg Fund Labeling Agency (LuxFLAG) are exempt from subscription tax. Microfinance institutions are defined as those that invest at least half of their assets in microfinance or microfinance UCIs. Microfinance includes all financial operations other than consumer loans, the objective of which is to support poor populations excluded from the traditional financial system by financing small revenue generating activities, and whose value does not exceed EUR 5,000.

#### E. Exchange Traded Funds or Products

2010 Law UCIs, or compartments thereof, whose securities are listed or traded on at least one stock exchange or another regulated market operating regularly, recognized and open to the public and whose exclusive objective is to replicate the performance of one or more indices are exempt from subscription tax.

<sup>4</sup> The EU Taxonomy Regulation defines the minimum criteria which economic activities must comply with in order to be considered environmentally sustainable:

- ▶ An environmentally sustainable economic activity contributes substantially to one or more of the following environmental objectives:
  - ▶ Climate change mitigation
  - ▶ Climate change adaptation
  - ▶ Sustainable use and protection of water and marine resources
  - ▶ Transition to a circular economy
  - ▶ Pollution prevention and control
  - ▶ Protection and restoration of biodiversity and ecosystems
- ▶ It does not significantly harm any of the other environmental objectives
- ▶ It is carried out in compliance with minimum safeguards set out in the regulation (including the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises, the International Labour Organisation, etc.)
- ▶ It complies with the Technical Screening Criteria (TSC) developed by the Technical Expert Group (delegated acts, applicable from 1 January 2022 for climate-related objectives and from 1 January 2023 for the other objectives)



### 11.3.2.3. Real estate levy

As from 2021, a real estate levy (*prélèvement immobilier*) of 20% applies to certain comprehensively listed investment vehicles receiving or realizing income from real estate located in Luxembourg.

The real estate levy only applies if the real estate income is realized by targeted investment vehicles with a legal personality distinct from that of their partners, being SIFs, 2010 Law Part II UCIs and RAIFs. SIFs, UCIs or RAIFs formed as a limited partnership (*société en commandite simple* – SCS), a specialized limited partnership (*société en commandite spéciale* – SCS<sub>p</sub>) or as an FCP are excluded from the measure. The real estate levy is levied on income derived from the renting and leasing of real estate located in Luxembourg, on capital gains derived from the transfer of real estate located in Luxembourg, and on income derived from the (direct or indirect) transfer of interests or units in a tax transparent entity or a mutual investment fund owning real estate located in Luxembourg.

Investment vehicles concerned will have to declare all income to which the levy applies that was received or realized during a given calendar year by 31 May of the next calendar year (31 May 2023 for calendar year 2022). Any real estate levy must be paid no later than 10 June.

### 11.3.2.4. Tax on dissolution

Mergers, demergers and dissolutions of a Luxembourg UCI generally do not give rise to Luxembourg direct tax at the level of the Luxembourg UCI.

The transformation of a SICAV into a common fund and *vice versa* has no impact for Luxembourg direct tax purposes at the level of the Luxembourg UCI.

If the Luxembourg UCI holds real estate located in Luxembourg, a case-by-case analysis is required for indirect tax purposes.

## 11.3.3. Taxation of the assets of Luxembourg UCIs

This section provides an overview of the taxation of assets of Luxembourg UCIs.

### 11.3.3.1. Withholding tax on income

Luxembourg UCIs may be subject to withholding taxes (WHT) on dividends and interest and to tax on capital gains in the country of source of the income from their investments.

Only certain double tax treaties (DTTs) signed by Luxembourg are applicable to Luxembourg UCIs. Treaties with the following 60 countries should be applicable to investment companies (according to existing legislation):

Andorra	Estonia	Korea <sup>5</sup>	Qatar	The Seychelles
Armenia	Finland	Kosovo	Romania	Trinidad and Tobago
Austria	Georgia	Laos	San Marino	Tunisia
Azerbaijan	Germany	Liechtenstein	Saudi Arabia	Turkey
Bahrain	Guernsey	Macedonia	Serbia	United Arab Emirates
Barbados	Hong Kong	Malaysia	Singapore	Uruguay
Brunei	Hungary	Malta	Slovakia	Uzbekistan
China	Indonesia	Moldova	Slovenia	Vietnam
Croatia	Ireland	Monaco	Spain <sup>7</sup>	
Cyprus	Isle of Man	Morocco	Sri Lanka	
Czech Republic	Israel	Panama	Tadjikistan	
Darussalam	Jersey	Poland	Taiwan	
Denmark	Kazakhstan	Portugal <sup>6</sup>	Thailand	

For investment companies set up under the SIF Law, treaties with these countries should, in principle, also apply (except for the treaty with Spain); they are also expected to apply to investment companies set up under the RAIF Law.

<sup>5</sup> On 16 January 2020, the Korean Supreme Court ruled that Luxembourg SICAVs and SICAFs were entitled to benefit from the DTT between Luxembourg and the Republic of Korea. The court ruled that SICAVs and SICAFs are Luxembourg tax residents and beneficial owners of the Korean source income earned and are not holding companies for the purposes of Article 28 of the treaty based on which the Korean Ministry of Strategy and Finance had, in May 2011, issued an authoritative tax barring them from treaty benefits.

<sup>6</sup> In August 2012, the Portuguese tax authorities published a technical note regarding the entitlement of Luxembourg domiciled investment companies with variable capital (SICAVs) to benefit from the DTT between Luxembourg and Portugal. The note clarifies that Treaty benefits should apply, provided the SICAV meets the residency requirements of the Treaty. However, it does not clarify whether Treaty benefits will be extended to entities other than SICAVs. Historically, Treaty benefits were not generally extended to Luxembourg SICAVs, due to interpretations of an article of the Treaty.

<sup>7</sup> Only applicable to UCITS (Part I of the 2010 Law).

The applicability of such DTTs, however, is not always clear. In principle, common funds will not benefit (with certain exceptions, such as Germany) unless the unitholders themselves are able to claim the reduced rate under the DTT, which, in practice, may be very difficult. Furthermore, investment companies may be able to benefit from DTTs with certain other countries that do not specifically mention their applicability to such funds. These include<sup>8</sup>:

- Bulgaria
- Greece
- Italy

Please refer to our separate publication “*Withholding Tax Rates Applicable to Luxembourg UCIs*” for detailed information on the WHT rates applicable to the different types of income received by Luxembourg UCIs.

#### 11.3.3.1.1. Reclaim opportunity for withholding tax

Investment funds may have the possibility to obtain refunds of dividend WHT (typically, where the WHT was considered to be discriminatory by the European Court of Justice (e.g., Aberdeen C-303/07, Santander C-338/11)).

Investment funds may therefore consider filing protective claims in a range of European jurisdictions in order to safeguard their potential refund claims.

Opportunities to file protective claims exist, for example, in a range of European jurisdictions including:

- |                  |                        |                   |
|------------------|------------------------|-------------------|
| ▸ Belgium        | ▸ Germany <sup>9</sup> | ▸ Portugal        |
| ▸ Czech Republic | ▸ Italy                | ▸ Spain           |
| ▸ Finland        | ▸ Norway               | ▸ Sweden          |
| ▸ France         | ▸ Poland               | ▸ The Netherlands |

#### 11.3.3.2. Financial transaction tax

Financial transaction tax (FTT) regimes may apply to certain transactions in financial instruments held by Luxembourg UCIs in case these transactions fall within the scope of domestic FTT regimes, e.g., in France, Italy or, since 2021, also Spain.

<sup>8</sup> See Circular L.G. A n°61 dated 8 December 2017 on Certificates of Residence for Luxembourg UCIs. With respect to Korea, see footnote No.5.

<sup>9</sup> For WHT suffered before 1 January 2018, the German Investment Tax Act treats foreign and domestic investment funds equally and eliminates the discriminatory taxation of foreign investment funds with regard to German WHT.

In September 2011, the European Commission (EC) published its proposals for the introduction of an EU Financial Transaction Tax (FTT). In February 2013, the EC submitted the revised *Proposal for a Council Directive implementing enhanced cooperation<sup>10</sup> in the area of Financial Transaction Tax*.

The key objectives of the FTT include:

- ▶ Harmonizing legislation concerning indirect taxation on financial transactions
- ▶ Ensuring that financial institutions make a fair and substantial contribution to public finances and creating a level playing field with other sectors from a taxation point of view
- ▶ Creating appropriate disincentives for transactions that do not enhance the efficiency of financial markets or of the real economy, thereby complementing regulatory measures to avoid future crises

Under the proposed directive, financial transactions carried out by “financial institutions” would be subject to FTT when there is an established link to the FTT-zone. The FTT-zone would consist of Member States participating in the FTT under the enhanced cooperation procedure.

“Financial institutions” would include credit institutions, investment firms, insurance and reinsurance undertakings, UCITS, pension funds, alternative investment funds (AIFs), securitization vehicles, regulated markets, and other organized trading venues or platforms.

The “residence” principle and the “issuance” principle would apply to determine whether there is a link to the FTT-zone.

In December 2015, the Finance Ministers of 10 participating Member States (Austria, Belgium, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain) issued a joint statement reaffirming their aim to create a harmonized taxation regime for financial transactions and to introduce an EU FTT and agreeing certain, but not all, features of such an EU FTT.

In March 2016, Estonia, which had previously intended to participate in the FTT, completed the formalities to leave the enhanced co-operation on FTT.

During the first half of 2016, within the relevant EU Working Party on Tax Questions which performs preparatory work for the EU Council, the debate continued, without unanimous agreement, on selected issues already raised: application of the “issuance” and “residence” principles and the territorial scope for the FTT, the possible exemption of market making activities and the scope of transactions in derivatives to be subject to the FTT.

In early 2017, the EU Commissioner responsible for FTT indicated that a draft legislative text would be forthcoming later in 2017. However, no draft has been published yet and the finance ministers of the 10 prospective participating Member States suspended negotiations in September 2017 to examine the impact on FTT of the UK’s departure from the EU, planned at the time for March 2019.

In October 2019, a meeting of the Finance Ministers of the prospective Participating Member States was held, which asked the German Finance Minister to circulate a new version of the proposed FTT directive on the basis of the discussions to date; this new version was circulated in December 2019.

Following the adoption in December 2020 of the EU’s long-term budget for 2021-2027, the Commission mentioned in its published Q&As that it will propose further new own resources, which could include a FTT, taking into account developments in the currently ongoing work on enhanced cooperation. In February 2021, the Portuguese presidency of the EU Council relaunched discussions between the Member States to move the file forward.

### 11.3.3.3. Taxation of holding structures

In addition to taxation at the level of the underlying assets of Luxembourg UCIs, intermediate holding structures may also be subject to taxation.

This section provides a general overview on the taxation of Luxembourg holding companies. The most common holding companies are SOPARFIs; securitization vehicles are also used in certain cases.

The taxation of international holding structures is beyond the scope of this *Technical Guide*.

#### A. SOPARFIs

Luxembourg SOPARFIs are briefly introduced in Section 2.7.1.

SOPARFIs are fully taxable Luxembourg companies, subject to corporate income tax (CIT), municipal business tax (MBT), net worth tax (NWT) and, potentially, VAT. The taxable worldwide income is subject to CIT (plus employment fund surcharge) and MBT. The aggregate tax rate is currently 24.94% in Luxembourg City. Furthermore, SOPARFIs are subject to annual NWT at a tax rate of 0.5% on the adjusted NAV (the unitary value) up to and including EUR 500 million plus 0.05% on the part of adjusted NAV exceeding EUR 500 million at the beginning of the year. Upon request, the NWT can be reduced (up to the amount of the prior year CIT due) by creating a special reserve equal to five times the amount of NWT to be reduced. Such reserve needs to be kept in the annual accounts for five years. SOPARFIs that are subject to Luxembourg CIT and whose sum of financial fixed assets, amounts owed by affiliated undertakings and by undertakings

<sup>10</sup> The enhanced cooperation procedure allows a group of Member States to cooperate within an EU framework without all Member States participating. At least nine Member States must address a formal request to the EC, describing the scope and the objectives of the cooperation, and should sign this request. The enhanced cooperation allows any other Member State to join at a later stage upon request.

with which the company is linked by virtue of participating interests, transferable securities, cash in banks, cash in postal check accounts, checks and cash in hand exceeds 90% of their balance sheet total and EUR 350,000 are subject to a flat annual minimum NWT amounting to EUR 4,815. SOPARFIs that do not meet the above conditions are subject to a variable annual minimum NWT, which ranges from EUR 535 to EUR 32,100, depending on the balance sheet total at the financial year end. SOPARFIs must hence pay the higher of the minimum NWT or the NWT determined on the basis of their unitary value. If the minimum NWT applies, it is reduced by the amount of CIT (including contribution to the employment fund but after deduction of possible tax credits) due by the company for the preceding year.

Assets that generate income (or are likely to generate income) that is not taxable in Luxembourg, including income for which the taxation right belongs to another country based on a DTT concluded with Luxembourg (e.g., immovable property, or assets allocated to a permanent establishment) should be excluded from the balance sheet total for the purpose of determining the said minimum tax. This allows, *inter alia*, Luxembourg real estate vehicles directly holding foreign real estate property not to be highly impacted.

Furthermore, provided certain conditions are met:

- ▶ Dividends paid by and capital gains realized from direct subsidiaries of a SOPARFI may be exempt from corporate income tax and municipal business tax (i.e., the participation exemption regime may apply)
- ▶ Interest expenses may be tax deductible if the arm's length principle is respected and they are not linked to the financing of a tax exempt asset; interest deductibility, since 2019, is nevertheless subject to the interest limitation rules and, where relevant, the anti-hybrid rules implementing the EU Anti-Tax Avoidance Directive (the "ATAD Laws" - see below)
- ▶ Participations in qualifying subsidiaries of the SOPARFI may be exempt from NWT

WHT may be levied on dividends distributed and, in certain specific cases, interest paid by a SOPARFI.

Dividends paid by SOPARFIs may be exempt from 15% WHT on the gross amount of the dividend under domestic law or DTT provisions. SOPARFIs have access to more than 80 DTTs and benefit from the provisions of EU Directives. Measures to prevent treaty abuse and improve dispute resolution have been introduced through the MLI (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS), with effect, for Luxembourg, from January and February 2020.

#### *The Anti-Tax Avoidance Directive (ATAD) Laws*

The two ATAD Laws (Law of 21 December 2018 implementing the European Union (EU) Anti-Tax Avoidance Directive 2016/1164 and the Law of 20 December 2019 implementing Directive 2017/952 amending EU Anti-Tax Avoidance Directive) introduced several anti-tax avoidance provisions applicable to tax years starting on or after 1 January 2019. The ATAD Laws have clarified the scope of the Luxembourg general anti-avoidance rule (GAAR) in line with the GAAR included in the ATAD itself. As reworded, the GAAR provides that tax law cannot be circumvented by an abuse of forms or institutions of law; such abuse occurs if a legal path is used, at least one of whose principal objectives is to obtain a circumvention or reduction of taxation that defeats the object or purpose of the tax law and is not authentic, i.e., is not put in place for valid commercial reasons which reflect economic reality.

The ATAD Laws also introduced anti-hybrid mismatch rules whereby Luxembourg will (i) deny the deduction of an expense related to a hybrid mismatch to the extent the expense would otherwise result in a deduction both in Luxembourg and in another State (double deduction) or in a deduction (in Luxembourg) without inclusion in another State involved in the mismatch; and/or (ii) tax income derived under a hybrid arrangement if the source country has not addressed the mismatch. While the scope of these rules was limited to intra-EU situations for financial years starting on or after 1 January 2019, the rules denying deductions apply, for tax years starting on or after 1 January 2020 to defined hybrid mismatches involving EU and third countries. Relevant hybrid mismatches include hybrid financial instruments, payments to and by a hybrid entity, hybrid permanent establishment (PE) mismatches, hybrid transfers, imported mismatches, and dual resident mismatches. As from tax year 2022, reverse hybrid entities that are established in Luxembourg may be subject to Luxembourg CIT.

The ATAD Laws limit the deductibility of "exceeding borrowing costs", corresponding to the excess of borrowing costs (as defined) over interest income and other economically equivalent taxable revenues, to the higher of EUR 3 million (safe harbor rule) or 30% of the taxpayer's taxable earnings before interest, tax, write-downs, depreciation and amortization (taxable EBITDA); exceeding borrowing costs may be carried forward with no limit in time and unused interest capacity may be carried forward for five years. Interest on loans concluded before 17 June 2016 and not subsequently modified is grandfathered; an equity escape rule is available to members of a group consolidated for financial accounting purposes; stand-alone entities and financial undertakings specified by the ATAD Laws (essentially credit institutions, regulated investment firms, insurance and reinsurance undertakings, UCITS management companies and AIFMs, UCITS, AIFs managed by an AIFM, and certain pension institutions) are not subject to interest limitation.

Finally, the ATAD Laws introduced Controlled Foreign Company (CFC) rules whereby the income of a CFC (as defined by the ATAD Laws) not distributed directly to the Luxembourg controlling entity, which results from arrangements put in place for the essential purpose of obtaining a tax advantage and which are "non-genuine arrangements", is included in the Luxembourg entity's taxable income to the extent it arises from assets and risks in relation to which the Luxembourg entity carries out significant people functions.

## B. Securitization Vehicles

Luxembourg securitization vehicles are briefly introduced in Section 2.7.2.

Luxembourg securitization vehicles have access to beneficial taxation regimes, which can be briefly summarized as follows:

- Securitization companies in corporate form:
  - Are fully taxable companies subject to corporate income tax and municipal business tax; however, commitments (interest or dividend) to investors and creditors qualify as tax deductible business expenses even if they have not actually been paid out in a given year
  - Are subject to the interest limitation rule which limits the annual deductibility of taxpayers' exceeding borrowing costs
  - Are subject to minimum NWT but are otherwise exempt from general NWT
  - Have access to existing DTTs on a case-by-case basis
- Securitization funds and securitization companies in partnership form are generally tax transparent entities that are exempt from any direct taxation in Luxembourg, including the annual subscription tax
- Management services provided to securitization vehicles are VAT exempt
- Repatriation of proceeds to investors are free from Luxembourg WHT

### 11.3.3.4. Transfer pricing considerations

Transfer pricing is the determination of the compensation to be applied on dealings between related parties, where a "natural" negotiation process and market behavior would not apply. These compensations impact the assessable basis of the relevant entities and are thus an area of focus for the tax authorities.

The Luxembourg transfer pricing legislation is included in Article 56 and Article 56bis of the Income Tax Law. Article 56 introduces the arm's length principle in the domestic legislation, while Article 56bis provides details on the application of the arm's length principle, in particular with regard to the comparability analysis.

Transfer pricing impacts all dealings between related parties, which include:

- Management company remuneration
- Management fees allocation
- Delegation of functions/retrocessions
- General partner remuneration
- Financing transactions
- Service flows and cost allocation
- Restructurings (transfer of functions, sale of portfolio, etc.)

Taxpayers need to be in a position to support the impact of these related party transactions on their tax returns. As it relies on the functions performed, assets used, and risks borne, transfer pricing documentation is not only of interest for the tax authorities but is also of interest for the regulators.

### 11.3.3.5. Other taxes impacting the assets of Luxembourg UCIs

There are many other types of taxes that may impact the assets of Luxembourg UCIs. For example, investments in real estate may be subject to transfer taxes or registration duties. Other taxes are beyond the scope of this *Technical Guide*.

## 11.3.4. Taxation of investors in Luxembourg UCIs

### 11.3.4.1. Withholding tax on dividends paid by Luxembourg UCIs

There is no WHT on dividends paid by Luxembourg UCIs (covered by the 2010 Law, SIFs and RAIFs).

### 11.3.4.2. Foreign UCI investors and foreign feeders

Non-resident UCI investors (individuals and corporations) are exempt from taxation in Luxembourg on capital gains realized upon sale of their shares in a Luxembourg corporate UCI (even in cases where they held a substantial shareholding of more than 10%). This facilitates the creation of master-feeder structures with a Luxembourg investment company as the master fund.

### 11.3.4.3. Luxembourg resident investors in UCIs

Upon distribution of dividends by the UCI or redemption of the shares or units of the UCI, the Luxembourg individual or corporate investor has to declare his income from the UCI in his annual tax return. Capital gains arising from the sale of UCI shares or units, other than speculative gains (i.e., sale of the shares or units of the UCI within six months after acquisition), are exempt from taxation in the hands of Luxembourg resident individual investors. In case the individual investor holds more than 10% of the capital of a UCI in corporate form<sup>11</sup>, any gain realized on sale of the shares is subject to individual taxation in Luxembourg.

<sup>11</sup> | The 10% threshold is determined on an umbrella fund basis.

Dividends and capital gains realized upon redemption of shares or units in a Luxembourg UCI are generally subject to corporate taxation at the level of a Luxembourg corporate investor (regardless of the holding period and the percentage held).

#### 11.3.4.4. Enhanced international cooperation

##### 11.3.4.4.1. European Union Member States

The Law of 29 March 2013 transposing part of the Directive 2011/16/EU on administrative cooperation in the field of taxation (often referred to as "DAC") entered into force with retroactive effect from 1 January 2013.

The Law of 29 March 2013, as amended, lays down the rules and procedures under which Luxembourg will cooperate with other EU Member States on the exchange of tax related information that is foreseeably relevant to the administration and enforcement of the domestic laws of the Member States. The Law complements Luxembourg's legislation enabling the exchange of information provided for by DTTs. In recent years, Luxembourg has signed new DTTs and amended existing DTTs with other countries that comply with the OECD standards on the exchange of information upon request between tax authorities.

The Law applies to all taxes except VAT, customs duties and excise duties covered by other EU legislation on administrative cooperation between EU countries. It does not apply to social security contributions.

The Law implements almost all provisions of the Directive, *inter alia*:

- ▶ Inclusion of information held by a bank or other type of financial institution in the scope of exchange of information on request regarding taxable periods from 1 January 2011
- ▶ Introduction of deadlines for the exchange of information
- ▶ Introduction of other forms of administrative cooperation

In March 2014, the Law of 26 March 2014 was adopted by the Luxembourg Parliament implementing automatic exchange of information in accordance with Article 8 of the Directive 2011/16/EU on administrative cooperation in the field of taxation, as amended.

The Law introduced the automatic and mandatory exchange of information for specific categories of income. Luxembourg tax authorities communicate information on employment income (falling within the scope of Luxembourg WHT on wages), pension income, and directors' fees paid from 2014 onwards.

On 9 December 2014, Council Directive 2014/107/EU amending Directive 2011/16/EU (often referred to as DAC 2) was adopted. It required that all EU Member States apply automatic exchange of information on financial accounts starting 1 January 2016 (except Austria, which had to start by 2017) in accordance with the OECD's Common Reporting Standard (CRS) (see Section 11.3.4.4.3.). DAC 2 was implemented in Luxembourg by the Law of 18 December 2015 on the automatic exchange of financial account information in tax matters (the "CRS Law").

The scope of the DAC has gradually been extended by the addition of further types of automatic exchange of tax-related information, through amending Directives known as DAC 3 on automatic exchange of information concerning tax rulings and advance pricing agreements, DAC 4 on country-by-country reporting of certain financial information by multinational groups, DAC 5 ensuring that tax authorities have access to beneficial ownership information collected for anti-money laundering purposes and DAC 6 on automatic exchange of information on reportable cross-border arrangements (also known as Mandatory Disclosure Rules - MDR - see Section 11.3.4.4.4.). On 22 March 2021, the Council of the European Union further extended the scope of DAC (DAC 7) by adopting new rules introducing a reporting obligation for digital platforms located both inside and outside the EU and an automatic exchange of information between Member States' tax administrations on revenues generated by sellers on these platforms as of 1 January 2023. The first reporting of data will be required by 31 January 2024.

##### 11.3.4.4.2. FATCA

The Foreign Account Tax Compliance Act (FATCA) provisions are United States legislation that apply mainly to non-US entities that FATCA defines as Foreign Financial Institutions (FFIs) and aims to prevent tax evasion by US persons through the use of accounts outside the US or of foreign investment vehicles.

The FATCA provisions were ultimately incorporated into the Hiring Incentives to Restore Employment Act (HIRE Act), which was enacted in March 2010. Regulations were issued in January 2013 and were amended and completed by a further package of Regulations in February 2014 and January 2017. The FATCA provisions were essentially applicable from 1 July 2014.

The implementation of FATCA is ensured mainly by Intergovernmental Agreements (IGAs) signed by the United States with many countries, including Luxembourg<sup>12</sup>.

<sup>12</sup> | The US Department of the Treasury publishes a list of partner jurisdictions and signs IGAs.

In March 2014, Luxembourg signed a Model 1 IGA providing that Reporting Luxembourg FFIs will report information annually on certain account holders to the Luxembourg tax authorities, which, in turn, will provide such information to the US under an automatic exchange of information. The Luxembourg-USA IGA was amended by an exchange of notes signed 31 March 2015 and 1 April 2015 and approved by the Law of 24 July 2015 (the "FATCA Law").

By the end of May 2022, the United States had IGAs in force with 95 countries, IGAs signed with a further nine countries, and substantial agreement had been reached with nine other countries.

Under FATCA, FFIs are *de facto* required to become information-gathering and tax collection agents on behalf of the IRS. FFIs, as defined by FATCA, cover a broad range of financial institutions, including banks, life insurance companies, investment funds, pension funds, mutual funds, private equity funds, broker dealers, and management companies.

FFIs' "on-boarding" processes<sup>13</sup> for "new account holders" (including investors in investment funds) had to be FATCA-compliant by 1 July 2014 and a data and (in some cases) documentation review process with respect to "pre-existing accounts" had to be performed and completed by specified dates, the latest being 30 June 2016. Luxembourg reporting FFIs are required to register with the IRS and to obtain a Global Intermediary Identification Number (GIIN).

FFIs that are Investment Entities (e.g., investment funds) must report the following information annually:

- ▶ The identity and account balances of US Specified Persons that were, at any time during the year reported, account holders or the Controlling Persons of a Passive Non-Financial Foreign Entity (Passive NFFE) that was an account holder, the aggregate income and redemption proceeds paid to such US accounts during the year reported and payments to non-participating FFIs
- ▶ Luxembourg Reporting FFIs are also required to provide a "nil report" to the Luxembourg tax authorities if they have no accounts to report

Certain FFIs may face a lighter burden of compliance if they fulfill conditions to be "deemed-compliant" FFIs, also referred to as "Non-Reporting FIs" under the IGA.

Failure by a FFI to comply with FATCA will result in a 30% WHT being applied by US withholding agents and by other FFIs on "withholdable payments"<sup>14</sup> to such a "non-participating FFI", including dividends and interest paid by US issuers (in some cases, starting 1 July 2014), as well as potentially in the future gross proceeds of the sale of US securities.

The FATCA Law also provides for penalties to be charged by the Luxembourg tax authorities, up to EUR 250,000 if a Luxembourg FI fails to comply with the required due diligence procedures or fails to implement reporting mechanisms and 0.5% of amounts due to be reported by the FI (and minimum EUR 1,500) in case of failure to report or incomplete or incorrect reporting. As of 1 January 2021, a further fine of EUR 10,000 may apply if a Luxembourg Reporting FI fails to submit an annual FATCA report on time (including in case of failure to submit a nil report). These penalties apply separately (and may therefore be cumulated) for FATCA.

Finally, in fulfilling its obligations under the FATCA Law, a Luxembourg FI has duties to fulfill pursuant to the EU Global Data Protection Regulation (GDPR) (see further details under in Section 11.3.4.4.3. OECD Common Reporting Standard (CRS)).

#### 11.3.4.4.3. OECD Common Reporting Standard (CRS)

In line with FATCA developments, in February 2014, the OECD released a new standard for the automatic exchange of information between tax authorities, also known as the Common Reporting Standard (CRS). Further details were published in July 2014.

The CRS, like FATCA IGAs, broadly defines Financial Institutions (FIs), thereby including, *inter alia*, banks, insurance companies, investment funds, pension funds, mutual funds, private equity funds, broker dealers, and management companies, unless they present a low risk of being used for evading tax and, subject to detailed conditions, are excluded from reporting obligations.

The CRS requires that FIs in CRS-participating countries should:

- ▶ Apply "account holder" identification and documentation procedures, including indicia searches, to identify the country of tax residence of account holders (including investors in investment funds)
- ▶ Annually report individuals resident (or deemed to be resident) in CRS-participating countries (including controlling persons of "passive" non-financial entities) and entities resident in CRS-participating countries other than FIs, the value of their assets or account and the aggregate of certain payments they receive, to the FI's tax authority, who will in turn forward this information to the tax authority of the country (or countries) of residence or deemed residence
- ▶ Luxembourg Reporting FIs are also required to provide a "nil report" to the Luxembourg tax authorities if they have no accounts to report

<sup>13</sup> This refers essentially to the procedures to be applied upon opening of a new "account" or upon issuance of new shares or units of a UCI to an investor. The UCI (or other FFI) must identify the investor (or other "account holder"), categorize it correctly for FATCA purposes, and obtain the appropriate documentation for FATCA purposes. With respect to pre-existing accounts of individuals, the presence of certain "US indicia" needs to be checked and, if present, triggers further documentation requirements or reporting of such individuals as Specified US Persons. In the case of entities, the categorization is relatively complex and, for some, control of the entity, through ownership or by other means, needs to be identified and, in some cases, reported.

<sup>14</sup> "Withholdable payment" includes not only payments of income and gains from US sources (including but not limited to dividends and interest, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income) but also gross proceeds from the disposition of securities that can produce US sourced dividends or interest. Payments relating to certain grandfathered obligations are excluded.

In May 2013, Luxembourg signed the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which provides a legal basis for the automatic exchange of tax information between signatory countries who so agree. By passing the Law of 26 May 2014, the Luxembourg Parliament approved the Convention.

As at 31 January 2022, 115 countries (including Luxembourg) have signed the Multilateral Competent Authority Agreement (MCAA) under which they participate in applying the OECD's common reporting standard. A total of 53 countries, including Luxembourg, signed as "early adopters" of the OECD's common reporting standard, adhering to the following phasing in of the CRS rules:

- ▶ 1 January 2016: New account opening procedures to record tax residence had to be in place for new accounts that are or were opened on or after this date
- ▶ 31 December 2016: Due diligence procedures for identifying high-value, pre-existing individual accounts had to be completed
- ▶ 30 September 2017: The first exchange of information between tax authorities was completed by this date, in relation to new accounts and pre-existing accounts identified as reportable for 2016
- ▶ 31 December 2017: Due diligence procedure for identifying low-value, pre-existing individual accounts had to be completed
- ▶ 30 September 2018: Exchange of information between tax authorities took place by this date in relation to accounts identified as reportable for 2017

Other signatories (48) of the MCAA committed to apply the CRS from 1 January 2017. For them, each of the above milestones is one year later than for the early adopters. One signatory committed to apply the CRS from 2018, five from 2019, one from 2020 and two from 2021.

Directive 2014/107/EU of 9 December 2014 (often referred to as "DAC 2") also required that all EU Member States apply the CRS between Member States starting 1 January 2016 (except Austria, which had to do so by 2017). In Luxembourg, the Directive and the CRS were implemented by the Law of 18 December 2015 on the automatic exchange of financial account information in tax matters (the "CRS Law").

Both the FATCA Law and the CRS Law provide for penalties to be charged by the Luxembourg tax authorities, up to EUR 250,000 if a Luxembourg FI fails to comply with the required due diligence procedures or fails to implement reporting mechanisms and 0.5% of amounts due to be reported by the FI (and minimum EUR 1,500) in case of failure to report or incomplete or incorrect reporting.

As of 1 January 2021, a further fine of EUR 10,000 may apply if a Luxembourg Reporting FI fails to submit an annual FATCA or CRS report on time (including in case of failure to submit a nil report). These penalties apply separately (and may therefore be cumulated) for CRS.

Finally, in fulfilling its obligations under the FATCA Law and under the CRS Law, a Luxembourg UCI is acting as a data controller as defined by the EU GDPR and, in accordance with the GDPR, the FATCA Law and the CRS Law, it has a duty to notify investors and investors' controlling persons (where applicable):

- ▶ That personal information will be collected and processed for the purposes of the FATCA Law and the CRS Law by the UCI, or by the UCI's investment manager, central administration agent, depository bank, global distributor, management company or their delegates on its behalf and will, where required by the FATCA Law and/or the CRS Law, be reported to the Luxembourg tax authorities and by the Luxembourg tax authorities to the US Internal Revenue Service and/or to the tax authorities of other countries that are or will be participating in the CRS
- ▶ Which data will be reported
- ▶ That replying to requests for information or documentation required by the FATCA Law or by the CRS Law is compulsory and the consequences that may result from the absence of the required response
- ▶ And that each person whose personal data is so collected and processed or disclosed to the Luxembourg tax authorities has a right of access to such data and a right to have incorrect or incomplete data rectified

#### 11.3.4.4.4 Mandatory Disclosure Rules (MDR)/DAC 6

The Council of the European Union has adopted Directive 2018/822 (DAC 6) aimed at boosting transparency to tackle what it sees as aggressive cross-border tax planning. The Directive, which entered into force on 25 June 2018, requires "intermediaries" to report transactions and arrangements that are considered by the EU to be potentially aggressive. If there are no intermediaries which can report, the obligation will shift to the taxpayers. Following the reporting of the arrangements, the information about the arrangements will automatically be exchanged between Member States.

The main objectives of the DAC 6 are to:

- ▶ Provide tax administrations with comprehensive and relevant information about potentially aggressive arrangements to enable authorities to react promptly against harmful tax practices, i.e., closing loopholes with new legislation or undertaking tax audits
- ▶ Place an obligation on those who are involved in designing, marketing, organizing or managing the implementation of reportable cross-border transactions or a series of such transactions, as well as those who provide assistance or advice
- ▶ Act as a deterrent against marketing and implementation of these types arrangements



To be reportable, an arrangement needs to meet the definition of being cross-border (involving one or more EU Member States, or, involving one EU Member State and a third-party country) and must meet one or more of the conditions that are defined through hallmarks.

Luxembourg implemented the DAC 6 Directive by enacting the Law of 25 March 2020. The final Luxembourg MDR legislation is broadly aligned to the requirements of the Directive and covers the same hallmarks.

Lawyers, certified accountants and independent auditors are exempt from reporting under the Law but they are still required to notify other intermediaries of their obligation to report or, in the absence of an intermediary that has a reporting obligation, to notify relevant taxpayers of their obligation to report.

Any potential reporting obligations must be complied with within 30 days beginning on the earlier of:

- The day after the arrangement was made available
- The day after the arrangement was ready for implementation
- The day when the first step of implementation was undertaken

Cross-border reportable arrangements, where the first step of implementation is taken in the period from the date of entry into force of the Directive (25 June 2018) until 30 June 2020:

- Had to be reported by 28 February 2021, and
- Arrangements that were made available for implementation, that were ready for implementation or for which the first step of implementation had been made between 1 July 2020 and 31 December 2020 were reportable by 31 January 2021

## 11.3.5. Taxation of fees paid by Luxembourg UCIs

### 11.3.5.1. Directors' fees

A WHT of 20% is levied on the gross amount of the fees (equivalent to 25% of the net amount of the fees) at the time of payment. It applies to directors' fees paid to companies and to individuals and is creditable against the recipient company's/individual's Luxembourg tax.

The WHT is usually not final for resident directors who must submit an individual income tax return whenever their income includes directors' fees whose amount exceeds EUR 1,500.

The WHT is final for non-resident directors provided that this is their only Luxembourg sourced professional income and provided this income does not exceed EUR 100,000 gross per year. However, a non-resident director may elect to file a tax return in order to profit from an average tax rate that may be less than the WHT rate (20%).

Starting with the income of the year 2014, the Luxembourg tax authorities automatically communicate with the tax authorities of the country of residence of the beneficiary (to the extent the beneficiary resides in another EU Member State) information regarding Luxembourg directors' fees.

A specific return (WHT return on directors' fees) is to be filed by the entity paying the directors' fees within eight days of the payment. The WHT must be paid to the relevant tax authority within the same period (within eight days of the fee payment). A register of the WHTs must be kept up-to-date, recording the name and address of the beneficiary, the amount of the tax withheld, and the date the tax was paid.

Directors' fees also fall within the scope of VAT but should benefit from a VAT exemption when in relation to the management of UCIs.

### 11.3.5.2. Carried interest

The AIFM Law defines "carried interest" as a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF and excluding any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF.

The Law considers that carried interest corresponding to such definition, realized by certain physical persons that are employees of the AIF or their management company is to be regarded as "speculative income" under Luxembourg's Income Tax Law, giving rise to a taxation at standard tax rates (maximum tax rate being 45.78%) and being subject to dependence insurance contribution levied at a rate of 1.4%. A beneficial tax rate was available under certain circumstances, whereby the applicable tax rate would be 25% of the average tax rate applicable to the taxpayer's adjusted income – i.e., a maximum of 11.44%. In addition, dependence insurance (1.4%) would also be due.

To benefit from the tax regime, physical persons must not have been Luxembourg tax residents, or subject to tax in Luxembourg on their professional income, during the five years before the year of implementation of the AIFM Law. The physical persons must, furthermore, establish their tax domicile in Luxembourg in the period from 1 January 2013 to 31 December 2018. The favorable tax treatment will no longer be applicable to individuals establishing their residence in Luxembourg after 31 December 2018. A new regime is currently under discussion. However, it is not yet known when new measures it will be enforced.

Provided that the carried interest is considered as compensation for the management of the AIF, the remuneration falls within the scope of VAT but should benefit from the VAT exemption scheduled for the management of UCIs.

### 11.3.6. Taxation impacts of selected restructuring scenarios

Tax considerations need to be examined carefully prior to proceeding with any particular restructuring project, be they mergers of UCIs (see also Section 3.7.), conversions of ordinary UCITS into feeder UCITS (see also Section 3.6.3.), creation of master-feeder structures (see also Section 2.3.4.1. and 11.3.4.2.), feeder UCITS changing master UCITS (see also Section 3.6.3.), cross-border restructuring of the fund management activities (see Sections 6.3.4. and 6.5.5.7.), or recourse to third-party service providers (see also Section 6.3.3.).

### 11.3.7. Taxation of foreign UCIs managed in Luxembourg

The 2010 Law and the AIFM Law have introduced provisions into Luxembourg tax law whereby UCIs established under foreign law whose place of effective management or central administration is in Luxembourg are exempt from corporate income tax, municipal business tax, and net worth tax.

Assets and profits of the management company resident in Luxembourg remain, however, fully subject to corporate taxation in Luxembourg (see Section 6.5.5.).

### 11.3.8. Guidance on tax offences indicators

On 3 July 2020, the CSSF issued Circular 20/744 to complement Circular 17/650 which aims to provide guidance on the extension of the offence of money laundering to aggravated tax fraud and tax evasion. CSSF Circular 20/744 provides new indicators to be taken into account in risk assessment duties and risk mitigation measures of professionals providing services in the collective investment industry.

Operators within the collective investment field will need to take appropriate action to confirm or reach the expected compliance level based on the latest tax developments and also considering the additional examples provided in the CSSF Circular.

CSSF Circular 17/650 published in February 2017 provided general guidance for all entities falling under the supervision of the CSSF to raise suspicions of tax evasion or money laundering through a non-exhaustive list of 21 common indicators set out under Annex 1 to the Circular.

CSSF Circular 20/744 completed Annex 1 by listing additional indicators more specific to the context of collective investment activities, still with the aim of detecting possible cases of money laundering offences relating to aggravated tax fraud or tax evasion.

The new indicators include, *inter alia*, the following :

- ▶ Complex investment structuring: Recourse to one or several legal entities or investment structures interposed between the UCI and the ultimate target investment, located in different jurisdictions with some of them not complying with international transparency standards
- ▶ Tax base erosion: Use of cross-border transfers to significantly erode the tax base of the investment manager (e.g., through base erosion strategies such as for example, management or marketing commissions and/or retrocessions but also interest or dividend flows, and/or cross-border transfers of intangible assets)
- ▶ The use of companies or legal structures located in a jurisdiction other than the tax residence or place of regular economic or professional interests of the beneficial owner, except where (1) the customer demonstrates that its establishment complies with the legal provisions of the country of residence of the customer/beneficial owner or (2) the existence of the legal person is in effect known by the tax authorities of the country of residence of the beneficial owner based on supporting evidence
- ▶ Completion of a commercial transaction at a price that is obviously under-estimated, overestimated or inconsistent
- ▶ Investment transactions: Performance of investment transactions on unregulated markets where the economic beneficiaries of the counterparties to the transaction and/or the intermediaries are located in jurisdictions not subject to the automatic exchange of information; transactions that do not have apparent economic rationale in a specific context, and recurring loss-making transactions that do not appear to raise any concern
- ▶ Efficient portfolio management techniques: Recourse to securities lending or similar transactions which may create tax arbitrage or tax refunds that have been or could be considered as aggravated tax fraud or tax evasion
- ▶ SICAR: Illegal use of the SICAR status where the UCI, for example, is not in a position to fulfil the requirement of investing in securities representing "risk capital" and, in particular, to create value at the level of the portfolio companies/ or developing the target entities
- ▶ Subscription tax: The UCI or the IFM is not able to file subscription tax returns, due to a lack of adequate and sufficient information on the quality and status of the investors
- ▶ Investor tax reporting: The UCI or the IFM does not comply with the local laws of the country of distribution

Taking into consideration this guidance and the practical examples provided by the CSSF and bearing in mind the simultaneous occurrence of further tax developments, such as ATAD and MDR, Luxembourg financial center operators have to demonstrate increased vigilance with respect to specific and sometimes highly complex areas of taxation, in order to ensure appropriate compliance. Luxembourg operators should therefore take appropriate steps to ensure that their tax governance is fully in line with the latest developments in the tax environment and to adapt their impact assessment, training, processes and procedures accordingly.

## 11.4. Value added tax (VAT)

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### 11.4.1. Introduction

This Section outlines the taxable status of Luxembourg UCIs and their service providers (in particular management companies, AIFM, and advisory companies) and the VAT regime applicable to services provided to such Luxembourg UCIs and their service providers.

In order to determine the VAT treatment, and therefore the VAT rate or exemption applicable, the following questions need to be answered:

- Are the supplier and the purchaser of services considered as VATable persons?
- In which country is the service deemed to take place?
- If the place of supply is in Luxembourg, what is the applicable VAT regime?

### 11.4.2. Status of UCIs and management companies

#### 11.4.2.1. Common funds and their management companies

As a common fund has no legal personality, it is disregarded for VAT purposes and is thus not a VATable entity, while its management company is deemed to be a VATable person. Consequently, services provided to a common fund are deemed to be provided to its management company.

Where a common fund is managed by a management company established in a different Member State, the lack of harmonization within the EU in respect of the independent taxable status of common funds could, from a VAT perspective, lead to any of the following situations in case of services provided to the common fund:

- Double taxation
- Taxation in the home Member State of the common fund
- Taxation in the home Member State of the management company
- No taxation

Based on the current interpretation of the Luxembourg VAT Authorities, a common fund is disregarded for VAT purposes and the services are deemed to be rendered to the management company<sup>15</sup>.

Consequently, from a Luxembourg VAT perspective, services provided by a third party to a common fund established in a Member State other than Luxembourg and that has a Luxembourg management company should continue to be deemed to be provided to its management company established in Luxembourg. A case by case analysis of the situation is usually needed.

#### 11.4.2.2. Investment companies

Unlike common funds, investment companies have a legal personality. Following a decision of the Court of Justice of the European Union (CJEU)<sup>16</sup>, SICAVs are to be considered as taxable persons for VAT purposes. In view of this, VAT Circular No. 723 of 29 December 2006 confirmed that investment vehicles (such as SICAVs and SICAFs) whose management is VAT exempt by virtue of Article 44(1)(d) of the Luxembourg VAT Law<sup>17</sup> have the status of "taxable persons" for VAT purposes.

#### 11.4.2.3. Other investment vehicles

Other investment vehicles also benefit from the exemption from VAT for their management. This is the case for SIFs, SICARs, pension funds set up under the Law of 13 July 2005, as amended, and that are subject to the supervision of the CSSF, pension funds set up under the law dated 7 December 2015, as amended, and subject to the supervision of the *Commissariat aux Assurances* as well as in-house collective life insurance investment funds for which the subscribers bear the financial risk and that are subject to the supervision of the *Commissariat aux Assurances*.

The exemption from VAT scheduled by article 44, §1, d) is also applicable to similar undertakings established in other EU Member States and subject to the supervision of a similar regulatory body to the CSSF or the *Commissariat aux Assurances*.

Finally, securitization vehicles set up under the Law of 22 March 2004 and similar vehicles performing a securitisation activity as defined by the ECB Regulation No 24/2009 and AIFs as defined by the Law of 12 July 2013 also benefit from the VAT exemption for their management.

<sup>15</sup> This interpretation is notably supported by some other EU Member States.

<sup>16</sup> In the BBL case (C-8/03, 21/10/2004), the CJEU highlighted the fact that the activities performed by investment funds investing in transferable securities surpass the scope of the simple acquisition and sale of securities and consist of the exploitation of an asset for the purpose of obtaining income on a continuous basis. Therefore, the activities carried out by SICAVs qualify as economic activities from a VAT perspective. Hence, SICAVs are to be considered as taxable persons for VAT purposes.

<sup>17</sup> Law of 12 February 1979 concerning value added tax, as amended.

#### 11.4.2.4. Management companies and AIFMs

In Luxembourg, management companies, general partners, and AIFMs are considered to perform an economic activity and consequently are regarded as VATable persons.

