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Preface by Rafik Fischer

To Jean-Nicolas Schaus, First Director General of the Luxembourg Banking Supervisory Authority (CSSF) from 1999 to 2009.

Easier access to ever more sophisticated saving products can be attributed to a large extent to the Mutual Fund Industry. For the first time, an ever increasing number of individuals with modest savings can benefit from access to numerous investment opportunities and asset classes thanks to the activities of the Mutual Fund Industry.

This industry really took off in Western Europe during the 80s and greatly benefited from the development of the Grand Duchy of Luxembourg as a recognized international financial center. Luxembourg is now widely acknowledged as being one of the main pillars of private banking and wealth management.

Numerous scientific books dedicated to Undertakings for Collective Investment adopt a largely theoretical approach, whether dealing with mainly legal questions or the fields of applied economics and the mathematics of financial management. The authors of this book have decided to follow an alternative approach by feeding the reader practical information acquired over the years in which they gained their own rich personal experience in the Fund Industry. Contributors to this book have taken an active role in the growth of a new financial industry – from its early development to its maturity – which profoundly changed the traditional landscape of public savings.

In this book, the authors hope to arouse the reader's curiosity to discover the different activities linked to UCI and provide a first contact with this fascinating and diverse sector. While being largely focused on the current practices applicable in Luxembourg, contributions to this book nonetheless have a universal applicability and it will constitute a source of inspiration and reference for all readers with an interest in the Mutual Fund Industry.

To the students who will read this book – hopefully with great interest – it will give an initial insight into a potential choice of professional orientation. Having myself followed this path, I hope that students will feel the fascination and enthusiasm which animate the different contributors. Should this book create new vocations, the authors could only congratulate themselves.

Foreword by Claude Kremer

Since the implementation of the UCITS Directive in 1988, the Luxembourg investment fund industry has grown substantially to become one of the cornerstones of the Luxembourg financial center. It has built its reputation and is renowned today as the second largest investment fund industry worldwide after the United States.

The multitude of foreign and cross-border initiatives demonstrates that Luxembourg has not only succeeded in creating a general environment for investment funds but is also committed to fostering the continuous growth of the fund and asset management industry as a whole. One of the ways of achieving this goal is through attracting young professionals and graduates from various schools worldwide to settle and pursue their careers in the Luxembourg investment fund industry.

I am pleased that the programs offered by HEC-ULG Management School of the University of Liège contribute to this development by offering specialized courses that help to train future professionals of our industry.

This practitioner's guide, as the name suggests, places an emphasis on practical aspects rather than on theoretical developments. It aims at providing students with the knowledge of the key principles of investment fund regulation and practice so that they can successfully pursue their careers in a wide variety of professions offered within the sector.

Having the privilege of being a lecturer myself at HEC-ULG Management School of the University of Liège, it is my great pleasure to welcome the reader to this publication and I hope that he or she will find it useful and informative. But above all, I hope that this publication will contribute to the formation of the professionals in the investment funds sector and consequently to the continued growth of the asset management industry as a whole.

List of abbreviations

AGM: Annual General Meeting
AIF: Alternative Investment Fund
AIFM: Alternative Investment Fund Manager
AIFMD: Alternative Investment Fund Managers Directive
ALFI: Association of the Luxembourg Fund Industry
AML: Anti Money Laundering
AuM: Asset under Management
CCP: Center Counter Party
CSD: Center Security Deposit
CSSF: Commission de Surveillance du Secteur Financier
DB: Depositary Bank
EFA: European Fund Administration
EGM: Extraordinary General Meeting
ESMA: The European Securities and Markets Authority
FCP: Fonds Commun de Placement
FESE: Federation of European Exchanges
KIID: Key Investor Information Document
KYL: Know Your Customer
LM: Liquidity Management
ManCo: Management Company
MIFID: Markets In Financial Instruments Directive
NAV: Net Asset Value
OTC: Over-The-Counter
PEP: Politically Exposed Person
RM: Risk Management
SIAG: Société d'Investissement Auto-Gérée
SICAR: Société d'Investissement en Capital à Risque
SICAV: Société d'Investissement à Capital Variable
SIF: Specialized Investment Funds

TA: Transfer Agent

TMF: Trading Member Firm

UCI: Undertaking for Collective Investment

UCITS: Undertaking for Collective Investment in Transferable Securities

VaR: Value-at-Risk

VAT: Value-Added-Tax

WFE: World Federation of Exchanges

Introduction

This collective book offers a comprehensive overview of the Fund Industry in Luxembourg. The organization of the book follows the different steps of a fund's life-cycle from its creation to its distribution.

The book starts with an introduction to the different investment vehicles that can be considered for the creation of a fund (chapter 1). A thorough description of the Undertakings for Collective Investment (UCI) is then made which covers both the steps necessary for the creation of a UCI and the steps of its early-life development (chapter 2).

Fund administration is studied in Chapter 3. The topic is treated via the length of funds 'main activities: Accountancy (including the risk management function) and funds' inflows/outflows management.

The role played by supporting organizations such as management firms and depositary banks is presented from both a regulatory and practical point of view (chapter 4). The exposition considers then logically the regulatory framework and the supervision authorities surrounding Luxembourg funds together with practical elements regarding those matters (chapter 5). The book concludes with the different elements relative to the distribution of funds to investors (chapter 6 and 7).

1. The different investment vehicles

In this chapter, we introduce the different investment vehicles that are available in Luxembourg. We first give an overview of the Luxembourg investment fund industry and the main available legal structures. After that, we present in a more detailed manner the UCITS vehicles that are limited to invest in traditional asset classes, as well as, SIF and SICAR structures that are most used for alternative fund strategies.

1.1 Introduction

1.1.1 Definition

An investment fund (often called UCI- Undertaking for Collective Investment) is defined as a:

Structure or organization, the object of which is to pool together money and savings collected from the public, for the purpose of investing in transferable securities and other assets, while sharing the costs and the profits (or even losses) of such investment, and whose management is entrusted to a professional in accordance with the risk spreading and diversification principle

Based on the definition above, there are three main criteria that any investment fund (UCI) should fulfill:

- There is a collective investment of funds
- The funds are collected from a number of investors
- The funds are invested according to the Risk Diversification Principle

1.1.2 Advantages/disadvantages

Investment funds (UCIs) provide a combination of benefits to investors which cannot be matched by other investment products. Here is a list of their major advantages:

- Liquidity
- Transparency
- Professional portfolio management
- Easier access to the financial markets already for limited amounts
- Economies of scale
- Diversification of risks
- Advantageous tax treatment

While investing in investment funds has its advantages, there are also some disadvantages that need to be highlighted. Here is a list of the major disadvantages of investment funds:

- No direct control of the share-/unit holders on the asset management decisions
- No direct influence on the investment management strategy
- Entry and exit fees, management fees and various other fees paid by the UCI and consequently by the investors

1.1.3 *Luxembourg investment fund industry*

Key features

- Luxembourg is the World's 2nd largest fund centre (after the USA), with more than EUR 3,083 billion in assets managed across more than 3,913 investment funds (13,885 fund units).
- It is the largest global distribution centre for investment funds, with its funds sold in more than 71 countries around the world (44,000 distribution agreements)
- It is the leading centre for cross-border distribution of investment funds in Europe, with 67% of the European market.
- 41 out of Top 50 cross-border management groups have chosen to set up their funds in Luxembourg. The largest promoters of Luxembourg UCIs, in terms of assets under management, are the US, Germany and the UK.

Key advantages of Luxembourg

The attractiveness of Luxembourg as an international hub for investment funds can be attributed to various key differentiating factors:

- Luxembourg offers a great political, economical and social stability
- It is the second largest international fund centre and the leading centre for cross-border distribution of investment funds. It provides an experienced and multilingual workforce, specialized service providers and a competitive tax environment
- It adopts an innovative & collaborative approach between government, regulator & fund industry players
- It has a strategic position in the heart of Europe
- It has more than 20 years experience in global fund distribution
- Various international promoters are concentrated in Luxembourg

1.2 Luxembourg legal structures for investment funds

Luxembourg offers a vast panel of structures for investment funds (UCIs), which are subject to different levels of regulations. When considering the launch of a fund, the choice of a structure is based on the answers to two main questions:

- Who are the targeted investors?
 - Private (retails, HNWI, ...)
 - Institutional (banks, insurance companies, pension funds, ...)
- Which target investments?
 - Plain vanilla/alternative
 - Listed/not listed
 - Other features: leverage, short selling, derivatives, ...

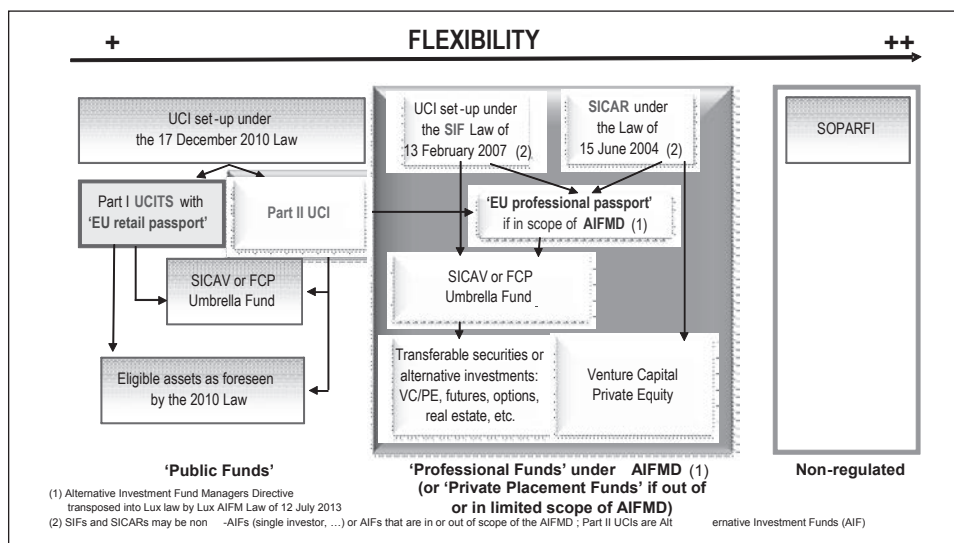


Table 1.1 – Luxembourg investment vehicles

Table 1.1 lists the different vehicles available in Luxembourg based on the degree of their flexibility. Overall, the different models can be grouped into regulated (Public Funds), less regulated (Professional Funds) and non regulated (SOPARFI) structures.

- Public Funds (also called retail funds) are marketed to both retail and institutional investors and are limited to invest in traditional asset classes. Public Funds contain the part I UCITS funds and the part II UCI funds.

This chapter focuses mainly on UCITS funds, the second category is not presented as not really used anymore.

- Professional Funds (also called alternative investment funds AIFs) are sold either with a passport to professionals or on a Private Placement basis. They are less regulated in comparison to UCITS funds and can invest in a wide range of traditional and alternative asset classes. The most used structures for alternative investment strategies, in Luxembourg, are the SIF (Specialized Investment Fund) and SICAR (Société d'Investissement en Capital à Risque) structures.
- Non-regulated funds (such as the Société de Participations Financières – SOPARFI) are not subject to any authorization and any legal requirements in terms of investment, borrowing and diversification rules.

1.2.1 *Public Funds (UCITS funds)*

UCITS legal environment

UCITS (Undertaking for Collective Investment in Transferable Securities): are funds investing in “Transferable Securities” and are sold to both retail and institutional investors. They are subject to detailed investment, borrowing and diversification rules and have a European Passport which means:

- that they are freely marketable throughout the EU
- and may be sold to investors with minimum formalities
- the principle of home country control prevails

UCITS funds are currently regulated by part I of the 2010 law which transposes the European UCITS IV Directive. Table 1.2 summarizes the evolution of the European UCITS legislation from UCITS I to UCITS IV to the future UCITS V.


			
UCITS (UCITS I) Dec. 1985	UCITS III Jan. 2001	UCITS IV June 2009	UCITS V Sep. 2014
<p>Harmonisation of investor protection rules through regulation of the product</p> <p>Marketing of UCITS in EU Member States through simple notification process -> Principle of "home country control"</p> <p>Birth of the UCITS passport and UCITS brand - in and outside Europe</p> <p>Luxembourg Law of 1988</p>	<p>Widening of investment powers, of eligible instruments and of investment techniques available to UCITS: funds of funds, index funds, money market funds, ...</p> <p>Increased scope of activities of UCITS Management Companies to</p> <ul style="list-style-type: none"> ➢ individual portfolio management, ➢ safekeeping of fund units ➢ investment advice on an ancillary basis <p>Law of 2002</p>	<p>Five principal amendments to UCITS regime:</p> <ul style="list-style-type: none"> ➢ Management company passport ➢ Simplified notification procedures & enhanced supervisory cooperation ➢ EU-wide fund merger regime ➢ European master-feeder structures ➢ KIID – Key Investor Information Document <p>Law of 2010</p>	<p>Topics covered are:</p> <ul style="list-style-type: none"> ➢ Depositary duties ➢ Managers' remuneration ➢ Sanctions in case of non compliance with the UCITS V requirements by the management company for the depositary <p>will be implemented by 18 March 2016</p>

Table 1.2 – Evolution of the UCITS regulation

The European UCITS IV Directive in comparison to the UCITS III Directive brings three main new opportunities:

- create new cross-border opportunities within the UCITS funds' Single Market: materialized via
 - master/feeder structures (85% rule)
 - merger of cross-border structures
 - management company passport and
- enhance pre-contractual information to investors (KIID)
- enhance smooth cross-border circulation of UCITS funds – cooperation between regulators

The 2010 law has replaced the 2002 law and:

- allows cross investments of sub-funds from the same umbrella
- introduces next to some corporate and regulatory changes several tax exemptions: ETFs (UCITS & UCIs), microfinance (UCIs & SIFs) and pension pooling (UCITS & UCIs)

UCITS set-up features

In Luxembourg, there are two ways to set up a UCITS fund. The fund can either designate itself as "self-managed" or appoint a management company. The appointed management company can be either a Luxembourg or a European "passport" UCITS IV ManCo. Tables 1.3 and 1.4 illustrate the two possible structures:

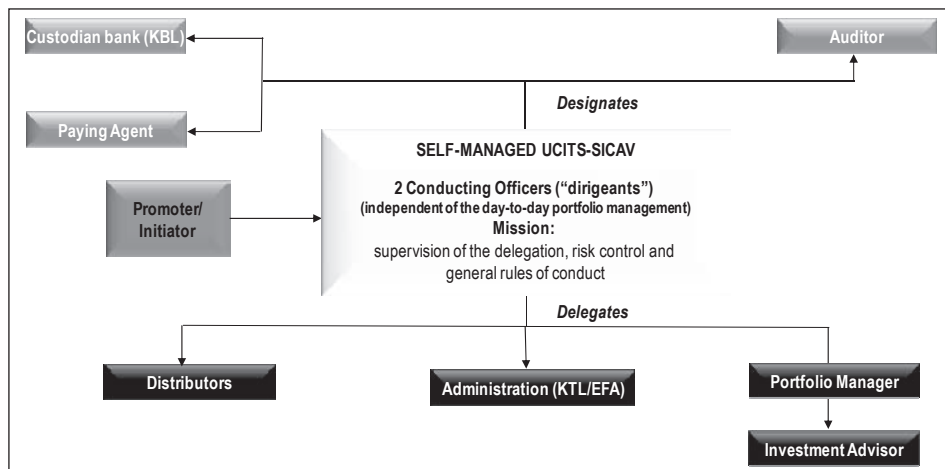


Table 1.3 – Self-managed SICAV under UCITS IV

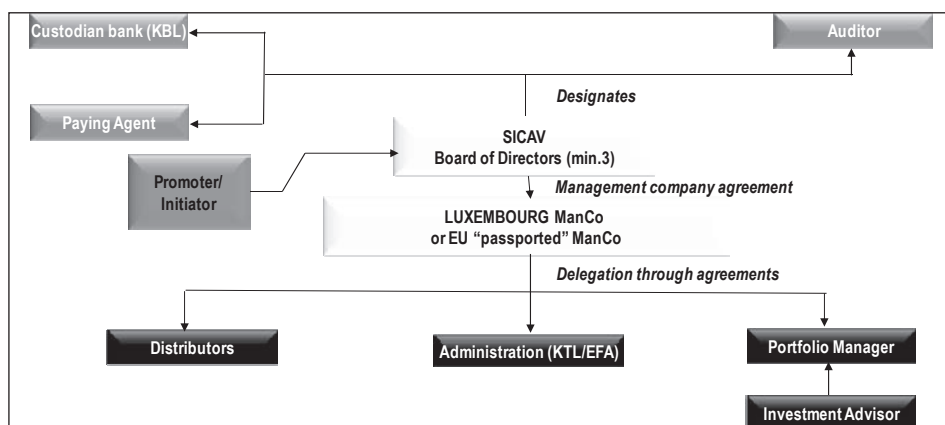


Table 1.4 – Designation of Luxembourg or EU ManCo

Table 1.5 briefly summarizes the regulatory requirements applicable to each UCITS management structure.

Requirements applicable		
Self-managed UCITS		<ul style="list-style-type: none"> • Legal form: S.A. (if SICAV) • Minimum capital of EUR 300,000 • Minimum 2 resident conducting officers (CO) with references, professional experience and respectability (possible derogation) • Possible delegation of some duties of the CO to third parties under their supervision • Appropriate internal control: <ul style="list-style-type: none"> – organizational procedures – risk management process – conflicts of interest – handling of complaints – ...
Third party ManCo	Luxembourg UCITS IV ManCo	<ul style="list-style-type: none"> • Management companies under Chapter 15 of the 2010 Law • Legal form: S.A., S.à R.L., S.C.A. • Registered shareholders • Min. capital of EUR 125,000 (+ share- holders' equity of 0.02% of the managed assets in the case those assets >EUR 250,000,000) – Max. capital of EUR 10 mn • Minimum 2 conducting officers (CO) with references, professional experience and respectability • Possible delegation of some duties of the CO to third parties under their supervision • Appropriate internal control: <ul style="list-style-type: none"> – organizational procedures – risk management process – conflicts of interest – handling of complaints – ...
	European 'passport' UCITS IV ManCo	<ul style="list-style-type: none"> • EU third country => ManCo passport introduced by UCITS IV

Table 1.5 – Possible UCITS structures

UCITS Products

UCITS funds are subject to strict rules in terms of investment, borrowing and diversification of risk. This section summarizes the main regulatory requirements for “*Long only plain vanilla*”-UCITS types:

- A UCITS must invest only in “Transferable Securities” such as listed equities, corporate bonds (incl. convertible bonds), government bonds and money market instruments and deposits. In addition, it must comply with the so-called 5/10/40 rule stating that:
 - A UCITS may invest only a maximum of 10% of its assets in one single security. In addition, for positions exceeding 5% of its assets, the aggregate has to be less than 40% of its assets.
- Money market funds: eligible money market instruments dealt on a regulated market or issued by regulated issuers
- Cash and deposits: a UCITS may not invest more than 20% of its net assets in deposits with the same credit institution. Bank deposits should be repayable on demand or have the right to be withdrawn and must reach maturity within 12 months
- Long only Index replicating funds: funds that seek to replicate the underlying investments of an equity or fixed income market index (20/35 rule)
- Funds of funds may invest only:
 - max. 20% in the same UCI or UCITS (per segregated sub-fund if target fund is an umbrella structure)
 - max. 30% in UCI other than UCITS
 - max. 25% of the capital of a UCI or UCITS (important influence on the management of an issuer)
 - max. 10% (in aggregate in the “trash ratio”) in a target fund that invests more than 10% of its assets in other funds (to avoid so-called “funds of funds”)

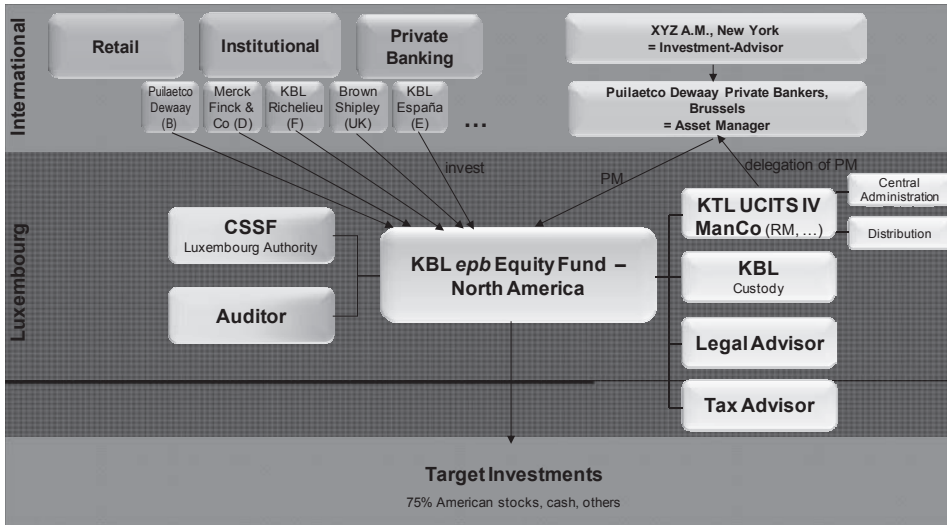


Table 1.6 – UCITS structure example

1.2.2 Professional Funds (AIFs)

AIFs legal environment

Unlike UCITS funds that can invest only in Transferable Securities and are subject to strict regulations, AIFs (Alternative Investment Funds) are subject to less regulations and can invest in a wider range of eligible investments (e.g. private equity, real estate...). These types of funds are marketed to only well-informed investors and are managed by entities called Alternative Investment Fund Managers (AIFM)

Luxembourg AIFs are currently regulated by the AIFM Law of 12 July 2013 (hereafter the 'Lux AIFM Law'), which transposes the European AIFM (Alternative Investment Fund Managers) Directive.

The European AIFM Directive was adopted in April 2009 and designed to introduce a harmonized European regulatory and supervisory framework for the alternative investment sector. In return for more regulation, the proposed Directive introduced 2 European passports:

- A “management passport” enabling AIFMs to offer their management services cross-border
- A “marketing passport” permitting them to market their Alternative Investment Funds (AIF) throughout the EU to professional investors

Unlike the UCITS Directive which is a Product Directive, the AIFMD is a Directive on Managers (AIFMs) and Products (AIFs).

The key objectives of the AIFM Directive are to:

- ensure that all AIFM are subject to appropriate authorization and registration requirements
- provide a framework for the enhanced monitoring of macro risks
- improve risk management and organizational safeguards at the individual AIFM level
- enhance investor protection
- develop a single market for AIFs

The Directive applies to:

- All AIFMs which are established within the EU regardless of where the AIFs that they manage are established - inside or outside the EU.
- All AIFMs established outside the EU (hereafter ‘Non-EU AIFMs’) if they manage AIFs established in the EU.

With its AIFM Law of 12 July 2013 (hereafter the ‘Lux AIFM Law’), Luxembourg implemented the AIFM Directive into national legislation. The Lux AIFM Law regulates the investment managers and indirectly almost all AIFs such as SIFs and SICARs.

The Lux AIFM Law applies to:

- All AIFMs established in Luxembourg and managing AIFs, irrespective of the country of origin of those AIFs (Lux, EU, third country), regulated or not, subject to exemptions or not
- All AIFMs that are established outside of Luxembourg (EU or Non-EU) that manage Luxembourg-based AIFs or market foreign AIFs to Luxembourg investors

Any legal person qualifying as AIFM (whose regular business is to manage one or more AIFs) must comply with the Lux AIFM Law unless that the AIFM is out of the scope of the Lux AIFM Law. AIFMs in scope of the Lux AIFM Law must apply for either an “*authorization*” from the CSSF or a simple “*registration*” with the CSSF if the AIFM falls within the exemptions set out by the law.