#### 11.4.2.5. Fund mergers

The merger of Luxembourg funds should be considered as a transfer of going concern outside the scope of VAT, provided certain conditions are met.

In case of cross-border mergers, the place of taxation is in principle the country of the absorbing UCI (except in case of real estate assets) with possible exemption depending on the type of services or goods transferred.

#### 11.4.2.6. Conversion of a UCI into a feeder fund and master-feeder structures

No Luxembourg VAT consequences arise from the sole conversion of a Luxembourg UCI into a feeder UCI. Moreover, the transfer of the portfolio of assets of a Luxembourg feeder UCI to a master UCI in Luxembourg or in another country should fall outside the scope of the Luxembourg VAT (with exceptions, such as for real estate assets).

### 11.4.3. VAT group

Luxembourg implemented the VAT group into its legislation in 2018. The main purposes of its implementation was to replace the use of “Independent Group of Persons” in the financial sector, to mitigate VAT costs on intra-company transactions and VAT leakage when VAT group members have a limited or no input VAT deduction right.

There are various criteria to be met to be able to be part of a VAT group: financial, economic and organizational. Moreover, the implementation of a VAT group triggers various obligations but also administrative simplifications.

An in-depth analysis of the pros and cons is essential before any implementation of a VAT group.

### 11.4.4. Place of supply

#### 11.4.4.1. General rule

In order to determine the VAT regime applicable to a service, it is necessary to establish the country in which the service is deemed to be rendered.

For services rendered by Luxembourg suppliers to a Luxembourg purchaser, the service is deemed to be rendered in Luxembourg.

*Example:* An advisory service provided by a Luxembourg bank to a Luxembourg UCI is deemed to have been rendered in Luxembourg.

For services rendered by foreign suppliers to a Luxembourg taxable purchaser, the place of service is, as a general rule, considered to be the place where the recipient is established, i.e., Luxembourg.

The general rule to determine the place of supply of a service is as follows:

- ▶ For services rendered to a VATable person<sup>18</sup>, the place of supply is where that person has established its business or the place where a fixed establishment is located (if those services are provided to that fixed establishment)
- ▶ For services rendered to a non-VATable person, the place of supply is where the supplier has established its business or the place where a fixed establishment is located (if the services are supplied from that fixed establishment – see Section 11.4.4.2.). For non-taxable persons outside the EU, the place of supply is where that person is established, has his permanent address, or usually resides

As the management company established in Luxembourg is considered to be a VATable person, services rendered to it by foreign suppliers generally fall within the scope of Luxembourg VAT.

*Example:* An advisory service provided by a foreign company to a Luxembourg management company is deemed to take place in Luxembourg. The Luxembourg management company is liable to pay VAT relating to this supply of services (reverse charge mechanism), unless an exemption applies.

<sup>18</sup> The concept of “taxable persons” for the purpose of applying the rules concerning the place of supply of services also includes, for all services rendered to them:

- ▶ A taxable person who also carries out activities or transactions that are not considered to be taxable supplies of goods or services from a VAT standpoint
- ▶ A non-taxable legal person who is identified for VAT purposes

As investment companies are considered as taxable persons, the place of supply of services provided by a foreign supplier to such Luxembourg entities is deemed to fall within the scope of Luxembourg VAT.

*Example:* An advisory service provided by a foreign company to a SICAV is, from a Luxembourg point of view, deemed to take place in the country of establishment of the SICAV (i.e., in Luxembourg).

#### 11.4.4.2. Fixed establishment in the field of supply of services

As mentioned in the previous section, the place of supply of services rendered to a VATable person is where that person has established his business or the place where its fixed establishment is located (if those services are provided to that fixed establishment).

A fixed establishment according to Council Implementing Regulation (EU) No 282/2011 of 15 March 2011<sup>19</sup> is any establishment, other than the place of establishment of a business that is characterized by a sufficient degree of permanence and a suitable structure in terms of human and technical resources to enable it to provide the services or receive and use the services supplied to it for its own needs.

When receiving a service, having a VAT identification number is not in itself sufficient to consider that a taxable person has a fixed establishment.

#### 11.4.4.3. Place of supply of services connected with immovable property

It is worth mentioning that there are several derogations to the above general rule to determine the place of supply for services. It is notably the case for the services connected with immovable property, which are taxable at the place where the immovable property is located.

In the investment fund sector, the main services connected with immovable property notably include the valuation of immovable property, property management (other than portfolio management of investments in real estate), intermediation in the sale or leasing or letting of immovable property, and services of experts and real estate agents.

### 11.4.5. Nature of service and applicable VAT rate

#### 11.4.5.1. General rule

Once the place of supply has been established, it is important to determine the applicable VAT rate, unless an exemption applies.

The standard VAT rate is 17% in Luxembourg while intermediate, reduced, and super reduced rates of 14%, 8%, and 3% are also applicable on various items and services.

*Example:* Lawyers' and tax advisors' services rendered to Luxembourg UCIs are, in principle, subject to the standard VAT rate.

#### 11.4.5.2. Domiciliary services

Domiciliary services provided to UCIs are considered to be part of the management services, which are, in principle, exempt from VAT under the Luxembourg VAT Law.

#### 11.4.5.3. Management services

Management services provided directly to UCIs and AIF (including RAIFs) are exempt from VAT in accordance with Article 44(1)(d) of the Luxembourg VAT Law.

The Luxembourg legislation does not expressly define the notion of management of UCIs.

<sup>19</sup> Article 11, §1 and §2 of Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC in the common system of value added tax, as amended.

Investment management services as well as UCI and AIF administration services fall within the VAT exemption provision<sup>20</sup>. In addition to portfolio management, the following administrative functions also fall within the VAT exemption (non-exhaustive list), as confirmed by the Luxembourg VAT administration in its VAT Circular No 723:

- Legal<sup>21</sup> and fund management accounting services
- Customer inquiries
- Valuation of portfolio and pricing of the shares or units (including tax returns)
- Regulatory compliance monitoring
- Maintenance of shareholder or unitholder register
- Distribution of income
- Unit issues and redemptions
- Contract settlements (including certificate dispatch)
- Record-keeping

Further to the release of VAT Circular No 723 by the Luxembourg VAT administration, the VAT treatment of depositary services, the aim of which is to ensure that the management is performed in compliance with the law, has been confirmed. While most of the services rendered by depositaries are exempt, the control and supervisory activities, as defined in Articles 7(1) and (3), and 14(1) and (3) of the UCITS Directive, are henceforth taxable at an intermediate VAT rate of 14%.

Subsequently, the CJEU confirmed that the exemption also applies to portfolio management and investment recommendations to funds that invest in real estate<sup>22</sup>.

#### 11.4.5.4. Outsourced services

The application of the exemption of Article 44(1)(d) of the Luxembourg VAT Law has been extended to outsourced services when certain conditions are met.

In this respect, outsourced services fall under the exemption provided the principal limits its activity to strictly re-charging the services received from the sub-contractor to the UCIs and that, in the case of administrative and management services of the UCI, these services form a distinct whole, fulfilling in effect the specific and essential functions of the exempt management services. Consequently, mere material or technical supplies, for instance, are not VAT exempt<sup>23</sup>.

Furthermore, the CJEU confirmed that advisory services provided by a third party to the management company of a UCI should be considered as VAT exempt<sup>24</sup> provided they are intrinsically connected to the activity of the UCI.

The CJEU also confirmed that services consisting of the calculation of the taxable income of unit holders in investment funds<sup>25</sup> and the grant of a right to use software, which is used exclusively to carry out calculations which are essential for risk management and performance measurement<sup>26</sup> could be considered as VAT exempt, if they are intrinsically connected to the management of such UCIs and if they are provided exclusively for the purpose of managing such UCIs.

#### 11.4.5.5. Risk management functions

VAT Circular No 723ter of November 2013 confirms that risk management services performed by managers of UCIs should be considered as a management service and, therefore, within the scope of the provisions relating to the VAT exemption scheduled by the Luxembourg VAT Law.

When the risk management activities are outsourced to a third party, the VAT exemption remains applicable provided that the subcontracted services, viewed broadly, form a distinct whole and are specific to and essential for the activity of the UCI. Please also refer to Section 11.4.5.4. for the use of software which is used exclusively to carry out calculations which are essential for risk management.

<sup>20</sup> The Luxembourg Bankers' Association (*Association des Banques et Banquiers*, Luxembourg – ABBL) together with the VAT Administration laid down a non-exhaustive list of the services falling under the scope of the exemption. However, more recently, the CJEU, in the Abbey National case (C169/04, 4/5/2006), confirmed that portfolio management services as well as UCI administration services fall within the VAT exemption provision. The CJEU, as well as the Luxembourg VAT administration in its VAT Circular No 723, referred to Annex II of the UCITS Directive providing a non-exhaustive list of services falling within the VAT exemption.

<sup>21</sup> To the extent that legal services are provided by the entity performing the administration.

<sup>22</sup> In the case *Fiscale Eenheid X NV* (C-595/13), the CJEU confirmed that the exemption scheduled by the VAT Directive for the management of investment vehicles also applies to funds which invest in real estate. The management of those special investment funds which invest in real estate is consequently covered by the article 44 (1) (d) of the Luxembourg VAT Law, as amended. The CJEU found that the definition of the term "management" cannot include property management and facilities management and is therefore limited to investment recommendations and portfolio management only.

<sup>23</sup> This is in accordance with the CJEU decision in the Abbey National case and has been implemented by the Luxembourg VAT administration in Circular No 723 and 723 bis.

<sup>24</sup> *GfBk Gesellschaft für Börsenkommunikation mbH* (C-275/11, 7 March 2013).

<sup>25</sup> K (C-58/20, 17 June 2021).

<sup>26</sup> DBKAG (C-59/20, 17 June 2021).

## 11.4.6. Summary tables

The summary tables hereafter have been prepared based on the Luxembourg legislation and doctrine, as well as the CJEU case law. It is important to note that the interpretation of the legislation could be different in countries other than Luxembourg, notably concerning the VAT status of UCIs and their management companies, which might have an impact on the localization of the supply of services.

### 11.4.6.1. Services provided to a Luxembourg investment company

Supplier	Service	Place of supply	VAT treatment
Luxembourg company	Management services	Luxembourg	Exempt
EU company (except Luxembourg)	Management services	Luxembourg	Exempt
US law firm	Legal advice	Luxembourg	17% VAT (reverse charge mechanism)
Luxembourg central administration	Administration services	Luxembourg	Exempt
Luxembourg depository	Control and supervisory services	Luxembourg	14% VAT
Luxembourg auditor/lawyer/tax advisor	Audit/legal advice/tax advice	Luxembourg	17% VAT
EU lawyer (except Luxembourg)	Legal advice	Luxembourg	17% VAT (reverse charge mechanism)

### 11.4.6.2. Services provided to a Luxembourg common fund managed by a Luxembourg management company

Supplier	Service	Place of supply	VAT treatment
Luxembourg company	Management services	Luxembourg	Outside the scope of VAT
EU company (except Luxembourg)	Management services	Luxembourg	Exempt
US law firm	Legal advice	Luxembourg	17% VAT (reverse charge mechanism)
Luxembourg central administration	Administration services	Luxembourg	Exempt
Luxembourg depository	Control and supervisory services	Luxembourg	14% VAT
Luxembourg auditor/lawyer/tax advisor	Audit/legal advice/tax advice	Luxembourg	17% VAT
EU lawyer (except Luxembourg)	Legal advice	Luxembourg	17% VAT (reverse charge mechanism)

### 11.4.6.3. Services provided to a common fund established outside Luxembourg managed by a Luxembourg management company (common fund managed cross-border from Luxembourg)<sup>27</sup>

Supplier	Service	Place of supply	VAT treatment
Luxembourg company	Management services	Luxembourg	Outside the scope of VAT
EU company (except Luxembourg)	Management services	Luxembourg	Outside the scope of VAT
US Law firm	Legal advice	Luxembourg	17% VAT (reverse charge mechanism)
Luxembourg central administration	Administration services	Luxembourg	Exempt
Luxembourg depository	Control and supervisory services	Luxembourg	14% VAT
Luxembourg auditor/lawyer/tax advisor	Audit/legal advice/tax advice	Luxembourg	17% VAT
EU lawyer (except Luxembourg)	Legal advice	Luxembourg	17% VAT (reverse charge mechanism)

<sup>27</sup> In the table, only the taxation in Luxembourg is considered. This does not preclude taxation in the country of the common fund, potentially resulting in a situation of double taxation.



# 12

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# MARKETING

EY fund distribution and marketing including impact on distribution models services:

- ▶ Distribution regulatory intelligence
- ▶ Fund registration and distribution
- ▶ Defining distribution strategy including review of distribution models and agreements
- ▶ Distributor due diligence and compliance reviews



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## 12.1. Introduction

This Chapter covers the requirements applicable to the marketing of UCITS and other UCIs:

- Information provided to investors before they invest
- Marketing Luxembourg UCITS in other European Union (EU)/European Economic Area (EEA) Member States<sup>1</sup>
- Marketing foreign UCITS in Luxembourg
- Marketing of full AIFM regime AIFs in the EU/EEA and third-country AIFMs and AIFs
- Marketing of simplified AIFM registration regime AIFs
- Marketing of AIFs in Luxembourg
- Marketing regulations applicable in Luxembourg
- Marketing intermediaries: distributors, nominees and other marketing intermediaries
- Pre-marketing rules for AIFs

The general requirements on fund documentation and reporting are covered in Chapter 10.

### 12.1.1. UCITS

Some of the main reasons why financial participants create UCITS are linked to marketing and distribution:

- UCITS can be marketed to all types of investors in most key distribution markets
- UCITS are relatively easy to distribute, compared with other UCIs
- Investors recognize and demand “UCITS brand” products

UCITS can be distributed to all types of EU/EEA investors, such as retail, professional and other eligible counterparties. Many international investors are also attracted to UCITS, for example, to benefit from well-recognized EU regulation and investment diversification.

The Luxembourg UCITS is the leading investment fund product for cross-border fund distribution in the EU and internationally throughout the world. A continuously increasing number of Luxembourg UCITS are registered for distribution in EU/EEA Member States and outside the EU/EEA, particularly in Asia, the Middle East, and Latin America.

The UCITS Directive provides for a harmonized “European passport” for UCITS - meaning that a UCITS authorized in one Member State (the “home Member State”) may be marketed in any other Member State (the “host Member State”) following notification to the host Member State competent authority via the home Member State competent authority.

The provisions on the notification procedure for marketing UCITS are covered by the 2010 Law. The practical and technical procedures that UCITS must follow for cross-border marketing - i.e., the notification procedures to be followed by a Luxembourg UCITS intending to market its shares or units in another EU/EEA Member State and by a UCITS of another EU/EEA Member State wishing to market its shares or units in Luxembourg - are clarified in CSSF Circular 11/509, as amended, and in CSSF Regulation 10-05, as amended.

The European Securities and Markets Authority’s (ESMA) *Q&A on the Application of the UCITS Directive* clarifies that a UCITS management company wishing to pursue cross-border activities by way of the UCITS management company passport can notify cross-border activities without having to identify a specific UCITS. When the management company, at a later point in time, has identified a UCITS that it wants to manage on a cross-border basis, it has to notify the competent authorities in the home Member State of the UCITS in accordance with Article 20 of the UCITS Directive, as amended.

Marketing of UCITS outside the EU/EEA is subject to each country’s national regime.

### 12.1.2. AIFs

In this chapter, the term:

- “Full AIFM regime AIFs” means AIFs managed by authorized AIFM and internally managed AIFs that are subject to the AIFM Law
- “Simplified AIFM registration regime AIFs” means AIFs whose manager is not subject to the AIFM Law (or the AIFM Directive) and internally managed AIFs that are not subject to the AIFM Law

#### 12.1.2.1. Full AIFM regime AIFs

Authorized AIFMs benefit from a “passport” permitting them to market EU/EEA AIFs they manage to professional investors in the EU/EEA, through simple notification. Authorized internally managed AIFs that are subject to the AIFM Law or the AIFM Directive also benefit from the “passport”.

Member States may also permit marketing by AIFM to retail investors in their Member State; however they may apply stricter requirements than those required for professional investors.

<sup>1</sup> | The EEA includes EU Member States plus Iceland, Liechtenstein and Norway. The reference to the EEA is clarified in 1.3.1.B.

A number of Member States have introduced further categories for retail investors (such as “qualifying investor”, “well-informed investor”, or “semi-professional investor”), which, by their definition, share some, but not all elements of the definition of “professional investor”. ESMA’s *Q&A on the Application of the AIFMD* clarifies that the AIF marketing passport may only be used for marketing to professional investors as defined in Article 4(1)(ag) of AIFMD, as amended. Any other cross-border marketing activity to non-professional investors as defined in Member States has to be notified and carried out according to national legislation in the host Member State of the AIF and cannot be carried out by way of the AIF marketing passport.

Marketing of full AIFM regime AIFs outside the EU/EEA is subject to each country’s national regime.

### 12.1.2.2. Simplified AIFM registration regime AIFs

Marketing of simplified AIFM registration regime AIFs is subject to each country’s national distribution requirements. Such AIFs do not benefit from the marketing passport.

The managers of qualifying European Venture Capital Funds (EuVECA) and of qualifying European Social Entrepreneurship Funds (EuSEFs) benefit from a specific “passport” permitting them to market the UCIs they manage to professional investors and to non-professional investors who commit to a minimum investment of EUR 100,000 across the EU/EEA.

Marketing of simplified AIFM registration regime AIFs outside the EU/EEA is subject to each country’s national regime.

### 12.1.3. Summary of marketing regimes

The general marketing rules applicable for UCITS and AIFs are determined by the respective directives, while local marketing requirements remain fully at the discretion of the respective EU/EEA Member States or non-EU/EEA countries where the UCITS or the AIFs are marketed.

The various charges levied by the CSSF to cover the handling costs of the notification and the registration costs for marketing in Luxembourg are laid down by the Grand-ducal Regulation of 21 December 2017, as amended.

The following table summarizes the marketing regimes applicable to the marketing of UCITS and open and closed-ended AIFs; in addition, in the case of closed-ended AIFs, Prospectus Regulation<sup>2</sup> requirements may apply:

**Summary of marketing of UCIs**

Regulatory framework	Description	Investors	Region	Marketing regime
UCITS	Marketing of UCITS	Retail and professional	EU/EEA	EU/EEA “passport”
		Retail or professional	Third countries	Third-country regime
Full AIFM regime AIFs	Marketing throughout the EU/EEA by or on behalf of:	Professional	EU/EEA	EU/EEA “passport”
		Retail	EU/EEA	National retail distribution regimes
		Retail or professional	Third countries	Third-country regime
			Authorized EU/EEA AIFMs of:	
	EU/EEA AIFs			
	Non-EU/EEA AIFs <sup>3</sup>			
	Authorized non-EU/EEA AIFMs <sup>4</sup> of:			
	EU/EEA AIFs			
	Non-EEA AIFs			
Simplified AIFM registration regime AIFs	Marketing of EU/EEA AIFs by registered EU/EEA AIFMs (i.e., not authorized AIFMs)	Professional	EU/EEA	National private placement regimes (NPPRs)
		Retail	EU/EEA	National retail distribution regimes
		Retail or professional	Third countries	Third-country regime
EuVECA and EuSEFs	Marketing of qualifying EuVECA and EuSEFs by registered managers	Qualified	EU/EEA	EU/EEA “EuVECA/EuSEF passport”
Other AIFs	Marketing:	Professional	EU/EEA	NPPRs
		Retail	EU/EEA	National retail distribution regimes
			Third countries	Third-country regime
Any AIFs	Professional investors investing on their own initiative, in any AIF of their choice, irrespective of the domicile of the AIF or the AIFM	Retail or professional	Third countries	Third-country regime
		Professional	EU/EEA	Reverse solicitation (i.e., no marketing)

<sup>2</sup> | As from July 2019, the Prospectus Directive was replaced by the New Prospectus Regulation, as amended (*Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market and repealing Directive 2003/71/EC*).

<sup>3</sup> | From 2023 at the earliest.

<sup>4</sup> | Idem.

<sup>5</sup> | Until 2023 at the earliest.

<sup>6</sup> | Idem.

In principle, a prospectus meeting the requirements of the New Prospectus Regulation must be published before closed-ended UCIs are offered to the public in the EU. However, the obligation to publish a prospectus does not apply to the offer of securities addressed:

- ▶ Solely to qualified investors (professional investors and/or investors who may be treated as professionals on request - see Section 12.5.1.) unless they have requested that they be treated as non-professional clients
- ▶ To fewer than 150 natural or legal persons per Member State, other than qualified investors
- ▶ To investors who acquire securities for a minimum total amount per investor, or to the offer of securities whose denomination per unit is above a specific amount, or with a limited total consideration. The amounts are laid down in the New Prospectus Regulation and delegated acts adopted pursuant to the New Prospectus Regulation

UCIs other than closed-ended UCIs (i.e., open-ended UCIs) are exempt from the requirement to publish a prospectus meeting the requirements of the New Prospectus Regulation.

A prospectus meeting the requirements of the New Prospectus Regulation is required if a UCI is listed on a regulated market (see Chapters 10 and 13).

ESMA has also published a Q&A on the New Prospectus Regulation.

As part of the EU's Capital Markets Union Action Plan, in June 2019, a new EU Directive<sup>7</sup> and Regulation<sup>8</sup> has been introduced, amending the UCITS and AIFM Directives and harmonizing various aspects of cross-border distribution.

The Law of 21 July 2021 transposed the Directive (EU) 2019/1160 on cross-border distribution of funds into the national legislation and has been applicable since 2 August 2021.

The main changes brought by the Directive are:

- ▶ A common definition and harmonized conditions applicable to AIFMs for pre-marketing
- ▶ A harmonized and simplified de-notification procedure for marketing of units/shares of UCITS and AIFs
- ▶ New facilities to be made available to UCITS/AIF retail investors, with a prohibition for Member States to require a physical presence or the appointment of a third-party representative
- ▶ New requirements in case of changes to information contained in the marketing notification of UCITS/AIFs

In addition, Regulation (EU) 2019/1156 became applicable on 1 August 2019 and lays down additional rules and procedures concerning, *inter alia*:

- ▶ Centralization and publication of the regulatory fees charged by the national competent authorities (NCAs)
- ▶ The standardization of notifications to ESMA and the implementation of a new central database on cross-border marketing of UCITS/AIFs
- ▶ Harmonization of the process and requirements for the verification of marketing material by NCAs
- ▶ Notification requirements

In March 2022, ALFI issued a Q&A on marketing and distribution clarifying, *inter alia*:

- ▶ Certain definitions
- ▶ How to qualify different types of entities involved in marketing and distribution
- ▶ Certain requirements applicable to IFMs, notably in light of CSSF Circular 18/698

## 12.2. Information provided to investors before they invest

### 12.2.1. UCITS

In general, the key investor information document (KIID) must be provided to investors free of charge before they invest.

An investment company and a management company for each of the common funds that it manages, that sells UCITS, directly or through another natural or legal person who acts on its behalf and under its full and unconditional responsibility, is required to provide investors with the KIID on such UCITS in good time before their subscription for shares or units.

<sup>7</sup> Directive (EU) 2019/1160 of the European Parliament and of the Council amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings.

<sup>8</sup> Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014.

ESMA's Q&A on the Application of the UCITS Directive issued in February 2016, in Section II - Key Investor Information Document (KIID) for UCITS, clarifies that the KIID constitutes pre-contractual information and that each additional subscription is considered a new contract.

All prospective investors, including professional investors, must be provided with a KIID.

As a pre-contractual document, the investor must receive the KIID for the compartment (or share/unit class, if applicable) that he/she is intending to invest into, including where this investment arises from switching from another compartment within the umbrella.

Where shareholders or unitholders in a UCITS invest through a regular savings plan, a KIID is not required in relation to the periodic subscriptions, unless a change is made to the subscription arrangements, for example, increases or decreases in the subscription amount, that would require a new subscription form.

ESMA also underlines that investors always have the right to be provided with the KIID on request.

An investment company and a management company for each of the common funds that it manages, that does not sell UCITS directly or through another natural or legal person who acts on its behalf and under its full and unconditional responsibility to investors, is required upon request, to provide the KIID to product manufacturers and intermediaries selling or advising investors on potential investments in such UCITS or in products offering exposure to such UCITS. The intermediaries selling or advising investors on potential investments in UCITS should provide the KIID to their clients or potential clients<sup>9</sup>.

Certain non-EU countries require that a document comparable to the KIID be provided to investors in UCIs before they invest (e.g., Hong Kong and Singapore).

The KIID may be provided to investors in a durable medium or by means of a website. *Commission Regulation (EU) No 583/2010* outlines the conditions applying when providing KIIDs to investors in a "durable medium" other than paper or by means of a website. A paper copy must be provided to investors on request and free of charge. An up-to-date version of the KIID must be made available on the website of the investment company or management company.

As of 1 January 2023, UCITS management companies must replace the UCITS KIID with the PRIIP KID when marketing a UCITS in any EU Member State to retail investors. UCITS KIID should still be provided as a pre-contractual document when distributing the UCITS in the UK as required by PS22/2 issued by the FCA in March 2022.

The prospectus and the latest published annual and semi-annual reports must be provided to investors on request and free of charge. The requirements covering the provision of these documents to investors and their content are covered in Chapter 10.

Additional investor information requirements applicable to the marketing of Luxembourg UCITS in other EU/EEA Member States, including translation requirements, are outlined in Section 12.3.6.

### 12.2.2. AIFs

Detailed information must be disclosed to investors before they invest in a full AIFM regime AIF (see Section 10.3.4.).

Luxembourg Law does not specifically require that information is automatically provided to investors in simplified AIFM registration regime AIFs before they invest.

For 2010 Law Part II UCIs, the prospectus and the latest published annual and semi-annual reports must be provided to investors on request and free of charge.

For SIFs and RAIFs, the offering document and the latest annual report must be provided to investors on request free of charge.

The requirements covering the provision of these documents to investors and their content are covered in Chapter 10.

### 12.2.3. Marketing communications of 2010 Law UCIs

Any marketing communication to investors (e.g., factsheet) must be clearly identifiable as such. It must be fair, clear, and not misleading.

In particular, any marketing communication that comprises an invitation to purchase shares or units of UCIs and that contains specific information about UCIs must not make a statement that contradicts or diminishes the significance of the information contained in the prospectus and, in the case of UCITS, the KIID. It must indicate that a prospectus exists and, for UCITS, that the KIID is available. It must specify where and in which language such information and documents may be obtained by investors or potential investors or how they may have access to them.

<sup>9</sup> According to the UCITS Directive, Directive 2009/65/EU, as amended, "Member States shall require that intermediaries selling or advising investors on potential investments in UCITS provide key investor information to their clients or potential clients." In Luxembourg, the 2010 Law transposed this requirement.

## 12.2.4. Marketing communications of UCITS and AIFs

The regulation on cross-border distribution of funds (the “Regulation”) aims at removing regulatory and supervisory barriers to cross-border marketing of UCIs.

On 31 January 2022, CSSF Circular 22/795 implemented ESMA’s *Guidelines on marketing communications*. These Guidelines have been applicable since 2 February 2022 to:

- ▶ Chapter 15 management companies
- ▶ Self-managed UCITS investment companies
- ▶ Authorized AIFMs
- ▶ Authorized internally managed AIFs
- ▶ Managers of EuVECAs within the meaning of Regulation (EU) No 345/2013
- ▶ Managers of EuSEFs within the meaning of Regulation (EU) No 346/2013

Registered AIFMs as well as non-EU AIFMs are excluded from the scope of the Circular.

The Guidelines apply to all marketing communications addressed to investors or potential investors but do not apply in the context of pre-marketing of AIFs.

The Guidelines significantly limit any deviation of the information contained in marketing communications from the information contained in legal and regulatory documentations and clarify acceptable practices.

The Guidelines indicate what does, and does not, qualify as a marketing communication.

Communication considered as marketing communication	Communication not considered as marketing communication
<ul style="list-style-type: none"> <li>▶ All messages advertising a UCI, regardless of the medium, including paper printed documents or information made available in electronic format, interviews, advertisements, documents made available on the internet, as well as webpages, video presentations, live presentations, radio messages or factsheets</li> <li>▶ Messages broadcasted on any social media platform, where such messages refer to any characteristics of a UCI, including the name of the UCI</li> <li>▶ Communications by a third party and used by a UCI manager for marketing purposes</li> <li>▶ Marketing material addressed individually to investors or potential investors, as well as documents or presentations made available by any fund manager to the public on its website or in any other places (fund manager’s registered office, distributor’s office, etc.)</li> <li>▶ Communications advertising a fund addressed to investors or potential investors located in Europe</li> </ul>	<ul style="list-style-type: none"> <li>▶ Legal and regulatory documents/information on a UCI, such as the prospectus or the information which is to be disclosed to investors in accordance with the annual and half-yearly reports of the UCI, the Memorandum and Articles of Association and so on</li> <li>▶ Corporate communications broadcast by the fund manager describing its activities or some recent market developments - such as the disclosure of quarterly or half-yearly earnings, dividend announcements, organizational announcements or senior management changes</li> <li>▶ Short messages broadcast online, in particular on social media platforms, which only include a link to a webpage where a marketing communication is available, but which do not contain any information on a specific fund</li> <li>▶ Information or communication issued in the context of pre-marketing</li> </ul>

Key requirements concerning the content of marketing communications are to:

- i. Clearly identify marketing communications  
The identification of marketing communications should be prominent and, when the format allows, it should include the following disclaimer:  
“This is a marketing communication. Please refer to the prospectus of the UCI/Information document of the UCI and to the [KIID/KID] before making any final investment decisions.”  
Any reference to a UCITS or an AIF in a marketing communication should only be published after the UCI’s approval by the NCA. Excessive cross-references to legal or regulatory provisions should be avoided unless this is appropriate.
- ii. Disclose risks and rewards in an equally prominent manner  
Rewards should not be referred to without referring to risks in the same document. Risks should not be presented in footnotes or smaller characters but at the same level or immediately after rewards. Presentation in the form of a two-column table or in a list differentiating risks and rewards on a single page is considered as an acceptable practice.
- iii. Ensure all marketing communications are fair, clear and not misleading

IFMs should stick to a number of general rules, notably in relation to:

- ▶ The suitability of the marketing communication to the target investors or potential investors: excessively technical wording should not be used for UCIs open to retail investors
- ▶ The consistency with other documents (prospectus, offering document, KID/KIID, periodic reports, IFMs' websites), in particular for indicators, simulations or figures relating to risks, rewards, costs or past and expected future performance
- ▶ The description of the features of the investment. The information should be up-to-date, proportionate but sufficient to understand the key elements of those features, without making excessive cross-references to the UCI's legal and regulatory documents. It should clearly distinguish investment in the UCI from an investment in a given underlying asset and should include a brief description of the investment policy and the types of assets into which the UCI may invest. Any information on the use of leverage should include an explanation on related risks of potential increased losses or returns
- ▶ Specific terminology to be used to clearly distinguish index-tracking UCIs from actively managed UCIs. Active UCIs managed in reference to an index should provide information on the benchmark index and indicate the degree of freedom from the benchmark
- ▶ References to the NCA. It is acceptable to mention visa/authorization but it should not be used as a sales argument
- ▶ Short marketing communications, such as messages on social media, which should provide links to the webpage where the information documents of the UCI are available
- ▶ Statements embedded in the communications which should be objective and verifiable, while overoptimistic or biased wordings are prohibited
- ▶ References to external documents and comparison with other funds

Information on risks and rewards should include at least the risks mentioned in the regulatory documents (prospectus, offering document, KID/KIID). When the UCI is marketed to retail investors, the illiquid nature of the investment, where relevant, should be clearly mentioned. Any representation of ranking should be based on similar UCIs in terms of investment policy and risk/reward profile. The relevant period and UCI's risk classification must be indicated.

Information on costs should allow investors to understand their impact on their investment amount and expected returns. Exchange rate risk should be specified where any costs are paid in a currency other than the Member State in which the target investors are residents.

Information on past performance should not be the main information of the marketing communication. Past performance should be based on historical data and mention the reference period of 10 years for UCIs preparing a KIID, five years for other UCIs or the whole life of the UCI where it has been offered for a shorter period. Any significant change affecting the past performance should be prominently disclosed. When cumulative performance is presented, the communication should also display the performance for each year. Currency risks and their impact on returns to investors should be mentioned.

Simulated performance should be limited to:

- ▶ A new share class of an existing UCI/compartment where the simulation is based on the performance of another share class with the same features
- ▶ A new feeder UCI where the simulation is based on the performance of the master UCI, provided that the feeder's characteristics do not differ materially from those of the master and that no other assets are held by the feeder

When past performance is presented, a statement that past performance does not predict future returns should be included.

Information on expected future performance should be based on reasonable assumptions supported by objective data. It should be disclosed at the level of the UCI, not on an aggregate basis, on a time horizon which is consistent with the recommended investment horizon of the UCI. Different disclaimers should be included to highlight the limits of estimates, the impacts of market conditions, taxation and risks of loss. An ETF's marketing communications should indicate the regulated market where the ETF is traded and the expected future performance should be based on the ETF's NAV.

Information on sustainability-related aspects should not outweigh the extent to which the investment strategy of the UCI integrates sustainability characteristics or objectives. A link to regulatory disclosures required by the Sustainable Finance Disclosure Regulation (SFDR) should be provided and the marketing communication should indicate that a decision to invest in the UCI should consider all characteristics or objectives disclosed in the prospectus or the offering document.

ESMA clarified that when the marketing of a UCI is not performed by the IFM but by a third-party distributor, the responsibility for ensuring that marketing communications comply with these key requirements still lies with the IFM, irrespective of who is the actual entity marketing the UCI, and of the relationship it has with the third-party distributor (whether it is contractual or not).

## 12.3. Marketing Luxembourg UCITS in other EU/EEA Member States

Where a Luxembourg UCITS intends to market its shares or units to investors in another EU/EEA Member State (i.e., in a host Member State), it must submit a notification to its home Member State regulator, the CSSF. This procedure applies in cases of:

- ▶ A UCITS intending to market all or part of its shares or units in the host Member State for the first time
- ▶ An umbrella UCITS intending to market all or part of its shares or units of one or several of its compartments in that host Member State for the first time
- ▶ An umbrella UCITS intending to market all or part of the shares or units of one or several additional compartments (i.e., where the marketing of shares or units of other compartments has already been notified in that host Member State) for the first time

In practice, the provisions on marketing of UCITS cross-border in the EU/EEA are generally considered to apply to the marketing of UCITS by entities based in the host Member State to investors in the host Member State. In other cases, NPPRs, where they continue to exist, or national retail distribution regimes and distance marketing requirements may apply (see also Section 12.6.1.).

Subsequent updates to the information submitted via the notification procedure must be provided directly to the host Member State 30 days in advance via a written notice and copying the home Member State regulator (see Section 12.3.4.).

On 17 December 2021, ESMA published an update to its *Q&A on the Application of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive*. The update covers, *inter alia*, advance notice for the marketing of new share classes of UCITS notified for cross-border marketing.

ESMA clarified that a UCITS is supposed to provide competent authorities of both the UCITS home and host Member States with a written notice if it intends to market a new share class in a Member State where it has already been notified for marketing. This notification should take place at least one month before the marketing of the new share class begins.

### 12.3.1. Key notification procedure components

The Luxembourg UCITS is required to submit to the CSSF a notification file that contains:

- ▶ A notification letter
- ▶ The latest versions of the required documents (see Section 12.3.2.)

The notification file is to be transmitted electronically to the CSSF via approved channels (see Section 12.3.3.).

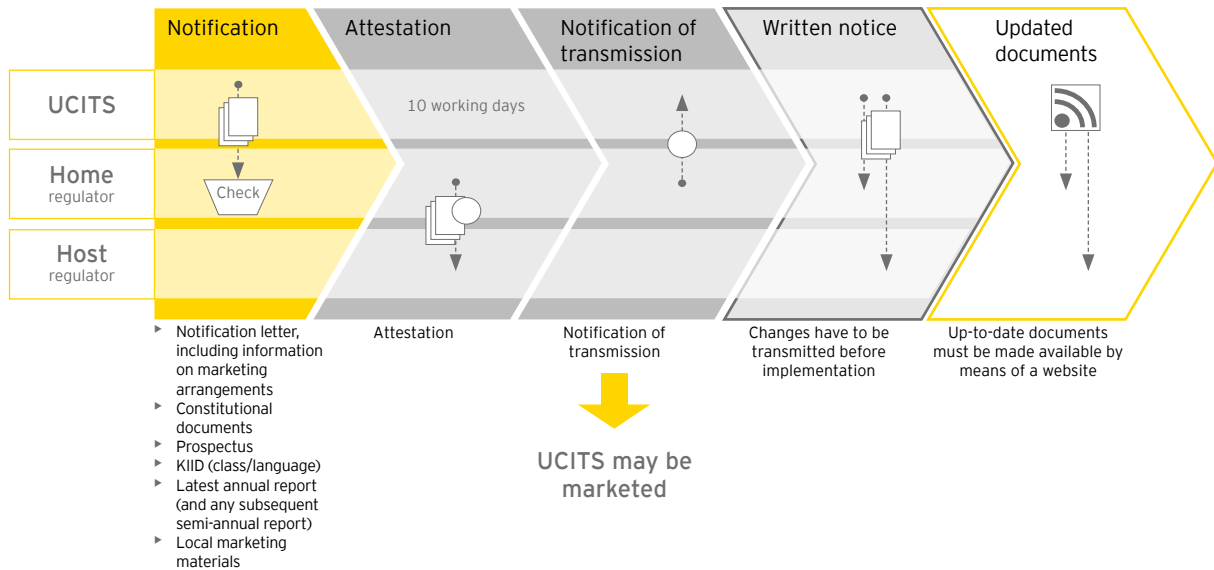
For each host Member State in which the UCITS intends to market its shares or units, a complete notification file needs to be prepared and transmitted to the CSSF.

The CSSF verifies that the documentation provided by the UCITS is complete. It then transmits, within a maximum of 10 working days, the complete documentation to the competent authorities of the host Member State together with an attestation that the UCITS complies with the provisions of the UCITS Directive. The host Member State competent authority confirms receipt and completeness of the notification within five working days. In practice, the host regulator's confirmation is not always issued.

This transmission to the competent authorities of the host Member State is notified without delay by the CSSF to the UCITS. The UCITS may access the market of the relevant host Member State as of the date of this notification.



## The UCITS notification procedure



### 12.3.2. Content of the notification file

The notification file must contain:

- ▶ Notification letter. The notification letter includes:
  - ▶ Information on the UCITS, the compartment and the share or unit classes to be marketed, the management company or self-managed investment company
  - ▶ The arrangements for marketing the UCITS in the host EU/EEA Member State
  - ▶ Details of the facilities that are available for making payments to shareholders or unitholders, repurchasing or redeeming shares or units, and making available the information that UCITS are required to provide
  - ▶ Other information required by laws, regulations, and administrative provisions of the host Member State that are not governed by the UCITS Directive and that are specifically relevant to the arrangements made for the marketing of shares or units of UCITS, such as details of any additional information to be disclosed to shareholders or unitholders or their agents (see also Section 12.3.5.)

The notification letter must follow the template provided for in *Commission Regulation (EU) No 584/2010*. CSSF Circular 11/509, as amended, provides further technical requirements to be met.

- ▶ The latest versions of the following documents:
  - ▶ CSSF attestation: The attestation to be attached to the file is the attestation that the CSSF delivered to the UCITS along with the latest visa-stamped prospectus
  - ▶ Constitutional document: The latest consolidated version of the constitutional document must be appended to the file as a single document
  - ▶ Prospectus: The prospectus to be appended to the file has to be the latest prospectus visa-stamped by the CSSF
  - ▶ KIIDs
  - ▶ Report(s): The latest audited annual report and any subsequent semi-annual report
  - ▶ Marketing arrangements: This document is optional based on host Member States' requirements and provides additional information on the arrangements made for marketing the shares or units of the UCITS in the case where the structure of the notification letter would not permit the internal methods of marketing to be reproduced exactly
  - ▶ Confirmation of payment: This document should only be appended to the file for marketing applications in host Member States requiring confirmation of the payment of charges to which the UCITS is subject in the host Member State

Requirements for information to be provided to investors, including translation requirements, are covered in Section 12.3.6.

### 12.3.3. Submission and processing of the notification file

The CSSF requires that the notification file is submitted electronically using one of the following:

- ▶ Systems based on channels accepted by the CSSF in accordance with the provisions of *CSSF Circular 08/334 on encryption channels for reporting firms*. This Circular provides detailed technical standards
- ▶ Direct filing of the required documents on the CSSF's website (subject to specific conditions specified on the CSSF's website)

From a technical point of view, all the documents constituting a notification file intended for a given host Member State must be grouped together in a “single package”. Further details on the nomenclature and format for electronic transmission are specified in the Annexes to CSSF Circular 11/509, as amended.

The CSSF executes a number of verifications on the notification files received to ensure completeness and compliance. The verification rules cover, *inter alia*, compliance with the required nomenclature, document format, ensuring that the documents relate to an existing Luxembourg UCITS or compartments thereof, that they are up-to-date, and, where relevant, consistent with CSSF documents.

In order to be able to execute the verifications effectively, the CSSF must, at all times, be in possession of the latest electronic versions of the constitutional document, prospectus, KIID, semi-annual reports and audited annual reports.

Where the formal verification of the file reveals that the file is incomplete or does not comply with the relevant technical requirements, the CSSF informs the UCITS, through the same communication channel the UCITS used for submitting the notification file to the CSSF, of the reason(s) preventing the submission of the file to the competent authorities of the relevant host Member State. It is then the responsibility of the UCITS to submit a new, correct and complete notification file.

If a host Member State competent authority does not, for any reason, accept a notification file submitted by the CSSF, the UCITS is informed of the reason(s) of refusal through the same communication channel it used for submitting the file to the CSSF or directly. It is then the responsibility of the UCITS to submit a new, correct, and complete notification file to the CSSF.

In July 2019, the CSSF published Circular 19/721 regarding “*Dematerialisation of requests to the CSSF*”. This Circular prescribes that certain requests to the CSSF should henceforth only be made via the CSSF’s online eDesk portal.

The eDesk portal is available at: <https://www.cssf.lu/edesk>

A list of the eDesk request types, as well as additional information and guidelines in the form of a user guide, are published and regularly updated on the homepage of the eDesk portal.

#### 12.3.4. Written notice

Updates to the information submitted via the notification procedure must be provided directly to the host Member State via a written notice 30 days in advance and copying the home Member State competent authority. This procedure applies in case of:

- ▶ Amendments to the information regarding the arrangements for marketing communicated in the notification letter
- ▶ A change regarding the share or unit classes to be marketed
- ▶ A change to the documents submitted in the notification file

The UCITS has to address a written notice of the amendments, together with all the amended documents, directly to the competent authority of the host Member State and copying the home Member State regulator 30 days before implementing the amendment.

The CSSF remains responsible for the approval of any amendment to the constitutional document or prospectus of the UCITS (see Section 3.4.). Such approval must be obtained prior to sending the written notice to the competent authority of the host Member State.

#### 12.3.5. Host Member State marketing requirements

A UCITS that markets its shares or units in a host Member State is usually required, in accordance with the laws and regulations and administrative provisions in force in the host Member State, to take the necessary measures to ensure that facilities are available for making payments to shareholders or unitholders, repurchasing or redeeming shares or units, and making available the information that UCITS are required to provide to investors in the host Member State.

The UCITS is also required to comply with the laws, regulations and administrative provisions of the host Member State that are not governed by the UCITS Directive and that are specifically relevant to the arrangements made for the marketing of shares or units of UCITS.

Selected types of host Member State requirements relevant to the marketing of UCITS:

- ▶ Definition of marketing
- ▶ Language requirements
- ▶ Promotion (i.e., public offering), including advertising materials
- ▶ Investor solicitation (i.e., communication to a targeted clientele)
- ▶ Means of communication (e.g., durable medium (such as paper, CD or DVD), email, website, radio, TV)
- ▶ Entities that are eligible to sell shares or units of UCITS (e.g., management companies, credit institutions, investment firms, such as investment advisors and distributors)
- ▶ Conduct of business rules applicable to entities (e.g., credit institutions, investment firms) selling UCITS and in particular when providing investment services (e.g., investment advice, or the reception and transmission of orders), *inter alia*, implementing the Markets in Financial Instruments Directive (MiFID)<sup>10</sup> requirements
- ▶ Rules of conduct applicable to management companies, as well as conduct of business requirements applicable to management companies providing investment services, *inter alia*, implementing MiFID requirements applicable to management companies
- ▶ Distance marketing, *inter alia*, implementing the Distance Marketing Directive<sup>11</sup>
- ▶ Consumer protection rules
- ▶ Information to be disclosed in the prospectus to investors in the host Member State
- ▶ Information about any investor compensation and/or guarantee scheme(s)
- ▶ Additional information that investors may request to be provided with
- ▶ Information on relevant tax provisions applicable to investors and on any locally applicable tax reporting regime complied with by the UCITS
- ▶ Information to be provided to investors regarding certain changes occurring during the life of the UCITS
- ▶ Publication requirements, e.g., for notices to investors and UCITS prices
- ▶ Remuneration of distributors (e.g., retrocessions)
- ▶ Information on any exemptions from rules or requirements applicable in the UCITS host Member State in relation to marketing arrangements for the UCITS, a specific share or unit class or any category of investors

Regulation (EU) 2019/1156 on *facilitating cross-border distribution of collective investment undertakings* explicitly allows Member States to introduce ex-ante verification of marketing communications which UCITS and their managers intended to use directly or indirectly in their dealings with investors. The sole purpose of this process should be verifying compliance with the Regulation and with national provisions concerning marketing requirements. The same rules apply for AIFs, EuVECAs and EuSEFs and their managers targeting retail investors. This *ex-ante* verification, however, should not constitute a prior condition for the marketing and should not be part of the notification procedure.