- AIFMs under “*authorization*” regime must comply with the full requirements of the Lux AIFM law relating to organizational structure, portfolio management, risk management policy, liquidity management, valuation & delegation, reporting to investors and to the CSSF, remuneration policy and conflicts of interest policy. In return for more regulation, AIFMs under “*authorization*” regime benefit from 2 passports – a “marketing passport” and a “management passport”.
- AIFMs under “*registration*” regime are subject to a lighter regime in terms of regulatory requirements. However, they do not benefit from

any distribution passport and can market their funds only under NPPR (National Private Placement Regimes). To benefit from the «registration» regime, the AIFM must fall within the following exemptions as provided by the Lux AIFM Law:

“intra group” exemption:

- AIFMs managing AIFs whose only investors are the managers themselves or their parent undertakings, their subsidiaries or other subsidiaries of their parent undertaking and where these investors are not themselves AIFs

“de minimis” exemption:

- AIFMs where the cumulative AuM, including any assets acquired through leverage, of the AIF under management fall below a threshold of EUR 100 mn, or
- AIFMs managing only unleveraged AIFs that do not grant investors redemption rights during a period of 5 years (following the date of the initial investment) where the cumulative AuM of the AIFs under management fall below a threshold of EUR 500 mn.

AIFMs that fall under one of the above mentioned exemptions could also ‘opt in’ for the authorization regime in order to benefit from the 2 passports.

AIFMs that no longer fall under one of the above mentioned exemptions need to apply for full authorization.

The AIFMD defines an AIF as a collective investment undertaking (i) that raises capital from a number of investors (ii) with a view to invest this capital in accordance with a defined investment policy for the benefit of those investors and, (iii) which is not a UCITS. Accordingly are out of scope of the Lux AIFM Law: single investor funds, holding companies, pension funds, securitization vehicles.

Table 1.7 presents the timeline of the implementation of the AIFMD

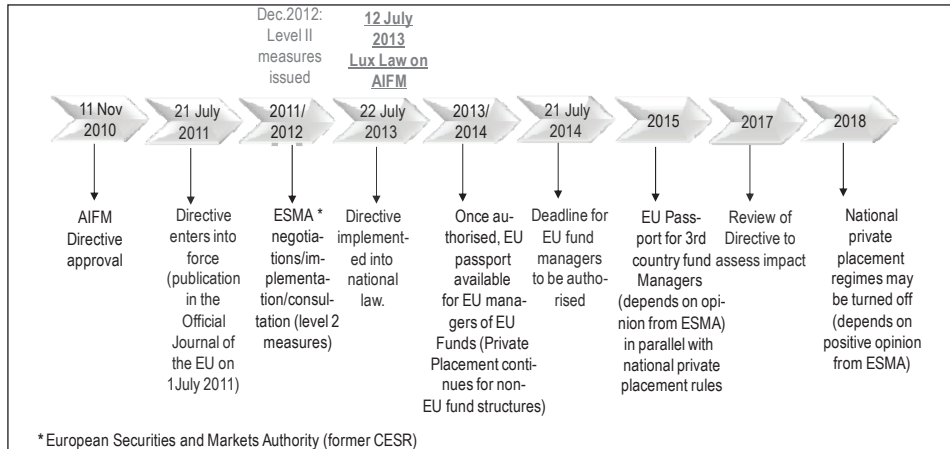


Table 1.7 – Timeline of the AIFMD

AIFs set up features

AIFs (SIF, SICAR) in scope of the Lux AIFM Law may either be:

- «externally managed» (see Table 1.9), which means the AIF appoints an external Lux (or EU) AIFM which is responsible for managing (portfolio management & risk management) the AIFs, or
- «internally managed» (see Table 1.8), which means the AIF itself is authorised as AIFM – where the legal form of the AIF permits internal management and where the AIF's governing body chooses not to appoint an external AIFM

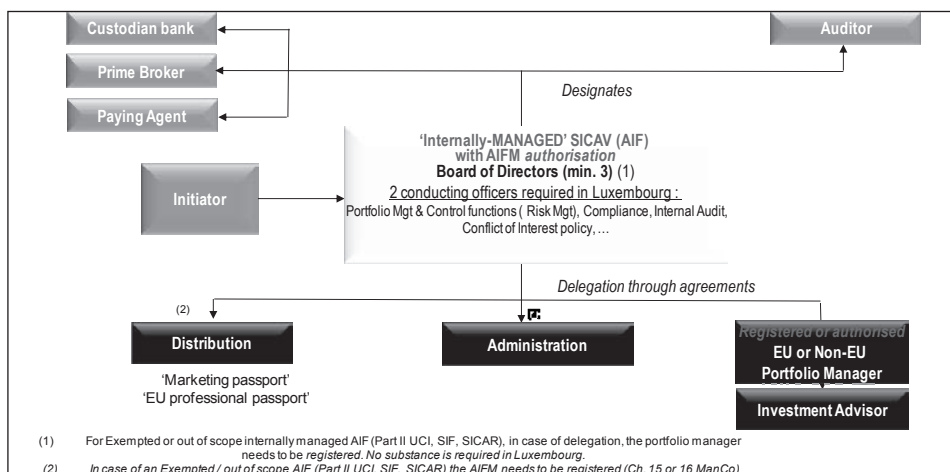


Table 1.8 – Internally managed AIF= AIF (SIF, SICAR) itself is authorised as AIFM

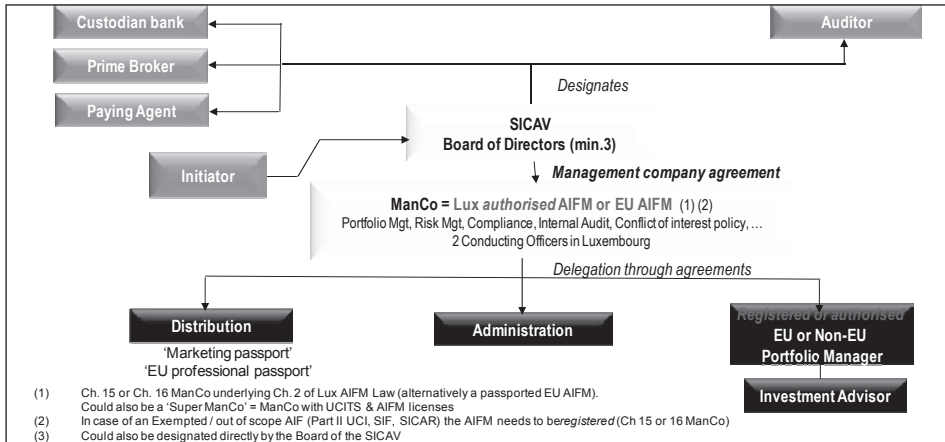


Table 1.9 – Externally managed AIF' = AIF (Part II UCI, SIF, SICAR) having designated an authorised AIFM

The distribution of both externally and internally managed AIFs (SIF, SICAR) depends on the regime governing the AIFM managing the fund:

- AIFs managed by AIFMs under “authorization” regime can be marketed in EU under the “marketing passport”
- AIFs managed by AIFMs under “registration” regime can be marketed only under NPPR (National Private Placement Regimes).

Table 1.10 summarizes the regimes governing AIFs under various situations:

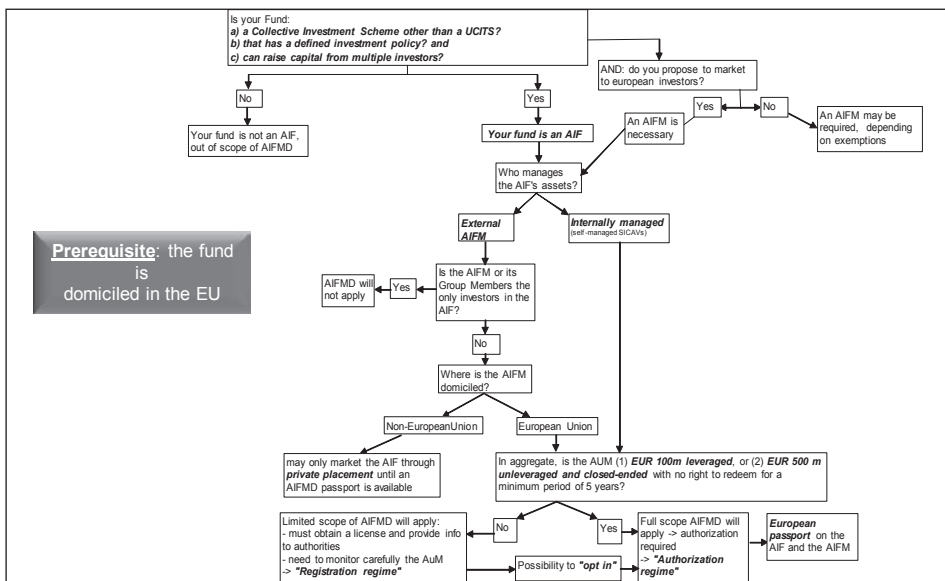


Table 1.10 – AIFs' regimes under various situations

Table 1.11 provides a comparison of the main features of the SIF and SICAR structures:

AIF SUPERVISED BY THE CSSF		SIF	SICAR
Laws & Circulars		Law of 13 February 2007 on Specialised Investment Funds as amended in July 2013	Law of 15 June 2004 on "Société d'Investissement en Capital à Risque" as amended in July 2013
Number of structures / sub funds		1,585 / 3,351	287 / 338
Type of Structure		Investment Fund	Investment Company / Vehicle set up as a fund
Legal forms		SICAV (S.A., S.C.A., S.à r.l., SCoSA, S.C.S., SCSp), FCP, SICAF	Corporate entity with fixed or variable share capital (S.A., S.C.A., S.à r.l., SCoSA, S.C.S., SCSp)
Targeted Investors and Type of distribution	"Out of (or limited) scope of AIFMD"	"Well-informed" (HNWI, professionals & institutionals), "Private Placement"	"Well-informed" (HNWI, professionals & institutionals) or persons involved in the management of the SICAR, "Private Placement"
	"In Scope of AIFMD"	"Professional passport"	"Professional passport"
Investment Strategies		All types of investment strategies as foreseen by CSSF Circular 07/309	Venture Capital and Private Equity investments only as stipulated in CSSF Circular 06/241
Risk diversification requirement		Yes - CSSF Circular 07/309 - 30% rule	Yes , if set up as an AIF
AIFM "substance" requirement	"Out of (or limited) scope of AIFMD"	SIF managed by a registered AIFM (internally managed, Ch. 15 or Ch. 16 ManCo)	SICAR managed by a registered AIFM (internally managed, Ch. 15 or Ch. 16 ManCo)
	"In Scope of AIFMD"	SIF managed by an authorized AIFM (internally managed, Ch. 15 or Ch. 16 ManCo with Ch. 2 Lux AIFM Law authorisation or EU passported AIFM)	SICAR managed by an authorized AIFM (internally managed, Ch. 15 or Ch. 16 ManCo with Ch. 2 Lux AIFM Law authorisation or EU passported AIFM)

Portfolio Management (PM) which is besides Risk Management (RM), one of the two core functions of an AIFM	"Out of (or limited) scope of AIFMD"	PM may be delegated to a EU or cooperating NON-EU registered AIFM (in Lux: Ch. 15 or Ch. 16 ManCo)	PM may be delegated to a EU or cooperating NON-EU registered AIFM (in Lux: Ch.15 or Ch. 16 ManCo)
	"In Scope of AIFMD"	PM may be delegated to a EU or cooperating NON-EU registered AIFM (in Lux: Ch. 15 or Ch. 16 ManCo)	PM may be delegated to a EU or cooperating NON-EU registered AIFM (in Lux: Ch.15 or Ch. 16 ManCo)
AIF SUPERVISED BY THE CSSF		SIF	SICAR
Service Providers (compulsory)		<ul style="list-style-type: none"> – Depositary & Central Administration established in Luxembourg – Auditor 	<ul style="list-style-type: none"> – Depositary & Central Administration established in Luxembourg – Auditor
Capital Requirement for fund / company	"Out of (or limited) scope of AIFMD" Registered AIFM	– EUR 1.25 mn within 12 months	– EUR 1 mn within 12 months
	"In Scope of AIFMD" authorised AIFM	<ul style="list-style-type: none"> – EUR 1.25 mn within 12 months – For internally-managed SICAV/ SICAF: EUR 0.3 mn at date of authorisation and EUR 1.25 mn within 6 months 	<ul style="list-style-type: none"> – EUR 1 mn within 12 months - For internally-managed SICAV/SICAF: EUR 0.3 mn at date of authorisation and EUR 1 mn within 12 months
NAV calculation frequency		Min. yearly	Usually at least yearly
Valuation principles		Valuation at "Fair Value" and in compliance with rules set out in constitutive documents	Valuation at "Fair Value" and in compliance with rules set out in constitutive documents
Accounting principles & Reportings		Lux GAAP or IFRS - Annual report	Lux GAAP or IFRS - Annual report

Table 1.11 – Overview of the Key Characteristics of the SIF and SICAR

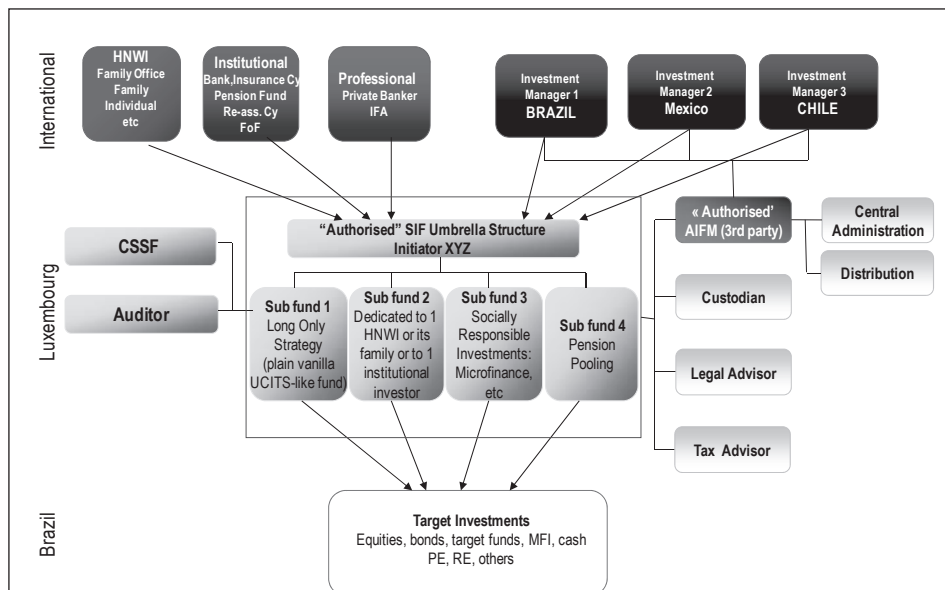


Table 1.12 – SIF structure – business case of a Brazilian asset manager

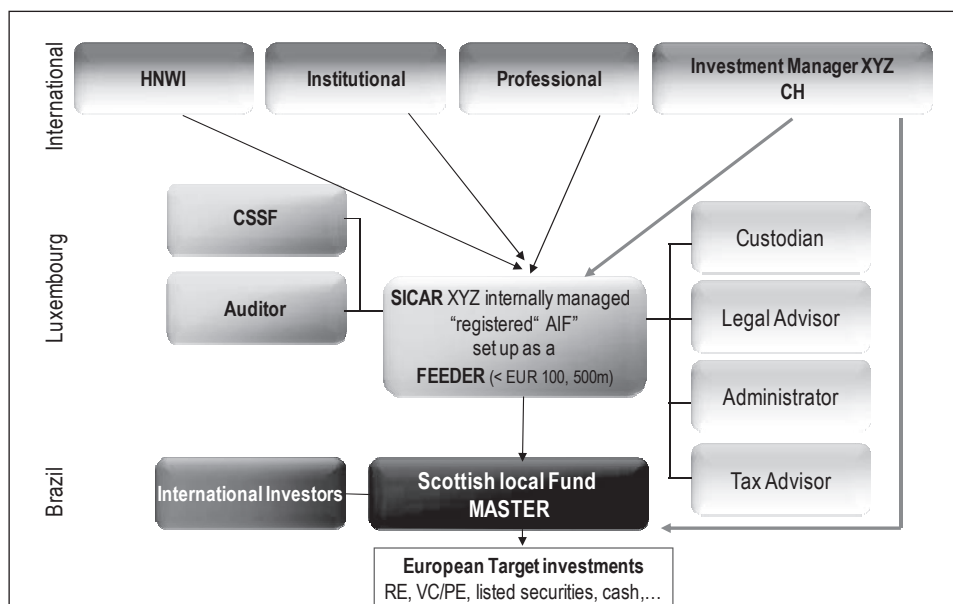


Table 1.13 – SICAR – "registered" master / feeder structure

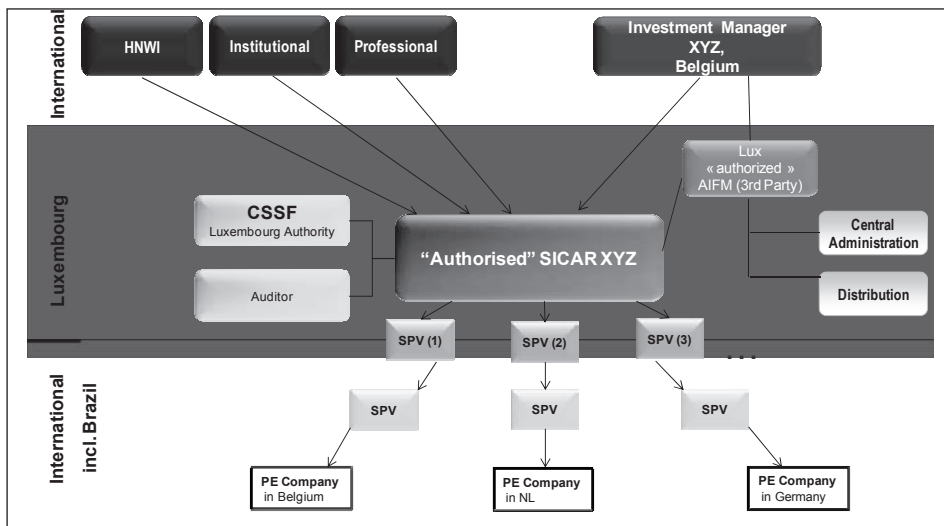


Table 1.14 – Example of a SICAR fund

1.3 Trends, Challenges and Opportunities

In addition to investment funds investing in traditional asset classes, new types of funds are currently discussed and set up in Luxembourg:

- SRI funds: Microfinance funds, New energy funds – renewable energy funds, ...
- Timberland funds (for example a fund investing in eucalyptus trees in Brazil)
- “Passion funds” (football player funds, wine funds, art funds...)
- Multi-manager funds
- Dedicated funds
- Re-domiciliation of Hedge Funds (HF) & Funds of Hedge Funds (FoHF)
- Master-Feeder Funds (UCITS or Alternative)
- ...

The implementation of the AIFMD represents both a challenge and an opportunity for alternative fund managers. On one hand, since the Directive has only recently been implemented into Luxembourg law (July 2013), its requirements have a significant impact on the day to day business of fund managers. On the other hand, with its passports, it opens for fund managers new markets and new opportunities.

1.4 *Conclusion*

As a conclusion, Luxembourg provides a wide range of investment funds (UCITS, SIF, SICAR, ...) suited to every type of investors' profile. To know what vehicle best fits, it usually comes down to answer two questions: (1) who are the targeted investors? (2) which target investments?. Among fund structures available in Luxembourg, The SIF is currently the vehicle with the highest growth. This is mainly due to its flexibility with respect to the eligible investment assets and a lighter supervisory regime. Because of these advantages, SIF is the vehicle the most used for alternative strategies (hedge funds, real estate funds, VC/PE funds, SRI funds, ...). After the success of the European passport for «plain vanilla» funds (UCITS), the passport for alternative products is currently tested and expected to become also a great success.

2. Set-up and legal life of the UCI

2.1 Introduction

The first chapter focused on the legal framework within which funds must operate in Luxembourg and more broadly at European level. We now concentrate on the legal requirements related to the inception and management of a UCI over its life cycle.

In the first part of this chapter, we present the necessary procedures and players in the set-up of an investment fund in Luxembourg. More precisely, we explain the role of the promoter, service providers, required documents and agreements. The second part of the chapter lists several events which may happen during the life of an investment fund and their legal implications.

2.2 Part I: Set-up of the UCI

2.2.1 The promoter of a UCI¹: concept

The CSSF considers the promoter of an investment fund as being "the person or the entity who initiates the set-up of the fund, who has an interest in its creation, and determines the conduct of its activity²".

The concept of promoter has evolved over the last years.

Initially, it only applied to UCITS and to funds subject to Part II of the Law of 17 December 2010 ("**Part II Funds**") but not to SIFs and SICARs, which could therefore be launched with no promoter.

Issue of CSSF Circular 12/546, UCITS and UCITS management companies (management companies are hereafter referred to as "**Mancos**") which fulfilled the requirements provided by that Circular were released from their obligation to have a promoter³. UCITS and UCITS Mancos were obliged to comply with the Circular by 30 June 2013 at the latest. Similarly, the CSSF has released those Part II funds which have designated a compliant UCITS Manco from the obligation to have a promoter.

1. UCI as used in this Section refers to UCITS, Part II Funds as well as to any other undertakings for collective investments.

2. CSSF Application Form to set-up a UCITS or a Part II Fund, as published on the CSSF website.

3. Although the CSSF clearly confirms abolishing the promoter concept for UCITS and UCITS management companies, it nevertheless retains the possibility, in certain circumstances, to require the issue of a "sponsorship letter" (*lettre de patronage*) whereby its issuer undertakes to the CSSF that the sponsored entity (namely the ManCo or the self-managed UCITS) complies/will comply with the prudential requirements imposed by the applicable law, particularly (but not only) regarding the ManCo's own funds requirements for the ManCo to have appropriate financial means (*solidité financière*).

The description below therefore only applies to Part II Funds which have not designated a UCITS Manco.

The existence of a promoter ensures the protection of investors notably in case of errors in Net Asset Value ("NAV") calculations and in case of corrections resulting from non-compliance with the investment rules applicable to UCIs. In particular, it is the responsibility of the UCIs' promoters to ensure that any errors are correctly dealt with in the strictest compliance with the rules of conduct specified in this circular.

During the approval procedure by the CSSF, UCIs are required to submit a file to the CSSF containing, among other things, information about the promoter, such as its recent financial reports. Due to the promoter's key implication in the creation and management of the Part II Funds, the CSSF considers that the promoter assumes a specific liability. The promoter is therefore responsible for the general organization and supervision of the activities of the Part II Fund in order to assure its proper functioning. As a consequence, although the law does not comprise any specific reference to the role, duties and liabilities of the promoter, the CSSF considers that the promoter is to be held ultimately liable for loss resulting from possible failures, irregularities or insufficiencies identified in the management and the administration of the Part II Fund, it being understood that the promoter can always take action against the final responsible third parties. In light of the promoter's role, the CSSF generally requires the promoter to have a majority representation on the management body of the UCI. The Law of 17 December 2010 further states that, in order to receive approval, the directors of the Part II Funds and of the depositary must be of sufficiently good repute and have sufficient experience in relation to the type of Part II Fund concerned. To that end, the names of the directors and of every person succeeding them in office must be communicated immediately to the CSSF. Directors shall mean those persons who, under the law or the constitutional documents, represent the Part II Fund or the depositary or who effectively determine the conduct of the activities of the UCI. Emphasis is placed on the reputation and on the qualifications of "Directors" to prevent any unfavorable situations for the investors and the Luxembourg financial centre. Sovereign decision rests with the CSSF.

In order to be approved by the CSSF, the promoter must fulfil three conditions, namely: (i) to be a regulated entity, (ii) to be of good repute and have sufficient expertise and (iii) to have sufficient financial resources. In general, minimum own funds of about €7.5 million are required. If the main promoter has insufficient resources, it can request the support of a so-called co-promoter, such as a banking institution which will have similar responsibilities to those of the main promoter.

2.2.2 The incorporation documents

Regarding the incorporation documents for investment funds, a distinction can be made between two forms of investment funds:

- First, mutual fund (or "FCP", *Fonds Commun de Placement*), which is a UCI under a contractual form without any legal personality; and
- the SICAV (*Société d'Investissement à Capital Variable*) and the SICAF (*Société d'Investissement à Capital Fixe*) which are investment companies with legal personality.

An FCP is managed by a ManCo. The management regulations determine the rules of the FCP and the relationship between the ManCo and the unitholders. These unitholders adhere to the management regulations through their subscriptions. The ManCo represents the community of the unitholders. Usually, the management regulations are countersigned and may not be modified without the prior consent of the depositary. Indeed, according to Art. 18 of the Law of 17 December 2010, the depositary of the FCP must "ensure that the sale, issue, redemption and cancellation of units effected on behalf of the mutual fund or by the management company are carried out in accordance with the law and the management regulations, ensure that the value of units is calculated in accordance with the law and the management regulations, carry out the instructions of the management company, unless they conflict with the law or the management regulations, [...], ensure that the income of the mutual fund is applied in accordance with the management regulations".