Where authorities opt to use this tool, they should establish, apply and publish on their websites, procedures for the prior notification. The internal rules and procedures should ensure transparent and non-discriminatory treatment of all UCIs, regardless of the Member States in which they are authorized.

Member States are required to make information on such provisions easily accessible from a distance and by electronic means - in general on the website of the competent authority.

### 12.3.6. Investor information requirements

Where a UCITS markets its shares or units in a host Member State, it must provide investors in the host Member State with all the same information and documents that it is required to provide to investors in Luxembourg (see Section 10.1.1. on the documents to be provided).

Such information and documentation must be provided to investors in compliance with the following provisions:

- ▶ The information or documents must be provided to investors in the host Member State in the way prescribed by the laws, regulations or administrative provisions of the host Member State
- ▶ The KIID/KID must be translated into the official language, or one of the languages, of the UCITS host Member State or into a language approved by the competent authority of that Member State
- ▶ Information and documents other than the KIID/KID may be translated, at the choice of the UCITS, into the official language, or one of the official languages, of the UCITS host Member State, or into a language approved by the competent authority of that Member State or into a language customary in the sphere of international finance
- ▶ Translations of information and documents must also be produced under the responsibility of the UCITS or the management company and must faithfully reflect the content of the original information

These provisions apply also to all changes to the relevant information and documents.

The frequency of the publication of the subscription or redemption price of shares or units of UCITS is subject to the current laws, regulations, and administrative provisions of Luxembourg (see Section 8.8.).

<sup>10</sup> Markets in Financial Instruments Directive (MiFID II), Directive 2014/65/EU, as amended.

<sup>11</sup> Directive 2002/65/EC concerning the distance marketing of consumer financial services.

## 12.4. Marketing foreign UCITS in Luxembourg

### 12.4.1. Notification

If a UCITS domiciled in another Member State wishes to market its shares or units in Luxembourg, the CSSF must receive a notification from its home Member State competent authority. The notification must be composed of:

- ▶ The documentation required by the UCITS Directive:
  - ▶ Notification letter
  - ▶ The latest versions of the following documents:
    - ▶ Constitutional document
    - ▶ Prospectus
    - ▶ KIIDs of the shares or units to be marketed in one of the following languages: French, German, Luxembourgish or English
    - ▶ Financial report(s)
- ▶ An attestation that the UCITS fulfills the conditions imposed by the UCITS Directive from the competent authority of the UCITS home Member State

The notification letter must provide the following information:

- ▶ The name and address of the paying agent that may make dividend payments and payments in relation to subscription and redemption of shares or units of the UCITS
- ▶ The place or contact where the investors may present subscription, redemption or conversion requests of shares or units of the UCITS
- ▶ The place where Luxembourg investors may obtain the net asset values (NAVs), issue and redemption prices, the latest prospectus, the latest financial reports, the constitutional document and, if relevant, access to contracts with the UCITS

The KIID/KID and other documents must be submitted in French, German, English or Luxembourgish. Translations are deemed to be made under the responsibility of the UCITS and must truly reflect the original information.

Upon confirmation to the UCITS of the transmission to the CSSF by the competent authority of the home Member State, the UCITS can access the Luxembourg market.

While evidence of fee payment needs to be provided with the application file, an invoice will be mailed by the CSSF to the applicant after receipt of the notification file. The various charges levied by the CSSF to cover the handling costs of the notification and the registration costs of a UCITS for marketing its shares or units in Luxembourg are laid down by the Grand-Ducal Regulation of 17 December 2021, as amended.

### 12.4.2. Written notice

Updates to the information submitted via the notification procedure must be provided to the CSSF via a written notice 30 days in advance and copying the Home Member State regulator (as described in Section 12.3.4.) via e-mail to the address NOTIF-OPCETRUPD@cssf.lu.

### 12.4.3. Luxembourg marketing requirements

A UCITS established in another Member State that markets its shares or units in Luxembourg must make available in Luxembourg, facilities to perform the following tasks:

- (a) Process subscription, repurchase and redemption orders and make other payments to share/unit-holders relating to the shares/units of the UCITS, in accordance with the conditions set out in the investor documents
- (b) Provide investors with information on how orders referred to in point (a) can be made and how repurchase and redemption proceeds are paid
- (c) Facilitate the handling of information and access to procedures and arrangements relating to investors' complaints and exercise of their rights arising from their investment in the UCITS
- (d) Make the information and investor documents available to investors for the purposes of inspection and obtaining copies thereof
- (e) Provide investors with information relevant to the tasks that the facilities perform in a durable medium
- (f) Act as a contact point for communicating with the competent authorities

The UCITS should ensure that the facilities to perform these tasks, including electronically, are provided:

- (a) In the official language or one of the official languages of the Member State where the UCITS is marketed or in French, German, English or Luxembourgish
- (b) By the UCITS itself, by a third party which is subject to regulation and supervision governing the tasks to be performed, or by both. Where the tasks are to be performed by a third party, the appointment of that third party should be evidenced by a written contract, which specifies which of the tasks are not to be performed by the UCITS and that the third party will receive all the relevant information and documents from the UCITS

There is no longer an obligation to have a local physical presence or to appoint a third party to perform those tasks.

## 12.4.4. Investor information requirements

The UCITS is required to take the necessary measures to ensure that the documents and information that must be provided to investors in its home EU/EEA Member State are made available to investors, either in French, German, English or Luxembourgish. This also applies to any changes to the documents and information.

The frequency of the publication of the subscription or redemption price of the shares or units of the UCITS is subject to the current laws, regulations, and administrative provisions in the UCITS home Member State.

Where a UCITS that is domiciled in an EEA country other than an EU Member State markets its shares or units in Luxembourg, the provisions described above are also applicable within the limits provided for in the EEA Agreement.

## 12.4.5. Cessation of marketing

The CSSF has to be informed about any cessation of marketing of shares or units of the UCITS.

As from 2 August 2021, Member States should ensure that a UCITS may de-notify arrangements made for marketing as regards shares/units, including, where relevant, in respect of share classes, in a Member State in respect of which it has made a marketing notification, where all the following conditions are fulfilled:

- (i) A blanket offer is made to repurchase or redeem, free of any charges or deductions, all such shares/units held by investors in that Member State, which is publicly available for at least 30 working days, and is addressed, directly or through financial intermediaries, individually to all investors in that Member State whose identity is known
- (ii) The intention to terminate arrangements made for marketing such shares/units in that Member State is made public by means of a publicly available medium, including by electronic means, which is customary for marketing UCITS and suitable for a typical UCITS investor
- (iii) Any contractual arrangements with financial intermediaries or delegates are modified or terminated with effect from the date of de-notification in order to prevent any new or further, direct or indirect, offering or placement of the shares/units identified in the notification to the Home Member state competent authority

The information referred to in points (i) and (ii) should clearly describe the consequences for investors if they do not accept the offer to redeem or repurchase their shares/units. Such information should be provided in the official language or one of the official languages of the Member State in respect of which the UCITS has made a marketing notification or in a language approved by the competent authorities of that Member State.

As of the date referred to in point (iii), the UCITS should cease any new or further, direct or indirect, offering or placement of its shares/units which were the subject of de-notification in that Member State.

The UCITS should submit a notification to the competent authorities of its home Member State containing the information referred to in points (i), (ii) and (iii). The competent authorities of the UCITS home Member State should verify whether this notification is complete. The competent authorities of the UCITS home Member State should, no later than 15 working days from the receipt of a complete notification, transmit that notification to the competent authorities of the Member State where marketing will cease and to ESMA.

Upon transmission of the notification, the competent authorities of the UCITS home Member State should promptly notify the UCITS of that transmission.

The UCITS should provide investors who remain invested in the UCITS as well as the competent authorities of the UCITS home Member State with the information required under Articles 68 to 82 and under Article 94 of the UCITS Directive, as amended (prospectus, KIID, periodical reports, information on issue, sale, repurchase or redemption price of shares/units). Member States should allow for the use of any electronic or other distance communication means, provided that the information and communication means are available for investors in the official language or one of the official languages of the Member State where the investor is located or in a language approved by the competent authorities of that Member State.

The competent authorities of the UCITS home Member State should transmit to the competent authorities of the Member State where marketing will cease information on any changes to the documents appended to the marketing notification.

The competent authorities of the Member State where marketing will cease should have the same rights and obligations as the competent authorities of the UCITS host Member State for monitoring and supervisory purposes as well as for taking actions against UCITS which infringe the laws, regulations and administrative provisions in force that Member State that fall outside the scope of the UCITS Directive. However, as from the date of transmission, the competent authorities of the Member State where marketing will cease should not require the UCITS concerned to demonstrate compliance with national laws, regulations and administrative provisions governing marketing requirements.

## 12.5. Marketing of AIFs with a passport and under National Private Placement Regimes (NPPRs)

### 12.5.1. Summary

Marketing covers any direct or indirect offering or placement, at the initiative of the AIFM or on behalf of the AIFM, of shares or units in an AIF it manages to or with investors domiciled in the EU/EEA.

In this section, we use the term AIFM to refer to authorized AIFMs and authorized internally managed AIFs.

The main principles of the marketing provisions of the AIFM Directive regime can be summarized as follows:

- ▶ Authorized EU/EEA AIFMs benefit from a “marketing” passport permitting them to market EU/EEA AIFs to professional investors in their home Member State and in other Member States (“host” Member States)
- ▶ For EU/EEA AIFMs managing EU/EEA feeder AIFs of non EU/EEA master funds, non-EU/EEA AIFs and non-EU/EEA AIFMs NPPR notification and local laws apply
- ▶ Non-EU/EEA AIFMs intending to market AIFs they manage in the EU/EEA with a passport must obtain prior authorization from their “Member State of reference”
- ▶ All marketing of EU/EEA and non-EU/EEA AIFs to professional investors by EU/EEA and non-EU/EEA AIFMs in their home Member State (or “Member State of reference”) or another Member State is subject to a notification procedure
- ▶ An authorized AIFM managing a feeder AIF benefits from a “passport” to market its feeder AIF only if the master AIF is managed by an authorized AIFM
- ▶ Member States may permit marketing of EU/EEA or non-EU/EEA AIFs by AIFMs to retail investors in the Member State. They may also apply stricter requirements
- ▶ EU/EEA professional investors may invest, on their own initiative, in any AIF of their choice, irrespective of the domicile of the AIF or AIFM (also referred to as “reverse solicitation”)

Professional investors<sup>12</sup> include:

- ▶ Entities that are required to be authorized or regulated to operate in the financial markets:
  - ▶ Regulated financial institutions and insurance companies
  - ▶ UCIs, pension funds, and their management companies
  - ▶ Commodity and commodity derivatives dealers
  - ▶ Locals<sup>13</sup>
  - ▶ Other institutional investors
- ▶ Large undertakings that meet at least two of the following criteria:
  - ▶ Balance sheet total: EUR 20m
  - ▶ Net turnover: EUR 40m
  - ▶ Own funds: EUR 2m
- ▶ National and regional governments, etc.
- ▶ Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitization of assets or other financing transactions
- ▶ Investors that may be treated as professional clients within the meaning of Annex II to the MiFID II Directive:
  - ▶ The client must as a minimum meet two of the following criteria:
    - ▶ The client must have carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters
    - ▶ The size of the client’s financial instrument portfolio, defined as including cash deposits and financial instruments, must exceed EUR 500,000
    - ▶ The client must work or have worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged
  - ▶ Before deciding to accept any request for waiver, the investment firm must take all reasonable steps to ensure that the client requesting to be treated as a professional client meets the aforementioned requirements
  - ▶ The client must state in writing to the investment firm that they wish to be treated as a professional client, either generally or in respect of a particular investment service or transaction, or type of transaction or product
  - ▶ The investment firm must give them a clear written warning of the protection and investor compensation rights they may lose
  - ▶ The client must state in writing, in a separate document from the contract, that they are aware of the consequences of losing such protections

<sup>12</sup> As defined in the Annex 2 of the Directive 2014/65/EU (MiFID), as amended.

<sup>13</sup> Firms dealing for their own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets, or dealing for the accounts of other members of those markets and being guaranteed by clearing members of the same markets, where responsibility for ensuring the performance of contracts entered into by such a firm is assumed by clearing members of the same markets.

Retail investors are investors that are not professional investors.

The extension of the “passport” regimes to non-EU/EEA AIFs and non-EU/EEA AIFMs is dependent on ESMA issuing a positive opinion on the functioning of the passport for EU/EEA AIFMs marketing EU/EEA AIFs and the European Commission adopting the required delegated act in light of ESMA’s advice. ESMA’s first opinion was issued in July 2015 and advised that only three third countries - Jersey, Guernsey and Switzerland - be allowed to distribute alternative funds across the EU. Further advice from ESMA was received in July 2016 in which ESMA provided advice relating to a further nine countries: Australia, Bermuda, Canada, Cayman Islands, Hong Kong, Isle of Man, Japan, Singapore and the United States. The phasing out of the NPPRs is dependent on ESMA issuing a second opinion on the functioning of marketing by EU/EEA AIFMs of non-EU/EEA AIFs in the EU/EEA and on the managing and marketing by non-EU/EEA AIFMs of AIFs in the EU/EEA (both under the passport and under NPPRs) and the termination of the existence of national regimes and the European Commission adopting a second delegated act. Initially, ESMA’s second opinion was expected three years after the adoption of the first delegated act, implying that the NPPRs could be phased out by 2018 at the earliest. The termination of the NPPR and functioning of marketing by EU/EEA AIFMs of non-EU/EEA AIFs in the EU/EEA should be addressed in the next two years following the EU regulatory initiatives and the progress of third-country equivalence decisions.

The regime for marketing of EU/EEA and non-EU/EEA domiciled AIFs by or on behalf of EU/EEA AIFMs to EU/EEA and non-EU/EEA investors is summarized in the following table:

**Marketing regimes applicable to authorized EU/EEA AIFMs**

Domicile		Any EU/EEA marketing?	Is AIFM Directive applicable?	AIFM marketing regimes	Requirements applicable to AIFM and AIF	Requirements applicable to third-country domiciles
AIFM	AIF					
EU/EEA	EU/EEA	Yes	Yes	Passport (from 2013)	Full AIFM Directive	None
EU/EEA	EU/EEA	No	Yes	None	Full AIFM Directive	None
EU/EEA	Non-EU/EEA	Yes	Yes	NPPR (2013 until at least 2023)	Full AIFM Directive except provisions on depositary, but entity needs to be appointed to execute depositary functions	Cooperation arrangements AML requirements
				Passport (potentially from 2023 onward)	Full AIFM Directive	Cooperation arrangements AML requirements Tax agreements
EU/EEA	Non-EU/EEA	No	Yes	None	Full AIFM Directive except provisions on depositary and annual report	Cooperation arrangements

The AIFM Directive applies to non-EU/EEA AIFMs only to the extent that they manage EU/EEA AIFs or market AIFs (EU/EEA or non-EU/EEA) to EU/EEA investors. The regime for marketing EU/EEA and non-EU/EEA domiciled AIFs by or on behalf of non-EU/EEA AIFMs to EU/EEA and non-EU/EEA investors is summarized in the following table:

**Marketing regimes applicable to non-EU/EEA AIFMs**

Domicile		Any EU/EEA marketing?	Is AIFM Directive applicable?	AIFM marketing regimes	Requirements applicable to AIFM and AIF	Requirements applicable to third-country domiciles
AIFM	AIF					
Non-EU/EEA	EU/EEA	Yes	Yes	NPPR (2013 until at least 2023 <sup>14</sup> )	Provisions on transparency and major holdings and control provisions (if applicable)	Cooperation arrangements AML requirements
				Passport (potentially from 2023 onward)	Full AIFM Directive, including “Member State of reference” authorization EU/EEA legal representative	Cooperation arrangements AML requirements Tax agreements
Non-EU/EEA	EU/EEA	No	Yes	None	Full AIFM Directive, including “Member State of reference” authorization EU/EEA legal representative	Cooperation arrangements AML requirements Tax agreements

<sup>14</sup> Because EU/EEA AIF is managed by non-EU/EEA AIFM.

Non-EU/EEA	Non-EU/EEA	Yes	Yes	NPPR (2013 until at least 2023)	Provisions on transparency and major holdings and control provisions (if applicable)	Cooperation arrangements AML requirements
				Passport (potentially from 2023 onward)	Full AIFM Directive, including "Member State of reference" authorization EU/EEA legal representative	Cooperation arrangements AML requirements Tax agreements
Non-EU/EEA	Non-EU/EEA	No	No	None	None	None

In addition to the AIFM Directive requirements, the SIF Law<sup>15</sup> and the RAIF Law<sup>16</sup> restrict distribution of the shares or units of SIFs and RAIFs to "well-informed investors", be they in or outside of Luxembourg (see Sections 2.4.2. and 2.4.3.). Should marketing to "well-informed investors" happen outside of Luxembourg, a specific notification must be sent to the host Member State competent authority according to local laws and regulations. Procedures must be implemented to ensure that this requirement is respected.

Cross-border management of AIFs by AIFMs is covered in Section 6.3.4.

## 12.5.2. EU/EEA AIFMs

### 12.5.2.1. Marketing of EU/EEA AIFs

#### 12.5.2.1.1. Passport regime

Authorized EU/EEA AIFMs are entitled to market their EU/EEA AIFs to professional investors in any EU/EEA Member State - they benefit from a "passport".

Where the EU/EEA AIF is a feeder AIF, however, there are two possible scenarios:

- ▶ The master AIF is an EU/EEA AIF managed by an authorized EU/EEA AIFM: in this case, the feeder benefits from a passport
- ▶ The master AIF is not an EU/EEA AIF managed by an authorized EU/EEA AIFM: in this case, the provisions applicable to the marketing of non-EU/EEA AIFs by EU/EEA AIFMs apply (see Section 12.5.2.2.2.)

Member States may permit the marketing of AIFs to retail investors in the Member State. The requirements of the AIFM Directive must be met and, in addition, Member States may impose on the AIFM or the AIF requirements stricter than those applicable to marketing to professional investors. These requirements must not be stricter for EU/EEA AIFs marketed cross-border than for AIFs marketed domestically (see also Section 12.5.4.).

When an EU/EEA AIFM intends to market to professional investors its EU/EEA AIFs in an EU/EEA Member State (its home Member State or a host Member State), it must submit a notification to its home Member State for each AIF. The notification must include:

- ▶ A notification letter identifying the AIF that the AIFM intends to market and information on where it is established
- ▶ The AIF constitutional document
- ▶ The identity of the depositary for each AIF
- ▶ A description of, or information on, the AIF available to investors, as well as information that must be provided to them before they invest
- ▶ Information on the master AIF, if the AIF is a feeder
- ▶ The identification of the Member State(s) in which it intends to market the AIF
- ▶ Measures to prevent the AIF from being marketed to retail investors (if relevant)
- ▶ Information on arrangements made for marketing the AIF in the home or host Member State and, where relevant, information on the arrangements established to prevent units or shares of the AIF from being marketed to retail investors, including in the case where the AIFM relies on activities of independent entities to provide investment services in respect of the AIF

<sup>15</sup> Law of 13 February 2007, as amended.

<sup>16</sup> Law of 23 July 2016, as amended.



The CSSF's FAQ concerning the Luxembourg Law of 12 July 2013 on alternative investment fund managers as well as the Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage transparency and supervision (CSSF's FAQ on AIFM) covers the impact of the Packaged retail and insurance-based investment products (PRIIPs) Regulation on AIFs. It clarifies that manufacturers of Luxembourg AIFs, the shares/units of which are being advised on, offered or sold to retail investors, needed to have in place a PRIIPs KID as of 1 January 2018, unless they benefit from the exemption provided under Article 32(2) of the PRIIPs Regulation, as amended. However, such AIFs may have issued a UCITS KIID before 1 January 2018 in order to be exempted from the obligations of the PRIIPs Regulation until 31 December 2022 provided that the following conditions are complied with:

- The UCITS KIID should comply with the provisions of the 2010 Law, as amended, as well as with the provisions of Commission Regulation (EU) No 583/2010 on key investor information
- The UCITS KIID should have been issued for each retail share/unit class of the compartments of the relevant Luxembourg AIF before 1 January 2018
- The offering document of the Luxembourg AIF in question should be amended in order to reflect the distribution of a UCITS KIID to all retail investors contemplating an investment in the AIF. The offering document should also mention that the UCITS KIID will be published on the website of the Registered or Authorized AIFM of the Luxembourg AIF and that it will be available, upon request, in paper form

The PRIIPs Regulation, as amended, does not apply to manufacturers of and persons advising on or selling Luxembourg AIFs the shares/units of which are solely being advised on, offered or sold to professional investors.

A PRIIPs KID does not need to be provided to retail investors outside the EU/EEA unless the applicable rules and regulations of the third-country in which the marketing takes place provide otherwise.

A PRIIPs KID does not need to be drawn up and provided to existing retail investors of a Luxembourg AIF, the shares/units of which are not being advised on, offered or sold to any new retail investors.

A PRIIPs KID needs to be drawn up and provided to existing retail investors of a Luxembourg AIF who wish to make an additional investment after 1 January 2018, unless they benefit from the exemption provided under Article 32(2) of the PRIIPs Regulation, as amended, or if the existing retail investors invest through a regular savings plan (unless a change is made to the subscription arrangements and a new subscription form is required).

When no exemption to a PRIIPs KID production is applicable, the person(s) advising on, or selling Luxembourg AIFs, the shares/units of which are being advised on, offered or sold to retail investors, must provide such investors with the PRIIPs KID in adequate time before those investors are bound by any contract or offer relating to the subscription of shares/units in that AIF, in accordance with Article 13(1) of the PRIIPs Regulation, unless the conditions of Article 13(3) or 13(4) of the PRIIPs Regulation, as amended, apply.

The PRIIPs KID must be made available to retail investors free of charge:

- In paper form, or
- By using a durable medium other than paper, subject to the conditions of Article 14(4) of the PRIIPs Regulation, or
- By means of a website subject to the conditions of Article 14(5) of the PRIIPs Regulation

In accordance with Article 5(1) of the PRIIPs Regulation, as amended, a PRIIP manufacturer must always publish the PRIIPs KID on its website.

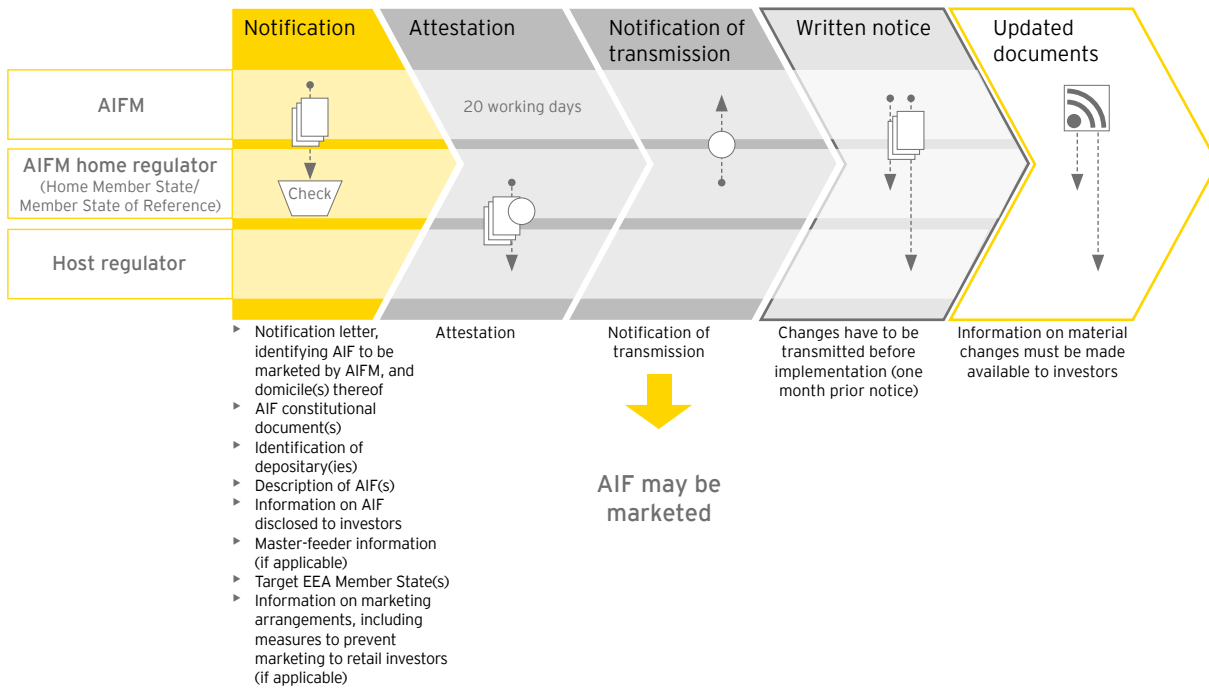
Where a Luxembourg AIF advises on, offers or sells its shares/units to retail investors, the PRIIPs KID should be written in the official languages, or in one of the official languages, used in the part of the Member State where the AIF is advised on, offered or sold or in a language accepted by the competent authorities of that Member State.

The final version of a PRIIPs KID will not be visa-stamped by the CSSF; however, the CSSF may request the final PRIIPs KID.

Additional compartments and/or share/unit classes launched after 1 January 2018 of Luxembourg AIFs that have issued a UCITS KIID also benefit from the exemption provided by Article 32(2) of the PRIIPs Regulation, as amended.

Luxembourg AIFs that have issued a UCITS KIID need to file a draft and final version of such document with the CSSF.

## The AIF notification procedure



Provided that the provisions of the AIFM Directive are met, in case of marketing in the AIFM's home Member State, the competent authority is required to inform the AIFM within 20 working days that it may start marketing the AIF. In case of cross-border marketing, the competent authority of the AIFM's home Member State is required to transmit the complete documentation to the competent authority of the host Member State, together with an attestation that the AIFM is authorized to manage AIFs with that particular investment strategy within 20 working days. Upon transmission, it is required to notify the AIFM of the transmission. The AIFM may start marketing the AIF in the host Member State from the date of notification of transmission.

Arrangements made for marketing the AIF and measures to prevent the AIF from being marketed to retail investors in the host Member State (if prohibited) are subject to the laws and supervision of the host Member State.

The CSSF's *FAQ on AIFM* clarifies that authorized Luxembourg AIFMs are required to notify all material changes to the information included in the initial notification file at least one month before implementing the change as regards any changes planned by the AIFM, or immediately after any unplanned change has occurred.

ESMA's *Q&A on the Application of the AIFMD* clarifies that the creation of a share/unit class of an AIF marketed in a host Member State by way of the AIFMD marketing passport, which is to be marketed cross-border within an already notified compartment, does not constitute a material change of the notification.

On 12 July 2019, the EU introduced a new Regulation<sup>17</sup> and a Directive<sup>18</sup> amending the UCITS and AIFM Directives and harmonizing various aspects of cross-border distribution. The Directive defines pre-marketing of EEA AIFs and sets harmonized notification procedures. It has been applicable since 2 August 2021.

The harmonized rules allow managers to target investors by testing their appetite for upcoming investment opportunities or strategies through the same pre-marketing process across all EU/EEA jurisdictions.

For pre-marketing to be recognized as such under this Directive, it should:

- ▶ Be notified to the home Member State competent authority within 15 days from the start of pre-marketing activities in each country
- ▶ Be addressed to a professional investor
- ▶ Concern an investment idea or investment strategy of an AIF which is not yet established, or of an AIF which is established, but not yet notified for marketing in the respective country

During pre-marketing, the following is not permitted:

- ▶ Investors to subscribe to the units or shares of the AIF pre-marketed
- ▶ Subscription forms or similar documents whether in draft or final form to be distributed to potential investors

<sup>17</sup> Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014.

<sup>18</sup> Directive (EU) 2019/1160 of the European Parliament and of the Council amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings.

Any subscription by professional investors, within 18 months of the EU AIFM beginning pre-marketing, to units or shares of an AIF referred to in the information provided in the context of pre-marketing, or of an AIF established as a result of the pre-marketing should be considered to be the result of marketing and should be subject to the applicable marketing passporting requirements.

Within two weeks after the commencement of pre-marketing notification to the competent authority in the host Member State, a notification should be made to the CSSF.

This notification should include, *inter alia*, the name of the targeted Member State(s), the periods of time in which the pre-marketing took place, a brief description of the pre-marketing including information on the investment strategies and, where relevant, a list of AIFs and compartments of AIFs which were the subject of the pre-marketing.

Pre-marketing and cross-border notifications and de-notifications must be sent exclusively in the eDesk portal.

#### 12.5.2.1.2. National private placement regimes (NPPRs)

Simplified AIFM registration regime AIFs are not required to comply with the full requirements of the AIFM Directive. Their AIFMs have the following options:

- ▶ Continue to market their AIFs under NPPRs, where permitted
- ▶ “Opt in” - i.e., voluntarily comply with the requirements of the AIFM Directive - and benefit from the marketing passport<sup>19</sup>
- ▶ Benefit from another passport<sup>20</sup>

#### 12.5.2.2. Marketing of non-EU/EEA AIFs

##### 12.5.2.2.1. Passport regime

Once the passport has been phased in (see Section 12.5.1.), authorized EU/EEA AIFMs may market, with a passport:

- ▶ Non-EU/EEA AIFs they manage (potentially from 2023 at the earliest)
- ▶ EU/EEA feeder AIFs they manage that do not have EU/EEA master AIFs managed by an authorized EU/EEA AIFM (from 2023 at the earliest)

The EU/EEA AIFM must comply with all of the relevant requirements of the AIFM Directive and the following additional conditions must be fulfilled:

- ▶ There must be appropriate cooperation arrangements between the EU/EEA AIFM home Member State competent authority and the supervisory authority of the non-EU/EEA AIF third-country, at least for efficient exchange of information
- ▶ The non-EU/EEA AIF country must not be listed as a non-cooperative country and territory (NCCT) by the Financial Action Task Force (FATF)<sup>21</sup>
- ▶ The non-EU/EEA AIF country must have signed a compliant Organisation for Economic Co-operation and Development (OECD) Article 26 Model Tax Convention<sup>22</sup> with the AIFM home Member State and any other Member State in which the non-EU/EEA AIF is intended to be marketed

ESMA has approved cooperation arrangements between EU/EEA competent authorities with responsibility for the supervision of AIFs and their global counterparts in third countries and territories. ESMA negotiated the agreements on behalf of all EU Member State competent authorities as well as the authorities from Iceland, Liechtenstein and Norway and the supervisory authorities of the third countries.

The CSSF has signed Memoranda of Understanding (MoU) with the supervisory authorities of third countries, based on ESMA's approved cooperation agreement templates.

On 26 March 2021, the UK and the EU agreed on a Memorandum of Understanding to establish a Joint UK-EU Financial Regulatory Forum, which will serve as a platform to facilitate dialogue on financial services issues between them. This agreement has yet to go live and no equivalence determination has been made or is likely to be made in the near future. UK-based IFMs looking to offer or sell UCIs in the EU are therefore required to contract with an EU-based operator or create a genuine EU operation with substance.

<sup>19</sup> See Section 2.4.4.1.

<sup>20</sup> See Section 12.6.3. on the marketing of EuVECAs and EuSEFs.

<sup>21</sup> An intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.

<sup>22</sup> Article 26 of the OECD Model Tax Convention creates an obligation to exchange information that is foreseeably relevant to the correct application of a tax convention as well as for purposes of the administration and enforcement of domestic tax laws of the contracting states.

#### 12.5.2.2.2. National private placement regimes (NPPRs)

EU/EEA Member States may permit EU/EEA AIFMs to market non-EU/EEA AIFs they manage, or EU/EEA feeder AIFs that do not have EU/EEA master AIFs managed by an authorized EU/EEA AIFM, without a passport, provided that:

- ▶ The AIFM complies with all the relevant requirements of the AIFM Directive except the full requirements of the AIFM Directive on depositaries. An entity must, however, be appointed to carry out depositary functions
- ▶ There are appropriate cooperation arrangements to ensure efficient exchange of information for systemic risk oversight between the EU/EEA AIFM home Member State competent authority and the non-EU/EEA AIF third-country supervisory authority
- ▶ The non-EU/EEA AIF country is not listed as a non-cooperative country and territory (NCCT) by FATF

Member States may impose stricter requirements on marketing to investors in their territory.

### 12.5.3. Non-EU/EEA AIFMs

#### 12.5.3.1. Marketing AIFs with a passport

Once the passport has been phased in (in 2023 at the earliest), non-EU/EEA AIFMs that have obtained authorization from their "Member State of reference" (see Section 6.3.4.3.) may market the EU/EEA and non-EU/EEA AIFs they manage with a passport.

The following requirements apply to non-EU/EEA AIFMs marketing AIFs with a passport:

- ▶ EU/EEA AIFs: Where an authorized non-EU/EEA AIFM intends to market its EU/EEA AIFs in an EU/EEA Member State (its Member State of reference or another Member State) with a passport, it must submit a notification to its Member State of reference for each EU/EEA AIF. The procedure is similar to that applicable to EU/EEA AIFMs intending to market EU/EEA AIFs
- ▶ Non-EU/EEA AIFs: The regime is similar to that for EU/EEA AIFs and, in addition:
  - ▶ There must be appropriate cooperation arrangements between the non-EU/EEA AIFM's Member State of reference competent authority and the supervisory authority of the non-EU/EEA AIF third-country, at least for efficient exchange of information (see also Section 12.5.2.2.1.)
  - ▶ The non-EU/EEA AIF country must not be listed as an NCCT by FATF
  - ▶ The non-EU/EEA AIF country must have signed a compliant OECD Article 26 Model Tax Convention with the non-EU/EEA AIFM's Member State of reference and any other Member State in which the non-EU/EEA AIF is intended to be marketed

#### 12.5.3.2. National private placement regimes (NPPRs)

EU/EEA Member States may permit non-EU/EEA AIFMs to market the EU/EEA or non-EU/EEA AIFs they manage without a passport, provided that:

- ▶ The non-EU/EEA AIFM complies with the relevant requirements on the annual report of AIFs (see Section 10.5.2.), disclosure to investors in AIFs (see Sections 10.3.5. and 10.4.2.) and reporting to competent authorities by AIFMs (see Section 6.5.2.)<sup>23</sup>, as well as, where relevant, the provisions on acquisition of control (see Section 4.6.) in respect of each AIF it markets
- ▶ There are appropriate cooperation arrangements to ensure efficient exchange of information for systemic risk oversight between:
  - ▶ EU/EEA AIFs: the competent authorities of the Member States where the AIFs are marketed, the EU/EEA AIF home Member State competent authorities and the non-EU/EEA AIFM third-country supervisory authority
  - ▶ Non-EU/EEA AIFs: the competent authorities of the Member States where the AIFs are marketed and:
    - ▶ The non-EU/EEA AIFM third-country supervisory authority
    - ▶ The non-EU/EEA AIF third-country supervisory authority
- ▶ Neither the non-EU/EEA AIFM country of establishment nor, where relevant, the non-EU/EEA AIF country must be listed as an NCCT by FATF

Member States may impose stricter requirements on marketing to investors in their territory but national laws, regulations and administrative provisions necessary to comply with and, in particular, with harmonised rules on pre-marketing, should not in any way disadvantage EU AIFMs *vis-à-vis* non-EU AIFMs<sup>24</sup>. This concerns both the current situation in which non-EU AIFMs do not have passporting rights, and a situation in which the provisions on such passporting in the AIFMD become applicable.

<sup>23</sup> In this case, the reporting must be provided to the competent authorities of the Member States where the AIFs are marketed.

<sup>24</sup> Pursuant to Recital (12) of the Directive (EU) 2019/1160 of the European Parliament and of the Council amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings.

## 12.5.4. Distribution to the public

A Member State may permit the marketing of AIFs to retail investors in the Member State (see Section 12.5.2.1.1.).

A number of EU/EEA and third countries have national retail distribution regimes permitting distribution of AIFs to the public provided specific requirements are met, such as:

- ▶ Registration with the national competent authority or prior authorization for distribution from the relevant authorities
- ▶ Regulation of the distributor
- ▶ AIFs meeting certain criteria:
  - ▶ Regulation – meeting specific regulatory requirements
  - ▶ Domicile of the AIF – some jurisdictions permit the distribution of AIFs from specific domiciles, the most recognized one being Luxembourg
  - ▶ Type of funds (e.g., certain funds of funds)
- ▶ Risk management or diversification
- ▶ Investment policy or strategy
- ▶ Stock exchange listing (see Chapter 13)

Other examples of types of requirements are outlined in Section 12.3.5.

## 12.6. Marketing of simplified AIFM registration regime AIFs and RAIFs

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Marketing of simplified AIFM registration regime AIFs is subject to each country's national distribution requirements. Some countries may permit private placement or even, in some circumstances, distribution to the public.

In addition, the SIF Law<sup>25</sup> and the RAIF Law<sup>26</sup> restrict distribution of the shares or units of SIFs and RAIFs to “well-informed investors”, be they in or outside Luxembourg (see Sections 2.4.2. and 2.4.3.). Procedures must be implemented to ensure that this requirement is respected.

### 12.6.1. National private placement regimes (NPPRs)

In some key distribution markets for AIFs, national distribution rules permit private placement. NPPRs permit market participants to buy and sell financial instruments, including the shares or units of AIFs, to each other without having to comply with rules that would usually apply when the same instruments are offered to retail investors.

Typically, NPPRs may provide exemptions from national public distribution regimes for distribution of funds meeting certain criteria (e.g., certain funds of funds) to:

- ▶ A limited number of investors
- ▶ A specific investor type, such as asset managers, professional or qualified investors, or high net worth individuals (HNWIs)
- ▶ Investors subscribing a minimum amount

These NPPR participants rely on private contract law to resolve any disputes that arise. The regulatory safeguards for retail investor protection are waived in “private placement”. Often, the marketing takes place through an intermediary or placing agent.

### 12.6.2. Distribution to the public

A number of countries permit distribution of other non-AIFM Directive-compliant Luxembourg UCIs to the public (see Section 12.5.4.).

### 12.6.3. Marketing EuVECAs and EuSEFs

The managers of qualifying EuVECAs and of qualifying EuSEFs benefit from a “passport” permitting them to market the shares or units of their qualifying European funds to suitably qualified investors throughout the EU/EEA from July 2013.

Eligible investors are professional clients, investors who have requested to be treated as professional clients<sup>27</sup>, and other investors who meet both of the following criteria:

- ▶ The investor commits to investing a minimum of EUR 100,000
- ▶ The investor states in writing, in a document separate from the contract to be concluded for the commitment to invest, that they are aware of the risks associated with the envisaged commitment or investment

<sup>25</sup> Law of 13 February 2007, as amended.

<sup>26</sup> Law of 23 July 2016, as amended.

<sup>27</sup> As defined in Section I of Annex II to the MiFID II Directive (Directive 2014/65/EU, as amended).

The managers of qualifying European funds wishing to use the EuVECA and EuSEF designations to market their qualifying European funds are required to inform the competent authority of their home Member State, providing the following information:

- ▶ The identity of the persons who effectively conduct the business of managing the qualifying European funds
- ▶ The identity of the qualifying European funds whose shares or units shall be marketed and their investment strategies
- ▶ Information on the arrangements made for complying with the requirements of the Regulation
- ▶ A list of Member States where the manager of the qualifying European funds intends to market each qualifying European fund
- ▶ A list of Member States where the manager of the qualifying European funds has established or intends to establish qualifying European funds

When the competent authority of the home Member State of the manager registers the manager, the registration provides the manager with a passport allowing it to market its qualifying European funds under the designation EuVECA and EuSEF throughout the EU/EEA.

The manager must also inform its home Member State authority if it intends to market:

- ▶ A new qualifying European fund
- ▶ An existing qualifying European fund in another Member State

Immediately after registration, or a change thereto, the competent authority of the manager's home Member State is required to notify the Member States where the manager intends to market its qualifying European funds. ESMA will maintain a central database of qualifying European fund managers, the qualifying European funds they market and the countries in which they are marketed.

Since 1 March 2018<sup>28</sup>:

- ▶ Fees cannot be imposed by competent authorities of host member states where no supervisory activity is performed
- ▶ The registration process has been simplified with the introduction of a guaranteed turnaround time of two months for new manager registrations

As part of the EU's Capital Markets Union Action Plan, in June 2019, a new EU Directive<sup>29</sup> and Regulation<sup>30</sup> were introduced, amending the UCITS and AIFM Directives with the aim of harmonizing various aspects of cross-border distribution of UCITS, AIFs, EuVECAs, EuSEFs and ELTIFs. The Directive should be adopted into the national legislation within 24 months from its publication in EU's Official Journal and in practice will be applicable from August 2021.

The Directive and its complementing Regulation lay down additional rules and procedures concerning:

- ▶ Alignment of national marketing requirements and regulatory fees
- ▶ Harmonization of the process and requirements for the verification of marketing material by NCAs
- ▶ Enabling ESMA to monitor investment funds in greater details

The EuVECA and EuSEF regimes are introduced in Section 2.4.4.3.

## 12.6.4. Marketing ELTIFs

The manager of an ELTIF will be able to market the units or shares of the ELTIF to professional and retail investors in its home Member State upon notification in accordance with Article 31 of AIFMD and in other Member States upon notification in accordance with Article 3 of AIFMD, as amended.

The manager of an ELTIF must, with respect to each ELTIF it manages, specify to competent authorities whether or not it intends to market the ELTIF to retail investors.

ELTIFs may be marketed to retail investors on the condition that such investors are provided with appropriate investment advice from the manager or the distributor. In addition, if ELTIFs are marketed to retail investors, special requirements must be met and procedures put in place:

- ▶ The manager must be authorized to provide management of portfolio of investments and investment advice services as referred to in the AIFM Directive and has performed the suitability test referred to below
- ▶ The manager must put in place facilities available for making subscriptions, payments to unit/shareholders, repurchasing or redeeming units or shares and making available the information which the ELTIF and the manager of the ELTIF are required to provide

<sup>28</sup> Regulation (EU) 2017/1991 of the European Parliament and of the Council of 25 October 2017 amending Regulation (EU) No 345/2013 on European venture capital funds (EuVECA) and Regulation (EU) No 346/2013 on European social entrepreneurship fund (EuSEF).

<sup>29</sup> Directive (EU) 2019/1160 of the European Parliament and of the Council amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings.

<sup>30</sup> Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014.

The regulatory standards, to specify the types and characteristics of the facilities referred to above, have been developed by ESMA and have been incorporated in the Commission Delegated Regulation (EU) 2018/480 of 4 December 2017, published in March 2018.

The CSSF has signed MoU with the supervisory authorities of third countries, based on ESMA's approved cooperation agreement templates.

In a letter with respect to the review of the ELTIF regime addressed to the European Commission on 3 February 2021, ESMA proposed to remove local physical presence requirements. ESMA also called to amend the rules applicable when marketing to retail investors by:

- ▶ Streamlining eligibility criteria with EuVECAs and EuSEFs
  - ▶ Providing guidance on details of suitability tests and aligning with MiFID suitability tests
- ▶ The manager must establish and apply a specific internal process for the ELTIF before it is marketed or distributed to retail investors. As part of this process, the manager must assess whether the ELTIF is suitable for marketing to retail investors, taking into account at least the life of the ELTIF and the intended investment strategy of the ELTIF
  - ▶ The manager must make available to any distributor all appropriate information on an ELTIF that is marketed to retail investors, including all information regarding its life and investment strategy, as well as the internal assessment process and the jurisdictions in which the ELTIF will be allowed to invest
  - ▶ The manager must obtain information regarding the retail investor's:
    - ▶ Knowledge and experience in the investment field relevant to the ELTIF
    - ▶ Financial situation, including that investor's ability to bear losses
    - ▶ Investment objectives, including the investor's time horizon

Based on the above information, the manager will recommend the ELTIF only if it is suitable to each retail investor (the "suitability test"):

- ▶ Where the life of an ELTIF exceeds ten years, the manager or the distributor must issue a clear written alert that the ELTIF may not be suitable for retail investors that are unable to sustain such a long-term and illiquid commitment
- ▶ Where the financial instrument portfolio of a potential retail investor does not exceed EUR 500,000, the manager or distributor of the ELTIF, after having performed the suitability test and having provided appropriate investment advice, must ensure, on the basis of the information submitted, that the potential investor does not invest an aggregate amount exceeding 10% of that investor's financial instrument portfolio in ELTIFs and that the initial minimum amount invested in one or more ELTIF is EUR 10,000
- ▶ The legal form of an ELTIF marketed to retail investors must not lead to any further liability for the retail investor or require any additional commitments on behalf of such an investor, apart from the original capital commitment
- ▶ Retail investors must be able to, during the subscription period and at least two weeks after the date of their subscription to units or shares of the ELTIF, cancel their subscription and have their money returned without penalty
- ▶ The manager of the ELTIF must establish appropriate procedures and arrangements to deal with retail investor complaints which allow retail investors to file complaints in the official language or one of the official languages of their Member State
- ▶ A KID must be prepared

## 12.7. Marketing of AIFs in Luxembourg

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### 12.7.1. Luxembourg AIFs

Luxembourg AIFs that are authorized by and subject to the supervision of the CSSF are automatically authorized for marketing in the territory of Luxembourg, subject to any specific restrictions laid down in the applicable law or the fund documentation.