The second case is the In the case of a SICAV/SICAF⁴, the incorporation is done through a notarial deed establishing the characteristics and the standard rules of the UCI.

	FCP Management Regulations	SICAV Articles of Incorporation
Denomination	X	X
Duration	X	X
Investment Policy	X	
Investment Restrictions	X	X
Distribution Policy	X	
Management Company Fees	X	
Other Fees	X	X

⁴ The requirements regarding the content of the articles of incorporation of a SICAV and a SIVAF differ. These differences are not highlighted in this Section.

Public nature	X	X
Accounting year	X	X
Procedure and condition for a liquidation	X	X
Procedure and condition for a modification of the incorporation documents	X	X
Procedure and condition of the issue of the shares/units	X	X
Procedure and condition of the redemption of the shares/units	X	X
Rules for the valuation of the assets	X	X
Reference currency	X	X
Specific information relating to the sub-funds	X	X
Segregation of the sub-funds	X	X

Table 2.1 – Incorporation document: FCP vs. SICAV

Note that the lists reported in Table 2.1 are not meant to be exhaustive. Art. 13 of the Law of 17 December 2010 enumerates the mandatory elements that the incorporation document of an FCP must contain:

- Denominations of the mutual fund, the ManCo and the depositary bank
- The duration of the fund together with its investment policy⁵
- The distribution policy consistent with Art. 16
- Expenses and fees that the ManCo is allowed to charge to the mutual fund under management and the method of calculation of those elements
- Provisions regarding fund advertising
- The closing date for the mutual fund accounting year
- Provisions in the event of dissolution
- Provisions regarding the modification of the management agreement
- Policy for the issue of shares
- Provisions regarding share redemption and conditions under which redemption can be carried out or suspended⁶

One can notice that there is no specific provision in the law concerning the rules for valuation of assets, the reference currency or information pertaining

5. The investment policy must be consistent with the goals set by the fund.

6. Note that this provision does not apply to Part II Funds even though it could.

to sub-funds segregation. It is customary, however, for such elements to appear in incorporation documents.

2.2.3 *The sale documents*

Subscriptions are not valid unless made on the basis of (i) the prospectus in force and (ii) the most recent annual report and by the most recent half-yearly report if the latter is published after the most recent annual report.

The Law of 17 December 2010 (Art. 151) stipulates that “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 risks attached thereto”. Necessary information includes (without limitation) the UCI structure, the investment policy and restrictions, the fees, the profile of the typical investor, the type of shares, the directors and the liquidation and merging rules.

The prospectus must also indicate the risk profile of the UCI as well as information on the service providers and taxes which are applicable to the fund.

In addition, UCITS are required to provide their investors with a Key Investor Information Document ("**KIID**"). The KIID is a synthetic and standardised document giving investors key information on investment funds in terms of objectives, risks, performance and costs so that they are able to understand the nature and risks related to the funds that are offered to them and hence take well-advised investment decisions. This document replaces the simplified prospectus for all UCITS funds.

Key Investor Information

This document provides you with key investor information about this fund. It is not marketing material. The information is required by law to help you understand the nature and the risks of investing in this fund. You are advised to read it so you can make an informed decision about whether to invest.

123 Fund, a sub-fund of ABC Fund SICAV (ISIN: 4321)

This fund is managed by ABC Fund Managers Ltd, part of the XYZ group of companies

Objectives and Investment Policy

Joint description of the objectives and policy of the UCITS in plain language (it is suggested not to copy-out the prospectus)

Essential features of the product which a typical investor should know:

- main categories of eligible financial instruments that are the object of investment
- a statement that the investor may redeem units on demand, and how frequently units are dealt in
- whether the UCITS has a particular target in relation to any industrial, geographic or other market sectors or specific classes of assets
- whether discretionary choices regarding particular investments are allowed, and whether the fund refers to a benchmark and if so which one
- a statement of whether any income arising from the fund is distributed or reinvested

Other information if relevant, such as:

- what type of debt securities the UCITS invests in
- information regarding any pre-determined pay off and the factors expected to determine performance
- if choice of assets is guided by growth, value or high dividends
- how use of hedging / arbitrage / leverage techniques may determine the fund's performance
- that portfolio transaction costs will have a material impact on performance
- minimum recommended holding term

Risk and Reward Profile

Lower risk Higher risk

←————→

Typically lower rewards Typically higher rewards

1	2	3	4	5	6	7
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Narrative explanation of the indicator and its main limitations:

- Historical data may not be a reliable indicator for the future
- Risk category shown is not guaranteed and may shift over time
- The lowest category does not mean 'risk free'
- Why the fund is in its specific category
- Details of nature, timing and extent of any capital guarantee or protection

Narrative presentation of risks materially relevant to the fund which are not adequately captured by the indicator:

- Credit risk, where a significant level of investment is made in debt securities
- Liquidity risk, where a significant level of investment is made in financial instruments that are likely to have a low level of liquidity in some circumstances
- Counterparty risk, where a fund is backed by a guarantee from, or has material investment exposure through contracts with, a third party
- Operational risks including safekeeping of assets
- Impact of any techniques such as derivative contracts

Charges for this Fund	
<p>The charges you pay are used to pay the costs of running the fund, including the costs of marketing and distributing it. These charges reduce the potential growth of your investment.</p>	
One-off charges taken before or after you invest	
Entry charge	□%
Exit charge	□%
<p>This is the maximum that might be taken out of your money [before it is invested] [before the proceeds of your investment are paid out].</p>	
Charges taken from the fund over a year	
Ongoing charges	□%
Charges taken from the fund under certain specific conditions	
Performance fee	□% a year of any returns the fund achieves above the benchmark for these fees, [insert name of benchmark].

The **entry** and **exit charges** shown are maximum figures. In some cases you might pay less - you can find out from your financial adviser.

The **ongoing charges** figure is based on expenses for the year ending □. This figure may vary from year to year. It excludes:

- Performance fees
- Portfolio transaction costs, except in the case of an entry/exit charge paid by the UCITS when buying or selling units in another collective investment undertaking

For more information about charges, please [see pages x to x / section x] of the fund's prospectus, which is available at www.ucitsfund/prospectus

Past Performance	
	<p>The chart will be supplemented with prominent statements which:</p> <ul style="list-style-type: none"> warn about its limited value as a guide to future performance indicate briefly which charges have been included or excluded state the year when the fund started to issue units indicate the currency in which past performance has been calculated.

Practical Information
<ul style="list-style-type: none"> Name of the depositary Where and how to obtain further information about the UCITS (prospectus, reports & accounts) Where and how to obtain other practical information (e.g. where to find latest unit prices) A statement that tax legislation of the fund's Home State may have an impact on the personal tax position of the investor A statement that "[Name of management company] may be held liable solely on the basis of any statement contained in this document that is misleading, inaccurate or inconsistent with the relevant parts of the prospectus for the fund" Specific information relating to umbrella funds (e.g. any switching rights between sub-funds) Information about other share classes, if applicable (KII may be based on a representative class)
<p>This fund is authorised in [name of Member State] and regulated by [identity of competent authority]. [Name of management company] is authorised in [name of Member state] on and regulated by [identity competent authority].]</p> <p>This key investor information is accurate as at [the date of publication].</p>

Table 2.2 – ESMA template of Key Investor Information Document

Regarding risk management, UCITS must employ a Risk Management ("RM") process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio; it must employ a process for accurate and independent assessment of the value of Over-The-Counter (OTC) derivative instruments. It must communicate to the CSSF regularly and in accordance with the detailed rules, as defined by the CSSF, the types of derivative instruments, the underlying risks, the quantitative limits and the methods which are chosen in order to estimate the risks associated with transactions in derivative instruments. In addition, a UCITS shall ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio. RM may differ from one fund to another and may involve the commitment approach or Value-at-Risk (VaR).

2.2.4 Public nature of the sale and incorporation documents

Regarding the publication of documents related to an investment fund in Luxembourg, the Law of 17 December 2010 imposes several requirements. First, the prospectus and the latest published annual and semi-annual reports must be available for consultation (the prospectus shall be available in a durable medium or by means of a website and the annual and semi-annual reports must be available to the public in the manner specified in the prospectus) and sent to subscribers free of charge upon their request. In addition, UCITS are required to submit a KIID to their investors prior to their subscription.

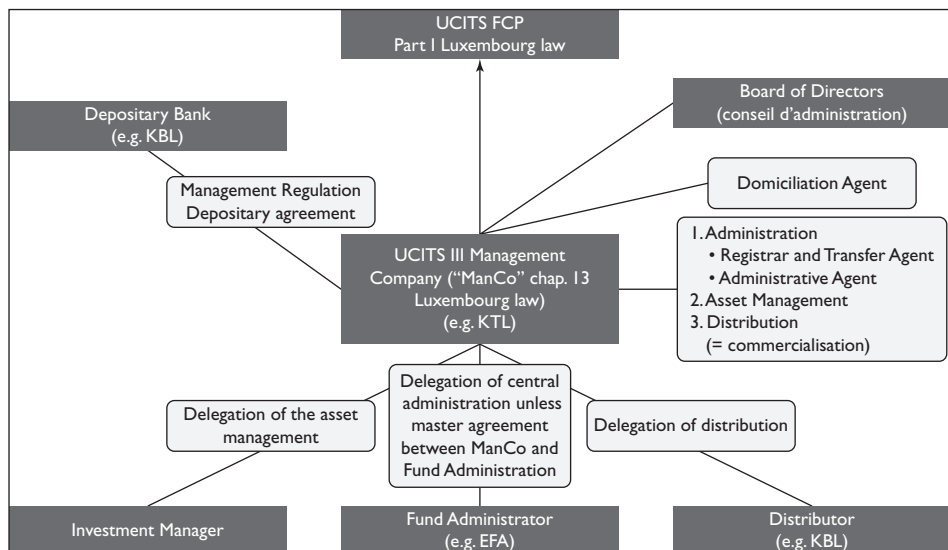


Table 2.3 – Service providers of mutual funds (FCP)

In this respect, the question arises whether the documents mentioned previously must, before the conclusion of the contract, be supplied to the subscriber only upon his request or whether they must be supplied in any event in the absence of such a request. The CSSF considers that the subscription contract may be entered into without the subscriber having actually looked at, or even received, a copy of the prospectus and periodical reports, provided these documents had been offered to him in the prescribed manner. This means the Law does not require the subscription form being attached to the prospectus and that it may be attached to a brief information brochure which includes the offer to subscribers to obtain the prospectus and the periodical reports. In any case, the KIID needs to be provided to investors prior to their subscription.

2.2.5 *Inscription on the official CSSF UCI list*

UCIs must, in order to carry out their activities, be previously authorised by the CSSF. Authorised UCIs shall be registered by the CSSF on an official list. Such registration shall be notified by the CSSF to the UCI concerned. For the UCIs referred to in Art. 2 and 87 of the Law of 17 December 2010, applications for entry on the list must be filed with the CSSF within the month following their constitution or formation. The said list and any amendments thereto shall be published in the “Mémorial” by the CSSF. The inscription and the maintaining on the list referred to above shall be subject to observance of all the provisions of laws, regulations or agreements relating to the organisation and operation of UCIs and the distribution, placing or sale of their units.

2.3 *Part II: Legal life of the UCI*

2.3.1 *Director and conducting officer: concept*

The management and direction apparatus of a UCI includes:

- in the case of a SICAV/SICAF managed by a management company: the board of directors of the ManCo and its conducting officers⁷;
- in the case a self-managed SICAV: the board of directors of the SICAV and its conducting officers;
- in the case of an FCP: the board of directors of the ManCo and its conducting officers.

The management and direction apparatus decides and acts exclusively in the interests of the SICAV or of the unitholders of the FCP within the purpose of the UCI i.e. it acts with due skill, care and diligence, in the best interests of its

7. In this case, the board of directors of the SICAV/SICAF will supervise the functions delegated to the Manco.

clients and the integrity of the market. The directors are held responsible for their management and should act as *pater familias* i.e. with the care, diligence and skill that a reasonable person would exercise in comparable circumstances. For instance, they should guarantee the accuracy of the prospectus disclosures and the suitability of entering into the various agreements and of the relevant investments. The directors are responsible toward the company, the investors and, to a certain extent, third parties and the responsibility of the board of directors is at the same time personal and collegial. They receive a discharge from the shareholders during the annual general meeting. The directors are also legally responsible in the event, for instance, of a breach of trust, use of forgeries or absence of submission of the annual report.

2.3.2 Modification of the incorporation documents of the UCI

For a SICAV/SICAF, the law on commercial companies (Law of 10 August 1915) applies to the modification of the incorporation documents. The modification of the incorporation documents is decided during an extraordinary general meeting ("EGM"). The majority requirement during the first EGM is at least 2/3 of casting votes provided a quorum of 50% is reached⁸. Otherwise, there is a second EGM without any required quorum and with a majority of at least 2/3 of casting votes. The agenda of the EGM must contain *inter alia* the listing of proposed changes (or the entire text of the changes relating to the object or the form of the company). In addition, the convening notice to the second EGM (if any) shall include the result and date of the first EGM and the date of the second EGM.

For FCPs, the procedure is somewhat different since unitholders of an FCP do not (normally) have any decision rights unless stated in the management regulations. The procedure can be specified in the management regulations.

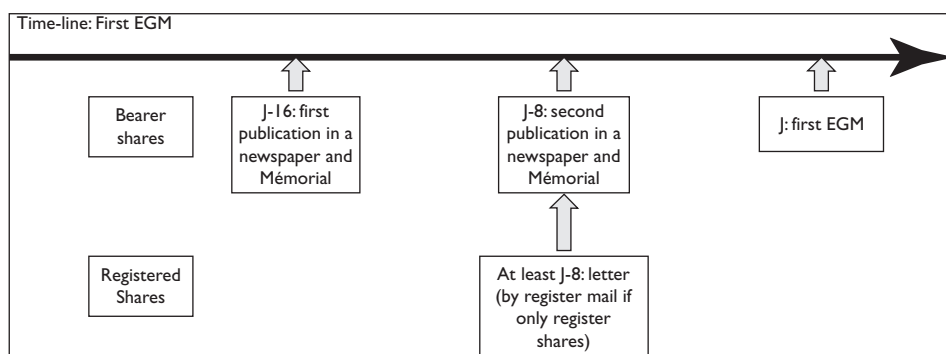


Table 2.4 – Timeline for the first EGM

8. The majority requirements are increased in the case of a change of nationality of the company and of an increase of the commitments of the existing shareholders: the unanimous consent of the shareholders is required.

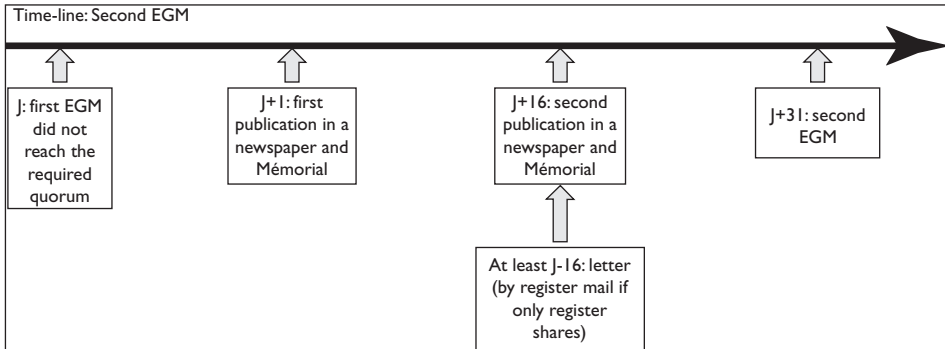


Table 2.5 – Timeline for the second EGM

2.3.3 *Modification of the sale documents of the UCI*

Several reasons may motivate the decision to modify the sale documents of a UCI. Such reasons may be the update of general information, the modification of the investment policy, the change of service providers, the fee structure or the launch of a new sub-fund. These modifications may or may not have an impact on the incorporation documents and may be decided by the board of directors or (if they affect the articles of incorporation of the SICAV), during an extraordinary general meeting. These modifications result in the issue of a new prospectus or of an addendum. These changes need to be approved by the CSSF which should be provided with a draft of the prospectus or addendum, the agreement, the notice to shareholders and the revised draft articles of incorporation (should the change require an amendment to the articles of incorporation). The CSSF may approve orally or in writing (for changes in the incorporation documents, merger of sub-funds and new sub-funds) or reply with feedback and comments.

2.3.4 *The board of directors and general meeting of the UCI*

At least one general meeting must be held each year within the municipality and on the day and time indicated in the articles of incorporation. It must take place no more than 6 months after the end of the financial year and the first Annual General Meeting ("AGM") can be held 18 months after incorporation.

The general meeting of shareholders shall have the widest powers to adopt or ratify any action relating to the company such as the nomination, discharge and removal of the directors or the auditors and the approval of annual accounts. The agenda of the AGM must contain the approval of the reports of the board of directors and the independent auditor of the UCI, the approval of the annual accounts accounting year-end and the allocation of the results, the discharge to

be granted to the directors and the statutory appointments. Physical participation at the AGM is exceptional and normally shareholders delegate a proxy to represent their interest.

The board of directors is composed of members whose terms of office range from one to six years with the possibility of an unlimited number of renewals. It is composed of physical persons and of companies which appoint a representative for the board meetings. The board of directors of a UCI is responsible for the fund's management and the fact that a UCI has appointed a Manco or not has no impact on the liability of the UCI's board which remains liable for the supervision and the coordination of the delegated functions.

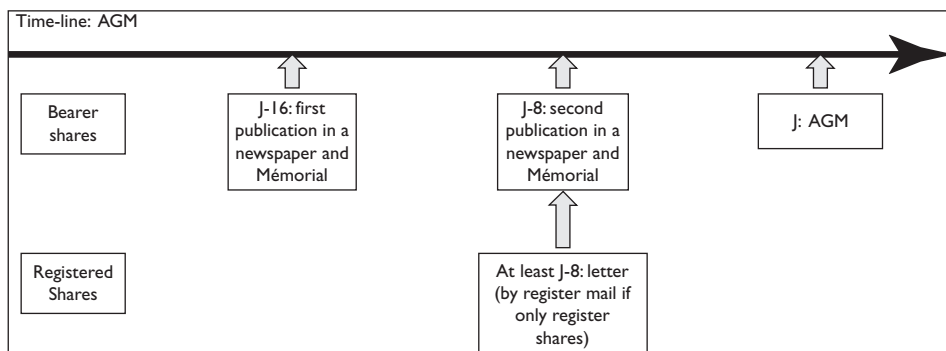


Table 2.6 – Timeline of the Annual General Meeting

Unless otherwise provided for in the articles of incorporation of the SICAV/ SICAF, the majority rule of the board meeting is 50% of the directors present or represented with a quorum of 50%. Physical meetings as well as videoconference or conference call can be used for the board meeting as long as they are provided for in the incorporation documents.

2.3.5 *Legal life events*

Several legal events may happen during a fund's life. These could be the replacement of one of the directors because of the end of his term of office, his death, his removal or resignation or the dissolution of the company, to name a few. There must be at least three directors and the nomination of a new director is subject to CSSF approval. The nomination usually takes place at the annual general meeting. Auditors may also be subject to changes during the life of an investment fund and also need CSSF approval.

Another legal life event of investment funds is the publication of the financial reports. The annual accounts require the approval of the annual general meeting.

3. Fund administration

3.1 *Introduction*

The previous chapter covered the legal requirements involved in the set up and management of the UCI during its legal life. We now focus on one of the core operational functions in a fund: *fund administration*. Efficient fund administration allows funds to operate smoothly and to interact properly with the other intervening parties in the life of a fund as well as to provide services to the fund's investors. The activities covered under the general heading of fund administration range from essential activities – interrelating for example with the asset management function, providing fund valuation, accounting and bookkeeping services or processing shareholder transactions to more value-added services in the field of Risk Management and distribution support.

3.2 *Overview of fund administration*

3.2.1 *Intervening parties in investment funds*

The intervening parties in an investment fund can be split into two parts regarding their respective roles and responsibilities. On the one hand, core control functions lie with the board of directors and the management company. They are responsible for, among other things, the monitoring in terms of risk management and compliance, as well as asset management, fund administration and distribution. Even though they are responsible for the overall functioning of the fund and for investor protection, they may delegate certain functions to external intervening parties. The depositary bank has an independent controlling and supervisory function on the assets of the investment fund and also on such aspects as investment restrictions breaches or the accuracy of the NAV calculation and the subscription and redemption process. On the other hand, the executing functions include the asset managers who manage the fund in accordance with the investment policy defined in the prospectus in terms of the specific assets in the portfolio, the custodian bank whose function is to process the investment transactions and to keep the assets of the investment fund (safekeeping function) and fund administration i.e. fund accounting and transfer agency.

Under UCITS legislation, the primary functions of fund administration are defined as follows: The accounts of an investment fund are kept in such a way that all assets and liabilities can be immediately identified and correctly valued. Accounting policy and procedure have to be in line with accounting standards of the Member State of origin of the fund so as to allow the precise calculation of the Net Asset Value (NAV) as well as the correct execution of subscription

and redemption orders based on such NAV. These requirements can be summarized as in Table 3.2 where the first part about NAV calculation refers to the accounting function of fund administration and the last part about subscriptions and redemptions refers to transfer agency.

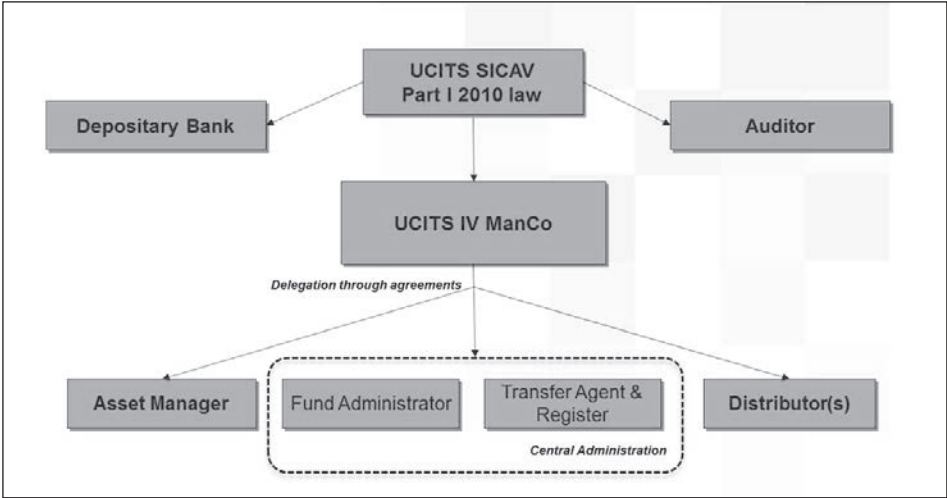


Table 3.1 – Overview of intervening parties in an investment fund (UCITS type)

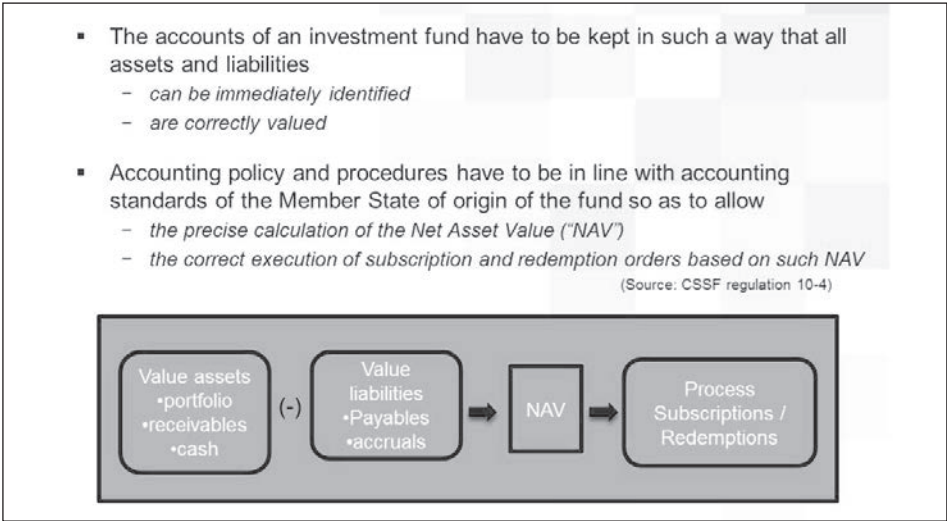


Table 3.2 – Primary functions of fund administration

3.2.2 Fund administration scope

In the previous section, we have highlighted two main functions of fund administration i.e. NAV calculation and subscriptions/redemptions execution. However, the roles of fund administration are not confined to passive bookkeeping and processing of investor transactions. Indeed, fund administration also provides so called value added services. The scope of fund administration effectively includes among other services risk management, compliance support, performance measurement and attribution, reporting, etc. Table 3.3 gives an idea of the variety of core and value-added services that fall under the generic term of fund administration). All these services typically translate into a complete service offering for all potential types of funds involving of course fund accounting services such as NAV calculation, reporting or trade management, transfer agency services such as the processing of subscription and redemption orders or distribution support as well as add-on services such as compliance or valuation services.