The marketing of Luxembourg AIFs that are not subject to supervision of the CSSF is limited to professional and other eligible investors. Such marketing needs to be notified to the CSSF.

### 12.7.2. Non-Luxembourg AIFs

Authorized AIFMs established in Luxembourg, or in another Member State, are permitted to market units or shares of the full AIFM regime AIFs they manage to retail and professional investors in Luxembourg, under certain conditions and following prior notification to the CSSF, irrespective of whether such AIFs are marketed on a cross-border basis or not, or whether they are EU/EEA or non-EU/EEA AIFs.

The marketing of AIFs that are not subject to authorization and supervision of the CSSF to professional investors by full AIFM regime AIFMs is subject to the requirement to submit a notification through the home Member State competent authority of the AIFM (see Section 12.5.).

The general requirements applicable to the marketing of AIFs in Luxembourg by EU/EEA AIFMs are covered in Section 12.5.2. and the marketing of AIFs by non-EU/EEA AIFMs is covered in Section 12.5.3.

Non-EU/EEA AIFMs wishing to market without a passport the AIFs they manage to professional investors in Luxembourg must complete an information form and submit it to the CSSF. The information form requires general information on the AIFM and on the AIF in relation to which marketing in Luxembourg is notified.

ESMA's *Q&A on the Application of the AIFMD* clarifies that when an AIFM wants to manage AIFs domiciled in another Member State by way of the AIF management passport (Article 33 of AIFMD, as amended), in the program of operations, where specific AIFs cannot be identified at the time of the notification, the AIFs to be managed may be identified by their investment strategy. In that regard, ESMA sees merit in relying on the investment strategies contained in the reporting template for identification purposes (Annex IV of Commission Delegated Regulation (EU) No 231/2013, as amended). Where an AIFM has only been authorized to manage certain types of AIFs, it could also refer to the scope of its authorization to identify the funds to be managed.

Where the AIFM is able to identify specific AIFs, such AIFs should be identified in the program of operations by their name and national identifier (if available). Information on those funds should also include their investment strategies.

All changes to the program of operations have to be notified by the AIFM to the competent authorities in its home Member State. This includes changes to the program of operations in cases where the AIFM intends to manage further AIFs (if specified by name) or types of AIFs (if specified by investment strategy) not previously listed in the program of operations.

The detailed rules for the marketing of foreign AIFs to retail investors in Luxembourg is laid down in the CSSF Regulation 15-03, issued on 2 December 2015.

The following provisions are applicable to the marketing in Luxembourg of open-ended, non-Luxembourg AIFs to retail investors:

- ▶ The AIFs must be subject in their home Member State to regulation providing investors' guarantees of protection at least equivalent to those provided by Luxembourg laws governing AIFs authorized to be marketed to retail investors in Luxembourg. These AIFs must also be subject in their home Member State to permanent supervision considered by the CSSF to be equivalent to that provided in Luxembourg laws governing AIFs authorized to be marketed to retail investors in Luxembourg. Cooperation between the CSSF and the supervisory authority of the AIFs must also be ensured
- ▶ The AIFs must be subject to supervision considered by the CSSF to be equivalent to that laid down in the 2010 Law. This condition is deemed fulfilled by AIFs subject to Part II of the 2010 Law
- ▶ The AIFs must be managed by a single manager
- ▶ The AIFs must appoint a credit institution to ensure that facilities are available in Luxembourg for making payments to share/unitholders and repurchasing or redeeming shares/units
- ▶ The AIFs must take the necessary measures to ensure that the information that it is obliged to provide is made available to share/unitholders in Luxembourg

An authorization request must be filed with the CSSF, which should include the following documents and information:

- ▶ A certificate by the relevant supervisory authority of the home Member State of the AIFs certifying that the AIFs are authorized and subject to a permanent supervision in its home State
- ▶ The addendum to the prospectus of the AIFs which includes specific information for the marketing in Luxembourg and which shall include all information useful to investors in Luxembourg to invest with full knowledge of the facts, such as:
  - ▶ Appropriate information on the risks inherent to the investment policy of the AIFs
  - ▶ Information on the fees and expenses that may be charged to investors
  - ▶ The name, address and duties of the paying agent in Luxembourg
  - ▶ The place where the latest prospectus, its constitutional documents and the latest financial reports are made available
  - ▶ Details on how the foreign AIFs' NAVs are published
  - ▶ The name of the Luxembourg newspaper in which the investor notices are published
- ▶ The latest annual report of the foreign AIFs
- ▶ The curriculum vitae of the conducting persons (dirigeants) of the foreign AIFs
- ▶ The draft agreement to be entered into between the Luxembourg paying agent and the foreign AIFs
- ▶ If the foreign AIFs are feeder AIFs, information on the master AIFs including information on where the master AIFs are established, the master AIFs' constitutional documents and the prospectus of the master AIFs

On the basis of the aforementioned requirements, the CSSF will decide whether or not the AIFs can be marketed in Luxembourg.



CSSF Regulation No 20-10 of 21 December 2020 lays down the conditions applicable to marketing foreign open-ended UCIs, other than UCITS, that are not covered by the CSSF Regulation No 15-03, i.e., which are not managed by an AIFM, to retail investors in Luxembourg.

When the AIF decides to no longer market its units or shares to retail investors in Luxembourg it must inform the CSSF.

On 15 January 2019, the CSSF and the Securities and Futures Commission of Hong Kong (SFC) signed an MoU concerning Mutual Recognition of Covered Funds (and Covered Management Companies).

The MoU provides a framework for mutual recognition of Luxembourg UCIs and Hong Kong domiciled AIFs to be offered, marketed and distributed to retail investors in Luxembourg and to the public in Hong Kong. The conditions and the process is detailed in the CSSF document “*CSSF streamlining requirements and process for mutual recognition of Hong Kong funds*” and in the SFC Circular “*Mutual Recognition of Funds between Luxembourg and Hong Kong*”.

## 12.8. Marketing regulations applicable in Luxembourg

The provisions governing marketing in Luxembourg that a UCI also needs to comply with are as follows:

- ▶ Law of 23 December 2016 on sales and selling on pavement and on misleading and comparative advertising, as amended
- ▶ Law of 2 April 2014 amending the Consumer Code in particular and repealing the amended law of 16 July 1987 on canvassing, street wending, displaying goods and seeking orders
- ▶ Law of 8 April 2011 (Consumer Code), as amended, which, *inter alia*, includes provisions concerning the distance marketing of consumer financial services implementing Directive 2002/65/EC

Additional Luxembourg regulations impacting the marketing of UCIs include:

- ▶ Conduct of business rules applicable to Luxembourg credit institutions and investment firms selling UCIs and providing investment services (e.g., investment advice or the reception and transmission of orders) under the 1993 Law<sup>31</sup> (implementing MiFID requirements)
- ▶ Rules of conduct applicable to management companies and AIFMs (see Section 6.4.2.), as well as conduct of business requirements applicable to management companies and AIFMs providing investment services (see Section 6.2.1.D.)

Entities marketing UCITS to investors in Luxembourg through their Luxembourg branches or on a cross-border basis are subject to their home Member State rules of conduct, implementing MiFID and UCITS Directive requirements, respectively.

## 12.9. Marketing intermediaries

The marketing and execution of subscriptions and redemptions of shares or units is often supported by Luxembourg or foreign intermediaries of different types. The appointment of intermediaries as financial agents and representatives for placing orders in shares or units of UCIs in no way restricts the ability of investors to deal directly with the UCI.

In March 2022, ALFI issued considerations on marketing and distribution for Luxembourg IFMs clarifying the principles of marketing and distribution under the AIFM Directive, the UCITS Directive and MiFID as well as good practices with regards to the identification of intermediaries performing the marketing functions. ALFI's document also includes practical guidance concerning distribution agreements.

Luxembourg or foreign intermediaries may participate in subscription and redemption operations provided that certain conditions are met. These intermediaries include, but are not limited to:

- ▶ Distributors
- ▶ Nominees
- ▶ Market makers

<sup>31</sup> | The Law of 5 April 1993 on the financial sector, as amended.

In April 2017, ALFI issued guidelines outlining *Principles of the oversight of financial intermediaries in distribution of funds - covering the full life-cycle of initial and ongoing due diligence reviews*. The purpose of these guidelines is to provide parties charged with the responsibility for oversight of financial intermediaries (FI) in the distribution chain with a set of high-level common principles for their consideration. ALFI believes that this will create efficiencies for the Luxembourg fund industry.

The scope of the document covers the key areas of FI oversight: risk assessment of the distribution model, initial due diligence, ongoing due diligence/monitoring, governance of the FI and reporting.

In the UK, EEA firms and EEA domiciliated investment funds which are carrying out a regulated activity in the UK through the EU passport and which have applied for the Temporary Permission Regime prior to 30 January 2020, are permitted to continue to operate within the scope of their current permissions for a limited period of time (1 February 2020 - 31 January 2025).

The key frameworks of the FCA<sup>32</sup>, which regulate investment fund activity, are the handbooks of the “Collective Investment Scheme Information Guide” and “Investment Funds sourcebook”.

Passporting of EEA<sup>33</sup> UCITS will be able to continue into the UK for a limited period of time under the temporary marketing permission regime (TMPR), provided that the management company or the self-managed UCITS had notified the FCA by 30 December 2020. In the absence of such notification, passporting firms automatically entered the Financial Services Contracts Regime (FSCR) to allow them to wind down their UK business in an orderly fashion.

The Financial Services Act 2021<sup>34</sup> (“the Act”) introduced a new overseas fund regime and will provide for recognition by the FCA of EEA UCITS so that they can continue to be marketed in the UK following the end of the TMPR. The Overseas Funds Regime (OFR) came into effect on 23 February 2022, but before the OFR can be used, HM Treasury (HMT) must assess and make a positive equivalence decision that another country’s regulatory regime for a specific type of investment fund is deemed equivalent. As a prerequisite, the UCITS home country must provide at least equivalent investor protection outcomes and HM Treasury<sup>35</sup> must be satisfied that there are adequate supervisory cooperation arrangements between the FCA and the national competent authority in the home country. This retail fund equivalence regime is introduced through a new section 271A of the Financial Services and Markets Act 2000 (FSMA) and provides a more streamlined and simplified process compared to the existing individual fund recognition system under section 272 of the FSMA. However additional requirements specified in separate legal instruments may apply to certain categories of overseas funds.

The Act extends the TMPR from three to five years to allow sufficient time for the UK government to complete any equivalence assessments and for UCIs to apply for recognition, either through the OFR or section 272 as appropriate.

The FCA will rely on self-certification from the notifying UCIs that they are eligible for recognition. Recognition is to be made at both the UCI and compartment level. The time limit for the FCA to require further information or confirm recognition is two months.

For a money market fund (MMF) marketed to retail clients, an equivalence determination is required under both section 271A FSMA, and the MMF equivalence regime<sup>36</sup>. In case no equivalence is granted under section 271A FSMA, MMFs must apply for individual recognition under section 272 FSMA to be able to be marketed to UK retail clients.

Additional requirements imposed by separate legal instruments may apply for certain categories of UCIs but are not designed to address fundamental shortcomings in an overseas regime. Proportionality and a level playing field are supposed to be achieved through a provision which requires HM Treasury to have regard to what is required of comparable UK authorized UCIs when specifying these additional requirements.

HM Treasury may modify or withdraw equivalence in response to material changes in the regulatory regime in either the UK or the overseas countries. In such circumstances, investors should not be forced to divest and the UCI should continue to service them. Under a transitional provision, HM Treasury can specify a period during which affected UCIs can apply for individual recognition under the FSMA section 272 regime or modify or disapply the time limits for the FCA to determine a section 272 application.

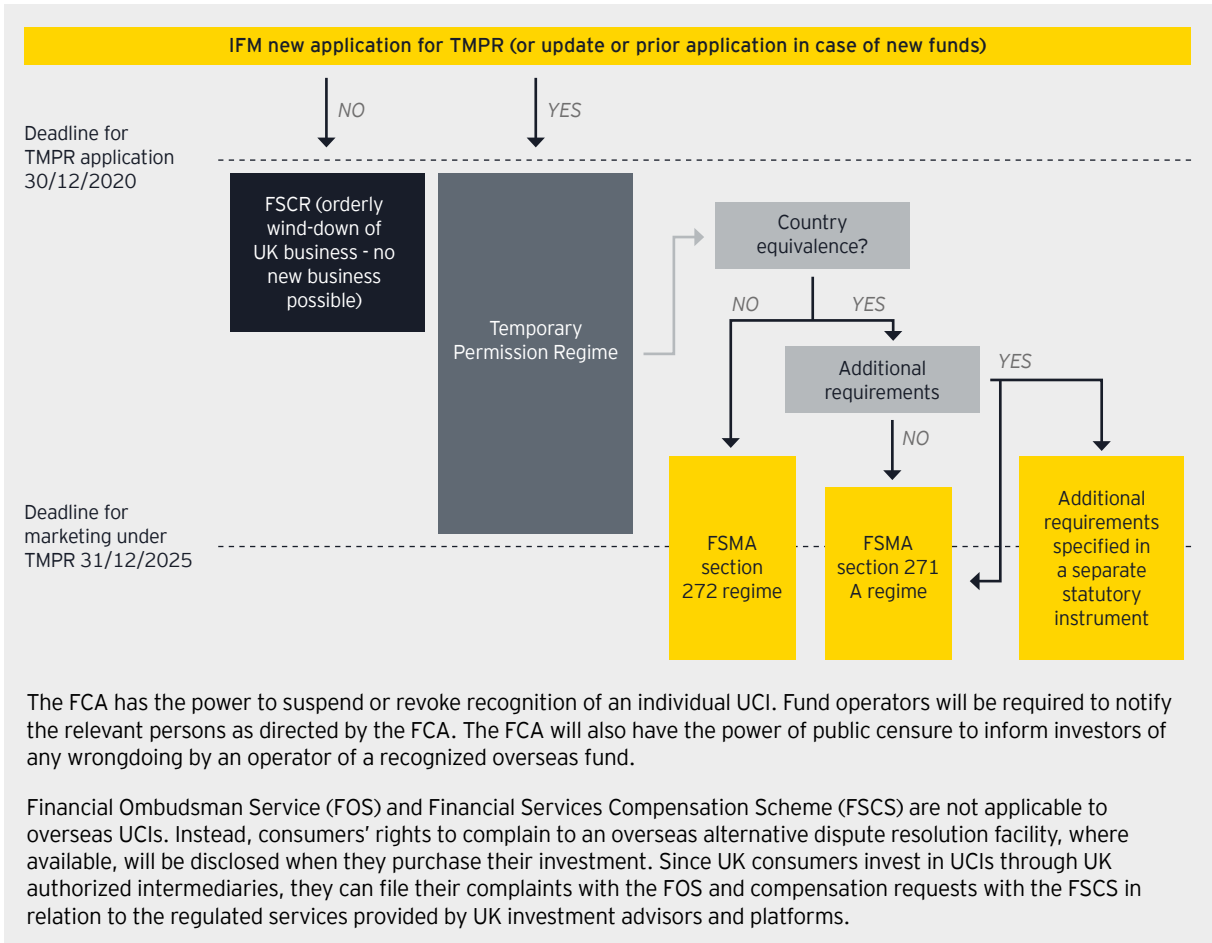
<sup>32</sup> Financial Conduct Authority.

<sup>33</sup> European Economic Area comprising European Union (EU) Member States plus Iceland, Liechtenstein and Norway.

<sup>34</sup> The Financial Services Act 2021 received Royal Assent and became law on 29 April 2021.

<sup>35</sup> Her Majesty’s Treasury.

<sup>36</sup> Article 4A of the MMR, as amended.



## 12.9.1. Distributors

Distributors are intermediaries that perform one or both of the following activities:

- Actively market the shares or units
- Receive subscription and redemption orders as appointed agents of the UCI

The following conditions are applicable to distributors:

- (1) For the purposes of processing the subscription and redemption orders, distributors must immediately forward the necessary data to the UCI management company or administrator (see, however, Point (4))
- (2) For orders concerning registered shares or units, distributors will provide the UCI management company or administrator with the registration data necessary to accomplish the related tasks on an individual basis
- (3) The requirement of Point (2) does not apply in the case of orders concerning bearer shares or units. In such cases, distributors act as subscribers in relation to the UCI management company or administrator in Luxembourg. They may therefore aggregate individual subscription or redemption orders and transmit them in the form of a combined order to the UCI management company or administrator in Luxembourg
- (4) It is not necessary for distributors to forward to the UCI management company or administrator the documentation relating to subscription and redemption orders from investors. However, the UCI management company or administrator must be allowed access to such documentation in case of need
- (5) Payments and receipts in respect of subscription and redemption orders may be aggregated by distributors in order to deal with the UCI management company or administrator on a net basis

## 12.9.2. Nominees

Nominees act as intermediaries between investors and the UCI of their choice.

The use of nominees is only authorized if the following conditions are met:

- (1) The relationship between the UCI, the nominee, management company or administrator, and the investors is determined by contract
- (2) The management company, investment company, or the UCI's sponsor, initiator or promoter is required to ensure that the nominee can adequately guarantee to execute properly its obligations towards investors
- (3) The role of the nominee is adequately described in the prospectus
- (4) Investors have the right to directly invest in the UCI without using a nominee and this right is expressly stated in the prospectus
- (5) Agreements between the nominee and the investors include a termination clause giving the investor the right to claim title to the shares or units subscribed through the nominee

The conditions of Points (4) and (5) are not applicable where the use of a nominee is either compulsory or indispensable.

The CSSF has introduced a template paragraph in relation to investor rights to be inserted in the prospectus covering, *inter alia*, cases where the UCI uses a nominee (see Section 10.3.1.K.).

## 12.9.3. Market makers

Market makers are intermediaries participating on their own account and at their own risk in subscription and redemption transactions of UCI shares or units.

The use of market makers is only authorized if the following conditions are met:

- (1) The relationship between the UCI, management company or administrator, and the market maker is determined by contract
- (2) The role of the market maker is adequately described in the prospectus
- (3) Market makers may not act as counterparties to subscription and redemption transactions without specific approval of the investors
- (4) Market makers may not price subscription and redemption orders addressed to them on less favorable terms than would be applied by the UCI directly
- (5) Market makers must regularly notify the UCI, management company or administrator of orders executed by them that relate to registered shares or units to ensure that the register of shareholders or unitholders is updated and that registered certificates or confirmations of investment may be sent out from Luxembourg

## 12.10. Special marketing information for distributors and insurers

ESMA clarified in its *Q&A on MiFID II and MiFIR investor protection and intermediaries topics* that asset managers need to provide PRIIPs transaction costs to their distributors. If transaction cost information along with other MiFID II relevant information is not sent to distributors, distributors will not be able to market the relevant UCIs.

A European Working Group has defined a standard template to exchange this MiFID II relevant information between asset managers and distributors/distribution platforms. This standard is called European MiFID II Template (EMT) and covers the following MiFID II relevant information per share class:

- Target market definition according to the following categories:
  - Type of clients to whom the product is targeted
  - Knowledge and experience
  - Financial situation with a focus on the ability to bear losses
  - Risk tolerance and compatibility of the risk/reward profile of the product with the target market
  - Client objectives and needs
- Distribution strategy
- Costs and charges *ex ante* (incl. PRIIPs transaction costs)
- Costs and charges *ex post* (incl. PRIIPs transaction costs)

As of 10 December 2020, under the coordination of FinDatEx (Financial Data Exchange), the EMT was revised and EMT V1.0 has been replaced by EMT V3.0.

- Along with the above-mentioned information, EMT V3.0 will introduce additional information requests, e.g., specification on whether the product is developed with the aim of being compatible with clients having ESG preferences and a specific breakdown for borrowing costs in both *ex post* and *ex ante* costs and charges sections
- To facilitate compliance with SFDR Level 1 requirements as of 10 March 2021, FinDatEx Steering Group has endorsed EMT V3.1. EMT V3.1 and V3.0 coexist and cannot be merged

In comparison to V3.0, the following has been amended:

- ▶ Data field 56 has been updated:
  - ▶ “05105\_Intended\_Compatible\_With\_Clients\_Having\_Sustainability\_Preferences”
- ▶ Data fields 95-98 have been added:
  - ▶ “09000\_ESG\_Category\_For\_German\_Market”
  - ▶ “09010\_ESG\_Focus”
  - ▶ “09020\_ESG\_Label\_Or\_Standard”
  - ▶ “10020\_AMF\_Doctrine”
- ▶ Following the coming into force of the SFDR Regulation, together with the creation of a standard European ESG Template to transmit ESG information from asset managers to distributors and insurers, the EMT V3.0 and V3.1 is replaced by EMT V4 starting since 1 August 2022. In comparison to the co-existing V3.0 and V3.1, the following has been updated:
  - ▶ The wording of the data field 05105 has been updated from *05105\_Intended\_Compatible\_With\_Clients\_Having\_Sustainability\_Preferences* to *05105\_Does\_This\_Financial\_Instrument\_Consider\_End\_Client\_Sustainability\_Preferences*
  - ▶ The country specific ESG-related data fields of V3.1 have been deleted

The PRIIPs Regulation requires that insurers collect information on funds, in case these are an investment option to the retail investor investing into this insurance product. A European Working Group has defined a standard template to exchange this PRIIPs relevant information between asset managers and distributors/distribution platforms to help them fulfil their PRIIPs regulatory obligations. This standard is called European PRIIPs Template (EPT) and covers the following PRIIPs relevant information per share class:

- ▶ General portfolio information
- ▶ Risk assessment
- ▶ Performance scenario (without entry cost with exit cost)
- ▶ Past performance information
- ▶ Costs
- ▶ Narratives
- ▶ Specific UCITS data for insurers opting for Art. 14 (2) for a multi-option product (MOP)
- ▶ Specific data for German CAT IV PRIIPs
  - ▶ Characteristics of the fund/portfolio
  - ▶ Additional information for capital preservation funds/portfolio
  - ▶ Specific data for Structured Products - reduction in yield (RIY) costs

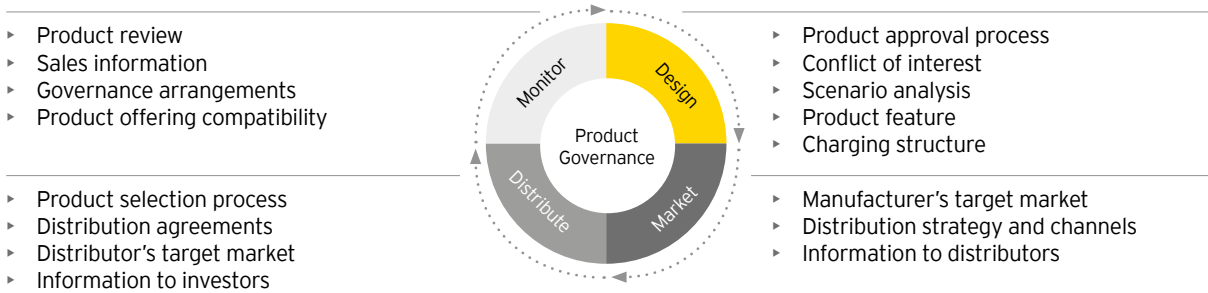
For MiFID II and PRIIPs, the target market needs to be clearly defined in these reports. In particular, the type of retail investor to whom the product is intended to be sold to, their ability to bear losses and their investment horizon preferences are taken into consideration when defining the target market. On top of this, the asset managers need to review periodically post-sale to ensure consistency with the needs, characteristics and objectives of the identified target market.

## Target market en product governance

The identification of a target market should be based on both quantitative and qualitative information

Type of client to whom the product is targeted	Knowledge and experience	Financial situation with a focus on the ability to bear losses	Risk tolerance and compatibility of the risk/reward profile of the product with the target market	Clients' objectives and needs
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Governance arrangements to be implemented throughout the product's life-cycle



# 13

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## STOCK EXCHANGE LISTING

EY listing services:

- ▶ Feasibility analysis and determination of listing process and requirements
- ▶ Support with preparation and submission of listing application
- ▶ Support with selection of listing service providers
- ▶ Support with changes to fund listing



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## 13.1. Introduction

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In certain limited cases, investors, in particular institutional investors, may only be permitted to purchase securities (generally shares or units) issued by UCIs that are listed on a recognized or regulated stock exchange. As a result, a stock exchange listing may often be important to accessing certain distribution channels.

This Chapter outlines a summary of some of the key conditions for listing the securities of UCIs either on the regulated market, the *Bourse de Luxembourg* of the Luxembourg Stock Exchange (LuxSE), on the “multilateral trading facility” (Euro MTF) operated by the LuxSE, or on the Luxembourg Stock Exchange Securities Official List (LuxSE SOL).

## 13.2. Luxembourg Stock Exchange (LuxSE)

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The LuxSE operates a “regulated market”<sup>1</sup> – designated as the “*Bourse de Luxembourg*” (BdL), a “multilateral trading facility”<sup>2</sup> – the “Euro MTF” and the “Securities Official List” (SOL), a dedicated section of the LuxSE’s official list. Securities may not be simultaneously admitted to more than one of these markets.

The BdL, the regulated market, offers issuers a European passport. Issuers on the regulated market must comply with the requirements of the Prospectus Regulation<sup>3</sup> and the Transparency Directive<sup>4</sup>, or benefit from an exemption. The CSSF is responsible for approving prospectuses under the Prospectus Regulation. The LuxSE will normally approve the prospectuses drawn up in connection with admission to trading on the regulated market of securities outside the scope of the Prospectus Regulation.

The Euro MTF, on the other hand, was set up to meet the needs of issuers not requiring a European passport. Issuers on the Euro MTF do not have to meet the requirements of the Prospectus Regulation and the Transparency Directive. The LuxSE is in charge of approving prospectuses of closed-ended funds for admission to the Euro MTF. Open-ended UCITS can use the prospectus approved for the distribution of the UCITS in Luxembourg.

With the launch in December 2017 of the LuxSE Securities Official List (SOL), a dedicated section of the LuxSE’s official list, the Luxembourg Stock Exchange allows registration of securities solely on the Official List without admission of these securities to trading on any of the markets operated by the Luxembourg Stock Exchange. This is intended to allow issuers to have their securities appear on a widely recognized official list, without the application of a number of capital markets related EU and national laws that solely focus on securities being admitted to trading.

The stock exchange listing requirements for the BdL and the Euro MTF are set out in the *Rules and Regulations of the Luxembourg Stock Exchange* published by the LuxSE. These were updated in January 2020 and are available on the LuxSE website. This latest version includes a UCI appendix to draft the prospectus of a closed-end UCI and incorporates:

- ▶ The Law of 13 January 2019 establishing a Register of Beneficial Owner, as amended, (the RBO Law), which partly implements the Fourth and the Fifth EU anti-money laundering (AML) directives
- ▶ The Regulation (EU) 2017/1129 of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, as amended, (the Prospectus Regulation) and the Luxembourg law of 16 July 2019 implementing this Prospectus Regulation (the “Prospectus Law”)

In order to comply with the RBO law, the LuxSE has full power and authority:

- ▶ To apply to UCIs all AML and know-your customer (KYC) measures and procedures it deems necessary
- ▶ To carry out verifications in order to identify the issuer and its Beneficial Owner(s) (the B.O.) during the scrutiny process
- ▶ To ask for any additional documents and information in order to identify the issuer, its B.O. and generally in order to fight against money laundering and terrorist financing

The due diligence process includes a KYC form which should be provided with the application form and should contain the full legal name of the UCI, the name of its B.O. and, where applicable, the name of any related or involved politically exposed person(s) as defined in Directive (EU) 2015/849, as amended.

An application for admission to the official list without admission to trading is possible subject to the conditions set out in the *Rulebook – LuxSE Securities Official List*, available on the LuxSE website ([www.bourse.lu](http://www.bourse.lu)).

<sup>1</sup> Within the definition of Article 4(1) 21 of the Markets in Financial Instruments Directive (MiFID II), Directive 2014/65/EC, as amended.

<sup>2</sup> Within the definition of Article 4(1) 22 of the Markets in Financial Instruments Directive (MiFID II), Directive 2014/65/EC, as amended.

<sup>3</sup> EU Regulation (EU) 2017/1129, as amended.

<sup>4</sup> Directive 2004/109/EC, as amended.



In late 2018, the LuxSE introduced two Professional Segments, available on the BdL and the Euro MTF markets.

Issuers targeting professional investors<sup>5</sup> only can now apply to have their financial instruments admitted to trading in the new segments. Admitted securities will not be accessible for retail investors as trading on the Professional Segments is only allowed between professional investors and qualified/well-informed investors.

Application files must clearly indicate the segment chosen by issuers.

The Luxembourg Stock Exchange launched its Luxembourg Green Exchange (LGX) in 2016 in order to help facilitate the development of sustainable finance.

LGX is a dedicated platform for green, social and sustainable securities and aims to provide issuers, asset managers and investors with an environment for bonds and funds which are green, social, sustainable, or ESG-focused. Entry is restricted to issuers and asset managers that provide full disclosure and fulfil their reporting obligations.

LGX is the world's first dedicated green stock exchange.

## 13.2.1. Listing UCIs on the Bourse de Luxembourg (BdL)

### 13.2.1.1. Listing UCITS and other open-ended UCIs

UCITS and other open-ended UCIs wishing to list on the BdL must have their prospectuses drawn up in accordance with the relevant product law, approved by the CSSF<sup>6</sup> or other EU competent authority. Open-ended UCIs do not fall within the scope of the Prospectus Law. Hence a prospectus approved by the CSSF, or by any other relevant EU supervisory authority may be used for public offering in Luxembourg and/ or admission to trading on the BdL.

### 13.2.1.2. Listing closed-ended UCIs

Closed-ended UCIs wishing to list on the BdL are required to draw up a prospectuses under the relevant section of the Prospectus Law<sup>7</sup>.

Annex 4 of the Commission Delegated Regulation (EU) 2019/980<sup>8</sup> of 14 March 2019 provides the template of the registration document for units of closed-ended UCIs.

On 20 April 2021, CSSF Circular 21/771 implemented *ESMA Guidelines on disclosure requirements under the Prospectus Regulation* into Luxembourg supervisory practices and regulatory approach. The guidelines clarify, *inter alia*:

- ▶ The information required in the prospectus on the methodology employed in pursuing the investment strategy
- ▶ The minimum information required to describe UCI's assets
- ▶ The information required where the UCI uses securities financing transactions
- ▶ The conditions to be met by an index to qualify as a broadly based index
- ▶ The information required with regard to fees, in addition to those paid to service providers
- ▶ The information required on the regulatory status and the experience of the investment manager
- ▶ The information required on the investment advisor
- ▶ The content of the comprehensive and meaningful analysis of the UCI's portfolio

The guidelines are applicable as from 5 May 2021.

The CSSF is responsible for the approval of the prospectus which should be submitted via e-prospectus, in accordance with the requirements of CSSF Circular 19/724, as amended.

<sup>5</sup> Within the meaning of Directive 2014/65/EU, as amended (MiFID II).

<sup>6</sup> The LuxSE is responsible for approving prospectuses in certain circumstances: admissions of securities not covered by Part II of the Prospectus Law, as amended; and foreign open-ended UCIs, not being distributed in Luxembourg. Appendix XII of the *LuxSE Rules and Regulations* contains information to be included in the prospectus for the admission to trading of shares and units for such UCIs.

<sup>7</sup> For an offer to the public in Luxembourg, closed-ended UCIs may not legally be required to publish a prospectus under Part II or III of the Prospectus Law, as amended, providing the following conditions are met: (i) offers of securities addressed solely to qualified investors (i.e., "professional investors" under MiFID), (ii) offers of securities addressed to fewer than 150 natural or legal persons, other than qualified investors, per Member State; and (iii) offers of securities addressed to investors that acquire securities for a total consideration of at least EUR 100,000 per investor and for each separate offer.

<sup>8</sup> Commission Delegated Regulation (EU) 2019/980 of 14 March 2019, as amended, supplementing Regulation (EU) 2017/1129 of the European Parliament and of the Council as regards the format, content, scrutiny and approval of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market and repealing Commission Regulation (EC) No 809/2004.

### 13.2.1.3. Listing requirements of the BdL

UCIs wishing to list their shares/units on the BdL must ensure that the shares/units fulfil the following:

- Are active and have a Net Asset Value (NAV)
- Are eligible for clearing and settlement
- Are freely transferable

The full listing requirements are outlined in Part I, Chapters 5 and 7 of the *Rules and Regulations of the Luxembourg Stock Exchange*. A section dedicated to the listing of investment funds is available on the website of the LuxSE.

## 13.2.2. Listing UCIs on the Euro MTF

### 13.2.2.1. Listing UCITS and other open-ended UCIs

UCITS and other open-ended UCIs wishing to list on the Euro MTF must have their prospectuses drawn up in accordance with the relevant product law, approved by the CSSF<sup>9</sup> or another EU competent authority. Open-ended UCIs do not fall within the scope of the Prospectus Law. Hence a prospectus approved by the CSSF, or by any other relevant EU supervisory authority may be used for public offering in Luxembourg and/or admission to trading on the Euro MTF.

### 13.2.2.2. Listing closed-ended UCIs, third-country UCIs and unregulated UCIs

Closed-ended UCIs, third-country UCIs and unregulated UCIs are required to draw up a prospectus using the UCI appendix in *Rules and Regulations of the Luxembourg Stock Exchange*. LuxSE is responsible for the approval of the prospectus. However, in cases where such UCIs have already drawn up a prospectus for an offer to the public in Luxembourg under the relevant section of the Prospectus Law<sup>10</sup>, the CSSF is responsible for the approval of the prospectus.

### 13.2.2.3. Listing requirements of the Euro MTF

UCIs wishing to list their shares/units on the Euro MTF must ensure that the shares/units fulfil the following:

- Are active and have a NAV
- Are eligible for clearing and settlement
- Are freely transferable

The full listing requirements are outlined in Part I, Chapters 6 and 7 of the *Rules and Regulations of the Luxembourg Stock Exchange*. A section dedicated to the listing of investment funds is available on the website of the LuxSE.

## 13.2.3. Listing UCIs on the LuxSE SOL

### 13.2.3.1. Listing UCIs

UCITS and other open-ended UCIs wishing to list on the LuxSE SOL should provide:

- An Information Notice, in English, French or German, providing details on, *inter alia*, the shares/units to be listed. However, a prospectus approved by the CSSF, or by any other competent authority, may replace the Information Notice
- An application form containing a declaration that the issuer will comply with the terms and conditions set out in the SOL Rulebook
- A written confirmation that the issuer and the securities comply with the applicable legislation and regulations
- Articles of incorporation and annual reports of the issuer (and of the guarantor, if any)

### 13.2.3.2. Listing requirements of the LuxSE SOL

Closed-ended UCIs wishing to list their shares/units on the LuxSE SOL must ensure that the shares/units fulfil the following:

- Are freely negotiable
- Have been actually issued prior to the admission onto the LuxSE SOL
- Application for admission must cover all shares/units of the same class already issued
- No free float conditions apply

The full listing requirements are outlined in the *Rulebook - LuxSE Securities Official List*.

<sup>9</sup> The LuxSE is responsible for approving prospectuses for closed-ended and foreign open-ended UCIs not being distributed in Luxembourg.

<sup>10</sup> For an offer to the public in Luxembourg, closed-ended UCIs may not legally be required to publish a prospectus under Part II or III of the Prospectus Law, as amended, providing the following conditions are met: (i) offers of securities addressed solely to qualified investors (i.e., "professional investors" under MiFID), (ii) offers of securities addressed to fewer than 150 natural or legal persons, other than qualified investors, per Member State; and (iii) offers of securities addressed to investors that acquire securities for a total consideration of at least EUR 100,000 per investor and for each separate offer.

## 13.3. Procedures for admission to a securities market of the LuxSE

The decision on the application will normally be taken within a few days and, in any case, a maximum period of 10 working days following receipt of a complete application. The admission date will be decided by the LuxSE, although applicants may request a specific date of admission.

### 13.3.1. Contents of the application for Bourse de Luxembourg or Euro MTF

To begin the listing process, the following documents should be completed and sent to the BdL at [bolide@bourse.lu](mailto:bolide@bourse.lu):

- ▶ A copy of the UCI's prospectus
- ▶ Application form
- ▶ KYC form for the Regulated Market/Euro MTF with additional documents:
  - (i) A proof of existence of the UCI
  - (ii) The full list of the UCI's legal representative(-s)
  - (iii) The full list of the UCI's B.O.(-s)
  - (iv) An organization chart representing the UCI, the guarantor where applicable, the B.O and any intermediaries
- ▶ Undertaking letter
- ▶ Articles of association or management regulations
- ▶ Existing agreements/conventions
- ▶ Last three years' annual reports

Listing will take place once the prospectus is clear of comments and after receipt of the final version of the prospectus and the first listing price (current NAV per share/unit).

The application file may be submitted in English, French or German and must include a duly signed application form detailing:

- ▶ Name of legal entity filing the application
- ▶ Object of the application - the securities market (BdL, Euro MTF, professional segment) for which the admission is sought
- ▶ Information on the UCI for which the application is submitted
- ▶ Details of securities to be listed
- ▶ Name of the legal entities responsible for payment of the approval, listing and maintenance fees
- ▶ Effective date of admission
- ▶ Declaration from the UCI seeking admission that it commits to comply with the EU and/or Luxembourg laws and regulations for the relevant market. A separate declaration from the UCI may be included with the application file instead of signing the declaration in the application form
- ▶ Auditor information

In practice, the documentation to be included in the application file would generally include the UCI's prospectus or offering document and any related supplements as well as the UCI's articles of association. The LuxSE will ensure that the prospectus or offering document complies with the *Rules and Regulations of the Luxembourg Stock Exchange*. If this is not the case, the LuxSE may request that the prospectus be amended accordingly. The listing procedures may be carried out by a listing agent on behalf of the UCI.

### 13.3.2. Contents of the application for "Securities Official List" ("LuxSE SOL")

The application for admission onto LuxSE SOL must specifically include the following documents:

- ▶ The Information Notice or any document having a similar purpose and containing at least the same data and information as included in the Information Notice (e.g., a prospectus duly approved by a competent authority)
- ▶ A declaration from the issuer in which it commits to comply with the requirements of the Rulebook
- ▶ The application must also mention, to the best of the issuer's (or applicant's) knowledge, where the securities are also listed and/or, as the case may be, admitted to trading
- ▶ KYC form for the SOL with proof of existence of the UCI. Other documents may be requested
- ▶ A written confirmation that:
  - ▶ The legal position and structure of the issuer comply with the applicable legislation and regulations relating to both its constitution and its operation under its articles of association
  - ▶ The legal position of the securities complies with the relevant applicable legislation and regulations
  - ▶ The administration of securities events and the payments of dividends and coupons shall be ensured and shall be made properly and in due time
- ▶ The articles of association of the issuer and, where applicable, of the guarantor, as well as their annual reports of the last three financial years, where applicable

The Information Notice is subject to approval by LuxSE taking into account whether the Information Notice meets the Rulebook requirements or not. The Information Notice will be published on LuxSE's website.

The Information Notice must detail the securities and the issuer and needs to contain at least the following sections:

- Section A - Introduction and Warnings
- Section B - Issuer and any Guarantor
- Section C - Securities
- Section D - Risks
- Section E - Offers

### 13.3.3. General rules and conditions for admission to the Bourse de Luxembourg

To qualify for admission to the BdL (as the LuxSE's regulated market), the securities must be freely negotiable, which means that they are "capable of being traded in a fair, orderly and efficient manner and to be negotiated freely".

In addition, the securities must be eligible for settlement in a recognized system by the LuxSE.

The LuxSE will consider the following when evaluating if an open-ended UCI's securities are "freely negotiable":

- The distribution of the securities to the public
- Whether there are appropriate market-making arrangements or whether the management body of the UCI provides appropriate alternative arrangements for investors to redeem the securities
- In the case of exchange-traded funds, whether, in addition to market-making arrangements, appropriate alternative arrangements for investors to redeem units or shares are provided, at least in cases where the value of the units or shares significantly varies from the NAV
- Whether the value of the securities is made sufficiently transparent to investors by means of the periodic publication of the NAV

With respect to a closed-ended UCI (see Section 2.3.), the LuxSE will consider the following:

- The distribution of the securities to the public
- Whether the value of the securities is made sufficiently transparent to investors either by publication of information on the UCI's investment strategy or by the periodic publication of the NAV

Non-UCITS are not required to comply with the registration, notification, or other procedures that are a necessary precondition for the marketing of the UCI in Luxembourg (see Chapter 12) if they are only seeking a listing.

### 13.3.4. General rules and conditions for admission to the Euro MTF

To enable admission to the Euro MTF, a UCI must generally comply with the conditions set out in Section 13.3.3. However, the LuxSE may grant a waiver to these conditions if they deem such a waiver is not detrimental to the principle of fair trading and a contravention of any other relevant listing provision.

### 13.3.5. General rules and conditions for admission to the official list

An application for admission to trading on either the BdL or the Euro MTF is also deemed to constitute an application for admission to the official list. However, an issuer may specifically request that the securities are not admitted to the official list.

A closed-ended UCI is required to meet certain conditions before its securities are admitted to the official list. These include:

- The UCI must comply with the laws and regulations applicable to its constitution and its operation
- Minimum capital of EUR 1 million (a lower amount may be accepted if the UCI can demonstrate that there is an adequate market in the securities)
- The UCI has existed for the preceding three years and has filed its annual reports and audited financial statements for the preceding three years in accordance with relevant national laws (a derogation is possible subject to certain conditions)
- Sufficient public distribution (generally defined as 25%) of the entity's securities to the public has been made at the time of the admission to the official list (or confirmation that this will be achieved shortly thereafter) (applicable to BdL and Euro MTF)
- Securities must be freely transferable
- All securities of the same category must be listed
- Where physical form of securities exist, there must be appropriate disclosures and sufficient procedures to safeguard and protect investors

The admission to the official list of securities issued by UCIs other than a closed-ended type is not subject to these conditions.

An application for admission to the official list without an application for admission to trading is possible subject to the conditions set out in the Rulebook - *LuxSE Securities Official List*. This Rulebook is not applicable for securities which are also intended to be admitted to trading on one of the markets operated by the LuxSE.

## 13.4. Continuing obligations for issuers of securities

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### 13.4.1. Information to be made available to the public

UCIs must ensure equal treatment of all security holders (generally shareholders and unitholders) who are in identical situations.

#### 13.4.1.1. UCIs admitted to the Bourse de Luxembourg

A closed-ended UCI admitted to the BdL is subject to the Transparency Directive, implemented in Luxembourg through the Law of 11 January 2008, as amended (the “Transparency Law”), and must comply with certain information requirements including the following:

- ▶ Periodic information:
  - ▶ Annual report, which must be made public within four months of each financial year-end. The report should comprise financial statements and the related audit report, a management report and a corporate governance statement
  - ▶ Semi-annual report, which must be made public within three months of the half year. The report should comprise a condensed set of financial statements, an interim management report and a corporate governance statement

On 5 October 2015, ESMA issued its *Guidelines on Alternative Performance Measures* aimed at promoting the usefulness and transparency of Alternative Performance Measures (APMs) included in prospectuses or regulated information, including management reports. The guidelines set out a common approach towards the use of APMs and are expected to benefit users and promote market confidence.

- ▶ Ongoing information:
  - ▶ Information on major holdings
  - ▶ Information for holders of securities admitted to trading on a regulated market

Open-ended UCIs admitted to the BdL are not within the scope of the Transparency Law. The periodic reporting requirements for open-ended UCIs are outlined in Section 10.5.

#### 13.4.1.2. UCIs admitted to the Euro MTF

UCIs admitted to the Euro MTF are also subject to ongoing obligations. They must make available to the public:

- ▶ Financial statements prepared in accordance with the UCI's national legislation, related audit report thereon and management report
- ▶ A semi-annual report on activities and results within four months of the end of the half year, except where the applicable national legislation does not require this. This report should include results of income and profit and a statement covering the six-month period discussing significant information enabling investors to make an informed assessment of the UCI's activities and results and, as far as possible, referring to the UCI's expected future developments in the current financial year
- ▶ Information on any new developments including changes to structure (holders and breakdown of holders) of the major holdings of its capital
- ▶ Any amendments to the rights attached to the different categories of securities

#### 13.4.1.3. UCIs admitted to the LuxSE SOL

Except equal treatment of all security holders (generally shareholders and unitholders) who are in identical situations and the additional information to be provided to the LuxSE, as listed in Section 13.4.2., there are no other particular continuing obligations for issuers of UCIs admitted to the LuxSE SOL.

### 13.4.2. Information to be provided to the LuxSE

In addition to the information required to be made available to the public, UCIs whose securities are listed on one of the three securities markets operated by LuxSE must communicate to the LuxSE as early as possible and, in any case in advance of the event, any events affecting the listed securities. Such communications may include:

- ▶ Amendments to the rights of the securities
- ▶ Any merger or demerger
- ▶ Any change of transfer or paying agent
- ▶ Announcement of any distribution
- ▶ Payment and detachment of dividends
- ▶ Change of name of the UCI
- ▶ Important changes in activities or any modifications to the constitutional documents
- ▶ Notices of shareholders' meetings
- ▶ Any other useful information for investor protection

## 13.5. Listing of SIFs and RAIFs on the BdL and Euro-MTF

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Because of their particular features, specifically that ownership of shares or units of SIFs and RAIFs is limited only to well-informed investors, specific and *ad hoc* solutions are required to ensure shares or units are distributed only to well-informed investors (see Sections 2.4.2. and 2.4.3.).