Fund Administration ... not just accounting / subscriptions & redemptions

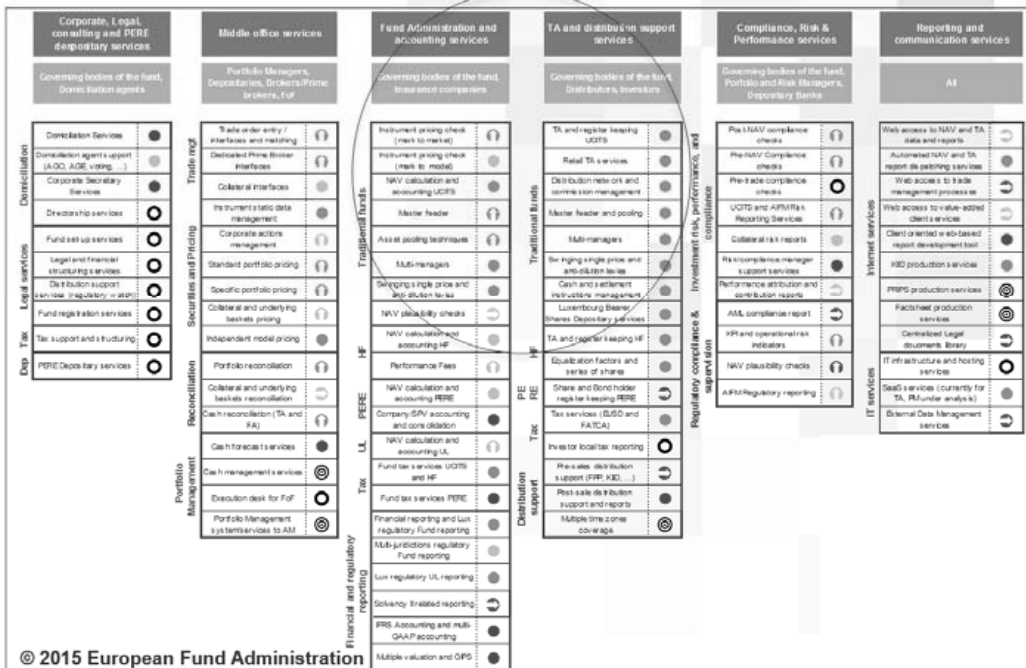


Table 3.3 – Scope of fund administration

The fund administration company is interconnected with the different players (portfolio managers, brokers, distributors and custodian banks and is at the

center of all information flows coming from and going to all intervening parties in the operational life of an investment fund.

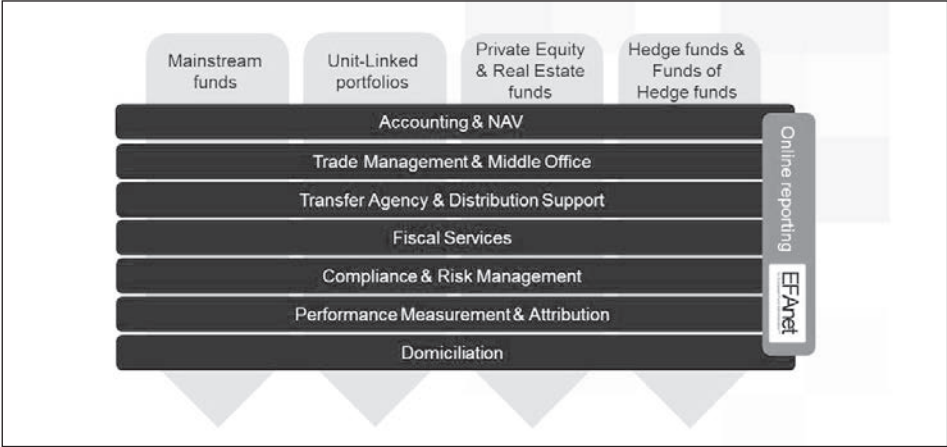


Table 3.4 – Example of a complete service offering

3.2.3 *Emergence of the outsourcing model*

Outsourcing allows a company to delegate some activities (which are not strategic or core) to an external specialized company. Fund administration is typically a complex function which requires a critical size and which, as a consequence, is frequently outsourced and delegated to companies whose business focus is fund accounting and transfer agency. Two other concepts which are growing in importance are offshoring and smart-sourcing which refer to finding domiciles which are relatively cheap (for instance in terms of labor costs) to outsource part of the manufacturing process.

Functionality	+	Service Quality	+	Technology	+	Cost	=	Outsourcing
---------------	---	-----------------	---	------------	---	------	---	-------------

Table 3.5 – The outsourcing equation

3.3 *Fund accounting*

3.3.1 *Fund accounting process*

Fund accounting can be broadly defined as the calculation of the Net Asset Value and price per share of an investment fund. Though it may seem relatively straightforward to understand the principle, it is the result of a complex and

highly integrated process. The frequency of the fund valuation is determined by the level of liquidity that the investment fund wishes to provide: i.e. in a daily fund, investors can subscribe and redeem on a daily basis whereas in a monthly fund, investors can only enter or leave the fund once a month on the valuation day.

The main part of the NAV of an investment fund is typically determined by the value of the securities portfolio while the remaining part of the NAV is composed of receivables, payables, bank accounts, etc.

A fund is typically composed of multiple share classes which may differ for example in their dividend distribution policy. Distributing funds offer a recurring dividend while capital gains and income are accumulated in the NAV price in accumulation funds and not distributed on a regular basis. Share classes can also differ with regard to the characteristics of the target investor (retail or institutional) translating into different management fees and commission structures. A further important feature may be share class hedging for currency exposure as an example.

Statement of valuation (in EUR)

Sample Fund
NAV date

Reports generated by EFA

Tel.: (352) 48 48 80 200

e-mail: efanet@efa.eu

The Finished Product

EFA

Designation	Cash/currency instr.	Cost	Valuation	accrued interests	% NAV -1	% NAV
Securities portfolio		374 333 204.99	413 973 565.92	5 483 359.87	-0.47 %	99.56 %
Futures		0.00	75 774.43	0.00	166.73 %	0.02 %
Receivable dividends		151 066.16	150 782.72	0.00	-0.65 %	0.02 %
Margins paid		- 75 885.72	- 75 774.43	0.00	-166.73 %	-0.01 %
Regularisation account		748.41	748.41	0.00	0.00 %	0.00 %
Commission payable		- 1 198 371.98	- 1 198 371.98	0.00	-1.05 %	-0.27 %
Fees payable		- 2 924.73	- 2 924.73	0.00	-1.09 %	0.00 %
Taxes payable		- 1 372.35	- 1 372.35	0.00	0.00 %	0.00 %
Matured fees payable		- 3 734.36	- 3 734.36	0.00	0.00 %	0.00 %
Matured taxes payable		- 370.80	- 370.80	0.00	0.00 %	0.00 %
Guarantee deposits		1 687 535.48	1 700 770.99	0.00	-0.55 %	0.40 %
Current bank accounts	EUR	- 8 221 555.34	- 8 221 555.34	- 4 241.01	-10.92 %	-1.94 %
	GBP	410 598.24	475 534.43	77.19	-1.30 %	0.11 %
	SGD	- 1 241 648.30	- 729 791.20	- 725 381.45	0.60 %	-0.16 %
	USD	12 689 565.22	9 379 293.55	9 553 556.65	-0.98 %	2.27 %
					0.00 %	
NET ASSETS		375 794 376.54	416 702 002.05	5 479 196.05		100.00 %

Data per class of share

	Net assets per share class	Number of shares outstanding	Number of shares subscribed	Number of shares repurchased	Change in shares outstanding	Curr. ency	NAV per share 12/31/2018	NAV per share 12/30/2019	Change in NAV per share	Change in %	Subscription price	Redemption price	% Net assets per share class
class A (Dist.)	10 268 552.80	12 671 080	36 000	0.000	36 000	EUR	810.39	814.10	-3.71	-0.46 %	850.91	810.39	2.44 %
class B (Cap.)	408 882 334.63	298 648 614	131 413	889 738	- 728 325	EUR	1 368.19	1 374.45	-6.26	-0.46 %	1 426.60	1 368.19	97.08 %
Class C (Cap.)	2 030 310.67	20 005 294	-	-	-	EUR	101.49	101.95	-0.46	-0.45 %	106.56	101.49	0.48 %

Total net assets 421 181 198.10

Table 3.6 – Example of a statement of valuation

In addition to the overall NAV of the investment fund, the evolution of the value of each of the securities constituting the portfolio is shown in the statement of valuation report as exhibited in Table 3.6. Important information shown

in portfolio reports are: the precise identifier of the security (ISIN code for instance), the current market price as well as the purchase price, the number of shares, the total value of the security in the portfolio , the currency, etc.

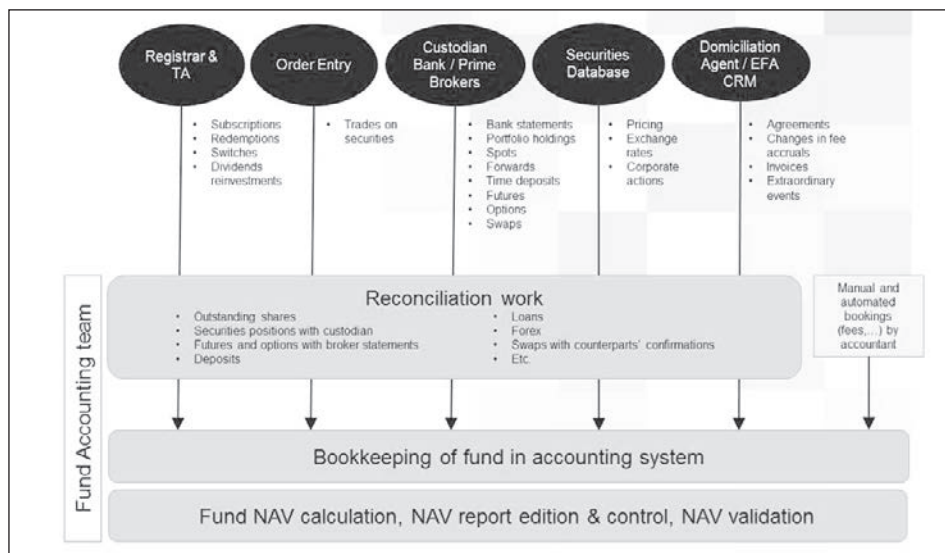


Table 3.7 – Overview of the fund accounting process

As one can see in Tables 3.7 and 3.8, the fund administrator receives during the fund accounting process pricing data (price, dividend payments, corporate actions such as stock splits, etc.) from financial information providers such as Bloomberg, TKS VDF, Reuters, etc. At the same time, asset managers inform the fund administrator about portfolio transactions (purchase or sale of securities) which affect the structure of the portfolio. The fund administrator also processes pre-NAV and post-NAV compliance checks to make sure that the investment rules and limits are not breached. The calculated NAV can then be published and made available to fund managers, control functions, management companies and investors. The pricing step is critical since any error in pricing leads to a wrong NAV and hence to subscriptions and redemptions processed at a wrong price, which may be very complicated to unwind. Since the process is repeated every day in daily NAV funds, the fund administrator needs to put in place automated controls regarding security prices. These automated controls are illustrated in Table 3.8. For instance, automated checks are developed to verify if the right security and stock exchange are taken into account⁹, cross-checks from different data sources are performed, unexpected absolute and relative (with respect to benchmarks) movements in asset prices are also checked to detect potential errors during the valuation process. The same kind

9. And not a similar one with different characteristics.

of control procedures are applied to the NAV per share itself. Daily performance is compared to benchmarks. Portfolio information is also compared to the information provided by the custodian bank which holds the assets of the investment fund in order to detect any discrepancies in portfolio holdings.