## 13.6. Market abuse

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UCIs admitted to trading or traded on the BdL and Euro-MTF are in scope of the Market Abuse Regulation<sup>11</sup> (MAR).

In its final report on the MAR review submitted to the European Commission on 23 September 2020, ESMA suggested that:

- ▶ There are no compelling arguments to exempt UCIs admitted to trading or traded on a trading venue (“listed UCIs”) from the scope of MAR
- ▶ Managers of IFMs of the listed UCIs without a legal personality and externally-managed funds with a legal personality should not be required to meet the MAR obligations applicable to persons discharging managerial responsibilities (“PDMR obligations”)
- ▶ Self-managed listed UCIs should be specifically excluded from the PDMR obligations
- ▶ IFMs of listed UCIs with legal personality should be held responsible for disclosing inside information when it arises. Asset managers to whom the execution of certain functions have been delegated by management companies, should be responsible for reporting immediately to the management company any information that may be relevant in terms of possible existence of inside information
- ▶ A recital should be included to clarify that management companies of listed UCIs are responsible for drawing up and maintaining lists of those who may have inside information
- ▶ Third-party delegates (asset managers, depositaries, accountants) should be explicitly in scope of the obligation to draw up and maintain their own lists of those people who may have inside information, where such information exists

## 13.7. Transfer, suspension, withdrawal and delisting

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Securities of a UCI may be transferred, suspended, or withdrawn from trading at the request of the issuer or by decision of the LuxSE. A decision to withdraw or delist from trading is also taken to mean a decision to remove from the official list. If the issuer requests securities be transferred, suspended, or withdrawn, reasons justifying the request must be provided.

The LuxSE may decide to suspend or withdraw securities of a UCI from trading/listing if the securities or their issuers no longer comply with the relevant rules and regulations.

The LuxSE may decide to transfer the securities from the BdL to the Euro MTF when the issuer does not comply with the regulatory provisions applicable to securities admitted to trading on a regulated market.

The LuxSE may also decide to delist a security if it believes that a normal and consistent market for the security cannot be maintained.

The failure to comply with AML/KYC obligations is also a potential cause for termination of membership by the LuxSE.

Decisions to transfer, suspend, withdraw, or delist securities will be published on the LuxSE’s website and will also be communicated to the CSSF. The LuxSE may request the issuer to publish a press release to this effect and to make such an announcement sufficiently in advance to give a reasonable timeframe between the announcement and the date on which the suspension or withdrawal becomes effective.

<sup>11</sup> | Regulation (EU) 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse, as amended.

# 14

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## SUSTAINABLE FINANCE

EY supports IFMs and UCIs in integrating sustainability factors throughout the value chain, including:

- ▶ Defining the strategy relating to the sustainability approach
- ▶ Setting up policies and procedures on the integration of sustainability risks for fund products
- ▶ Setting up processes and tools to identify and monitor adverse sustainability impacts of investments
- ▶ Implementing due diligence of investee companies regarding their sustainability performance
- ▶ Setting up disclosures and reporting processes in line with the latest sustainable finance regulatory requirements
- ▶ Certifying compliance with sustainable finance disclosures and other ESG regulations



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## 14.1. Introduction

This Chapter describes the minimum requirements applicable to IFMs and UCIs with regards to Environment, Social and Governance (ESG) factors and risks, as well as the requirements applicable to UCIs which aim to make a positive contribution to those factors.

To meet the ambitious targets set by the United Nations (UN) 2030 Sustainable Development Goals (SDGs) and the EU's environmental and climate action objectives by 2050, the capital markets are becoming an essential channel of investments to enable sustainable projects. In this context, the European Commission (EC) published an action plan for financing sustainable growth (the EU Action Plan) in March 2018 and adopted a package of measures on sustainable finance (SF) with the aim to:

- Reorient capital flows towards sustainable investment to achieve sustainable and inclusive growth
- Mainstream sustainability into risk management, focusing on climate change, resource depletion, environmental degradation and social issues
- Foster transparency and long-termism in financial and economic activity

In December 2019, the European Commission renewed its commitment to Sustainable Development with the European Green Deal. To achieve its ambitions, the EU aims to mobilise investment and help unlock private funds through the EU budget and associated instruments - the "Green Deal Investment Plan".

On 6 July 2021, the European Commission unveiled its Renewed Strategy for Financing the Transition to a Sustainable Economy (the "Renewed Strategy"). The most notable developments concern:

Renewed Strategy	Recent developments
<b>Financing the path to sustainability</b>	
Controversial economic activities	Publication on 2 February 2022 of the <i>Commission Delegated Regulation amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities</i>
Environmental objective	Publication in March 2022 of the <i>Joint research report on Development of the EU Sustainable Finance Taxonomy - A framework for defining substantial contribution for environmental objectives 3-6</i>
<b>Double materiality perspective</b>	
Accounting	Mandate for the EC to develop sustainability reporting standards in Article 19b CSRD proposal  Provisional political agreement reached by the Council and EP on 21 June 2022 on new rules on corporate sustainability reporting
Credit ratings	Conclusion on 6 June 2022 on the <i>Call for evidence on environmental, social and governance ratings and sustainability risks in credit ratings</i> - legislative proposal expected in Q1 2023
Micro/macro prudential requirements	EBA consultation on the role of environmental risk in the prudential framework (closed for feedback on 2 August 2022)
<b>International consensus for global sustainable finance agenda</b>	
Ensure low- and middle-income countries are included and supported	The Commission is setting up a high-level expert group for scaling up Sustainable Finance in Low- and Middle-Income Countries (the call for application closed on 31 May 2022)



The European policy initiatives embedding sustainability into the financial system bring significant changes in the investment fund value chain:

#### Impact on the whole asset management chain

		EU Taxonomy	CSRD*	Benchmark Reg.	SFDR	AIFMD/UCITS	MIFID II
		2022	Exp. FY 2023	April 2020	March 2021	August 2022	August 2022
Asset Manager Value Generation	Strategy & Organization	Indirect	Indirect	Indirect	Indirect	Direct	Indirect
	Products & Distribution	Direct	Indirect	Indirect	Direct	Indirect	Direct
	Risk & Performance	Direct	Direct	Indirect	Indirect	Direct	Indirect
	Data & Reporting	Direct	Direct	Indirect	Direct	Direct	Direct

\* Proposal for a Corporate Sustainability Reporting Directive

This Chapter focuses on the obligations arising from the following regulations that directly impact IFMs and UCIs:

- ▶ “Sustainable Finance Disclosure Regulation” (SFDR): Regulation (EU) 2019/2088 of 27 November 2019 on *sustainability-related disclosures in the financial services sector*, as amended, and the related regulatory technical standards (“SFDR RTS” Commission delegated regulation (EU) 2022/1288 of 6 April 2022 supplementing Regulation (EU) 2019/2088) that will be applicable as of 1 January 2023

In two letters published on 6 May 2022, the EC invited the European Supervisory Authorities (ESAs) to propose amendments to the RTS in relation to the information that should be provided in pre-contractual documents, on websites, and in periodic reports about the exposure of financial products to investments in fossil gas and nuclear energy activities.

The amendments should ensure that the disclosures, relating to the degree to which investments are in environmentally sustainable economic activities, i.e., taxonomy-aligned activities, provide for full transparency of investments in sectors and sub-sectors of the economy covered by, and compliant with, the Complementary Climate Delegated Regulation. In particular, in-scope UCIs should disclose the proportion that such investments represent of all investments promoting environmental characteristics or with an environmentally sustainable objective.

The EC also asked the ESAs to:

- ▶ Consider extending the lists of universal indicators for principal adverse impacts (PAIs), as well as other indicators
- ▶ Refine the content of all the indicators for adverse impacts and their respective definitions, applicable methodologies, metrics and presentation
- ▶ Propose amendments to the RTS laid down in the SFDR Delegated Regulation in relation to the information provided regarding financial products in pre-contractual documents, on websites, and in periodic reports, on decarbonization targets, including intermediary targets and milestones, where relevant, and actions pursued

- ▶ “EU Taxonomy”: Regulation (EU) 2020/852 of 18 June 2020 on *the establishment of a framework to facilitate sustainable investment and amending regulation (EU) 2019/2088* and the related regulatory technical standards including Technical Screening Criteria (TSCs)
- ▶ UCITS Directive and AIFMD delegated acts, respectively:
  - ▶ Commission Delegated Directive (EU) 2021/1270 of 21 April 2021 amending Directive 2010/43/EU *as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities* (UCITS)
  - ▶ Commission Delegated Regulation (EU) 2021/1255 of 21 April 2021 amending Delegated Regulation (EU) No 231/2013 *as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers* (AIFMs)

Other regulations that may also impact EU-based IFMs and UCIs are mentioned in Section 14.2.4.

The graphic below summarizes the international sustainability initiatives and the expected timeline of related EU regulatory developments:

1. Disclosure Regulation (SFDR)	Sustainability risk integration at an entity and a product level	10 March 2021
	Adverse sustainability impact statement at an entity level (trigger criteria of FTE >500)	30 June 2021
	RTS disclosure requirements for Art. 8 and Art. 9 products (pre-contractual information and periodic reports)	1 January 2023
	Adverse sustainability impact statement and “do no significant harm” tests at ESG product level	December 2023
2. Taxonomy Regulation	Taxonomy reporting on climate change mitigation and adaptation (in-scope ESG and opt-in products)	January 2022
	Full application of the Art.8 Taxonomy Delegated Act for financial undertakings	January 2024
3. MIFID II/IDD	Integration of sustainability into risk management, product governance, conflicts of interests, suitability testing (for onboarding/investment decisions)	August 2022
4. UCITS V/AIFMD “II”	Integration of sustainability into organizational and risk governance and investment due diligence and monitoring	August 2022
5. NFRD and CSRD	Integration of Taxonomy Disclosures (Taxonomy-eligible activities) in the non-financial reporting on previous calendar year for entities in the scope of the non-financial reporting directive (NFRD)	January 2022
	Application of Taxonomy KPI disclosures for reporting data on FY22 for non-financial undertakings in scope of NFRD	January 2023
	Application of CSRD Requirements for reporting data of FY24 for companies already in scope of NFRD	January 2025
	Application of CSRD Requirements for reporting data of FY25 for all companies in scope of CSRD	January 2026

A law was voted on 25 February 2022 by the Luxembourg Government (“the Law”) to implement, *inter alia*, SFDR and the Taxonomy Regulation.

The Law grants the CSSF powers to:

- ▶ Access documents and information, regardless of the form, and request a copy from a supervised entity
- ▶ Request information from a supervised entity without delay
- ▶ Conduct on-site inspections of a supervised entity
- ▶ Take measures to ensure a supervised entity complies with SFDR and the Taxonomy Regulation
- ▶ Direct a supervised entity to comply with SFDR and the Taxonomy Regulation and order such entity to refrain from breaching such regulations
- ▶ Instruct a supervised entity to publish compulsory information on its website, in product pre-contractual information or periodic reports
- ▶ Direct a supervised entity to modify or remove wrong or misleading information published by the supervised entity and to publish a corrective statement
- ▶ Submit information to the state prosecutor in view of penal proceedings
- ▶ Instruct a statutory auditor or an expert to proceed with controls or investigations

The CSSF is also empowered to impose effective, proportionate sanctions which have a deterrent effect such as:

- ▶ A public declaration naming the entity concerned and describing the nature of the breach
- ▶ A temporary prohibition to exercise management responsibilities for the executive who is legally responsible for a compliance breach
- ▶ Administrative fines of between EUR 250 and EUR 250,000

The entity subject to a sanction may refer the case to the administrative court within one month.

The CSSF will publish sanctions on their website unless it is considered as being disproportionate or harmful to the stability of the financial system.

*Key definitions of concepts used in the below section*

**Sustainability Factors:** Environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

**Sustainability Risks:** ESG events or condition that, if they occur, could cause an actual or potential material negative impact on the value of the investment.

**Sustainable Investment:** An investment is deemed to be sustainable where such investment is made in an economic activity that contributes to an environmental or a social objective, provided that such investment does not significantly harm any of those objectives and that the investee company follows good governance practices.

**Sustainability Indicators:** Key Performance Indicators (KPIs) used by market participants to measure and track the achievement of their chosen sustainability objectives and/or characteristics. These KPIs should be chosen to allow an appropriate level of monitoring of the performance in the sustainability characteristics of the product, e.g., share of renewable energy, share/% of energy efficiency reduction of CO<sub>2</sub> emissions, % of women in governance bodies, % of net asset value (NAV) linked to securities which meet ESG criteria and % of exposure to fossil fuels.

**Do not significant harm (DNSH):**

Under EU Taxonomy: For an activity pursuing one or more of the six objectives to qualify as sustainable, it cannot cause significant harm to any of the other Taxonomy objectives.

Under SFDR, as amended: Assessment which requires product providers to conduct additional screenings based on the PAIs and good governance to ensure the sustainable investments that a financial product partially intends to make should not cause significant harm to any environmental or social sustainable investment objective.

The ESAs clarified that a financial market participant still needs to perform an SFDR DNSH assessment for an investment in a taxonomy-aligned activity for which the investee company performed a DNSH assessment pursuant to the EU Taxonomy. The ESAs also clarified that DNSH requirements may apply at different levels under SFDR:

- At the level of sustainable investments
- At the level of the financial product
- At the level of the financial market participant

**Principal Adverse Impacts (PAIs):** Impacts defined by the EU as “negative, material, or likely to be material, effects on sustainability factors that are caused, compounded by, or directly linked to, investment decisions and advice performed by the legal entity”.

The EU has identified 64 PAIs, of which 18 will be mandatory to report, and 46 voluntary.

On 2 June 2022, the ESAs acknowledged that PAIs may be used in three instances:

- Disclosure of DNSH for sustainable investments
- Disclosure of PAI considerations at the product level
- Measurement of the attainment of environmental or social characteristics and the sustainability-related impacts

These different possible uses are independent from each other.

## 14.2. EU legislative initiatives regulating the ESG framework for UCIs and their IFMs

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### 14.2.1. SFDR - Sustainability related disclosures in the financial services sector

SFDR, as amended, harmonizes disclosures for end investors on:

- The integration of sustainability risks
- The consideration of adverse sustainability impacts
- Sustainable investment objectives, and
- The promotion of environmental or social characteristics in investment decision-making and in advisory processes

By setting specific disclosure requirements at the IFM and UCI level, SFDR implicitly sets out various minimum operational elements to consider in order to integrate sustainability factors, for all financial products, throughout the product lifecycle.

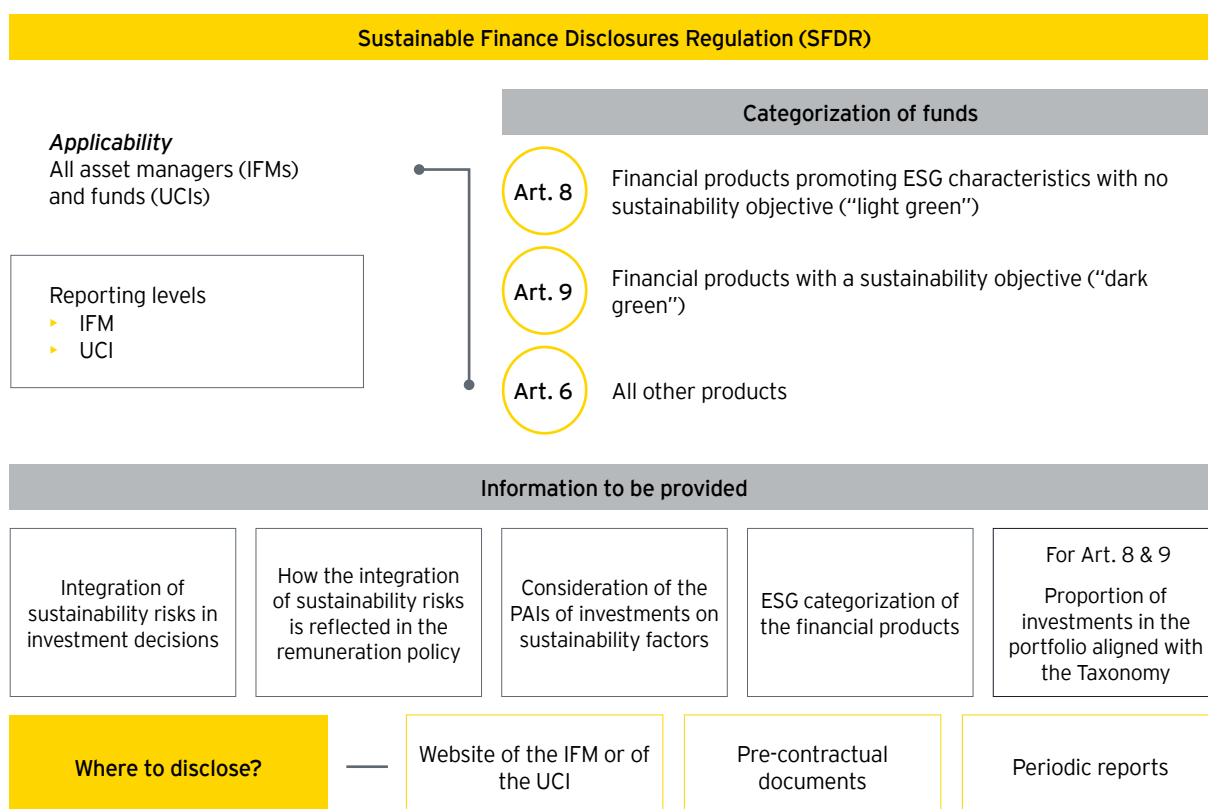
In a Decision issued on 6 July 2021, the EC clarified that both non-EU AIFMs marketing AIFs by means of a National Private Placement Regime and registered AIFMs should comply with SFDR.

Since pre-contractual disclosures to investors and annual reports defined in AIFMD do not apply to AIFs managed by registered AIFMs, such AIFs should disclose sustainability-related information in pre-contractual and periodic information made available to investors under national law.

The Commission confirmed that pre-existing financial products that continued to be available to end investors on or after 10 March 2021 are subject to SFDR.

However, the Commission also indicates that financial products that were no longer made available to end investors as of 10 March 2021, but that are still subject to an obligation to prepare a periodic report, are required to ensure that such periodic report complies with Article 11 of SFDR. The Commission also indicates that such financial products are subject to the product-level website disclosure obligations under Article 10 of SFDR.

Overview of the main components of SFDR (see also Section 14.5.):



The applicability of each rule differs and depends on whether the disclosure is made at the IFM level or the UCI level. The applicability is also subject to factors such as the size of the IFM or the category of ESG product manufactured. More details on disclosures are provided in the Appendix of the RTS, which will be applicable as of 1 January 2023.

In March 2021, ALFI<sup>1</sup>, ABBL<sup>2</sup> and ACA<sup>3</sup> issued SFDR Guidelines for Luxembourg clarifying the SFDR scope, key SFDR and RTS requirements as well as some practical consideration for SFDR implementation. The SFDR RTS were adopted by the EC in April 2022 and published in the official Journal of the European Union on 25 July 2022.

Further regulatory guidance was provided on the application of SFDR, such as:

- ▶ A Q&A on SFDR published by the EC on 25 May 2022
- ▶ ESA clarifications on SFDR issued on 2 June 2022
- ▶ ESMA’s supervisory briefing on sustainability risks and disclosures in the area of investment management issued on 31 May 2022

<sup>1</sup> Association luxembourgeoise des fonds d’investissement.

<sup>2</sup> Association des banques et banquiers Luxembourg.

<sup>3</sup> Association des compagnies d’assurances et de réassurances.

## 14.2.2. The EU Taxonomy

On 12 July 2020, the Regulation (EU) 2020/852 on *the establishment of a framework to facilitate sustainable investment* and amending Regulation (EU) 2019/2088 (the EU Taxonomy Regulation) entered into force.

The EU Taxonomy Regulation enables IFMs to gather reliable, consistent and comparable sustainability related indicators from investee companies and incorporate this data into their investment decision and risk management process as well as fulfil their disclosure duties under SFDR.

The EU Taxonomy Regulation also provides further details on the content of sustainability-related disclosures required in pre-contractual and periodic reports of sustainable UCIs and UCIs promoting environmental characteristics.

The EU Taxonomy Regulation defines the minimum criteria which economic activities must comply with in order to be considered environmentally sustainable:

- ▶ An environmentally sustainable economic activity contributes substantially to one or more of the following environmental objectives:
  - ▶ Climate change mitigation
  - ▶ Climate change adaptation
  - ▶ Sustainable use and protection of water and marine resources
  - ▶ Transition to a circular economy
  - ▶ Pollution prevention and control
  - ▶ Protection and restoration of biodiversity and ecosystems
- ▶ It does not significantly harm any of the other environmental objectives
- ▶ It is carried out in compliance with minimum safeguards set out in the regulation (including the OECD Guidelines for Multinational Enterprises, the International Labour Organisation, etc.)
- ▶ It complies with the TSC developed by the Technical Expert Group (delegated acts, applicable from 1 January 2022 for climate-related objectives and from 1 January 2023 for the other objectives)
  - ▶ The TSC are developed in delegated acts. For each environmental objective, these science-based criteria specify environmental performance requirements that should ensure that economic activities make a substantial contribution to the environmental objective in question and do not significantly harm the other objectives
  - ▶ On 21 April 2021, the Commission adopted the first set of TSC on the objectives of climate change mitigation and climate change adaptation. These TSC cover activities that are most relevant for reductions in greenhouse gas emissions and for improvements in climate resilience. This first set is complemented by another delegated act, adopted by the Commission on 10 March 2022, covering gas and nuclear activities

In March 2022, the Joint Research Center of the European Commission proposed a framework for defining a substantial contribution to the four other objectives. This report serves as a technical recommendation for the future delegated act.

Over time, the TSC will be reviewed and evolve on the basis of the latest developments and technological progress, based on the work of the Technical Work Group of the Platform on Sustainable Finance - an advisory body to the EC. More economic activities are expected to be included.

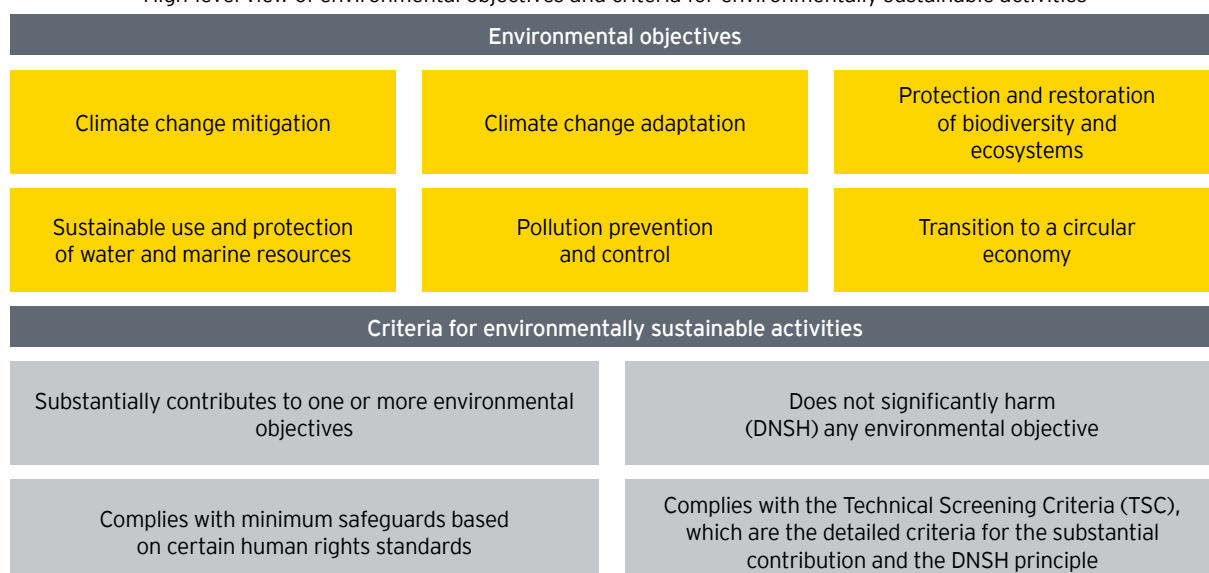
In addition, the EU Taxonomy recognises two specific types of activities that also make a substantial contribution to environmental objectives:

- ▶ Enabling activities: Activities that directly enable other activities to contribute to an environmental objective (e.g., energy efficient building, restoration, energy efficient manufacturing or low-carbon energy production)
- ▶ Transitional activities: Activities that directly contribute to an objective of climate mitigation under certain specified conditions (e.g., manufacturing of renewable energy technologies, professional, and scientific and technical activities for climate change adaptation)

The Taxonomy Regulation also lays down disclosure obligations that supplement the SFDR and the NFRD acting as a bridge between corporate disclosure requirements and the IFM/UCI needs (see Section 14.2.4.B.) and providing a common understanding of environmentally sustainable activities.

The Taxonomy Regulation will be further developed over time to cover economic activities that are socially sustainable. In February 2022, the EC Platform for Sustainable Finance presented its report on social taxonomy which serves as a technical recommendation for the future legislation.

## High-level view of environmental objectives and criteria for environmentally sustainable activities



### 14.2.3. Incorporation of sustainability risks and factors in the UCITS/AIFM Directives

On 21 April 2021, the EC adopted UCITS Directive and AIFMD delegated acts providing that management entities are expected to integrate sustainability risks and, where applicable, the PAIs of their investment decisions on sustainability factors in their operations. CSSF Regulation 22-05, published on 27 July 2022 and amending CSSF Regulation 10-04, transposes the UCITS delegated Directive into Luxembourg Law. These requirements are described in the rules applicable to IFMs (see Section 14.3.).

### 14.2.4 Other legislative initiatives impacting IFMs and UCIs

#### A. The low-carbon benchmark regulation

The European Parliament and the Council adopted *Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-Aligned Benchmarks and sustainability-related disclosures for benchmarks* (hereinafter the "Benchmark regulation").

The main characteristics of the two types of low-carbon benchmarks are:

- ▶ EU Climate Transition Benchmarks (EU CTB)
  - ▶ The whole portfolio of the benchmark must be on a decarbonization trajectory
  - ▶ Decarbonized trajectory must be measurable, science-based and time-bound towards alignment with the objectives of the Paris Agreement
  - ▶ Underlying assets do not significantly harm any other sustainability objectives
- ▶ EU Paris-Aligned Benchmarks (EU PAB)
  - ▶ The whole portfolio's carbon emissions must be aligned with the objectives of the Paris Agreement
  - ▶ Underlying assets should not significantly harm any other sustainability objectives

The regulation also covers new sustainability-related disclosures for benchmark providers and administrators.

Article 8 and Article 9 UCIs designating an index as a reference benchmark may be required to use benchmark statements to fulfil their own disclosure requirements under the SFDR. Consequently, UCIs should examine the new benchmark required disclosures carefully and should map them with their own disclosures where appropriate.

According to the SFDR delegated technical standards, such UCIs should explain in their pre-contractual disclosures:

- ▶ How the reference benchmark is continuously aligned with each environmental and/or social characteristic or the sustainable investment objective and the investment strategy
- ▶ Where an index is designated as a reference benchmark consistent with each environmental and/or social characteristic promoted or the sustainable investment objective, how that index differs from a broad market index

Such UCIs will also need to publish on their websites some information on the benchmark's input data, the methodologies used to select that data, the rebalancing methodologies and how the index is calculated. Alternatively, a hyperlink to the benchmark administrator website may be included.

For financial years starting after 1 January 2022, such UCIs will also need to include in their periodic reports an explanation on how the index designated as a reference benchmark differs from a broad market index, including at least the performance during the reference period of the sustainability indicators deemed relevant by the UCI to determine the alignment of the index with the sustainable investment objective and the sustainability factors referred to in the benchmark statement of the benchmark administrator.

Article 9 UCIs with a CO<sub>2</sub> emissions reduction objective should include in their pre-contractual documents and websites a statement that the reference benchmark qualifies as an EU CTB/PAB benchmark.

#### B. The non-financial reporting directive (NFRD)

Directive (EU) 2014/95 on *non-financial reporting*, published in the Official Journal of the EU on 22 October 2014, transposed into Luxembourg law by the Law of 23 July 2016 and applicable since 1 January 2017, requires large undertakings<sup>4</sup> which are public interest entities (PIEs) to disclose information on:

- Environmental, social and employee matters
- Respect for human rights
- Anti-corruption and bribery matters

The information disclosed should include:

- A brief description of the undertaking's business model
- A description of the policies pursued by the undertaking in relation to those matters, including due diligence processes implemented
- The outcome of those policies
- The principal risks related to those matters linked to the undertaking's operations including, where relevant and proportionate, its business relationships, products or services which are likely to cause adverse impacts in those areas and how the undertaking manages those risks
- Non-financial key performance indicators relevant to the particular business

The NFRD is supplemented by non-binding guidelines on the methodology for reporting non-financial information.

The NFRD is applicable to large PIEs, which are primarily:

- EU listed companies
- Credit institutions
- Insurance companies

To standardize the disclosure of non-financial information in management reports and to extend the scope of the NFRD, the EC published a proposal for the Corporate Sustainability Reporting Directive (CSRD), that would amend four existing pieces of legislation:

- The Accounting Directive (2013/34/EU)
- The Transparency Directive (2004/109/EC)
- The Audit Directive (2006/43/EC)
- The Audit Regulation (537/2014)

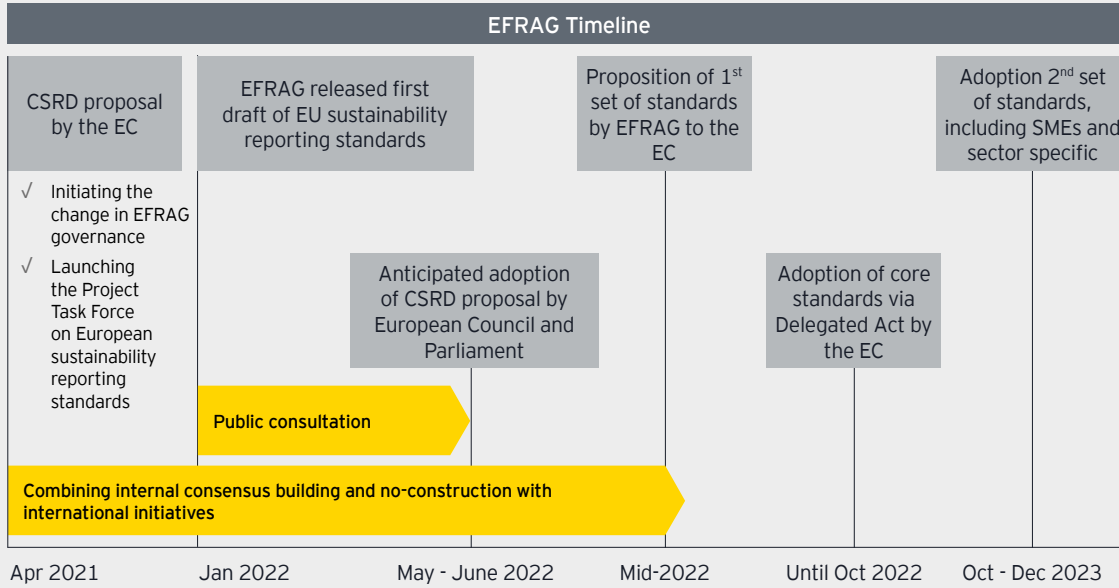
On 21 June 2022, the Council and European Parliament reached a provisional political agreement on CSRD.

One of the main aims of the proposal is to align companies' disclosures with the Taxonomy Regulation. In this manner, by linking both CSRD and SFDR to the Taxonomy, the EC aims to create a link among investors' and companies' non-financial disclosures, ensuring that investors have the correct information to report a product's share of investment aligned with the Taxonomy. CSRD will integrate Taxonomy alignment through the EU Sustainability Reporting Standards (ESRS), that are yet to be developed by the EFRAG<sup>5</sup>. The first set of sustainability reporting standards is expected by 31 October 2022. It will specify the minimum level of non-financial disclosures to understand companies' impacts on sustainability matters and how sustainability matters affect the companies' development, performance and position. The second set of sustainability reporting standards is expected to be adopted by 31 October 2023. It will detail complementary disclosures on sustainability matters for reporting areas, as well as sector specific KPIs. Companies in scope of the NFRD should apply the standards to their reports published in 2025, covering financial year 2024. From 2026 (on the basis of 2025 data), large companies, not yet subject to non-financial disclosure obligations, will need to report as per the CSRD.

<sup>4</sup> Large undertakings exceeding on their balance sheet dates the criterion of the average number of 500 employees during the financial year.

<sup>5</sup> European Financial Reporting Advisory Group.

## Time for the development of EFRAG reporting standards



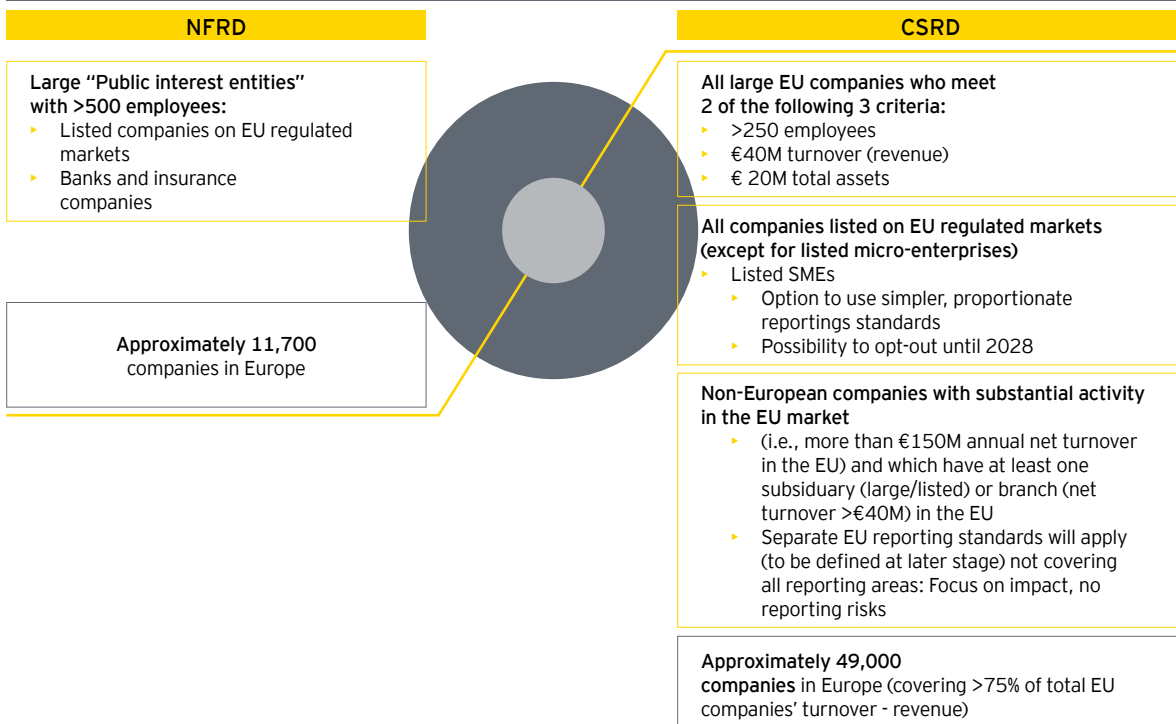
Under CSRD, companies will be expected to notably:

- ▶ Have their sustainability information subject to third-party assurance
- ▶ Integrate sustainability information in the management report
- ▶ Disclose their management report in a digital, machine-readable format

CSRD expands the scope of NFRD to “large companies”, other than PIEs, with more than 500 employees and to all companies listed on EU-regulated markets (listed SMEs are eligible to an “opt out” clause until 2028). The CSRD will also affect non-European companies which have substantial activity in the EU market (annual turnover in the EU greater than EUR 150 million) and which have at least one subsidiary or branch in the EU. In addition, the EC pushes for the consolidation of sustainability reporting, allowing parent companies to report at group level for the subsidiaries falling in scope of CSRD.

The proposed scope of CSRD captures all listed entities, regardless of the number of employees. Therefore, CSRD covers listed financial instruments, such as ETFs, and would thereby trigger a double reporting obligation for listed UCIs under both SFDR and CSRD. With SFDR being the dedicated regime for sustainability reporting for financial products and CSRD for company reporting, the asset management industry is currently advocating for an exemption from CSRD for financial products which already comply with SFDR.

### Which entities is it applicable to?





### C. Securitization sustainable disclosures

On 2 May 2022, the ESAs issued a joint consultation paper on regulatory technical standards to frame sustainable disclosures of simple, transparent and standardized securitizations (STS securitizations) with the aim to:

- ▶ Facilitate disclosure by the originators of the PAIs of assets financed by STS securitizations on ESG factors
- ▶ Supplement the single rulebook under the Securitisation Regulation, as amended, by the Capital Markets Recovery Package (CMRP)
- ▶ Draw upon the ESAs' work in respect of sustainability-related disclosures in the financial services under the SFDR

The proposed delegated act included in the consultation paper defines:

- ▶ The means, frequency and format of disclosures
- ▶ The content of sustainability policies required from originators and the criteria for selection of the assets in the pool
- ▶ The indicators contained in the PAI statement (non-green asset ratio, indicators relating to real estate including commercial real estate, indicators relating to auto loans and leases, indicators relating to exposures to corporates including small- and medium-sized enterprises as well as trade receivables, indicators relating to other types of securitization)

### D. Corporate Sustainability Due Diligence Directive

On 23 February 2022, the EC adopted a proposal for a directive on corporate sustainability due diligence (CSDD).

This Directive will aim to foster sustainable and responsible corporate behavior and to anchor human rights and environmental considerations in companies' operations and corporate governance. The new requirements will ensure that businesses address the adverse impacts of their activities, including in their value chains inside and outside Europe.

### E. Amendments to MiFID II

The EC adopted on 21 April 2021 two amending Delegated Acts to require MiFID firms selling UCIs to integrate their clients' preferences in terms of ESG considerations:

- ▶ Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organizational requirements and operating conditions for investment firms
- ▶ Commission Delegated Directive (EU) 2021/1269 of 21 April 2021 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations. This Directive was transposed into Luxembourg Law by the Grand-Ducal Regulation of 27 July 2022

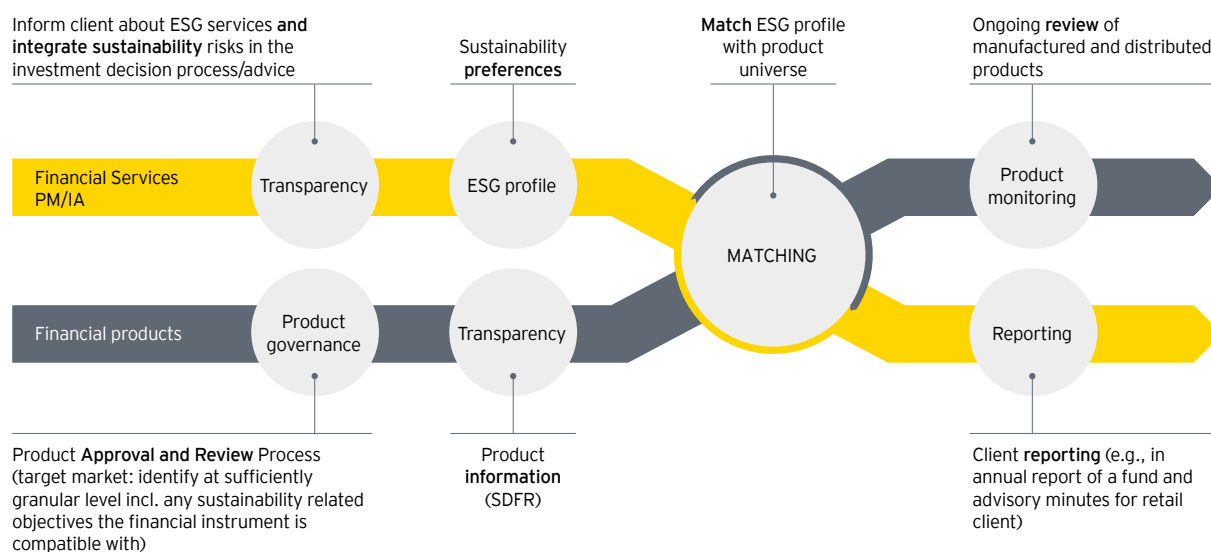
On 27 January 2022, the European Securities and Markets Authority (ESMA) proposed guidelines on certain aspects of the MiFID II suitability requirements in response to ESMA's consultation 34-43-2998. The consultation was ongoing until 27 April 2022. The final report is expected in Q3 2022. Guidelines on product governance requirements will be separate.

These amendments require MiFID II companies to:

- ▶ Take sustainability risks into account when:
  - ▶ Complying with general organizational requirements
  - ▶ Setting up risk management policies and procedures
- ▶ Take sustainability preferences into account when identifying conflicts of interest
- ▶ Carry out an assessment of sustainability preferences of their clients
- ▶ Include clients' sustainability preferences in the information about the investment objectives
- ▶ Describe, where relevant, the sustainability factors taken into consideration in the selection process of financial instruments, when providing information about investment advice
- ▶ Report to clients how the investment recommendation made to them meets their sustainability preferences
- ▶ For investment firms manufacturing financial instruments:
  - ▶ Include any sustainability-related objectives in the identification of a target market
  - ▶ Examine if the financial instrument's sustainability factors are consistent with the target market
  - ▶ Present the sustainability factors of the financial instrument in a transparent manner and provide distributors with the relevant information to duly consider any sustainability-related objectives of the clients
  - ▶ Include any sustainability-related objectives when considering if the financial instrument remains consistent with the objectives of the target market

- ▶ For distributors:
  - ▶ Include any sustainability-related objectives in the product governance arrangements
  - ▶ Include any sustainability-related objectives in the assessment of whether the product or service remains consistent with the identified target market

### Matching the ESG profile with financial product universe



#### F. Development of an EU Ecolabel for financial products

Action 2 of the EU Action Plan proposes to create standards and labels for sustainable financial products, in order to:

- ▶ Increase the accessibility of sustainable financial products
- ▶ Facilitate the research of investors who seek to invest in sustainable financial products
- ▶ Facilitate the choice of retail investors who would like to express their investment preferences on sustainable activities

The Joint Research Centre published its fourth report on the EU Ecolabel, but the final approval remains on hold.

## 14.3. Rules applicable to IFMs

This section presents the organizational rules contained in the UCITS Directive and the AIFMD delegated acts, as well as the SFDR and Taxonomy rules applicable to IFMs.

### 14.3.1. Integration of sustainability risks in the organization, procedures and policies of IFMs

As introduced in Section 14.2.3, management entities will be required to review their policies related to governance, allocation of responsibilities, procedures and organization, conflicts of interest, responsibilities of senior management, and to integrate sustainability risks therein.

#### A. General organizational requirements

IFMs will be required to review their organization and procedures to ensure that they take into account the impacts of sustainability risks, when complying with the following requirements:

- ▶ Establishment, implementation and maintenance of clear and documented decision-making procedures and an organizational structure specifying reporting lines
- ▶ Allocation of responsibilities with proper discharge
- ▶ Internal control mechanisms to ensure compliance with decisions and procedures
- ▶ Internal reporting and communication and effective information flows with any third party involved
- ▶ Maintenance of adequate and orderly records of business and internal organization

#### B. Resources

IFMs must ensure that they retain the necessary resources and expertise for the effective integration of sustainability risks throughout the organization. To do so, they must consider hiring specialists with the relevant knowledge, or train employees to ensure that they gain sufficient expertise for the integration of sustainability risks.

### C. Control by senior management

The senior management of an IFM is responsible for the integration of sustainability risks in the activities for which they are already responsible. For each UCI they manage, senior management of IFMs should make sure they take sustainability risks into account when:

- Implementing the general investment policy
- Approving investment strategies
- Implementing periodic verification of compliance with the general investment policy, the investment strategy and the risk limits
- Approving and periodically reviewing the adequacy of the internal procedures for undertaking investment decisions
- Approving and periodically reviewing the risk management policy and arrangements, processes and techniques for implementing that policy, including the risk limit system

The senior management of an AIFM should specifically conduct similar reviews to ensure that sustainability risks are taken into account when:

- Establishing a permanent and effective compliance function
- Establishing and performing valuation policies and procedures
- Establishing and applying a remuneration policy

To ensure that the senior management has sufficient knowledge of the regulatory challenges and impacts on their organization, adapted trainings should be performed.

### D. Conflict of interests

IFMs should set up processes to identify conflicts of interests that may arise as a result of the integration of sustainability risks in their processes, systems and internal controls.

### E. Due diligence

IFMs should review their due diligence policies and procedures in order to consider sustainability risks when:

- Selecting and monitoring investments
- Gaining adequate knowledge and understanding of the assets in which the UCIs they manage are invested
- Ensuring that investment decisions are carried out in compliance with the objectives, investment strategies and, where applicable, the risk limits of each UCI

Where IFMs consider the PAIs of their investments on sustainability factors, whether on a mandatory or voluntary basis, IFMs must include this consideration in their due diligence policies and procedures (see Section 14.3.4.B.).

### F. Risk management policy

IFMs should review their risk management policy to include the consideration of sustainability risks to which UCIs may be exposed, along with market, liquidity and counterparty risks.

Investment companies are required to integrate sustainability risks in the management of UCITS in a proportionate manner. Investment companies should design processes and procedures to ensure that sustainability risks are adequately considered in the management of UCITS.

## 14.3.2. Investment decision-making process

Portfolio managers and advisors are expected to integrate relevant sustainability risks in their pre-trade risk assessment.

All IFMs must publish information about their policies on the integration of sustainability risks in their investment decision-making processes on their website. When IFMs amend that information, they must publish a clear explanation of the amendment on the same website.

## 14.3.3. Remuneration policies

IFMs must describe in their remuneration policies how those policies are consistent with the integration of sustainability risks. The aim is to ensure that remuneration policies do not encourage excessive risk-taking with respect to sustainability risks and that these policies are linked to risk-adjusted performance.

This information must be disclosed and kept up-to-date on the IFM's website. When IFMs amend this information, an explanation of the amendment is also required on the IFM's website.

## 14.3.4. Consideration of adverse sustainability impacts

An activity is considered sustainable when it does not significantly harm any sustainability objective. One of the objectives of the SFDR is to ensure that entities disclose relevant information regarding their actual adherence to this principle where their financial products invest in sustainable investments. Information on principal adverse impacts is thus particularly helpful to assess whether and how investments comply with the principle of “do no significant harm” (DNSH).

The SFDR, as amended, also aims at harmonizing the disclosures on the adverse impacts of investments on sustainability factors, to increase the level of comparability of information.

IFMs should define whether and how they consider the PAIs of their investments and investment decisions on sustainability factors and disclose such information. A PAI statement should be published by in-scope IFMs by 30 June 2023. It must disclose quantitative information on 20 PAIs (18 mandatory, two additional) as well as mitigating actions to improve the metrics and the actual impacts. IFMs should also monitor PAI metrics between periods.

### A. Scope and exemptions

The requirements apply to:

- ▶ IFMs and parent IFMs employing fewer than 500 persons. If IFMs and parent IFMs between 3 and 500 persons do not consider PAIs, they must provide on their website an explanation as to why PAIs are not considered
- ▶ IFMs and parent IFMs employing more than 500 persons on a mandatory basis

In its Decision issued on 6 July 2021, the EC clarified that the 500-employee criterion relates to a large group in its entirety: the calculation of the headcount takes into account the number of employee of a parent undertaking and of subsidiary undertakings regardless of whether they are established inside or outside the EU.

However, in such cases the website statement on due diligence policies with respect to the PAIs of investment decisions on sustainability factors should be adapted to the specific situation of the parent undertaking and not to the group as a whole.

### B. Requirements for management entities that must or wish to comply

IFMs that must or wish to consider PAIs should take into account those PAIs in their written policies and procedures on due diligence requirements and arrangements for:

- ▶ The selection and ongoing monitoring of investments
- ▶ Gaining adequate knowledge and understanding of the assets in which UCIs are invested
- ▶ Ensuring that investment decisions on behalf of the UCIs are carried out in compliance with the objectives, investment strategy and risk limits of the UCIs

Information on PAIs must be made available on the IFM’s website along with a description of the related due diligence policy and the PAIs considered.

The final RTS of the SFDR provides a standardized template to be used by complying entities in order to disclose information relating to PAIs, including mandatory narratives, mandatory KPIs and a set of voluntary KPIs allowing measurement of the impacts of the entities’ investments on sustainability factors.

### C. Requirements for management entities that do not consider PAIs

Entities should assess the relevance of considering at least the mandatory PAIs. Where IFMs do not consider PAIs, they should disclose the clear reasons why.

If they intend to consider PAIs in the future, they should define when they intend to do so.

## 14.3.5. Monitoring of Taxonomy alignment

### A. Management entities in scope

The requirements to monitor the alignment of activities on the EU Taxonomy at the entity level apply to IFMs that comply with all following criteria:

- ▶ They are PIEs
- ▶ They exceed, on their balance sheet date and during two consecutive years, the numerical thresholds of at least two of the following criteria:
  - ▶ Balance sheet total: EUR 20 million
  - ▶ Net turnover: EUR 40 million
  - ▶ Average number of employees during the financial year: 250
- ▶ They exceed, on their balance sheet date, the criterion of the average of 500 employees during the financial year

The EC issued a proposal for a CSRD (see Section 14.2.4.B.) amending the existing reporting requirements of the NFRD. The CSRD will extend the scope of companies subject to non-financial reporting requirements to all large companies, as defined by Directive 2013/34/EU, as amended, (the Accounting Directive) and all companies listed on regulated markets, except micro-enterprises. These companies will therefore be subject to the requirements to disclose the alignment of their activities as per the Taxonomy Regulation.

## B. Method to calculate the Taxonomy alignment

IFMs in scope of Article 8 of the Taxonomy must monitor their investments in Taxonomy-aligned activities and the amounts invested in them.

On 6 July 2021, the EC adopted the Delegated Regulation (EU) 2021/2178 supplementing the Taxonomy Regulation to specify the content and presentation of the Taxonomy alignment, as required by Article 8 of the Taxonomy. The Delegated Regulation lays down KPIs to be presented as part of the non-financial report and introduces the calculation methodologies of these KPIs as well as templates for standardized disclosures.

1. From 1 January 2022 until 31 December 2023, IFMs in scope of NFRD should disclose:

- (a) The proportion of their total assets exposed to Taxonomy non-eligible and Taxonomy-eligible economic activities
- (b) The proportion of their total assets exposed to central governments, central banks and supranational issuers
- (c) The proportion of their total assets exposed to undertakings which are not in scope of NFRD
- (d) Qualitative information:
  - Contextual information in support of the quantitative indicators including the scope of assets and activities covered by the KPIs, information on data sources and limitation
  - Explanations of the nature and objectives of Taxonomy-aligned economic activities and the evolution of the Taxonomy-aligned economic activities over time, starting from the second year of implementation, distinguishing between business-related and methodological and data-related elements
  - Description of the compliance with the Taxonomy Regulation in the financial undertaking's business strategy, product design processes and engagement with clients and counterparties
  - Additional or complementary information in support of the financial undertaking's strategies and the weight of the financing of Taxonomy-aligned economic activities in their overall activity

The EC clarified that the RTS do not require the use of the reporting templates provided in the Annexes for eligibility reporting. However, the advice is for in-scope IFMs to voluntarily use them to prepare their Taxonomy-eligibility reporting.

Eligibility reporting is not weighted by the stake in the undertaking's equity, debt or enterprise value including cash but by the value of the exposures in the total assets of the IFM.

From 1 January 2024, in scope IFMs will be required to disclose a KPI calculated as a ratio between the numerator and the denominator where:

- The numerator consists of a weighted average of the value of investments in Taxonomy-aligned economic activities of investee companies. The weighted average of the value of investments should be based on the proportion of Taxonomy-aligned economic activities of investee companies measured by the following:
  - (a) For investees that are non-financial undertakings, turnover and CapEx KPIs resulting from the calculation of the KPIs of the investee
  - (b) For investees that are asset managers, turnover-based and CapEx-based KPIs, resulting from the calculation of the KPIs of the investee
  - (c) For investees that are credit institutions, the turnover-based and CapEx based green asset ratio resulting from the calculation of the green asset ratio of the investee
  - (d) For investees that are investment firms, investments and revenues, resulting from the calculation of the turnover-based and CapEx-based KPIs of the investee in accordance with the proportion of services and activities of dealing on own account and not dealing on own account in the income of the investment firm
  - (e) For investees that are insurance or reinsurance undertakings, investments, gross premiums written or, as applicable, total insurance revenue, resulting from the calculation either of the turnover-based or CapEx-based investment KPI, combined, where applicable, with the underwriting KPI of the non-life investee insurance and reinsurance undertakings

The calculation allows netting for the purposes of reporting the proportion of investments in Taxonomy-aligned economic activities by applying the methodology used to calculate net short positions laid down in Article 3, paragraphs 4 and 5 of Regulation (EU) No 236/2012 of the European Parliament and of the Council *on short selling and certain aspects of credit default swaps, as amended*.

Debt securities with the purpose of financing specific identified activities or projects or environmentally sustainable bonds issued by an investee undertaking should be included in the numerator up to the value of Taxonomy-aligned economic activities that the proceeds of those bonds and debt securities finance, on the basis of information provided by the investee undertaking.

The EC clarified mortgages should qualify as eligible assets for both IFMs and not only for the credit institutions which provided the loans originally.

- ▶ The denominator consists of the value of all assets under management without exposures to central governments, central banks and supranational issuers resulting from both collective and individual portfolio management activities of asset managers

Asset managers should disclose a KPI based on turnover KPIs of the investee companies and a KPI based on the CapEx KPI of investee companies.

For the purposes of their Taxonomy-alignment disclosure, asset managers should:

- (a) Disclose the KPIs for each environmental objective and for aggregated Taxonomy-aligned economic activities at the level of the relevant undertaking or group
- (b) Identify a subset of transitional and enabling economic activities and disclose the KPIs for aggregated economic activities at the level of the undertaking or group
- (c) Provide for a breakdown of the numerator and denominator per type of investment
- (d) Disclose the KPIs in relation to aggregated Taxonomy-eligible economic activities
- (e) Disclose the proportion of Taxonomy-non-eligible economic activities within the assets under management
- (f) Disclose the proportion of investments in exposures to central governments, central banks and supranational issuers
- (g) Provide the KPIs at the level of the individual asset manager where that undertaking prepares only individual non-financial statements or at the level of the group where the undertaking prepares consolidated non-financial statements

## 14.4. Rules applicable to UCIs

This section introduces the rules which are, and will progressively become, applicable at the level of UCIs.

### 14.4.1. Requirements for UCIs

The SFDR, as amended, requires that pre-contractual documents of UCIs include information regarding:

- ▶ The integration of sustainability risks in the investment decisions of the investment vehicle
- ▶ The consideration of the adverse impacts of the investments of the UCI on sustainability factors

The pre-contractual documents (or offering documents) referred to in the SFDR, as amended, are the longer pre-contractual documentation, such as a UCI prospectus or the offering document of a SIF or a RAIF.

The SFDR RTS provide a standardized template for pre-contractual disclosures to be used by complying entities in order to disclose information relating to Article 8 or Article 9 products, including mandatory narratives and quantitative information such, *inter alia*, asset allocation and proportion of sustainable investment.

#### A. Integration of sustainability risks

UCIs should identify where and to what extent the consideration of sustainability risks for their financial products is deemed relevant and define due diligence processes accordingly for underlying investments and investment decisions. The due diligence set up should allow a UCI to assess the likely impacts of sustainability risks on its returns.

Pre-contractual documents of UCIs must include descriptions of:

- ▶ How sustainability risks are integrated into their investment decisions
- ▶ The results of the assessment of the likely impacts of sustainability risks on the UCI's returns

Where the consideration of sustainability risks is deemed not relevant to the UCI, a clear and concise explanation of the reasons why they are not considered should be included.

In its Decision issued on 6 July 2021, the EC confirmed that integration *per se* of sustainability risks is not sufficient to qualify a UCI as Article 8.

#### B. Consideration of adverse sustainability impacts

UCIs should define whether and how they consider the adverse sustainability impacts of their investments consistently with the policy defined at the IFM level (see Section 14.3.4.).

From 30 December 2022, pre-contractual documents of UCIs should include a clear and reasoned explanation of whether and, if so, how the UCI considers the PAIs of its investments on sustainability factors. Periodic reports should contain information on the product's adverse impacts throughout the period.

Where the information regarding PAIs in periodic reports includes quantifications of the adverse impacts, UCIs may use the standardized template for the entity's PAI statement provided by the SFDR RTS (see 14.3.4.B.).

Where the management entity does not consider PAIs (see Section 14.3.4.C.), the pre-contractual documents of its managed UCIs should include a statement that the management entity does not consider the adverse impacts of investment decisions on sustainability factors and the reasons thereof.

## 14.4.2. Requirements for ESG products

#### A. Defining and launching the product

The EU legislation recognizes, through Articles 8 and 9 of the SFDR, as amended, different levels of sustainability intensity that a UCI may apply when it comes to the integration of ESG factors into its investment strategy.

SFDR product type	EU definition
"Article 8" products	Financial products that take into account sustainability factors in investment decisions, among other characteristics, but which do not have sustainable investment as an objective
"Article 8+" products <sup>6</sup>	Financial products classified "Article 8", but committing to a minimum of sustainable investments with an environmental and/or social objective
"Article 9" products	Financial products that have sustainable investment as an objective

Pursuant to SFDR, a sustainable investment is defined as an investment in:

- ▶ Economic activities that contribute to an environmental objective<sup>7</sup>, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or
- ▶ Economic activities that contribute to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labor relations, or
- ▶ Human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance

<sup>6</sup> This denomination is not a legal term and only reflects a market practice.

<sup>7</sup> The Taxonomy Regulation provides a legal definition of economic activities that contribute to environmental objectives (see Section 14.2.2.). Other sustainable objectives (e.g., social) are currently not legally defined. Over time, the Taxonomy will be developed to also provide a legal definition of activities that contribute to social objectives. The Technical Expert Group, which advised the EC on the development of the Taxonomy Regulation Technical Screening Criteria, also recommended to issue a taxonomy of "brown" activities, or activities that are environmentally harmful.

In its Decision issued on 6 July 2021, in the context of the Article 8 UCI qualification, the EC provides examples of what the term of promotion of environmental or social characteristics encompasses.

Promotion includes direct or indirect claims, information, reporting, disclosures as well as an impression that investments pursued by the UCI also consider environmental or social characteristics in terms of investment policies, goals, targets or objectives or a general ambition in, *inter alia*:

- ▶ Pre-contractual and periodic documents
- ▶ Marketing communications
- ▶ Advertisements
- ▶ Product categorization
- ▶ Description of investment strategies or asset allocation
- ▶ Information on the adherence to sustainability-related financial product standards and labels
- ▶ Use of product names or designation
- ▶ Memoranda or issuing documents
- ▶ Fact sheets
- ▶ Specification about conditions for automatic enrolment or compliance with sectoral exclusions or statutory requirements

These criteria apply regardless of the form used, such as on paper, durable media, by means of websites, or electronic data rooms.

When UCIs define their ESG investment strategies, they must clearly define the strategy's binding elements to select the investments, to attain the environmental or social characteristics, or the sustainable investment objectives. This strategy must be implemented in the investment process on a continuous basis.

Where the IFM commits to reduce the UCI's investment universe by a minimum rate prior to the application of the strategy, that rate must be clearly defined by IFMs.

The product committee review of the UCI should:

- ▶ Consider and understand the legislative requirements relevant to the chosen strategy
- ▶ Review the technical criteria of the environmental or social characteristics, or the sustainable investment objectives

The UCI should be able to provide a description of the environmental or social characteristics, or the sustainable objective of the product, as well as specifications of the indicators used to measure the attainment of those characteristics.

In a supervisory briefing issued on 31 May 2022, ESMA clarified, *inter alia*, that:

- ▶ Only a UCI committing to make sustainable investments (an Article 8+ or Article 9 UCI) should use the terms "sustainable" or "sustainability" in its name
- ▶ UCI documentation should avoid investment policy objectives that are too general and are not clearly identified
- ▶ For a UCI strategy to be clearly identified, at least some of following non-exhaustive key elements should be disclosed:
  - ▶ Investment universe (including limits and thresholds)
  - ▶ Screening criteria applied
  - ▶ Specific ESG characteristics/themes or non-financial impacts pursued
  - ▶ Use of benchmark/indices and relative expected tracking error (if applicable)
  - ▶ Stewardship approach

ESMA also recommended to national competent authorities to screen the repeated use of the same or similar standard text across different UCIs to spot unclear and/or misleading disclosures.

The UCI should set the minimum share of investments aligned with the EU Taxonomy, the minimum share of sustainable investments that are not aligned with the EU Taxonomy and plan the asset allocation of their portfolios. If the UCI, whether Article 8 or Article 9, intends to invest in activities that contribute to a sustainable investment objective, the UCI should ensure that those investments do not significantly harm other sustainable objectives. If the UCI considers the PAIs of its investments, it may use that information to explain how sustainable investments do not significantly harm other sustainable objectives.

The EC's Decision, issued on 6 July 2021, clarified that Article 9 UCIs may include investments for certain specific purposes such as hedging or liquidity, provided that they meet minimum environmental or social safeguards.

The Decision highlights the neutrality of Article 9 of SFDR, as amended, in terms of product design, investment tools, strategies or methodologies to be employed. However, the UCI documentation must explain how the given mix complies with the sustainable investment objective of the UCI in order to comply with the DNSH principle.



UCIs that choose to qualify as Article 8 or Article 9 products under SFDR, as amended, must take operational measures throughout the financial product lifecycle to ensure that it attains the environmental or social characteristics promoted by the product, or its sustainability objectives. These are covered in the following sections.

## B. Investment process

The disclosure of criteria for the selection of underlying assets should be limited to those criteria that are binding on the fund manager in the investment decision-making process. UCIs must set up due diligence processes to be carried out on the underlying assets on specific ESG aspects related to the environmental or social characteristics promoted by the product, or its sustainability objectives. Such due diligence processes must reflect the ESG investment strategy by assessing those ESG aspects that allow the attainment of the environmental and social characteristics or the sustainable investment objective and that prevent investments from doing significant harm to other sustainable objectives.

To this end, UCIs must define a policy to assess good governance practices of investee companies. UCIs should assess good governance practices in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

Risk-based due diligence should pay attention to what extent investee companies' and other issuers' disclosures cover Taxonomy-required information on whether they:

- Comply with minimum safeguards
- Embed responsible business conduct into their policies and management systems
- Identify, assess, prevent or mitigate actual or potential adverse impacts
- Gain and use leverage to prevent and mitigate the impacts
- Track performance
- Communicate and report publicly
- Enable remediation when appropriate

Significant challenges are expected for investments in EU companies and bond issuers that do not fall under the scope of the NFRD (see Section 14.2.4.B.) and non-EU companies. In such situations, the EU Technical Expert Group recommended a five-step approach:

- Identify the activities conducted by the company or issuer or those covered by the financial product (e.g., projects, use of proceeds) that could be Taxonomy-aligned and to which environmental Taxonomy objective(s)
- For each potentially aligned activity, verify whether the company or issuer meets the relevant screening criteria - e.g., electricity generation <100g CO<sub>2</sub>e/kWh
- Verify that the DNSH criteria are being met by the issuer. IFMs would most likely use a due diligence-type process for reviewing the performance of underlying investees and would rely on the legal disclosures of eligibility from those investees
- Conduct due diligence to avoid any violation of the social minimum safeguards
- Calculate alignment of investments with the Taxonomy and prepare disclosures at the investment product level

Since 10 March 2021, UCIs making available Article 8 or Article 9 products under SFDR should publish details of the due diligence and screening criteria on their websites.

Due diligence processes and policies on good governance practices are particularly relevant when investing internationally as standards in areas of governance and sustainability-related performance may differ across countries.

The EC confirmed that Article 8 and Article 9 UCIs which fail to invest in companies following good governance practices breach their legal obligation.

ESMA clarified that a disclosure of criteria for the selection of underlying assets should be limited to those criteria that are binding on the fund manager in the investment decision-making process.

### *Investing in environmentally sustainable activities*

UCIs that are Article 8 or Article 9 financial products under SFDR may consider investing in environmentally sustainable activities as defined by the Taxonomy Regulation (see Section 14.2.2.). At the time of writing, TSC are only in force for climate-related objectives.

TSC for other environmental objectives are currently being developed, notably on the basis of a technical report issued in March 2022 by the Joint Research Centre of the European Commission.

When considering an investment in an environmentally sustainable activity as defined by the Taxonomy, UCIs must assess the compliance of the considered activity against the environmental performance requirements and thresholds specified by the TSC.

In that regard, as part of the due diligence on the considered investments, UCIs should:

- Identify whether activities considered are covered by the TSC of the Taxonomy
- Obtain information on the environmental performance of the activities as established by the TSC of the Taxonomy
- Assess the compliance of the activities with the specific DNSH criteria as established by the TSC

The EC has created the EU Taxonomy Compass, a digitalized version of the contents of the Taxonomy and the TSC to make them easier to access by a variety of users, by displaying:

- Which activities are covered by the Taxonomy (Taxonomy-eligible activities)
- To which objectives they substantially contribute
- What criteria they have to meet to be considered environmentally sustainable

#### *Investing in other sustainable objectives*

According to the SFDR, as amended, sustainable investments are not limited to Taxonomy-aligned activities and can also contribute to other sustainable objectives.

When UCIs intend to invest in sustainable investments, they should set up processes to ensure that their investments will contribute to the objectives defined as part of the investment strategy and that they will not significantly harm other sustainable objectives.

When investing in economic activities that contribute substantially to social or environmental objectives other than climate-related, UCIs should:

- Assess the potential investments against their contribution to the defined environmental objectives through the means of, for example, indicators specific to the objective as defined in the investment strategy
- Assess how the potential investments do not significantly harm other sustainable objectives
- Assess whether the sustainable investment is aligned with the *OECD Guidelines for Multinational Enterprises* and the *UN Guiding Principles on Business and Human Rights*, including the principles and rights set out in the eight fundamental conventions identified in the *Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work* and the *International Bill of Human Rights*
- Assess the good governance practices of investee companies

#### *C. Monitoring the UCI's ESG performance through sustainability indicators*

UCIs that choose to qualify as Article 8 or Article 9 products under SFDR, as amended, must monitor the ESG performance of their product and the attainment of the environmental or social characteristics, or the sustainability objectives of the UCI throughout its lifecycle.

To this end, UCIs must:

- Define methodologies that permit the measurement of the attainment of the environmental or social characteristics, or the sustainability objective of the product
- Identify sustainability indicators that will be used consistently with the methodologies to quantitatively measure the attainment of the environmental or social characteristics, or the sustainability objective of the product
  - UCIs must identify suitable data sources, or estimate data, to monitor sustainability indicators and take appropriate measures to ensure data quality
  - The chosen indicators must allow historical comparison
  - UCIs may consider having sustainability indicators assured or reviewed by a third party
- Set up processes to monitor the environmental or social characteristics or the sustainable objectives and the sustainability indicators throughout the lifecycle
- Set up internal and external control mechanisms on those monitoring processes

UCIs must identify any limitations to the methodologies and the data sources as well as how such limitations may or may not impact the attainment of their environmental or social characteristics. UCIs must take actions to address such limitations.

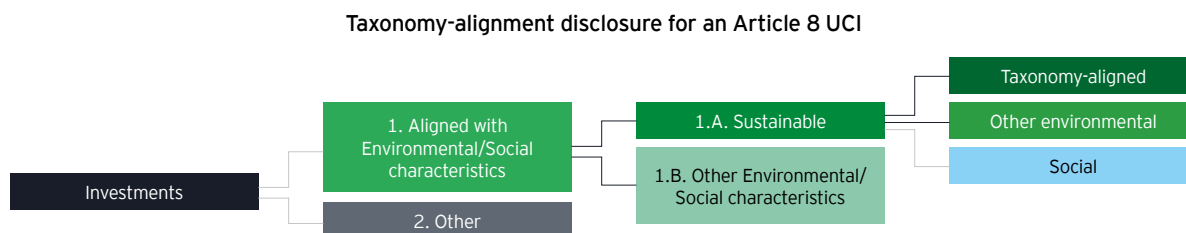
UCIs must monitor the PAIs of their investments to ensure that they comply with the principle of DNSH.

Where an index has been designated as a reference benchmark for the financial product, the UCI must be able to compare the performance of the financial product with regards to the indicators measuring the sustainability factors of the index.

The ESAs confirmed that PAI indicators may be used to measure the environmental or social characteristics or the overall sustainable impact of the UCI, e.g., by showing improvements of the investments against those indicators over time. Such use does not require any prior consideration of PAIs at entity level or at product level.

#### D. Monitoring the UCI's asset allocation

Article 8 and Article 9 UCIs under SFDR must also monitor the composition of their portfolio to reflect the proportion of investments that are sustainable investments, and if their positive contribution is on a social or environmental objective. For sustainable investment with an environmental objective, the asset allocation between Taxonomy-aligned investments and non-aligned must be disclosed. UCIs must plan this composition and disclose it in pre-contractual information and on the UCI's website. The periodic report should contain the proportions during the reference period.



#### E. PAI reporting and DNSH at UCI level

When determining DNSH for sustainable investments, appropriate values should be used to substantiate the assessment (where feasible, in compliance with the TSC).

To substantiate the DNSH, it is possible to consider PAIs at the product level even if the IFM opted out at the entity level. It is expected that Article 9 products will disclose PAIs at the product level.

A look-through approach is expected to be applied for PAI reporting. If data is not available for indirect exposures, best efforts should still be demonstrated in the disclosure.

#### F. Monitoring the UCI's Taxonomy alignment

Taxonomy-alignment disclosures are required for any Article 8 UCI promoting environmental characteristics. It is irrelevant if the UCI commits to invest in economic activities contributing to environmentally sustainable objectives.

Taxonomy-alignment disclosures apply to Article 9 UCIs with an environmental objective. Commitment to a minimum proportion of taxonomy-aligned investment in pre-contractual documentation is binding and breaches are subject to sanctions under sectoral legislation.

Taxonomy-alignment disclosures are also triggered if an Article 9 UCI with a social objective actually invests in economic activities contributing to an environmental objective.

The disclosures of investee companies should enable UCIs to report the proportion of their UCI invested in Taxonomy-aligned activities for each investee company. This should be eased by the CSRD proposed by the EC (see Section 14.2.4.B.). For climate change mitigation, turnover can be recognized where an economic activity meets the Taxonomy TSC for substantial contribution to climate change mitigation and relevant DNSH criteria. For climate change adaptation, turnover can be recognized only for activities enabling adaptation but not for adapted activities.

Companies that disclose their capital expenditures in economic activities in a Taxonomy-aligned manner will be providing invaluable information for constructing green portfolios and for analyzing companies' transition plans and/or environmental sustainability performance and strategies.

Article 8 and Article 9 UCIs under SFDR which include sustainable investments should present a graphical representation in the form of a pie chart of the minimum Taxonomy alignment of investments, calculated as follows:

$$\frac{\text{market value of all Taxonomy-aligned investments of the financial product}}{\text{market value of all investments of the financial product}}$$

For debt instruments, the proportion of the proceeds used for environmentally sustainable economic activities should be included in the numerator.

The assessment should build upon the framework applicable to the undertakings falling in the scope of the NFRD which will be required to disclose the proportion of their turnover, capital expenditure or operating expenditure which is Taxonomy-aligned pursuant to Article 8 of the Taxonomy Regulation.

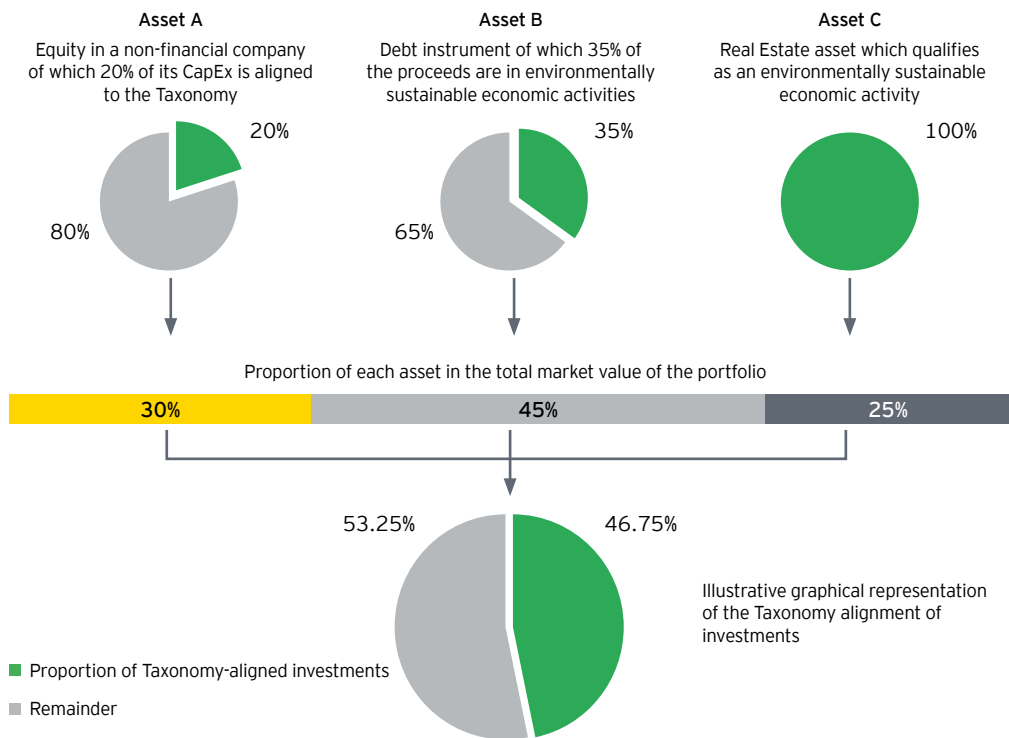
For the assessment of investments in investee companies which are not in scope of NFRD, public reporting of data should be preferred, followed by privately obtained data, either directly from investee companies or from third parties, provided the information is equivalent to the disclosures made in accordance with Article 8 of the Taxonomy Regulation.

Where an IFM fails to collect data on the environmental objective or objectives set out in the Taxonomy Regulation and on how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable for a given UCI, the pre-contractual and periodic UCI related disclosures must indicate zero. Should the IFM decide to use narrative explanations, clarifications should neither leave room for ambiguity about the Taxonomy-alignment of the UCI's investments, nor should they include negative justifications, such as explaining a lack of the alignment by a lack of data.

There are some cases where IFMs cannot reasonably obtain the relevant information to reliably determine the alignment with the TSC as far as economic activities carried out by undertakings that are not subject to the Taxonomy Regulation are concerned. In such exceptional cases and only for those economic activities for which complete, reliable and timely information could not be obtained, IFMs are allowed to make complementary assessments and estimates on the basis of information from other sources. Such assessments and estimates should only compensate for limited and specific parts of the desired data elements, and produce a prudent outcome. IFMs should clearly explain the basis for their conclusions as well as the reasons for having to make such complementary assessments and estimates for the purposes of UCI disclosures to end investors.

The KPI used to measure the Taxonomy-alignment of investee companies should be the same for both pre-contractual and periodic disclosures of all investee companies that are non-financial undertakings. The selection of the indicator and its suitability to inform end investors should be explained. The same consistency requirements apply at the level of all investee companies which are financial undertakings.

The proportion of sustainable investments of a portfolio may be calculated and graphically represented as follows:



The ESAs also provided some clarifications on the KPI calculation methodology as well as certain individual PAI indicators in their clarification on the ESA's draft RTS under SFDR published on 2 June 2022.

#### Tax incentives linked to Taxonomy-alignment

On 19 December 2020, the 2021 Luxembourg Budget Law introduced reduced subscription tax rates for UCIs or individual compartments of such UCIs that invest a specific portion of their NAV in determined sustainable economic activities, as defined in the EU Taxonomy Regulation.

The Budget Law only impacts certain types of UCIs under the regime of the 2010 Law, as amended. Institutional share classes, specialized investment funds (SIFs) and reserved alternative investment funds (RAIFs) already benefit from a subscription tax rate at 0.01% which is the floor rate foreseen in this new regime.

The following scale is foreseen:

Percentage of the NAV invested in qualifying sustainable economic activities	Subscription tax rate
At least 5%	0.04%
At least 20%	0.03%
At least 35%	0.02%
At least 50%	0.01%

The portion of the net assets invested in qualifying economic activities at the year-end date of the UCI must be audited by an independent auditor as part of the annual audit of the financial statements, or, alternatively, an independent auditor can issue a separate *ad hoc* assurance report in accordance with International Standard on Assurance Engagements. The portion, as well as the percentage this portion represents of the total net assets of the UCI/compartment, should be included in either the annual report of the UCI, or the separate *ad hoc* report.

An attestation certified by the independent auditor must furthermore be transmitted by the UCI to the tax administration in charge of collecting the subscription tax (*Administration de l'enregistrement, des domaines et de la TVA*). The portion of the NAV invested in sustainable economic activities will be used as the basis to determine the taxation rate applicable to these assets.

These provisions apply since 1 January 2021. A transitory measure provides for a derogation to the obligation to file subscription tax returns electronically in respect of the declaration of the portion of total net assets qualifying for a reduced tax rate.

In February 2022, ALFI issued Q&A on reduced subscription tax for EU taxonomy compliant investment funds. The Q&A provides guidance on the declaration process and few specific situations. It also provides some practical examples of the filing process.

### G. Requirements applicable to control functions

#### Internal audit

The internal audit function of the IFM, the self-managed UCITS or the internally managed AIF choosing to qualify as an Article 8 or Article 9 product must assess whether the UCI complies with:

- All relevant and specific regulatory requirements arising from the SFDR, the Taxonomy and UCITS Directive or AIFMD delegated acts
- The binding elements of the UCI's strategy and its commitments in terms of ESG

Therefore, UCIs should ensure appropriate internal controls are set up and consider all relevant ESG-related knowledge and expertise when reviewing the UCI's compliance with the above.

#### Risk Management, AML and KYC

UCIs should identify where and to what extent the consideration of sustainability risks is deemed relevant.

Additional safeguards regarding anti-money laundering (AML) and Know Your Customer (KYC) rules to integrate the specificities of investments in sustainability-related projects should also be considered and established.

In connection with the potentially enhanced attractiveness of sustainability-related activities and the high demand from the buy-side for sustainable investments, UCIs that invest in such activities should reinforce their attention with regards to specific risks of money laundering on the asset side.

#### Compliance

The compliance function of UCIs should integrate processes to control the UCI's compliance with the ESG-related regulations and should be able to take appropriate remediation actions, in cases of non-compliance.

### H. Distribution

The SFDR, as amended, requires financial advisors to disclose how they take sustainability risks into account in the selection process of the financial product that is presented to the end investors before providing the advice, regardless of the sustainability preferences of the end investors.

The amendments to MiFID II also require that financial product distributors include the ESG preferences of their clients in suitability assessments (see Section 14.2.4.E.). Therefore, financial products promoting environmental or social characteristics or financial products with a sustainable investment objective may meet their target markets.

The future EU Ecolabel for financial products should provide clarity for financial advisors and retail investors as to which products are the best environmentally performing products (see Section 14.2.4.F.).

## 14.5. Summary of reporting and disclosure requirements

Sustainability disclosures are required to be made in the following:

- IFM's website
- UCI prospectus/offering documentation
- UCI periodic reporting
- For IFMs subject to the Luxembourg Law of 23 July 2016 on non-financial reporting (transposition of the NFRD), the management report or the separate non-financial report

As a general consideration, marketing communications must not contradict sustainability-related disclosures included in other supporting infrastructure and documentation.

### 14.5.1. IFM level disclosures

Supporting infrastructure and documentation	Disclosure item	Level 1 requirements	Level 2 requirements	Application date
Website	Integration of sustainability risks	<ul style="list-style-type: none"> <li>▸ Information on how policies embed sustainability risks in the investment decision-making process for financial market participants (and financial advisors)</li> <li>▸ Information on how the remuneration policies are consistent with the integration of sustainability risks</li> </ul>	None	10 March 2021 Comply
	Consideration of principal adverse impacts	<ul style="list-style-type: none"> <li>▸ Information on whether PAIs are considered and a statement on due diligence policies with respect to those impacts (identification, prioritization, mitigation actions, engagement policy, reference to conduct codes or standards for due diligence and reporting)</li> </ul>	RTS adopted by the Commission on 6 April 2022	10 March 2021 Comply or Explain 30 June 2021 Large IFMs to comply
UCI prospectus/offering document	Integration of sustainability risks	<ul style="list-style-type: none"> <li>▸ Information on how policies embed sustainability risks in the investment decision-making process</li> <li>▸ The results of the assessment of the likely impacts of sustainability risks on the returns of the financial products IFMs make available</li> <li>▸ Where IFMs deem sustainability risks not to be relevant, a clear and reasonable explanation of the reasons should be provided through pre-existing disclosures as referred to in the relevant sectoral legislation (e.g., AIFMD/UCITS/MiFID)</li> </ul>	None	10 March 2021 Comply or Explain
Non-financial report or Management report (for entities subject to the NFRD)	Taxonomy alignment	<ul style="list-style-type: none"> <li>▸ Taxonomy alignment of the entity's activities</li> </ul>	Taxonomy Article 8 RTS	1 January 2022 for qualitative disclosures  1 January 2024 for quantitative disclosures Large PIEs <sup>8</sup> to comply

<sup>8</sup> Entities which are:

- Entities governed by Luxembourg law whose securities are admitted to trading on a regulated market in a Member State
- Credit institutions governed by Luxembourg law
- Insurance and reinsurance undertakings governed by Luxembourg law, with the exception of captive insurance and reinsurance undertakings

## 14.5.2. UCI level disclosures

Supporting infrastructure and documentation	Disclosure item	Level 1 requirements	Level 2 requirements	Application date
Website	Financial products with environmental or social characteristics or with a sustainable investment objective	<ul style="list-style-type: none"> <li>▶ Description of the environmental or social characteristics or their sustainable investment objective</li> <li>▶ Information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investment, including the data sources, screening criteria and the relevant sustainability indicators</li> <li>▶ Information which is required in pre-contractual documentation and the periodic reports</li> <li>▶ When amending the information above, IFMs must publish a clear explanation of such amendments on the same webpage</li> </ul>	RTS adopted by the Commission on 6 April 2022	10 March 2021 Comply
UCI prospectus/ offering document	Integration of sustainability risks	<ul style="list-style-type: none"> <li>▶ Information on how policies embed sustainability risks in the investment decision-making process</li> <li>▶ The results of the assessment of the likely impacts of sustainability risks on the returns of the financial products IFMs make available</li> <li>▶ Where IFMs deem sustainability risks not to be relevant, a clear and reasonable explanation of the reasons should be provided through pre-existing disclosures as referred to in the relevant sectoral legislation (e.g., AIFMD/UCITS/MiFID)</li> </ul>	None	10 March 2021 Comply or Explain
	Consideration of PAIs	<ul style="list-style-type: none"> <li>▶ IFMs, whether they consider PAIs on a voluntary or mandatory basis, should provide a clear and reasoned explanation of whether and if so how a UCI they manage considers PAIs. Offering documents should include a statement that information on PAIs is available in periodic reports. For IFMs which do not consider PAIs, each UCI prospectus/offering document should include a statement that the IFM does not consider PAIs and the reasons therefore</li> </ul>	None	30 December 2022 Comply or Explain
	Financial products with environmental or social characteristics or with a sustainable investment objective	<ul style="list-style-type: none"> <li>▶ Information on how these characteristics are met or on how the sustainable objective is to be attained should be included in the offering documentation</li> <li>▶ Where an index has been designated as a reference benchmark, information should be provided on whether and how this index is consistent with those characteristics or this objective</li> <li>▶ Offering documents should indicate where the methodology used for the calculation of that index can be found</li> <li>▶ Where the objective of the UCI is to reduce carbon emissions, disclosure should include the objective of low carbon exposure in view of achieving the long-term global warming objectives of the Paris Agreement. Where no EU CTB<sup>9</sup> or EU PAB<sup>10</sup> is available, a detailed explanation must be provided concerning the continued effort undertaken to attain the objective to reduce carbon emissions in view of achieving the long-term global warming objective of the Paris Agreement</li> </ul>	RTS adopted by the Commission on 6 April 2022	10 March 2021 Comply

<sup>9</sup> EU Climate Transition Benchmark

<sup>10</sup> EU Paris-Aligned Benchmark

Supporting infrastructure and documentation	Disclosure item	Level 1 requirements	Level 2 requirements	Application date		
Periodic reports	Financial products with environmental or social characteristics or with a sustainable investment objective	<ul style="list-style-type: none"> <li>▶ Where a UCI is promoting environmental or social characteristics, the periodic report should include a description of the extent to which those characteristics are met</li> <li>▶ Where a UCI has a sustainable investment objective, the periodic report should describe the sustainability impact of the product and disclose relevant sustainability indicators</li> <li>▶ Where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the UCI with the impact of the designated index and of a broad market index through sustainability indicators should be included</li> <li>▶ Luxembourg UCIs may use the information in management reports in accordance with Article 1720-1(1) of the Law of 10 August 1915, as amended, or the information in non-financial statements in accordance with Article 1730-1(2), where appropriate</li> </ul>	RTS adopted by the Commission on 6 April 2022	1 January 2023 Comply		
		Consideration of PAIs <ul style="list-style-type: none"> <li>▶ Information on PAIs should be included in periodic reports</li> </ul>			None	30 December 2022 Comply or Explain
		Taxonomy alignment <ul style="list-style-type: none"> <li>▶ All UCIs should include specific information pursuant to Articles 5, 6 and 7 of the EU Taxonomy</li> </ul>			None	1 January 2022







# APPENDICES



## APPENDIX

# I Understanding UCIs

## I.1. Introduction

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This Appendix introduces investment funds (referred to in this Guide as Undertakings for Collective Investment - UCIs), describes their characteristics, the various types and structures and the asset classes in which they invest.

## I.2. What is a UCI?

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A UCI has the following characteristics:

- ▶ There is collective investment of funds
- ▶ The capital is raised from a number of investors
- ▶ The capital is invested in accordance with a defined investment policy for the benefit of those investors, generally in accordance with the principle of risk spreading

The shares or units of some UCIs may be distributed to the general public while others are reserved for certain circles of investors, such as informed, qualified or institutional investors. Depending on the structure of the UCI, these shares or units may be obtained through private placement, direct distribution, distributors, or through stock exchanges.

The portfolio of collective investments may consist of transferable securities and/or other assets. Risk spreading is required to prevent excessive concentration of investments.

A UCI can offer investors the possibility to:

- ▶ Generate current income or capital appreciation, or both
- ▶ Access a diversified portfolio of investments
- ▶ Benefit from professional management of the portfolio
- ▶ Share the associated costs
- ▶ Gain exposure to specific investments in the case of investors who are not able to access the investment directly, for example, due to investor qualification requirements

## I.3. Types of UCIs

The following table summarizes the key characteristics of different types of UCIs, the typical asset classes in which they invest, the typical types of investors to whom they are offered and the typical investment horizon.

**Summary of key characteristics of different types of UCI**

	Typical asset classes	Typical investor types	Typical investment horizon
Equity	Shares/stocks		Medium- to long-term
Fixed income			
▸ Money market	High quality short-term money market instruments (MMIs) and deposits with credit institutions	▸ Retail ▸ High net worth individuals (HNWIs)	Short- to medium-term
▸ Bonds	Longer-term fixed income securities (e.g., government bonds, corporate bonds, convertible bonds, mortgage backed securities)	▸ Institutional (e.g., pension funds and insurance)	Medium- to long-term
Mixed	Mixture of instruments (e.g., equity and fixed income securities)		Medium- to long-term
Hedge funds	Wide range of financial instruments (e.g., equities, fixed income securities, financial derivative instruments (FDIs) such as options, futures, swaps, contracts for differences)  May use techniques (securities lending and borrowing, repurchase and reverse repurchase)  May use short selling		Medium- to long-term
Real estate	Property assets or structures holding property assets	▸ High net worth individuals (HNWIs) ▸ Institutional (e.g., pension funds and insurers)	Long-term
Infrastructure	Development infrastructure (e.g., new transport or utility infrastructure), operational infrastructure (e.g., operating motorways) or infrastructure technology (e.g., water treatment)		Long-term
Private equity	Equity, debt or other exposures to non-listed companies		Long-term
Thematic	Exposures to investments with a specific theme such as responsible investment, specific segments such as healthcare, collectible goods and intangibles		Long-term
Exchange traded	Exposures to baskets of equity, fixed income or other securities or commodities tracking an underlying index	▸ Retail ▸ High net worth individuals (HNWIs) ▸ Institutional (e.g., pension funds and insurers)	Short- to long-term
European long-term investment fund (ELTIF)	Equity, quasi-equity, debt, money market instruments, shares/units of other UCIs/ELTIFs/EuSEFs/EuVECAAs, loans, real estate	▸ Retail ▸ High net worth individuals (HNWIs) ▸ Institutional (e.g., pension funds and insurers)	Long-term

The principal types of UCIs are described in more detail hereafter.

## I.3.1. Equity

Equity funds invest predominantly in equities, otherwise known as stocks or shares. The investment strategies of equity funds are generally geared towards long-term growth through capital appreciation and/or receiving income from the underlying equities, in the form of dividends which can be reinvested in the UCI or paid out to the investors.

According to the European Fund Classification (EFC)<sup>1</sup>, an equity fund must invest at least 85% of its assets in equities. For a fund to be classified in a specific investment category, it must invest a minimum of 80% of its assets in equities in that investment category. Investment categories can be briefly illustrated as follows:

- ▶ Country or geographic region, e.g.:
  - ▶ Global: Equity Global, Equity Global Advanced Markets
  - ▶ Americas: Equity Americas, Equity North America
  - ▶ Asia Pacific: Equity Asia Pacific, Equity Asia Pacific Ex Japan, Equity Greater China
  - ▶ Europe: Equity Europe, Equity Advanced Europe, Equity Eurozone, Equity Europe Ex UK, Equity Nordic, Equity Iberia
  - ▶ Emerging Markets: Equity Emerging Market Global, Equity Emerging Latin America, Equity Emerging Asia Pacific, Equity Emerging Asia Sub Continent, Equity Emerging Europe, Equity Emerging Middle East and North Africa, Equity Emerging Africa
  - ▶ Country: Equity Belgium, Equity Germany, Equity France
- ▶ Sector, e.g.: Consumer discretionary, Consumer staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Natural Resources, Real Estate, Telecommunication Services, Utilities
- ▶ Market capitalization - Small Cap: Equity funds investing at least 80% of their assets in small capitalization stocks as defined by the following regional limits: United States - US\$ 4 billion, United Kingdom - £ 1 billion, Eurozone - EUR 3 billion, Asia Pacific - US\$ 1.5 billion, Global - US\$ 2.5 billion
- ▶ Investment theme: Used to classify equity funds investing a large part of their assets in companies belonging to a specific investment theme. It is not verified from the fund holdings but derived from a declaration of the fund group concerned. (See Section I.3.8.)

Being exposed to variations in share prices, equity funds are generally more volatile than fixed income and mixed funds (see Sections I.3.2. and I.3.3.) - they offer investors higher potential returns but with a higher level of risk.

## I.3.2. Fixed income

Fixed income funds invest mainly in fixed income instruments such as bonds and money market instruments (MMIs). These investments generate regular fixed income.

### I.3.2.1. Money Market

Money market funds (MMFs) generally invest in high quality MMIs or deposits with credit institutions. They do not take direct or indirect exposures to equities or commodities, including via derivatives. Therefore, they are generally considered low risk funds which pay dividends reflecting the money market rates.

According to the EFC, MMFs are classified in line with the *Regulation (EU) 2017/1131 on money market funds*, as amended:

1. Variable Net Asset Value (VNAV) MMF
  - a. Short-term VNAV MMF
  - b. Standard VNAV MMF
2. Public Debt Constant Net Asset Value (CNAV) MMF
3. Low Volatility Net Asset Value (LVNAV) MMF

VNAV MMFs offer unit/share purchases and redemptions at a variable price, whereas CNAV and LVNAV MMFs offer unit/share purchases at a fixed price. CNAV MMFs must invest at least 99.5% of their assets in public debt. Units/shares in a LVNAV MMF can be purchased or redeemed at a constant price, as long as the value of the assets in the fund does not deviate by more than 0.2% from par.

The Regulation also distinguishes between short-term and standard MMFs. Short-term MMFs are required to adhere to tighter investment rules than standard MMFs. Three types of funds may be categorized as short-term MMFs: public debt CNAV, LVNAV and short-term VNAV. Standard MMFs must be variably priced and are therefore all standard VNAV funds by type.

The EFC also classifies MMFs according to their currency exposure.

<sup>1</sup> The EFC is a pan-European classification system for investment funds developed by the European Fund Categorization Forum (EFCF), a working group of the European Fund and Asset Management Association (EFAMA). In August 2021, EFAMA published its updated publication *The European Fund Classification Categories*. The general rule applying to the classification structure is that one fund can only be classified in one category according to the assets in which it invests. The main types of funds can be classified as equity, bond, multi-asset and money market, according to nine criteria: country/region, sector, market capitalization, currency exposure, credit quality, interest rate exposure, emerging market exposure, asset allocation and structural characteristics (e.g., fund of funds, ETF instruments, responsible investment or style). The EFC also describes Absolute Return Innovative Strategies (ARIS) and other types of funds falling outside the five broad categories (e.g., capital protection, convertibles, real estate). In this appendix, we refer, on a number of occasions, to the EFC.

### I.3.2.2. Bond

Bond funds focus primarily on generating income by investing in fixed income securities with maturities of more than approximately one year.

Bond funds may also be characterized by:

- ▶ Credit quality
- ▶ Interest rate exposure
- ▶ Currency exposure

According to the EFC, bond funds must invest a minimum of 80% of their assets in fixed income securities. Investment in cash should not exceed 20%. Investment in other assets should not exceed 10% and should be limited to ensure that the 80% minimum investment in fixed income securities is always respected. Convertible bonds are limited to 20% of assets. Asset-backed and mortgage-backed securities are permitted and may be held up to a maximum of 20%. Equity exposure is not permitted.

A bond fund's credit quality will be classified as follows:

- ▶ A government bond fund must invest at least 80% in such government bonds (issued or explicitly guaranteed by a national government) with a maximum of 10% exposure to corporate bonds. The exposure to emerging market debt should be less than 30%. The maximum exposure to non-investment grade bonds is 30%, of which a maximum of 10% can be emerging market bonds
- ▶ A corporate bond fund must invest at least 70% in corporate bonds with a maximum exposure of 30% to non-investment grade bonds, of which a maximum of 10% can be emerging market bonds. The maximum exposure to emerging market debt is 30%
- ▶ An aggregate bond fund invests in government and corporate bonds and in emerging market bonds (maximum 30%) with a maximum exposure of 30% to non-investment grade bonds, of which a maximum of 10% can be emerging market bonds
- ▶ An aggregate high yield bond fund invests between 30% and 70% of its assets in non-investment grade bonds, of which up to 30% can be in emerging market bonds
- ▶ A high yield bond fund invests at least 70% of its assets in non-investment grade bonds (less than 30% can be in emerging market debt)

A bond fund's interest rate exposure will be classified as follows:

- ▶ Short-term: less than three years average modified duration
- ▶ Medium-term: more than three years and less than seven years average modified duration
- ▶ Long-term: more than seven years average modified duration
- ▶ Flexible: the modified duration does not fit the current duration bands or is defined by the fund group as flexible regardless of the current modified duration that can be deducted from the holdings
- ▶ Unspecified: the modified duration is not defined by the fund group and cannot be determined. In this case, the fund will only receive an indicative classification

Currency exposure is referred to in the name of the category when the fund has at least 70% exposure to the stated currency (with or without currency hedging).

Other types of bond funds include:

- ▶ Emerging market bond funds
- ▶ Floating rate funds
- ▶ Inflation linked bond funds
- ▶ Flexible bond funds

The risk and return of bond funds are generally lower when the securities invested in are investment grade and higher when the fund invests in non-investment grade securities.

### I.3.3. Mixed

Mixed funds invest in a mixture of variable income securities, debt securities, cash and cash equivalents. Debt securities include, among other things, floating rate notes, convertible bonds, high yield and corporate bonds. Real estate and commodity securities should be treated as variable income securities.

According to the EFC, mixed funds (which the EFC calls "multi-asset" funds) can be classified according to:

- ▶ Geographical exposure: This reflects the local or regional exposure of the fund investments. A single country fund must invest at least 80% of its assets in securities of companies established in the country or region. The domicile of a company is based on the company's primary listing or the country/region of operations

- ▶ Asset allocation:
  - ▶ Defensive: less than 35% variable income securities
  - ▶ Balanced: between 35% - 65% variable income securities
  - ▶ Aggressive: more than 65% variable income securities
  - ▶ Flexible: may invest up to 100% in any asset class
- ▶ Currency exposure, where applicable, a minimum of 70% exposure to a stated currency (with or without currency hedging)

Other mixed funds<sup>2</sup> will adapt the portfolio mix to market conditions or investor aims. For example, life-cycle funds offer investors the possibility to adapt their investment to their changing life circumstances - typically, in view of retirement, by gradually decreasing exposure to equities and increasing exposure to fixed income investments over time, progressively providing more stable income at less risk.

The risk/return profile of a mixed fund is generally between that of an equity fund and a fixed income fund.

### 1.3.4. Hedge funds

Although several bodies have attempted to provide a definition of a hedge fund, there is no official definition. Hedge funds vary widely in investment strategy, risk levels, types of securities owned, etc. However, one could describe a hedge fund by looking at the common or similar characteristics of hedge funds.

While traditional investment funds aim for “relative returns” - i.e., a return relative to a benchmark - hedge funds often aim for “absolute returns”, i.e., positive returns that are linked not to a benchmark but to particular assets. Hedge fund portfolios are commonly a basket of securities that have been “cherry picked” as a result of the hedge fund manager employing investment strategies that differ from the traditional investment fund and that often make extensive use of derivatives.

The EFC defines such funds as absolute return innovative strategies (ARIS) funds. ARIS funds are classified on the basis of the fund promoters’ declaration on strategy style:

- ▶ Directional strategies: broad range of strategies with a bias triggered by macro factors
- ▶ Long/short: funds that implement analytical techniques to capture the direction of price movement regardless of whether prices are rising or falling
- ▶ Relative value: relative value techniques to exploit a valuation discrepancy (i.e., price discrepancies)
- ▶ Event driven: investment in securities of companies currently or prospectively involved in corporate transactions or subject to other corporate events
- ▶ Multi-strategy: different types of strategies (e.g., equity long/short, commodities, volatility arbitrage)
- ▶ Index trackers: replicate the performance of a particular index made by a minimum of five different ARIS funds
- ▶ Leveraged index trackers: replicate the performance multiplied by X of a particular index made by direct or indirect long or short exposure to the underlying securities. Conventional long index funds are classified as conventional funds
- ▶ Fund of ARIS funds: investment in a portfolio of other ARIS funds rather than directly in securities (see also Section 1.4.2.)

Over recent years, many hedge and traditional asset managers have pursued investment fund strategies referred to as “liquid alternatives”. These strategies are generally created within a UCITS structure and use many of the investment fund techniques previously associated with the hedge fund industry such as shorting using synthetic shorts through the use of total return swaps. Previously such products were only available to professional and institutional investors. If a liquid alternative strategy is created within a UCITS structure, it must comply with all the UCITS requirements. The UCITS liquid alternative products may be more expensive to operate than the traditional offshore hedge fund and performance may also be impacted by the requirement to comply with all the UCITS risk diversification and leverage requirements. However, such products do benefit from the brand associated with UCITS including the well-established regulatory framework, transparency and liquidity.

### 1.3.5. Real estate

There are two main categories of real estate UCIs: direct real estate funds and indirect real estate funds.

Direct real estate funds invest in property assets or structures holding property assets, generally in sectors such as:

- ▶ Retail (e.g., shopping centers)
- ▶ Offices
- ▶ Residential (e.g., apartments)
- ▶ Parking
- ▶ Industrial premises
- ▶ Leisure (e.g., hotels, leisure parks)
- ▶ Logistics (e.g., warehouses)

<sup>2</sup> | Here we are no longer referring to the EFC.

They generally generate returns from the increases in the value of the assets and from rental income. Other potential investments include land, construction activities, real estate financing activities and distressed real estate debt securities.

Diversified direct funds invest in more than one sector.

INREV, the European Association for Investors in Non-Listed Real Estate Vehicles, defines three “styles” of direct real estate funds, depending on the fund characteristics:

- ▶ Core funds tend to be less risky real estate funds. Core funds invest less than 15% of the gross asset value in non-income producing investments. Their development exposure may not exceed 5% of the gross asset value. Core funds use low leverage (up to 40% of the fund gross asset value). They are required to have at least 60% of the target return derived from income distribution
- ▶ Value added funds are funds whose non-income producing investments range between 15% and up 40% of the fund gross asset value. The percentage of development exposure cannot exceed 25% of the gross asset value. The capital leverage ratio ranges between 40% and 60%
- ▶ Opportunity funds tend to be riskier real estate funds. They invest more than 40% of fund gross asset value in non-income producing investments. They have a development exposure that may exceed 25% of the fund gross asset value. The capital leverage ratio may exceed 60% of the gross asset value

Direct real estate funds are required to meet all the aforementioned ratios to be classified as the particular style of fund. Otherwise, the fund will be classified as the riskiest style into which it falls, considering its characteristics.

The table below summarizes the different criteria determining the style of direct real estate funds:

	Core <40%	Core > 40%	Value added	Opportunity
Target percentage non-income producing investments	≤15%		>15% - ≤40%	>40%
Target percentage of (re)development exposure	≤5%		>5% - ≤25%	>25%
Target return derived from income		≥60%		
Maximum loan-to-value (LTV)	≤40%	>40%	>40% - ≤60%	>60%

Source: INREV Style Classification

Indirect funds invest in listed real estate securities or in other real estate funds.

### 1.3.6. Infrastructure

“Infrastructure” is a term covering multiple types of investments and segments, with very varied inherent risks. There is no single definition of infrastructure<sup>3</sup>.

The following are typical types of infrastructure investment funds:

- ▶ Development infrastructure focusing mainly on participating in the development of new infrastructure. Examples include:
  - ▶ Building transport infrastructure, such as motorways, train and tramlines, airports, ports
  - ▶ Building utility infrastructure, such as dams, hospitals, waste treatment plants

Such infrastructure investments often present some of the following characteristics and risks:

- ▶ Significance in the context of their local environment and dependency on administrative decisions for their approval
- ▶ Complexity, increasing the challenge of setting and meeting budget and deadline
- ▶ In the case of public private partnerships, dependency on both the private and public participants (e.g., state or local authorities) for continued long-term financing
- ▶ Operational infrastructure focusing mainly on participating in operating existing infrastructure, such as motorways or water treatment plants

Such operational infrastructure investments often offer relatively stable and predictable returns. Operational infrastructure funds often present some of the following characteristics and risks:

- ▶ Less diversification than many other types of AIF, focusing on a limited number of projects
- ▶ Dependency on authorities for continuation of licenses to operate
- ▶ Good liquidity characteristics due to stable revenue streams
- ▶ Counterparty risk, related to financing infrastructure projects
- ▶ Infrastructure technology focusing on investment into companies developing infrastructure technology, such as tunneling and water treatment technology

Such infrastructure technology investments are close to private equity investments.

Some of the segments which may be considered within the infrastructure asset class include, for example:

- ▶ Environment, such as water and waste storage, treatment and recycling
- ▶ Energy, such as electricity grids and power generation facilities including wind farms and photovoltaic plants

<sup>3</sup> | The European Parliament has defined “infrastructure” as “basic physical and intangible organizational structures and facilities needed for the operation of a society or enterprise”.



- ▶ Healthcare including hospitals, medical centers and other facilities
- ▶ Logistics centers
- ▶ Office buildings
- ▶ Urban infrastructure, such as roads, drainage, street lighting, water distribution
- ▶ Public and local utility facilities, such as buildings used by authorities, schools, student accommodation, custodial buildings, sports facilities, defence infrastructure
- ▶ Telecommunications, such as communications systems
- ▶ Transport, such as motorways, airports, rail and waterways

Certain infrastructure segments overlap between each other and/or with private equity or real estate.

### 1.3.7. Private equity

Private equity generally refers to the acquisition of a company or a stake in a company through a transaction involving privately held equity or other non-public securities by an investor or group of investors; private equity investments are usually medium- to long-term.

The strategies adopted by private equity funds/vehicles will depend on the maturity of the target company:

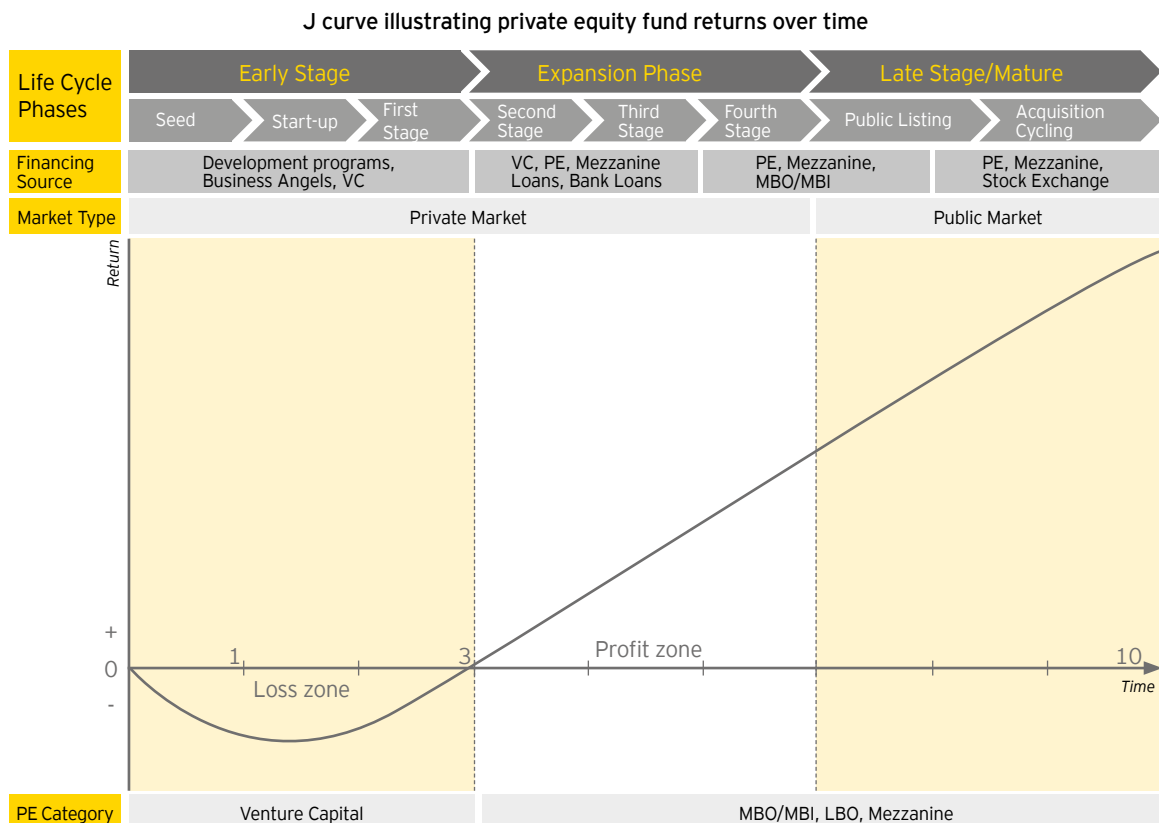
- ▶ Early stage: at this stage, the company is at the beginning of its activity and needs financing to develop its product (seed financing, start-up, etc.)
- ▶ Expansion phase: at this stage, the product is developed and the company needs money to make it (post-creation, etc.). In this phase, there may be leveraged buy-out (LBO), management buy-out (MBO) or management buy-in (MBI) activities, involving the acquisition of a company, business unit or business asset
- ▶ Late stage/mature stage: at this stage, the company may want to raise money from the public (via initial public offering - IPO), develop a new product or enter a new market, manage generation handover issues where there is no successor, turn around or de-list (go private)

The lifecycle of a private equity fund may be represented by a J curve. A key characteristic of a private equity fund, as well as, in certain cases, a direct real estate fund, is the draw-down. The private equity fund will collect or “call” capital from the investors in a series of tranches - i.e., when the fund manager wants to invest, he requests the cash he needs from investors. The goal is to have a minimum amount of cash held in the fund in order to optimize performance.

At the beginning of the fund activity, during the investment period, the fund will invest and pay management fees, set-up costs, etc.

During the realization period, income (e.g., capital gains, dividends) will be generated.

The following figure illustrates the J curve:



A private equity fund/vehicle is generally a “partnership” between a private equity firm (general partner) and investors in the fund/vehicle (limited partners). In many cases, the general partner of a private equity fund takes the form of an unregulated entity.

Private equity vehicles can be set up as funds. There are, however, also other vehicles specifically designated for private equity instruments.

### 1.3.8. Thematic funds

Thematic funds specialize in areas such as specific segments, exotic assets or meet specific criteria.

Thematic funds may offer investors potentially higher returns than certain other types of funds, opportunities to diversify a portfolio and exposure to asset classes which may have a low correlation with traditional asset classes.

There are few commonly agreed definitions of the types of thematic funds. In many cases, the categories of thematic fund types overlap:

- ▶ Responsible investment - generally funds meeting certain environmental<sup>4</sup>, social and/or governance criteria (ESG)<sup>5</sup>. They have a long-term perspective (with an emphasis on sustainable development)
  - ▶ Environment<sup>6</sup>, including:
    - ▶ Renewable energy and environmental technologies, such as solar, wind and biomass
    - ▶ Carbon investments, related to carbon credits
    - ▶ Environmental technology, such as water and waste treatment technology
    - ▶ Sustainable investments, such as fair trade, sustainable agriculture and infrastructure
    - ▶ Impact finance, covering areas such as education, health and food
    - ▶ Social entrepreneurship - funds which have the achievement of measurable, positive social impacts as a primary objective (see Section 2.4.4.3.)
    - ▶ Microfinance<sup>7</sup> - funds which invest in microfinance institutions
  - ▶ Ethical funds: These funds invest in compliance with religious guidelines and are not only driven by financial gains purpose. Ethical funds include funds such as Catholic, Sharia and Dharma funds
  - ▶ Specific segments, such as:
    - ▶ Energy, such as equity in energy companies and energy commodities
    - ▶ Technology, such as mechanical technologies, materials, electronics and information technologies
    - ▶ Biotechnology
    - ▶ Life sciences
    - ▶ Natural resources, such as forestry, plantations and water supply
    - ▶ Transportation, such as ships, aircraft, containers
    - ▶ Commodities, generally including a combination of commodities, commodity futures and options
  - ▶ Collectible goods such as luxury goods, including art objects, jewelry, racing and breeding animals (such as horses), expensive alcohols (wines and spirits) and vehicles (such as cars and motorbikes)
  - ▶ Intangible assets such as patents, marketing rights and libraries of intellectual property (e.g., music libraries)

The investment themes included in the EFC structure to classify equity funds are updated whenever deemed necessary:

- |                      |                   |
|----------------------|-------------------|
| 1. Natural Resources | 8. Clean Energy   |
| 2. Infrastructure    | 9. Digitalization |
| 3. Climate           | 10. Nutrition     |
| 4. Agriculture       | 11. Trends        |
| 5. Water             | 12. High Dividend |
| 6. Biotechnology     | 13. Other         |
| 7. Medtech           |                   |

Since 2018, the European Commission has published a number of texts and adopted a package of measures relating to sustainable finance. For further detail on the implications for IFMs and UCIs, please refer to Chapter 14.

<sup>4</sup> For example, meeting the United Nations Principles for Responsible Investment.

<sup>5</sup> The Luxembourg Fund Labeling Agency (LuxFLAG) offers an ESG Label designed to reassure investors that the investment fund actually invests its assets in a manner which incorporates ESG considerations throughout its investment process. The eligibility criteria for the ESG Label require applicant funds to screen 100% of their invested portfolio according to one of the ESG strategies and standards recognized by LuxFLAG.

<sup>6</sup> The Luxembourg Fund Labeling Agency (LuxFLAG) offers an Environment Label designed to reassure investors that the funds actually primarily invest their assets in environment-related sectors in a responsible manner. The eligibility criteria for the Environment Label require eligible funds to have a portfolio of investments in environment-related sectors corresponding to at least 75% of the fund's total assets.

<sup>7</sup> The Luxembourg Fund Labeling Agency (LuxFLAG) offers a Microfinance Label designed to reassure investors that the microfinance investment vehicle (MIV) actually invests, directly or indirectly, in the Microfinance sector. Investing indirectly means that the MIV can, rather than giving direct loans to Microfinance Institutions (MFIs), invest into other MIVs themselves investing more than 50% in microfinance.

## I.4. Structuring of UCIs

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UCIs may be structured in different ways depending on the investment policy elected by the manager and the type of investors to whom the units/shares are addressed.

### I.4.1. Single and multiple compartment UCIs

The simplest UCIs are single funds. The UCI has one investment compartment with one investment policy and is managed by one portfolio manager. In this case, if the asset manager wishes to offer investors another investment policy, then another UCI must be created.

Multiple compartment UCIs (otherwise known as umbrella funds) are UCIs which comprise, or may comprise, two or more compartments (sub-funds), each with different features – generally a different investment policy. Different compartments may, for example, invest in different asset classes and be managed by different portfolio managers.

Multiple compartment structures are favored by the larger promoters and initiators of UCIs.

The assets of each compartment of a multiple compartment UCI are generally segregated and the accounting records of each compartment are kept separate.

It is also possible to create funds with interlinked compartments. For example, a multiple compartment UCI can include private equity and hedge fund portfolios, whereby the hedge fund portfolio provides the liquidity for flexible draw-down and cash management that private equity general partners are seeking and the hedge fund managers gain access to the potential returns from private equity investment.

Multiple compartment UCIs and cross investment are covered in Sections 2.3.2. and 2.3.5.

### I.4.2. Fund of funds

A fund of funds invests in several other investment funds. Some funds of funds allocate their assets to diverse or geographical fund strategies while others focus on just one or two.

A key role of the manager of a fund of funds is the selection and monitoring of the underlying UCIs.

Funds of funds generally offer a more diversified and lower risk investment opportunity than the underlying funds themselves. They may also offer exposure to investment funds to some investors who would not be able to invest in the underlying funds directly.

Funds of funds are covered in Sections 1.3.5.1.

### I.4.3. Master-feeder structures

In master-feeder structures, the feeder UCI invests most of its assets – at least 85% – in a master UCI.

A feeder UCI is a non-diversified investment structure investing into a diversified product (master UCI), permitting the pooling of assets.

The management of a significant portion of the portfolio of the feeder UCI is effectively performed by the manager of the master UCI.

The master UCITS, or one or more of the feeder UCITS, can be located in different Member States.

Master-feeder structures may be used by asset managers as a distribution mechanism to facilitate access to certain markets.

Master-feeder structures are covered in Sections 1.3.5.2.

## I.4.4. Holding structures of UCIs

Alternative assets are often held through holding vehicles, typically holding companies (often referred to as special purpose vehicles – “SPVs” or special purpose entities). Such holding vehicles may be owned either exclusively by the AIF or its AIFM on its behalf, or as joint ventures, for example, with other AIF.

Typically, holding vehicles are used in AIF structures to hold assets such as:

- ▶ Real estate in real estate AIFs
- ▶ Unlisted companies in private equity AIFs

Holding structures are covered in Section 2.7.

## I.4.5. Exchange-traded funds

Exchange-traded funds (ETFs) are investment funds investing in a basket of securities or commodities generally designed to track the performance of an underlying index. They are listed on stock exchanges and can be traded in the same way as any other listed transferable security.

The shares or units of ETFs are not issued or repurchased in the same way as traditional funds. Institutional investors create and redeem ETF shares directly from the ETF, in large blocks, called “creation units”. The transaction is generally in kind, with the institutional investor swapping a basket of securities or commodities for units of the ETF in the case of a creation or *vice versa* in the case of a redemption. Some ETFs may require or permit a purchasing or redeeming shareholder to substitute cash for some or all of the securities or commodities in the basket. The creation and redemption mechanism means that units are normally traded at a price close to the net asset value (NAV).

The shares or units of ETFs are traded on the secondary market where prices are available from market makers on an intra-day basis.

ETFs combine advantages of stocks (tradability and liquidity) and of index funds (low costs and diversification) into one product:

- ▶ **Trading flexibility:** unlike traditional investment funds, which can only be traded at the end of the trading day, ETFs can be bought and sold at current market prices and at any time during the trading day and market makers quote continuous prices on them. This allows investors to react to adverse or beneficial market conditions on an intra-day basis
- ▶ **Transparency:** ETFs combine the diversity of an investment fund with the transparency, ease of use and low trading costs of a listed stock. Because asset managers can trade ETFs throughout the trading day, ETF investment performance can be monitored continuously and holdings published daily, providing transparency to the market
- ▶ **Lower costs:** as most ETFs are not actively managed, ETFs total expense ratios are much lower than those of other forms of investment vehicles. In addition, most ETFs are shielded from the costs of having to buy and sell securities to accommodate shareholder purchases and redemptions
- ▶ **Diversification:** in a single transaction, ETFs provide exposure to a diversified index

ETFs traditionally replicate an index by directly holding all the constituents of the underlying index. This is referred to as “physical replication”. Managers of ETFs using physical replication have to rebalance the portfolio to match periodic changes in the composition of the index. This approach has worked successfully for the main plain vanilla indices.

Second generation ETFs resort to “swap-based” or “synthetic” replication: rather than directly holding all constituents of the tracking index in its portfolio, the fund uses swaps to replicate the performance of the index. This more recent form of ETF offers a number of advantages.

## Physical vs synthetic ETFs

	Physical	Synthetic
Tracking responsibility	Fund manager	Swap counterparty
Tracking efficiency	Varies according to index being tracked	Minimal tracking error <sup>8</sup> before fees
Sources of counterparty risk	Securities lending	Swap counterparty (for UCITS, the maximum exposure is 10% of net assets)
Product types available	Equity, bond and money market indices	Equity, bond, money market, credit, currency, commodity, hedge fund, leveraged, short indices, real estate, etc.
UCITS compliant	Yes	Yes
Advantages	<ul style="list-style-type: none"> <li>▶ Efficient for indices with few constituents such as the DAX, CAC 40 or FTSE</li> <li>▶ Transparency</li> <li>▶ Direct holding of index constituents easy to understand for investors</li> </ul>	<ul style="list-style-type: none"> <li>▶ Efficient for indices with many constituents, such as the MSCI World, which has over 1,800 constituents</li> <li>▶ Minimized tracking error</li> <li>▶ Offers exposure to a wide range of indices from equity, to hedge fund and real estate<sup>9</sup></li> <li>▶ Provides access to markets such as emerging countries (e.g., Brazil, Russia, India, China, Vietnam) which would not otherwise be directly accessible to many investors</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>▶ Re-balancing necessary after changes in constituents or weights</li> <li>▶ Index turnover costs</li> <li>▶ Tax treatment of dividends</li> <li>▶ Tracking issues related to timing of dividend payments</li> <li>▶ Limited to equity, bond and money market indices</li> </ul>	<ul style="list-style-type: none"> <li>▶ Exposure to swap counterparty risk</li> <li>▶ More complex derivatives that need to be understood by investors</li> <li>▶ Leveraged and short ETFs are carefully scrutinized by regulators concerned about their suitability and appropriateness for retail investors</li> <li>▶ Some stock exchanges are more reluctant to list synthetic ETFs</li> </ul>

While passive ETFs track the performance of an underlying index, actively managed ETFs seek to outperform a benchmark. These ETFs could aim to outperform through an algorithmic process, such as ranking stocks under certain criteria at set intervals and automatically rebalancing the portfolio accordingly, or by linking performance to the discretionary trading expertise of a particular manager.

See also Section 2.6.2.

### 1.4.6. Structured products

A structured product is normally a “packaged” product with a pre-defined investment objective. The “package” will normally include a combination of traditional financial instruments, derivatives and/or insurance products.

Within the context of investment funds, there are two categories of structured products:

- (1) Structured funds, or structured compartments (sub-funds) of funds, which offer investors a predefined payoff depending on different scenarios based on the value of the underlying assets
- (2) Structured products based on funds

There are two main types of structured funds:

- ▶ **Guaranteed funds:** guaranteed funds offer partial or full capital or income protection - i.e., some or all of the investment in the fund or income generated therefrom is guaranteed (e.g., at maturity). At the same time, guaranteed funds offer some exposure to specific financial instruments. Some guaranteed funds implement a lock-in mechanism, whereby at certain times, or when certain thresholds are met, the gains are “locked in” - i.e., guaranteed. Guarantees are generally achieved by using financial instruments and/or by dynamically adjusting exposures to risky assets; a guarantor may also be involved. Guaranteed funds are generally long-term investments
- ▶ **Leveraged funds:** leveraged funds take risk exposure exceeding the amount of capital invested, by borrowing or through the use of financial derivative instruments (FDIs). Thus, the potential returns, but also the risk inherent in leveraged funds, are greater

For more information on structured UCITS, see Section 2.6.6.

<sup>8</sup> A tracking error can be defined as the difference in performance between the index to be replicated and the ETF. Part of the tracking error will be explained by the fees paid by the ETF to the service providers.

<sup>9</sup> Such ETFs may be UCITS using a number of investment techniques permitted by the UCITS Directive, which enable them to pursue alternative strategies. Exposure is gained through financial indices.

Structured products based on funds include capital protection products, products offering leveraged exposure to a basket of funds or products dynamically allocating assets to a basket of funds, for example, to top performing funds. Structured products based on funds are outside the scope of this Guide.

#### I.4.7. Pension Fund Pooling Vehicles (PFPVs)

PFPVs are collective investment schemes (e.g., common funds) created by international groups in order to pool the assets of different pension funds that they manage in various jurisdictions where they have operations.

Pooling assets of multiple pension funds, often in different jurisdictions, offers benefits such as reduced operational fees and costs, efficient management of assets, access to a wider range of potential investments, a centralized governance structure and consistency between pension funds. However, to offer these advantages to investors, the PFPV must allow investors the same fiscal treatment as if they had invested in their home jurisdiction.

#### I.4.8. European Long-Term Investment Funds (ELTIFs)

On 29 April 2015, the European Parliament and the Council of the European Union adopted Regulation (EU) 2015/760 that created a new investment fund vehicle, namely the European long-term investment fund (ELTIF). The purpose of this regulation is to boost European long-term investments in the real economy.

The Regulation applies to EU AIFs that are marketed in the European Union under the ELTIF label. Only authorized EU AIFMs may manage and market ELTIFs. ELTIFs will be subject to additional rules requiring them, *inter alia*, to invest at least 70% of their capital in clearly-defined categories of eligible assets (generally illiquid assets including, *inter alia*, infrastructure, research and development, private equity, other ELTIFs, EuSEFs and EuVEECAs) and up to 30% in assets other than long-term investments.

ELTIFs are discussed in more detail in Section 2.4.5.



## APPENDIX

# II Glossary

## II.1. Introduction

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The glossary provides:

- ▶ A list of acronyms and abbreviations and the full meanings and the French translations of terms used in this *Technical Guide*, where relevant
- ▶ A list of other common UCI-related terms used in this *Technical Guide* in English, with French translations

## II.2. Acronyms and abbreviations, and French translations

Acronyms and abbreviations, full meanings and French translations

Abbreviation	English Name	French Name
1915 Law	Law of 10 August 1915 on commercial companies, as amended	Loi de 1915 concernant les sociétés commerciales, telle que modifiée
1993 Law	Law of 5 April 1993 on the Financial Sector, as amended	Loi du 5 avril 1993 sur le secteur financier, telle que modifiée
2002 Law	Law of 19 December 2002 on the companies and trade register and the accounting and annual accounts of undertakings, as amended	Loi du 19 décembre 2002 concernant le registre de commerce et des sociétés ainsi que la comptabilité et les comptes annuels des entreprises, telle que modifiée
2010 Law	Law of 17 December 2010 relating to undertakings for collective investment, as amended	Loi du 17 décembre 2010 concernant les organismes de placement collectif, telle que modifiée
2010 Law Part I UCI	UCIs under Part I of the 2010 Law (UCITS)	OPC régis par la Partie I de la Loi de 2010 (OPCVM)
2010 Law Part II UCI	UCIs under Part II of the 2010 Law	OPC régis par la Partie II de la Loi de 2010
2016 Law	Law of 10 May 2016 relating to undertakings for collective investment	Loi du 10 Mai 2016 concernant les organismes de placement collectif
ABBL	Luxembourg Bankers' Association	Association des Banques et Banquiers, Luxembourg
ABCP	Asset-backed commercial paper	Papier commerciaux adossés à des actifs
ABS	Asset backed securities	Titres adossés à des actifs
AGM	Annual general meeting	Assemblée générale annuelle
AIF	Alternative Investment Fund	Fonds d'investissement alternatifs (FIA)
AIFM	Alternative Investment Fund Manager	Gestionnaire de fonds d'investissement alternatifs
AIFMD	Alternative Investment Fund Managers Directive	Directive sur les gestionnaires de fonds d'investissement alternatifs
AIFM Law	The Law of 12 July 2013 on Alternative Investment Fund Managers, as amended	Loi du 12 juillet 2013 relative aux gestionnaires de fonds d'investissement alternatifs, telle que modifiée
ALCO	Association of Luxembourg Compliance Officers	Association luxembourgeoise des compliance officers
ALFI	Association of the Luxembourg Fund Industry	Association luxembourgeoise des fonds d'investissement
ALRiM	Luxembourg Association for Risk Management	Association luxembourgeoise de risk management
AML/CFT	Anti-money laundering (AML) and counter-terrorist financing (CFT)	Lutte anti-blanchiment de capitaux et contre le financement du terrorisme (LAB/CFT)
APM	Alternative performance measures	Indicateurs alternatifs de performance
ARIS	Absolute return innovative strategies	
ATAD	Anti-Tax Avoidance Directive	Directive Anti Tax Evasion
AUM	Assets under management	Actifs sous gestion
B.O.	Beneficial owner	Bénéficiaire économique
BdL	Luxembourg Stock Exchange	Bourse de Luxembourg
BCL	Luxembourg Central Bank	Banque centrale du Luxembourg
CaA	Luxembourg Insurance Supervisory Authority	Commissariat aux Assurances
CAPEX	Capital expenditures	Dépenses en capital
CCLux	CCLux	Centrale de Communications Luxembourg S.A.
CCP	Central counterparty	Contrepartie centrale
CDD	Customer due diligence	
CDO	Collateralized debt obligation	
CDS	Credit default swap	
CEBS <sup>1</sup>	Committee of European Banking Supervisors	

<sup>1</sup> | Now EBA.



Acronyms and abbreviations, full meanings and French translations

Abbreviation	English Name	French Name
CEIOPS <sup>2</sup>	Committee of European Insurance and Occupational Pensions Supervisors	
CES <sup>3</sup>	Committee of European Securities Regulators	Comité européen des régulateurs des marchés de valeurs mobilières (CERVM)
CIS	Collective investment scheme	Organisme de placement collectif
CIT	Corporate income tax	Impôt sur les sociétés
CIU <sup>4</sup>	Collective Investment Undertaking	Organisme de placement collectif (OPC)
CJEU	Court of Justice of the European Union	Cour de justice de l'Union européenne
CNAV	Constant NAV	Valeur nette d'inventaire indicative
CRA	Credit rating agency	Agence de notation de crédit
CRD	Capital Requirements Directive	Directive sur les exigences de fonds propres
CRF	Financial intelligence unit (FIU)	Cellule de renseignement financier
CRR	Capital Requirements Regulation	Règlement sur les exigences de fonds propres
CRS	Common Reporting Standard	Norme Commune de Déclaration
CRS Law	Law of 18 December 2015 on the automatic exchange of financial account information in tax matters, as amended	Loi du 18 décembre 2015 concernant l'échange automatique de renseignements relatifs aux comptes financiers en matière fiscale, telle que modifiée
CSA	Common supervisory action	Action de surveillance commune
CSD	Central securities depository	Dépositaire central de titres
CSP	Cloud service provider	
CSRD	Corporate Sustainability Reporting Directive	
CSSF	Commission for the Supervision of the Financial Sector	Commission de Surveillance du Secteur Financier
CVaR	Conditional Value-at-Risk	Valeur-sous-risque conditionnelle
DORA	Digital Operational Resilience Act	Acte sur la résilience opérationnelle numérique du secteur financier
DNSH	Do No Significant Harm	Ne cause pas de préjudice important
DTT	Double taxation treaty	Convention contre la double imposition
EBA	European Banking Authority	Autorité bancaire européenne
EC	European Commission	Commission européenne
ECB	European Central Bank	Banque centrale européenne
EDD	Enhanced due diligence	
EEA	European Economic Area	Espace économique européen (EEE)
EFAMA	European Fund and Asset Management Association	Association européenne des sociétés de gestion de fonds et d'actifs
EFC	European Fund Classification	Classification européenne des fonds
EFCF	European Fund Categorization Forum	
EGM	Extraordinary general meeting	Assemblée générale extraordinaire (AGE)
EIOPA	European Insurance and Occupational Pensions Authority	Autorité européenne des assurances et des pensions professionnelles
ELTIF	European Long-Term Investment Funds	Fonds européens d'investissement à long terme (FEILT)
EMIR	European Market Infrastructure Regulation	
EPM	Efficient Portfolio Management	Gestion de portefeuille efficace
ESA	European Supervisory Authorities	Autorités Européennes de Surveillance
ESG	Environmental, social and governance (responsibilities)	(Responsabilités) environnementales, sociales et de gouvernance
ESMA	European Securities and Markets Authority	Autorité européenne des marchés financiers
ETF	Exchange traded funds	Fonds négociés en bourse (FNB)
EU	European Union	Union européenne (UE)
EU CTB	EU Climate Transition Benchmarks	Indices de référence «transition climatique» de l'UE
EU PAB	EU Paris-Aligned Benchmarks	Indices de référence «accord de Paris» de l'UE
EuSEF	European Social Entrepreneurship Funds	Fonds d'entrepreneuriat social européens
EuVECA	European Venture Capital Funds	Fonds de capital-risque européens
EVT	Extreme Value Theory	Théorie des valeurs extrêmes
FAQ	Frequently asked questions	Questions fréquemment posées
FATCA	Foreign Account Tax Compliance Act	
FATF	Financial Action Task Force	Groupe d'Action financière (GAFI)
FCP	Common fund	Fonds commun de placement
FDAP	Fixed or determinable annual or periodical	

<sup>2</sup> | Now EIOPA.

<sup>3</sup> | Now ESMA.

<sup>4</sup> | See also UCI.

Acronyms and abbreviations, full meanings and French translations

Abbreviation	English Name	French Name
FDI	Financial derivative instrument	Instrument financier dérivé
FFI	Foreign Financial Institutions	
FGDL	Deposit Guarantee Fund, Luxembourg	Fonds de Garantie des Dépôts, Luxembourg
FSB	Financial Stability Board	
FTT	Financial Transaction Tax	Taxe sur les transactions financières
GAAR	Luxembourg general anti-avoidance rule	
HNWI	High net worth individual	
ICT	Information and communication technologies	
IFAC	International Federation of Accountants	Fédération internationale des comptables
IFM	Investment Fund Manager	Gestionnaire de fonds d'investissement
IFRS	International Financial Reporting Standards	Normes internationales d'information financière
IGA	Inter-Governmental Agreement	
ILA	Luxembourg Institute of Directors	Institut luxembourgeois des administrateurs
ILNAS	Luxembourg Institute of Normalization, Accreditation, Security and Quality of Products and Services	Institut Luxembourgeois de la Normalisation, de l'Accréditation, de la Sécurité et Qualité des Produits et Services
IMD	Insurance Mediation Directive	Directive sur l'intermédiation en assurance
IML <sup>5</sup>	Luxembourg Monetary Institute	Institut monétaire luxembourgeois
IMMFA	Institutional Money Market Funds Association	Association des fonds monétaires institutionnels
INAV	Indicative Net Asset Value	Valeur nette d'inventaire indicative
IORP	Institutions for Occupational Retirement Provision	Institutions de retraite professionnelle
IOSCO	International Organization of Securities Commissions	Organisation internationale des commissions de valeurs (OICV)
IRE	Luxembourg Institute of Auditors	Institut des réviseurs d'entreprises
IRS	Internal Revenue Service	
ISA	International Standards on Auditing	Normes internationales d'audit
ISAE 3402	International Standard on Assurance Engagements (ISAE) 3402, <i>Assurance Reports on Controls at a Service Organization</i> issued by the International Auditing and Assurance Standards Board	
ISIN	International Security Identification Number	Numéro international d'identification des valeurs mobilières
KID	Key information document	Document d'informations clés
KIID	Key Investor Information Document	Document d'informations clés pour l'investisseur (DICI)
KPI	Key performance indicator	
KYC	Know Your Customer	Connaître son client
LCBR	Low Carbon Benchmark Regulation	Règlement sur les indices de référence à faible intensité de carbone
LMT	Liquidity management tool	
LPEA	Luxembourg Private Equity + Venture Capital Association	
LuxFLAG	Luxembourg Fund Labeling Agency	Association luxembourgeoise de labellisation des fonds d'investissement
LuxGAAP	Luxembourg Generally Accepted Accounting Principles	Principes comptables généralement reconnus (PCGR) au Luxembourg
LuxSE	Luxembourg Stock Exchange	Bourse de Luxembourg
LuxSE SOL	Luxembourg Stock Exchange Securities Official List	
LVNAV	Low Volatility Net Asset Value	Fonds monétaire à valeur liquidative à faible volatilité
MiFID	Markets in Financial Instruments Directive	Directive sur les Marchés d'instruments financiers
MiFIR	Markets in Financial Instruments Regulation	Règlement concernant les instruments financiers
MBS	Mortgage backed securities	
MMF	Money Market Funds	Fonds monétaires
MMI	Money market instruments	Instruments du marché monétaire
MoU	Memorandum of Understanding	
MTF	Multilateral Trading Facility	Système de négociation multilatéral
NAV	Net asset value	Valeur nette d'inventaire (VNI)
NCA	National competent authority	Autorité nationale compétente
NCCT	Non-cooperative country or territory	Pays et territoires non coopératifs (PTNC)
NFFE	Non-financial foreign entity	
NFRD	Non Financial Reporting Directive	Directive sur la publication d'informations non financières

<sup>5</sup> | The predecessor of the BCL and the CSSF.

Acronyms and abbreviations, full meanings and French translations

Abbreviation	English Name	French Name
NPPR	National Private Placement Regime	Régime national de placement privé
NWT	Net worth tax	Impôt sur la fortune
OECD	Organization for Economic Co-operation and Development	Organisation de coopération et de développement économiques (OCDE)
OEREF	Open-ended real estate funds	Fonds immobiliers de type ouvert
ORSA	Own Risk and Solvency Assessment	
OTC	Over-the-counter	De gré à gré
OTF	Organized trading facility	Système organisé de négociation
PAIs	Principal adverse impacts	Principales incidences négatives
PEP	Politically exposed person	Personne politiquement exposée
PEPP	Pan-European personal pension product	Produit paneuropéen d'épargne-retraite individuelle
PFPV	Pension fund pooling vehicles	Véhicules <i>Pension Pooling</i>
PIE	Public Interest Entity	Entité d'Intérêt Public
PRIP	Packaged retail investment product	Produit d'investissement de détail packagé
PRIIPS	Packaged retail and insurance-based investment products	Produits d'investissement packagés de détail et fondés sur l'assurance
PSDC	Dematerialization and preservation service provider	Prestataire de services de dématérialisation ou de conservation
PSF	Financial sector professional	Professionnel du secteur financier
Q&A	Questions and Answers	Questions réponses
RAIF	Reserved Alternative Investment Fund	Fonds d'investissement alternatifs réservé
RAIF Law	Law of 23 July 2016 relating to reserved alternative investment funds, as amended	Loi du 23 juillet 2016 concernant les fonds d'investissement alternatifs réservés, telle que modifiée
RBA	Risk-based approach	Approche fondée sur le risque
RBO	Register of Beneficial Owner	Registre des bénéficiaires effectifs
RBO Law	Law of 13 January 2019 establishing a Register of Beneficial Owner, as amended	Loi du 13 janvier 2019 instituant un registre des bénéficiaires effectifs, telle que modifiée
RC	Compliance officer	Responsable du contrôle des obligations
RCS	Trade and Companies Register	Registre de commerce et des sociétés
REIF	Real Estate Investment Fund	
RESA		Receuil Électronique des Sociétés et Associations
RMP	Risk management process	Processus de gestion de risque
RR	Governing body or one of his/her members who is responsible for compliance	Responsable du respect des obligations
RTS	Regulatory technical standards	Normes techniques de réglementation
SAQ	Self-assessment questionnaire	
S.à r.l.	Private limited company	Société à responsabilité limitée
S.A.	Public limited company	Société anonyme
S.C.A	Partnership limited by shares	Société en commandite par actions
S.C.S.	Limited partnership	Société en commandite simple
S.C.Sp.	Special limited partnership	Société en commandite spéciale
S.E.	European company	Société européenne
SCI	Single Commodity Index	Indice sur Matière Première Individuelle
SDGs	Sustainable Development Goals	Objectifs de développement durable
SFDR	Sustainable finance disclosure regulation	Règlement sur la publication d'informations en matière de durabilité dans le secteur des services financiers
SFI	Structured Financial Instrument	Instrument financier structuré
SFP	Structured Financial Products	Produits structurés
SFT	Securities Financing Transaction	Opérations de financement sur titres
SICAF	Investment company with fixed capital	Société d'investissement à capital fixe
SICAR	Investment company in risk capital	Société d'investissement en capital à risque
SICAR Law	Law of 15 June 2004 relating to the investment company in risk capital (SICAR), as amended	Loi du 15 juin 2004 relative à la Société d'investissement en capital à risque (SICAR), telle que modifiée
SICAV	Investment company with variable capital	Société d'investissement à capital variable
SIF	Specialized Investment Fund	Fonds d'investissement spécialisé (FIS)
SIF Law	Law of 13 February 2007 on Specialized Investment Funds, as amended	Loi du 13 février 2007 sur les Fonds d'Investissement Spécialisés, telle que modifiée (Loi FIS)
SLA	Service level agreement	Accord de niveau de service
SME	Small- and medium-sized enterprises	Petites et moyennes entreprises (PME)
SOPARFI	Luxembourg financial holding company	Société de participations financières
SPAC	Special purpose acquisition vehicle	

### Acronyms and abbreviations, full meanings and French translations

Abbreviation	English Name	French Name
SPV	Special purpose vehicle	Fonds commun de créances (FCC)
SRRI	Synthetic Risk and Reward Indicator	Indicateur de risque et de rémunération
STATEC	Central Service for Statistics and Economic Studies	Service central de la statistique et des études économiques
T2S	Target2-Securities	
TCF	Third-country firm	
TEG	Technical Expert Group	Groupe d'experts techniques
TER	Total expense ratio	Total des frais sur encours
TID	Taxable income distributed	Bénéfices distribués imposables
TIS	Taxable income per share	Bénéfice par action imposable
TRS	Total Return Swap	
TSC	Technical screening criteria	
UCI	Undertaking for Collective Investment	Organisme de placement collectif (OPC)
UCITS	Undertakings for Collective Investment in Transferable Securities	Organismes de placement collectif en valeurs mobilières (OPCVM)
US	United States of America	États-Unis d'Amérique
VaR	Value-at-Risk	Valeur-sous-risque
VASP	Virtual asset service provider	Fournisseur de services d'actifs virtuels
VNAV	Variable Net Asset Value	
VAT	Value Added Tax	Taxe sur la valeur ajoutée (TVA)
WAL	Weighted average life	Durée de vie moyenne pondérée
WAM	Weighted average maturity	Maturité moyenne pondérée
WHT	Withholding tax	Retenue d'impôt à la source

## II.3. Other common UCI-related terms, and French translations

### Other common UCI-related terms, and French translations

English Name	French Name
Administrator	Administration centrale
Approved statutory auditor <sup>6</sup>	Réviseur d'entreprises agréé
Carried interest <sup>7</sup>	Intérêt reporté
Compartment	Compartment
Cooperative company	Société coopérative
Cooperative company organized as a public limited company	Société coopérative organisée sous la forme d'une société anonyme
Depositary	Dépositaire
Distributor	Distributeur
Domiciliation agent	Agent domiciliataire
Management company	Société de gestion
Master-feeder	Maîtres-nourricier
Official Gazette	Mémorial
Paying agent	Agent payeur
Private portfolio manager	Gérant de fortunes
Promoter	Promoteur
Registrar	Agent teneur de registre
Repurchase agreement (Repo)	Achat de titre à réméré
Repurchase transaction	Opérations de mise en pension
Reverse repurchase agreement (Reverse repo)	Vente de titre à réméré
Sale with right of repurchase transaction	Opération à réméré
Securities lending	Prêt de titres
Securities borrowing	Emprunt de titres
Short selling	Vente à découvert
Subscription tax	Taxe d'abonnement
Transfer agent	Agent de transfert
Unlimited company	Société en nom collectif

<sup>6</sup> In this Technical Guide, we use the term "independent auditor".

<sup>7</sup> Share of profits paid as a form of compensation to general partners/managers. It is used in alternative investments, such as private equity and hedge funds.



## APPENDIX



# EY investment fund services

## III.1. Introduction

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### *Who we are*

In Luxembourg, with over 1,700 professionals, we combine our European and global capability with our local knowledge to deliver a full range of services to meet our clients' business needs.

Our global asset management network encompasses key financial centers in EMEIA (Europe, Middle East, India and Africa), the Americas and Asia-Pacific comprising over 22,000 professionals, including 1,000 partners.

Our combination of talent and resources gives us the ability to anticipate and adapt to the rapid and accelerating changes of today's global economy.

### *How we support our clients*

Being the most globally connected of the Big Four organizations, operating in four integrated regions – the Americas, EMEIA, Asia-Pacific, and Japan – enables our Luxembourg asset management practice to work effectively on a cross-border basis:

- ▶ Moving swiftly to bring together the best teams to serve our clients, working together on key issues, and leveraging our strengths, capabilities, and knowledge irrespective of geographies
- ▶ Providing seamless, consistent, high-quality services to our financial services clients across EMEIA and globally
- ▶ Responding quickly and effectively to market developments that impact our clients
- ▶ Providing our clients access to our perspective on current and emerging trends, industry issues, and regulation

Our Luxembourg investment fund services include audit, financial accounting, tax, transactions and advisory services covering the complete lifecycle of an investment fund from concept, through launch, to business as usual, and beyond.

## III.2. Fund lifecycle services

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EY offers a complete suite of services to:

- ▶ Asset managers, sponsors, initiators, general partners, promoters
- ▶ Management companies
- ▶ Investment managers
- ▶ Depository banks and sub-custodians
- ▶ Distributors
- ▶ Administrators and transfer agents
- ▶ Specialist providers, such as valuers, compliance, risk management, and fund information service providers

Our services generally relate to:

- ▶ Managed services including regulatory reporting, fund registration, tax reclaims
- ▶ Advice on establishing investment fund structures, setting-up traditional and alternative management companies and MiFID firms
- ▶ Regulatory compliance and CSSF Circulars
- ▶ Marketing

- Third party due diligence support
- Listing
- Operations
- Transactions
- Risk management and reporting
- Information technology
- ESG strategies, monitoring and reporting
- Ongoing regulatory support
- Ongoing tax support
- Migration of investment fund complexes
- Structuring and restructuring of investment funds and corporate asset management structures
- Liquidation and closure of investment funds

We tailor our approach to the unique needs of each client of the investment fund industry, serving as a business advisor to management while providing the objectivity demanded by regulators, boards, counterparties, and investors.

Our multi-disciplinary approach encompassing regulatory, tax, reporting, and other operational aspects allows us to provide a holistic answer to our clients' needs.

### III.2.1. Investment fund, traditional and alternative management companies and MiFID firm set-up services

We adopt the following approach to support clients in setting up and launching an investment fund, or a management entity (a regulated management company or AIFM, or an unregulated general partner (GP)) or MiFID firm:

#### *Feasibility study*

Providing guidance on and assisting you in the determination of the most appropriate regime, legal form, and structure from regulatory and tax perspectives, corporate governance model, and other features of the fund as well as of its Management Company/AIFM/GP

#### *Operational and regulatory advice*

Providing you with operational, governance and regulatory advice in the process of setting up the fund, Management Company, AIFM or GP structure and related documentation

#### *CSSF regulatory approval process*

Professional coordination with the CSSF to obtain approval for the fund (and its Management Company/AIFM/GP, if applicable)

#### *Incorporation and launch*

Coordination of the incorporation of the fund and, where applicable, its Management Company/AIFM/GP before public notary

### III.2.2. Services for Alternative Investment Fund Managers (AIFMs)

The Alternative Investment Fund Managers Directive (AIFMD) regulates managers of Alternative Investment Funds (AIFs).

The AIFMD subjects AIFMs to compulsory regulation in the EU and impacts the structures, strategies, operations, and EU distribution/marketing methods.

Non-EU managers are also impacted if they wish to distribute their AIFs to EU investors.

EY offers the following services to AIFMs, their AIFs and service providers:

- Assistance in setup of new AIFMs and alternative asset service providers
- Assistance in operating model design and implementation
- Policies and procedures related to the Internal Governance Framework
- The delegation framework: Initial and ongoing due diligence
- Assistance in the selection of service providers
- Health check assessments regarding compliance with key regulatory requirements for AIFMs and alternative asset service providers
- Preparation for Supervisors on-site visits
- Training and regulatory workshops for AIFMs and alternative asset servicing companies

### III.2.3. Regulatory compliance and CSSF Circulars

We can assist you to assess your management company and investment firm governance in light of the CSSF and European regulatory framework to ensure compliance with local and European regulation and to have knowledgeable and trained resources.

CSSF Circular 18/698, applicable to all investment fund managers (IFMs) incorporated under Luxembourg Law, is a welcome addition to the Luxembourg regulatory regime. The strengthening and alignment of requirements is important given ESMA's opinion dated 13 July 2017 which called for supervisory convergence in the area of investment management in the context of Brexit as well as the assessment by the International Monetary Fund.

EY subject matter experts can help you with, *inter alia*:

- Definition or review of Target Operation Model (TOM)
- Notification of branches and new services
- Policy and procedure review and gap analysis
- Review/documentation of governance arrangements and organizational process

### III.2.4. Inspection readiness assessments

On-site inspections by Supervisors should be regarded by Investment Fund Managers (IFMs) as business as usual rather than *ad-hoc* events.

EY can assist you with your preparation for such on-site visits covering the following areas:

- Anti-Money Laundering/Counter Terrorist Financing
- Internal Governance of IFMs
- Compliance with MIFID/MIFID II
- Compliance with Money Market Funds Regulation
- Compliance with the requirements of CSSF Circular 02/77
- Risk Management (e.g., liquidity stress testing)

### III.2.5. Regulatory reporting and fund registration services

Our EY subject matter experts can help you navigate and meet various regulatory reporting requirements as well as perform and monitor effective registration of your products in European and non-European jurisdictions:

#### III.2.5.1. Regulatory reporting

EY's cutting edge regulatory reporting service provides a full end-to-end service for asset managers, from data collection to data treatment, calculations and dissemination. The service is digitally enabled through the EY Financial Managed Services Platform, providing a dedicated single database for each client.

*Fully Managed Reporting Solutions for Asset Managers*

The managed service can be tailored to the asset manager's individual needs and covers a continuously expanding suite of reports including:

- AIFMD Annex IV
- Alternatives risk monitoring
- BVI Property Return Method
- Basel III (GroMiKV, CRR, Solva)
- CSSF UCITS Risk Reporting
- ESG/SFDR Disclosure (EET, pre-contractual, periodic reporting)
- Factsheets

- ▶ Investment simulator
- ▶ MiFID II (EMT, OpenFunds, WM Daten)
- ▶ Money Market Fund Reporting
- ▶ Pension reporting (Dutch FTK, German VAG, Austrian PKG, Italian COVIP, Sweden traffic light)
- ▶ PRIIPs EPT, CEPT
- ▶ PRIIPs KID for funds and insurer
- ▶ Solvency II TPT
- ▶ Transaction cost calculation
- ▶ Transaction reporting oversight (MiFIR, EMIR, SFTR)
- ▶ UCITS KIIDs
- ▶ UK Pension (DCPT, FVPT, CTI)
- ▶ US: N-Port, CPO-PQR, FormPF
- ▶ Value for Money

#### *EY Fund Reporting Cockpit*

The EY Fund Reporting Cockpit is setting new industry standards with the following key features:

- ▶ Client dashboard to oversee production and have access to all reports and data in one place
- ▶ Flexible interfaces and connections to third party administrators
- ▶ Versatile and robust calculation engine
- ▶ Sourcing of required market data
- ▶ Open dissemination platform

### III.2.5.2. Fund registration

Fund registration relies on a dedicated team whose specialist distribution skills and client-focused style can help you perform and monitor the effective registration and maintenance of your UCITS and AIFs in European and non-European jurisdictions.

#### *Our fund registration services:*

- ▶ Online fund registration platform
- ▶ For all countries not covered by the e-file platform, direct submission of application files to regulators
- ▶ Centralized follow-up of cross border application files
- ▶ *Ad-hoc* registration and distribution related services
- ▶ Extended dash-boarding functionalities allowing you to monitor the registration status of your funds on an ongoing basis

### III.2.5.3. Marketing support

- ▶ Assistance with the preparation of commercial documentation
- ▶ Analysis and the determination of the fund target investors' universe
- ▶ Customization of Fund's features to investors' needs

## III.2.6. Service provider oversight

In the context of CSSF Circular 18/698, we provide an oversight platform which supports our clients with the following:

- ▶ Management of delegation and outsourcing
- ▶ Service provider due diligence
- ▶ KPI monitoring

## III.2.7. Listing services

- ▶ Feasibility analysis and determination of the listing process and requirements
- ▶ Support with the selection of a local listing agent, calculation agent, and any other service providers

## III.2.8. Anti-Money Laundering and Counter Terrorist Financing services

#### *Our services:*

- ▶ AML/KYC/KYT testing for the EY audited clients (banks, funds, management companies, other professionals of the financial sector and insurances)
- ▶ All AML/CFT related issues (Law of 12 November 2004 as amended, CSSF or CRF Circulars/regulations, etc.)
- ▶ Regulatory compliance with AML/CFT
- ▶ Specialized department focusing on enhancing client AML and sanctions compliance framework
- ▶ Support to avoid sanctions and long-lasting reputational damage and to mitigate the severe financial and commercial damage brought by non-compliance with regulations, or association with money laundering



#### *AML/KYC/Tax services:*

- ▶ Gap analysis
- ▶ AML/CFT remediation support
- ▶ Process and procedure calibration
- ▶ AML/CFT robotic process automation
- ▶ AML/KYC IT solutions selection
- ▶ Assessment of existing AML/CFT IT tools
- ▶ Managed services (AML/CFT)
- ▶ Staff/BoD training
- ▶ Review of specific relationships (clients, distributors, investors, etc.)
- ▶ Onboarding assistance
- ▶ AML tax services (with the tax department)
- ▶ Due diligence services

### III.2.9. Forensic and Integrity Services

We assist our clients to achieve their integrity agenda, thereby resulting in increased protection of their reputation and respect of the applicable laws and regulations, in order that they maintain their stakeholder's trust.

#### *Managing unethical behavior risks:*

- ▶ Investigations/fact-finding missions
- ▶ Assistance in case of judicial and/or regulatory inquiries, including on-site controls

#### *Corporate compliance:*

- ▶ Analysis and assessment of existing company prevention infrastructure, activities and behaviors
- ▶ Development and/or assistance on improvement - locally and globally - of compliance and management systems, guidelines, code of conduct and ethics framework
- ▶ Business Integrity assessments and/or upgrades
- ▶ Forensic deep dive into client portfolios
- ▶ Assessment and/or development of whistle-blowing processes and guidelines
- ▶ Forensic risk management assistance on third parties and distribution networks

#### *Economic sanctions and export controls:*

- ▶ Assessment and set-up of the Economic Sanctions compliance framework
- ▶ Review of specific operations or business relationships
- ▶ Full-scale look-back exercise in relation to communication to authorities
- ▶ Creation of specialized trainings

#### *Crisis management assistance:*

- ▶ "Lessons to be learned" assistance in objectively identifying the factors which contributed to the failure of capital expenditures or other important projects undertaken by a company
- ▶ Crisis Management assistance - either in a preventive context or in case of actual incident

#### *Transaction forensic:*

- ▶ Pre-acquisition due diligence focusing on corruption, money laundering, asset misappropriation, economic sanctions, export control and conflict of interest exposure risks
- ▶ Post-acquisition investigations and dispute

#### *Forensic technology and discovery services:*

- ▶ eDiscovery
- ▶ Forensic data analytics and data sciences
- ▶ Cyber breach response management and cybercrime investigation

### III.2.10. Risk and quantitative services

- ▶ Risk system (identification, measurement, management, monitoring and disclosure) program designed for senior management and control functions
- ▶ Valuation services including pricing model review and OTC derivative valuation
- ▶ Risk management process review for UCITS management companies, AIFM, and SIFs
- ▶ Quantitative services in relation to:
  - ▶ Market risk (e.g., global risk exposure, portfolio hedging, leverage calculation)
  - ▶ Credit risk (e.g., internal rating system, default transition matrices, concentration risk)

- Counterparty risk (e.g., exposures aggregation)
- Liquidity risk (e.g., cash-flow modeling, LVaR, swing pricing)
- Operational risk (e.g., risk and control self-assessments, SSAE/ISAE reports, key risk indicators, third party delegation/oversight delegation model)
- Risk appetite and risk profiles definition
- Risk reporting template definition
- Synthetic risk and reward indicator (SRRI) model validation and calculation
- Model validation and review

### III.2.11. Strategy and Transaction services

#### I. *M&A and Transaction support*

##### A. Support with investment acquisition activities:

- Assistance with identifying potential acquisition targets and advice on target approach
- Determining appropriate acquisition/deal structure, proposed offer for consideration payable, bid preparation and submission
- Advice and assistance with negotiating the purchase price and other commercial terms of the share purchase agreement, assistance with deal closing
- Buy-side financial and tax due-diligence
- Buy-side sustainability/ESG due diligence
- Review of completion accounts, SPA and other closing-related services

##### B. Support with divestment activities

- Assistance with identifying potential acquirers, PMO of the disposal process
- Development of the information memorandums and other marketing materials
- Advice and assistance with the bidding process, negotiation of the sales price and other commercial terms of the share purchase agreement, assistance with deal closing
- Vendor/sell-side financial due diligence, other types of sell-side reporting to facilitate divestment (white-paper reports, databooks, seller information documents)

##### C. Investor services

- Assessment of the strategic fit, value and performance of the funds' investments
- Market research on assets for performance benchmarking
- Review of the historical performance of the promoter/investment manager as part of the funds' capital raising (sell-side) or investment decision (buy-side) process

#### II. *Valuation & Business Modelling*

Our service offering covers a comprehensive range of situations where valuations play a key role in your daily business

##### A. Where we assist

###### 1. Transactions

- Mergers, acquisitions and divestments
- Feasibility studies for investment decisions
- Capital allocation decisions
- Basis for price negotiations
- Corporate restructuring
- Intellectual property licensing
- Fund raising/borrowing

###### 2. Financial reporting/compliance/good governance

- Valuations in the context of the AIFMD
- Private equity complex shareholding situations (e.g., preferred dividend & liquidation rights, mezzanine, warrants)
- Allocation of purchase price to tangible and intangible assets
- Impairment testing of goodwill and other assets including real estate
- Third party valuation reviews
- Financial model independent reviews (AIFM Level 2 Regulation, Art. 68)

###### 3. Managed services

- Managing continued compliance with AIFM Level 2 Regulation, Art. 68 – use of models to value assets
- AIF Valuation oversight support services

#### 4. Others

- ▶ Shareholder disputes
- ▶ Intellectual property disputes
- ▶ Project evaluation
- ▶ Rates of return and discount rates estimation
- ▶ Market research and benchmarking

#### B. What we value?

- ▶ Businesses and companies across a range of industries
- ▶ Shares and other equity
- ▶ Intangible assets and goodwill
- ▶ Capital equipment
- ▶ Real estate assets including commercial real estate & infrastructure
- ▶ Alternative assets including private equity & private debt

### III. Debt restructuring and liquidation

#### A. Voluntary liquidation

- ▶ Acting as liquidators for investment funds to ensure that the winding-down is conducted in an orderly manner and in compliance with Luxembourg law

#### B. Formal insolvency

- ▶ Acting as liquidators (if appointed by the court) for entities placed into bankruptcy proceedings or acting in an advisory role to recover value for stakeholders

#### C. Debt restructuring

- ▶ Advising on debt restructuring options available in Luxembourg to distressed entities and stakeholders seeking to preserve value

## III.2.12. Internal audit

- ▶ Internal audit co-source and outsource: planning, performance of the risk assessment, execution of the fieldwork and reporting for the whole or part of your IA plan
- ▶ Special IA reviews/project-related: where we can supplement your resources with our subject-matter experts and carry out special requests from management, the audit committee and the Board
- ▶ IA diagnostic/quality assessment reviews: assessment of compliance with the Institute of Internal Auditors Standards and benchmarking your internal audit function performance
- ▶ Set-up of your IA function: tailored to your organization, size, strategy, needs and resources
- ▶ IA transformation: by leveraging a digital and purpose-driven approach to help companies develop a refreshed strategy, mandate and road map to their future digitally-enabled IA
- ▶ Collaboration between your existing teams and our qualified consultants to provide expertise on regulatory matters and leading practices. We provide project support on key issues:
  - ▶ Cash flow management
  - ▶ Breaches
  - ▶ GDPR assessments
  - ▶ IT and cyber assessments
  - ▶ IT regulatory assessments

## III.2.13. Operations

- ▶ Intelligent automation: improve operational efficiency through the deployment of the right mix of new technologies. Our toolbox includes: decision analytics and machine learning, natural language processing, chatbots, Robotics Process Automation, Optical Character Recognition, Interactive Voice Response
- ▶ Operating model design and review: design and review of operational strategy, target operating model design, regulatory feasibility assessment of envisaged operating models, target operating model implementation
- ▶ Benchmarking of operational excellence and operational excellence improvement (identification and implementation of process improvements)
- ▶ Service provider selection and assessment support: request-for-proposal management (set-up of short/long list of providers, request for proposal (RFP) questionnaire set-up, RFP distribution, and RFP answers collection and analysis or second opinion on work performed) and service-level agreement (SLA) and key performance indicator (KPI) set-up and review
- ▶ Process transformation or organization change: support in set-up of business process management, policies and procedures

- ▶ Business analyst work: analysis of new requirements, business and future functional specifications, and testing thereof
- ▶ Pre- and post-merger integration: operational due diligence (mapping of products, services, processes, systems and risks), merger benefit analysis (analysis of related operational costs and potential savings in different set-ups/situations)
- ▶ Program and project management: operate project management office (project lead, workstream lead, project management office (PMO) support) during, e.g., merger, carve-out, outsourcing, integration, business migration, IT change projects or perform assessment, and monitoring of project services
- ▶ Supporting periodic reporting for UCIs, management companies, and AIFM to competent authorities
- ▶ Supporting distributor due diligence processes

### III.2.14. Information technology and systems

- ▶ IT security services: improvement of the operational efficiency and effectiveness of the security efforts by obtaining a clearer understanding of the current state of your information security framework
- ▶ IT risk and controls: assistance in the development and implementation of a comprehensive IT risk and control framework, in terms of organization, processes, tools, dashboard, and reporting
- ▶ Data analysis and data management: assistance to improve the execution of your data management and governance activities
- ▶ IT internal audit: a cost-effective alternative for the development and execution of an internal audit plan aimed at addressing IT related business risks
- ▶ Assessment of IT effectiveness
- ▶ IT architecture: design of the target functional and technical IT architecture and identification of the required components and providers. In case of outsourcing, support in the selection of outsourcing service providers for all or part of the IT architecture
- ▶ IT transformation: support in benchmarking and selection of IT systems, system implementation and system release update, software testing. Support in the selection of outsourcing of certain elements
- ▶ Program advisory services: project assessment, assurance and support services to IT change programs (closing the gap between program failure and effective program management and controls)
- ▶ Robotics Process Automation: deployment of Software that emulates human agents doing manual tasks, e.g., Blue Prism

### III.2.15. Migration services

- ▶ Feasibility analysis of your migration project, including the determination of the most appropriate option to migrate your fund or management company
- ▶ Presentation to and pre-approval of the proposed migration project by the home and host country supervisory authorities and local service providers (as required)
- ▶ Support in the preparation and submission of an application file with the host country supervisory authority and assistance throughout the regulatory approval process
- ▶ Support in the planning and execution of the fund/management company migration (project management support, process alignment support, testing support)

### III.2.16. Restructuring services

- ▶ Assistance with the merger, demerger and/or liquidation of funds, compartments or classes
- ▶ Assistance with the creation of new compartments or classes
- ▶ Support in the change of custodian/central administration, including liaising with service providers and the supervisory authority

### III.2.17. General Data Protection services

Our comprehensive service offering covers the following domains:

- ▶ GDPR-CARPA Certification
- ▶ Finalization of implementation (drafting of policies and procedures, system adaptations, etc.)
- ▶ Support to your Data Protection Officer on all their recurring activities (PIA execution, ROPA maintenance, etc.)
- ▶ Execution of GDPR remediation plans
- ▶ Post implementation health checks
- ▶ Training, e-learning deployment
- ▶ Data breach management including assessment, investigation and reporting services

### III.2.18. Third party reporting

- ▶ Assurance that your company is operating IT systems and processes as well as financial controls according to your objectives and your third party contractual commitments and obligations. For example:
  - ▶ SOC-1: assurance reports on controls at a service organization by utilizing defined standards such as ISAE 3402, US Attestation Standard AT-C section 320, and CSAE 3416
  - ▶ SOC-2 and SOC-3: internationally recognized attestation reports on the AICPA Trust criteria for availability, security, confidentiality, privacy, and processing integrity
  - ▶ ISO 27001/27002: certification provided based on the International Organization for Standardization over the Information Security Management System (ISMS) standard
  - ▶ Agreed upon procedures: report of findings based on specified controls

### III.2.19. Accounting, compliance and financial advisory services

Our accounting, compliance and financial advisory services include:

- ▶ Fund accounting
- ▶ Assistance with NAV calculation
- ▶ Preparation of consolidated financial statements
- ▶ GAAP conversions
- ▶ SPV accounting
- ▶ Management reporting
- ▶ Management company accounting
- ▶ Preparation and filing of statutory financial statements
- ▶ Treasury assistance
- ▶ Preparation and filing of tax and VAT returns
- ▶ Regulatory reporting (e.g., BCL, CSSF)
- ▶ Investor reporting (e.g., INREV, EVCA)
- ▶ Performance measures computations
- ▶ Reporting process design
- ▶ Accounting governance and compliance support
- ▶ Accounting support on specific technical matters
- ▶ Financial due diligence

### III.2.20. Audit

We provide audit services that are based on an audit approach that includes a thorough examination of your organization's concerns and needs.

### III.2.21. Ongoing tax services

The Luxembourg tax practice offers you:

- ▶ European fund tax reporting services
- ▶ VAT services
- ▶ Fund tax services
- ▶ Local and international tax advisory and compliance services
- ▶ Base Erosion Profit Shifting (BEPS) and EU ATAD services
- ▶ Transfer pricing services
- ▶ Tax controversy services
- ▶ People advisory services
- ▶ Automatic exchange of information: FATCA and CRS services
- ▶ Mandatory Disclosure Regime/DAC6 services

#### III.2.21.1. European fund tax reporting services

Our European Fund Tax Reporting team can provide tax reporting services in the various jurisdictions. Our service offering provides:

- ▶ A customized approach considering the necessary flexibility of your operations to provide you with tailored services
- ▶ A proven operating model with a distinguished track record, supported by dedicated individuals and transparent processes and controls, all of which are scalable to meet your needs
- ▶ Dedicated experienced local teams with strong working relationships with local tax authorities, industry bodies, and legislators, while always operating as a single team through our EMEIA network
- ▶ A central point of contact to coordinate the offering and senior country contacts at your disposal
- ▶ A smooth transition from your current service provider due to our vast experience of transition arrangements in the past
- ▶ The most experienced provider of coordinated European tax reporting services in the market
- ▶ A local point of contact - the country lead partner - to provide related tax advice for each jurisdiction

### III.2.21.2. VAT services

Our VAT team assists our clients with:

- ▶ The review of the VAT status of asset managers, funds, special purpose vehicles and third parties, including the determination of their VAT filing obligations and VAT recovery rights
- ▶ The review of agreements, invoices and other relevant documents, including suggestions to ensure the application of the proper VAT exemption, VAT accounting treatment and the potential impacts of a transfer pricing review
- ▶ The preparation of VAT registration files and reporting obligations (e.g., VAT returns)
- ▶ The review of ERP systems from a VAT perspective and the automation of the VAT compliance process
- ▶ Assistance in VAT audits and requests from the Luxembourg VAT Authorities
- ▶ On-call VAT advisory services on specific transactions

In situations where intermediate holding/financing entities are set up, a similar analysis of the VAT status of these entities should be performed to determine whether they have to fulfil VAT obligations in Luxembourg. It could also include the review of the allocation of costs and resources between the fund and these entities.

### III.2.21.3. Fund Tax Services

#### III.2.21.3.1. Tax reclaim services

EY offers an holistic approach to prepare and file eligible tax reclaims in the countries for which refunds have been granted, with or without limitations. We offer a “one-stop-shop” model whereby you will have:

- ▶ A CRM dedicated coordination point reporting to you and managing and monitoring actions
- ▶ A dedicated email address for all EY communications with you and your team
- ▶ A mixed team of experienced professionals in the tax reclaims process
- ▶ In contact with all the service providers
- ▶ EY managing the document and data collection, data reconciliation and quality checks as well as file compilation
- ▶ Team members focusing on quality assurance and issue resolution

Our services include:

- ▶ Proposition of an opportunity analysis (i.e., cost and benefit analysis) to determine amounts and chances of success to collect excess withholding tax paid
- ▶ On the basis of the opportunity analysis, the following actions can be performed:
  - ▶ WHT reclaims based on DTT
  - ▶ WHT reclaims based on ECJ
  - ▶ Relief at source
  - ▶ Local tax agent services for the entity that needs a local representation to best value its investments
  - ▶ Follow-up on payments collected post-filing of returns

These services are supported by a highly digitalized user interface that helps provide a continuous view on the status of the reclaimable amounts, the status of the filings and payments as well as the interface to extract data and reports for the entities' board meetings.

We have a global network of experienced professionals dedicated to the asset management industry. Our ability to work across global locations in a coordinated and consistent way has significantly contributed to us delivering well-controlled and timely service to clients.

#### III.2.21.3.2. Rapid Security Analyzer (RSA)

Simplifying dividends, interest and capital gains tax complexities globally through the use of an automated tool.

##### *Rapid Security Analyzer*

The Rapid Security Analyzer (RSA) automates the process of analyzing your portfolios for interest, dividends and capital gains liabilities at the financial instrument level. The RSA's reports reflect the tax rate and associated rules (including netting rules), as well as the tax considerations noted with the status of each security.

Additional features include:

- ▶ An executive dashboard that provides a broad overview of the findings by country, region and RAG (red, amber or green) status
- ▶ Side-by-side comparison of taxation of different fund types and tax rates by date
- ▶ RSA Lite, an online version of RSA that enables one-off lookups and comparisons of capital gains tax rules, rates and statuses

### III.2.21.3.3. Foreign Tax Representative

*What is the business issue?*

As large investors seek to diversify and make increasing foreign investments, many hold investments in countries where they may have no physical presence. Many countries have been increasing tax compliance requirements for non-resident investors. As a result, the tax compliance and reporting obligations for these investors have grown significantly in volume and complexity.

Local country requirements may demand that investors file returns and require them to use a service provider located in the country or have a registered tax agent. In addition, the increased complexity of the global tax landscape requires investors to consider the tax implications of the markets where they invest.

Global investors must therefore identify and coordinate with numerous local tax service providers to meet their compliance and reporting requirements.

The growing complexity of this responsibility is driving demand for a single globally coordinated service offering: EY Foreign Tax Representative (FTR) Services.

EY provides a globally centralized approach to the tax compliance services for direct investments into foreign markets (as non-resident investors), where in-country services are required.

Our Global Investor Services professionals understand the role of the tax service provider in various non-US markets, the interaction of the taxpayer with global and local custodians, and the compliance and reporting responsibilities that our clients face.

We have a proven methodology for global service management to provide greater visibility and control to our clients, and allow them to be more proactive in meeting and monitoring the growing tax requirements in the markets where they invest and manage risk.

- FTR service offering combines investor needs with EY resources
- Utilizes a well-established and proven online platform
- Leverages local country experience and resources
- Our FTR professionals have developed a detailed understanding of the role of the tax service provider in various markets
- Provides significant reduction in the administrative burden of working directly with various local teams; and managing multiple contracting and billing procedures with providers in each market

### III.2.21.3.4. Global Withholding Tax Reporter (GWTR)

We also offer access to EY's Global Withholding Tax Reporter (GWTR), a subscription-based service that provides detailed technical information regarding withholding taxes, treaties and procedures in relation to portfolio dividends, portfolio interest, and capital gains in over 90 markets. The GWTR, which is tailored to the needs of global financial institutions, contains valuable information such as statutory withholding rates, treaty withholding rates, and tax relief procedures. The GWTR, a web-based tool, provides monthly updates that are based on quarterly reviews of information. Important tax alerts are e-mailed to licensees between updates. Please visit our sample website, [www.globaltaxreporter.com](http://www.globaltaxreporter.com), for more information regarding GWTR.

### III.2.21.4. Local and international tax advisory and compliance

We provide, *inter alia*:

- (i) Fund and holding structure formation
  - Tax advice on the fund structuring and the setting up of Luxembourg holding and financing platforms or special purpose vehicles
  - Tax assistance on legal implementation including review of fund (e.g., limited partnership agreements, private placement memorandums), corporate and financing documents
  - Tax advice on cash and invoicing flows, repatriation strategies, withholding taxes
  - Advice on Luxembourg employee and governance structuring
  - Preparation of Tax Operational Memorandums for Luxembourg fund and holding structures
  - Advice and assistance with compliance of initial tax filings and registrations
- (ii) Tax advisory assistance during the life of the fund
  - On-call tax teams specifically dedicated to assist asset managers, investors and fund industry professionals throughout the lifecycle of the fund
  - Tax advice on the acquisition and disposal of assets in domestic and/or cross-border transactions from a direct and indirect tax perspective, including intellectual property
  - Buy-side and sell-side tax due diligences
  - Tax advice on the implications of complex financial products or transactions

- ▶ Assistance in applying for tax clearances
  - ▶ On-going monitoring of new tax legislation and performing tax impact and opportunity assessments where relevant
  - ▶ Assistance in navigating the complex tax rules across jurisdictions in coordination with our foreign offices
- (iii) Tax compliance assistance during the life of the fund
- ▶ Assistance in managing your direct and indirect tax obligations
  - ▶ Assistance in handling queries from tax authorities
  - ▶ Assistance in the estimation or review of your tax provisions and analysis of your uncertain tax positions
  - ▶ Filing of requests to the tax authorities (e.g., functional tax currency, special fiscal years, fiscal unity)
  - ▶ A global tax risk management including a digitally-enabled and automated workflow management

### III.2.21.5. Base Erosion Profit Shifting (BEPS) and EU ATAD services

The legislative changes being brought by the OECD BEPS initiative and the EU Anti-Tax Avoidance Directive (ATAD) have significantly increased the complexity and tax controversy risk of the tax rules affecting fund and holding structures while requiring evidence of the business purposes of such structures.

In this context, EY can support you with:

- ▶ Tax impact assessments on fund and holding structures
- ▶ Review of fund structure and investor profile to assess impact of EU ATAD anti-hybrid rules
- ▶ Review of fund documentation to address provisions dealing with BEPS impact (e.g., neutralization of anti-hybrid rules between different investors)
- ▶ Preparation of support files with analysis of relevant complex tax provisions (e.g., anti-hybrid, interest limitation rules) to be used for the purposes of tax compliance, financial reporting and support in discussions with local tax authorities
- ▶ Advice on how to navigate from an operational and corporate governance perspective the BEPS and EU ATAD anti-abuse concepts (principal purpose test, general anti-abuse rule, beneficial ownership and substance) in line with business considerations
- ▶ Principal Purpose Test support file to be used in discussions with local and foreign tax authorities documenting the business rationale of the structure and the application of relevant anti-abuse concepts
- ▶ Tax advice with regards to the impact of BEPS/ATAD on structures, specifically but not limited to the identification of controlled foreign companies and analysis of the significant people functions

### III.2.21.6. Transfer pricing services

Our transfer pricing services include:

- ▶ Review of business circumstances to identify, map and streamline dealings between related parties
- ▶ Design of transfer pricing policies and models
- ▶ Assistance with the operational implementation of transfer pricing policies
- ▶ Preparation of transfer pricing documentation and related support, including benchmarking analyses (e.g., interest rates, royalty rates, margin computations)
- ▶ Transfer pricing analysis assessing specific transactions, in particular in light of the latest OECD guidance on financing transactions
- ▶ Assessment of appropriate debt-to-equity ratios in light of company characteristics and market circumstances
- ▶ Assistance with tax audit and queries from tax authorities/regulators
- ▶ Transfer pricing planning to meet business developments
- ▶ Transfer pricing valuation in the context of an intragroup transfers of assets and going concerns
- ▶ Assistance in the design of efficient specific financial instruments
- ▶ Country-by-country reports (if meeting requirements)

### III.2.21.7. Tax controversy services

Our tax controversy services include:

- ▶ Prevention of tax controversy, including:
  - ▶ Advice on tax disputes' prevention and preparation of robust defense files
  - ▶ Assistance in the preparation for tax disputes and likelihood of success
  - ▶ Assistance regarding information requests received, documentation required as well as deviation letters
  - ▶ Organization of workshops to prepare for the tax authorities' visits, with focus on the rights and obligations of both taxpayers and tax authorities
  - ▶ Assistance in relation to directors' personal/joint liability in tax matters, including organization of workshops to explain the relevant legal and theoretical background governing the director's/manager's personal liability for corporate tax debt, but also how to practically and successfully manage the risks in relation to their functions



- ▶ Support upon tax controversy, including:
  - ▶ Assistance in answers to questions from the tax authorities and connected strategy
  - ▶ Assistance in management of tax audits and exchange of information between tax authorities communicated
  - ▶ Resolution of tax disputes with tax administrations
- ▶ Proposition of technology-enabled solutions to cope with tax controversy changes and risks

### III.2.21.8. People advisory services

Our people advisory services include:

- ▶ Expat support (tax, social security, immigration, posted workers, etc.)
- ▶ Salary package: identifying opportunities, assessing interest of employees, design of salary components, supporting with implementation and communication as well as reporting obligations
- ▶ Guidance related to sharing of resources amongst group entities
- ▶ Employment tax: support with wage tax audit and appropriate tax and social security treatment of benefits
- ▶ Payroll services

### III.2.21.9. Automatic exchange of information: Qualified Intermediary (QI), FATCA and CRS services

EY offers a global response to QI, FATCA and CRS compliance. EY services include:

- ▶ Assistance for the QI Responsible Officer to fulfil his/her obligations by:
  - ▶ Ensuring that an appropriate QI Compliance Program is in place
  - ▶ Preparing a Certification of Internal Controls to be provided to the IRS
  - ▶ Reviewing the written policies and procedures and systems and processes
  - ▶ Reviewing the training and internal communication policies and procedures
  - ▶ Reviewing the process for monitoring changes in business practices and arrangements
  - ▶ Reviewing findings from previous audits or reviews and of any corrective actions taken
  - ▶ Undertaking a QI Periodic Review required under the Qualified Intermediary Agreement Revenue Procedure 2017-15 with tests of documentation, withholding Rate Pools, withholding responsibilities, return filing and information reporting as well as any significant changes of circumstances
- ▶ Advice on the implementation of FATCA and CRS compliance procedures:
  - ▶ Provision of awareness and training sessions for FATCA and CRS
  - ▶ Assistance in the classification of investment funds and related entities (e.g., GP, management company) to comply with FATCA and CRS requirements
  - ▶ Assistance in the classification of the entities of private equity and real estate groups
  - ▶ Assistance with the FATCA registration on the IRS portal
  - ▶ Assistance to complete entity FATCA and CRS self-certification forms
  - ▶ Assistance to identify gaps and to ensure that written procedures are correct and complete
  - ▶ Spot checks of FATCA and CRS account due diligence and reporting implementation
- ▶ Assistance with investor due diligence:
  - ▶ Assistance with the amendments of procedures for FATCA and CRS due diligence
  - ▶ Assistance with the due diligence of pre-existing accounts
  - ▶ Review of investor self-certification forms and of the application of the reasonableness test
  - ▶ Assistance with *ad hoc* questions on account classification
- ▶ FATCA and CRS report filing and generation:
  - ▶ Assistance with data collection
  - ▶ Review of data quality
  - ▶ Generation of FATCA and CRS XML reports
  - ▶ Filing of FATCA and CRS declarations
- ▶ Provision of FATCA and CRS reporting services
  - ▶ Advice on information required to be reported
  - ▶ Review of information prepared for reporting purposes
  - ▶ Conversion of reports to the XML format required by the relevant tax authority
  - ▶ Transmission of reports to the relevant tax authority on behalf of Reporting FIs

### III.2.21.10. Mandatory Disclosure Rules (MDR)/DAC 6 services

EY provides an array of services in respect of compliance with the Mandatory Disclosure Rules, such as:

- ▶ Provision of MDR introduction session
- ▶ Assistance in the drafting and issuance of an impact assessment analysis and report
- ▶ Assistance through on call tax advisory services
- ▶ Provision of tax technical training
- ▶ Access to an EY Web enabled MDR tool
- ▶ Assistance on the MDR implementation phase
- ▶ Assistance in the “business as usual” stage

### III.2.22. Climate Change and Sustainability Services

Throughout the fund lifecycle, we can support as follows:

- ▶ Integration and understanding of sustainability and ESG factors
- ▶ Compliance with the regulatory framework

#### *Strategy definition*

- ▶ Assessment of ESG maturity, benchmarking of ESG-related practices
- ▶ Identification of sustainability factors that are material to portfolios
- ▶ Analysis of stakeholders and their relations with the IFM or the UCI
- ▶ Development and implementation of policies with respect to the ESG strategy
- ▶ Analysis of climate change-related scenarios and measurement of impacts on valuation/financial returns

#### *Impact investing specifics*

- ▶ Definition of the impact objectives
- ▶ Alignment with the EU Taxonomy regulation
- ▶ Analysis of the attainment of the impact objectives throughout the fund lifecycle

#### *Investment process*

- ▶ Definition and implementation of screening criteria
- ▶ Buy-side ESG due diligence

#### *Risk Management*

- ▶ Measurement and monitoring of sustainability-related risks
- ▶ Support in implementing organizational changes to account for sound sustainability risk management

#### *Compliance*

- ▶ Diagnostic, readiness analysis and gap assessment for compliance with ESG frameworks
- ▶ Implementation of remediation actions
- ▶ Compliance with:
  - ▶ Binding frameworks (e.g., SFDR, EU Taxonomy of sustainable activities)
  - ▶ Voluntary frameworks (e.g., PRI, GRI, TCFD)

#### *ESG performance monitoring*

- ▶ Definition of methodologies to monitor ESG performance
- ▶ Identification of data sources to feed sustainability indicators
- ▶ Set up of data flows and management systems
- ▶ Adoption or definition of ESG performance benchmarks and indices

#### *Reporting and communications*

- ▶ Ensure compliance with the SFDR (website communications, pre-contractual disclosures and periodic reports) and the EU Taxonomy regulation
- ▶ Non-financial and ESG/sustainability-related reporting process design
- ▶ Support in the adoption of specific reporting frameworks (e.g., INREV, GRI)

#### *Assurance*

- ▶ Assurance report on ESG-related processes and controls
- ▶ Assurance on sustainability indicators and investor report narratives





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## EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

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