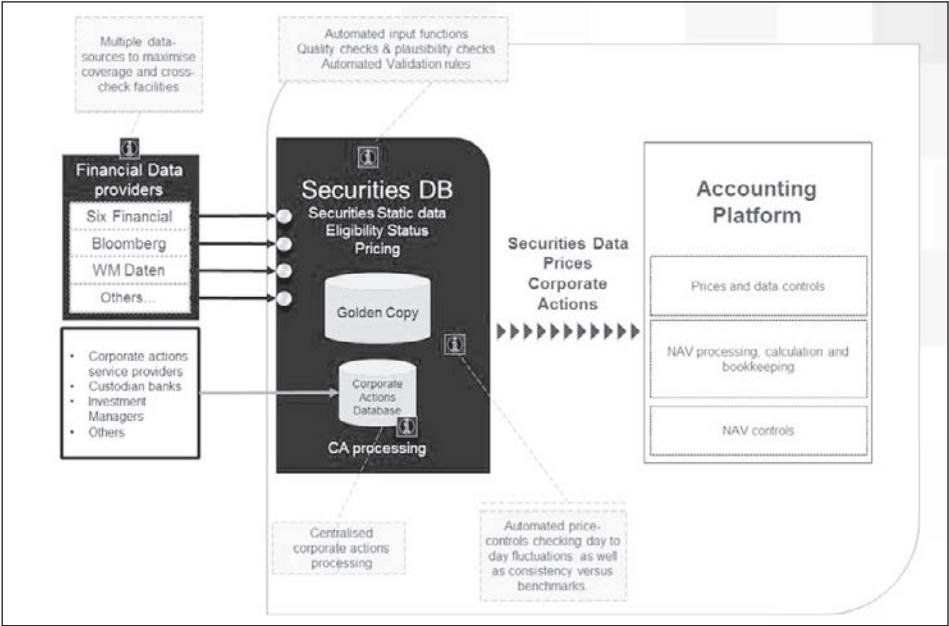


Table 3.8 – Security pricing process

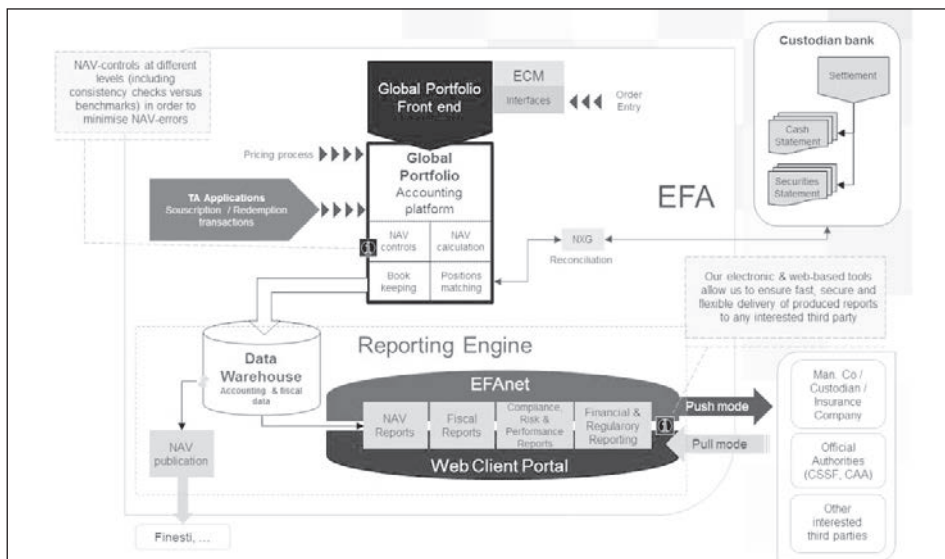


Table 3.9 – NAV production and reporting

3.3.2 Investor protection rules

Despite the numerous checks which are performed during the Net Asset Value calculation process, errors may nevertheless happen resulting in a wrong NAV per share. A problem may also arise if a portfolio manager invests in a security in proportions which are not allowed by the investment policy of the investment fund. In Luxembourg, the regulator has foreseen a particular procedure to deal with NAV errors which affect investors. Since calculating Net Asset Values is not an exact science and repairing small and insignificant errors can be very costly, the regulator has set a certain degree of tolerance (materiality concept). This tolerance threshold depends on the investment policy of the fund. It is respectively 0.25% of NAV for money market funds, 0.50% for bond and mixed funds and 1.00% for equity funds. The different thresholds reflect the implicit degree of imprecision in the valuation process based on volatility. The materiality concept does not apply to investment restriction breaches i.e. breaches of the investment policy by the portfolio manager. There is a formal notification procedure in case of a material error. The promoter, custodian, auditor and the CSSF have to be notified immediately and an action plan must be submitted. This action plan must describe the measures taken to cure the problem, the improvement implemented in the administration and control structures to prevent a reoccurrence of the problem, as well as the identification of the investors affected by the error. The Net Asset Value has to be recalculated for the period during which the error occurred if subscriptions and redemptions have been

processed and the amount which should be injected into the fund or repaid to the investors must be determined. The notification process to impacted investors and supervisory authorities in the distribution countries also has to be described. A simplified procedure can be used provided the total indemnification amount is less than €25 000 and the amount to be reimbursed to a single investor is less than €2 500. In that case, no corrective action plan needs to be submitted to the CSSF and a simple notification and repair is sufficient. The cost of correction and auditor intervention cannot be charged to the fund.

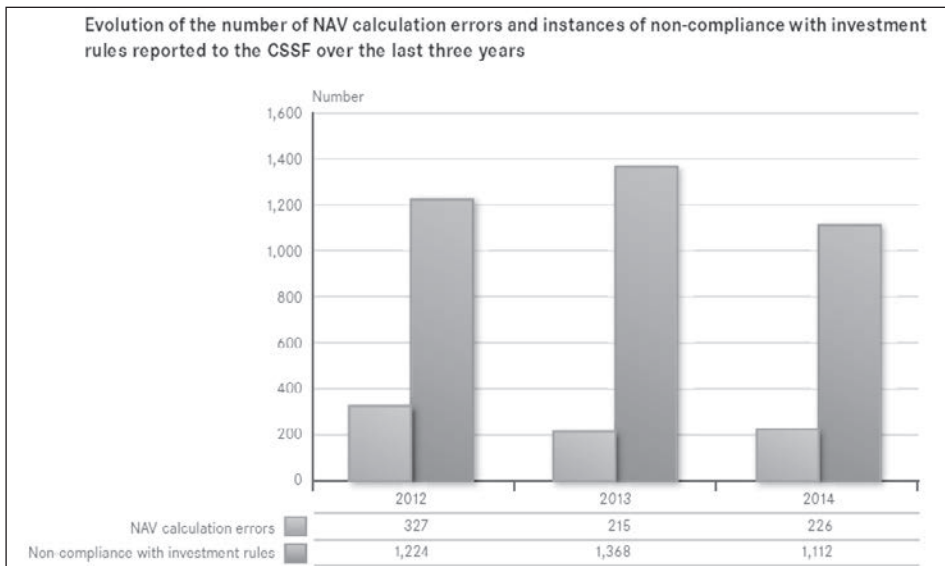


Table 3.10 – Number of NAV errors and investment breaches in Luxembourg funds – source: CSSF

3.3.3 Compliance and risk management

The UCITS framework as transposed into Luxembourg laws and regulations has established an extensive system of risk limitations and risk controls in order to ensure investor protection. The CSSF circular 12/546 relating inter alia to the organization of Luxembourg management Companies defines the obligation to implement a risk management process which enables it to monitor and measure at any time the risk of the positions and their contributions to the overall risk of the portfolio. In addition, it must supervise mandates given to third party fund managers. In particular, measures shall exist which enable the persons who conduct the business of the management company to monitor effectively at any time the activity of the undertaking to which the investment mandate is given. Eventually, it must define its risk profile by conducting a self-assessment

of its risk based on its investment policy and the use of derivatives. UCITS with less and less complex positions on financial derivative instruments or with financial derivative instruments used solely for hedging purposes can use the commitment approach to risk management. More sophisticated UCITS using, for an important part, financial derivative instruments and making use of more complex strategies or instruments have to develop internal models and be able to calculate the VaR (Value-at-Risk).

A management company needs to supervise on a daily basis several kinds of risk. For instance, it must check whether the asset manager complies with the law and the investment policy of the fund described in the prospectus (investment breaches and asset eligibility). Market risk, credit risk, liquidity risk, concentration risk and operational risk are also to be controlled by the management company. All these requirements are reported in Table 3.11. It is supported in this task by the fund administration company on a daily basis.

UCITS IV Key Risks			Commitment Approach	VaR Approach	Daily calculations and reporting
	Market Risk / Global Risk		✓	✓	
	Concentration Risk		✓		
	Counterparty Risk related to OTC derivatives		✓		
	Counterparty Risk related to efficient portfolio management		✓		
	Coverage Rules for transactions in Financial derivatives		✓		
	Liquidity Risk		✓	✓	
Additional Risks Covered	Currency Exposure Risk		✓		
	Credit Risk		✓		
	Interest Rate Risk		✓		

Table 3.11 – Comprehensive risk management process required

A typical compliance solution is illustrated in Table 3.12 and consists in first filtering any transaction proposed by the asset manager. The fund administration company checks whether the kind of asset is eligible and if it does not create a breach. This part is referred as pre-NAV check and aims at preventing any breach before the transaction is posted in the fund's accounts. It is nevertheless not totally precise since it is based on the last known NAV. It may consequently happen that a purchase or sale of a security (or even no movement at all in case of passive breach due to the relative performance of assets in the portfolio) leads to a breach which is only detected after the new NAV calculation. The

fund administration company proceeds to post-NAV checks at the end of the day with correct prices.

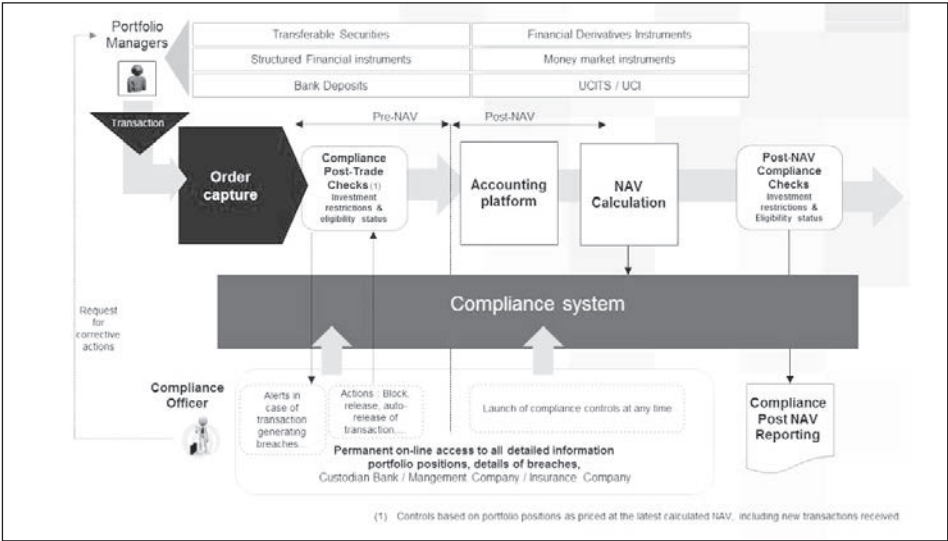


Table 3.12 – Compliance solution

3.4 Transfer agency

In addition to fund accounting, transfer agency is the second main activity of fund administration. The transfer agent deals with the subscriptions to and redemptions out of an investment fund. Traditional transfer agents sit between the fund and the investors and interact with the distributor to process subscriptions and redemptions. Among other things, the transfer agent is responsible for shareholder identification and maintenance of the investors' static data (address, etc.), anti-money laundering, transaction processing, settlement and cash management, reporting and commissions/fees management.

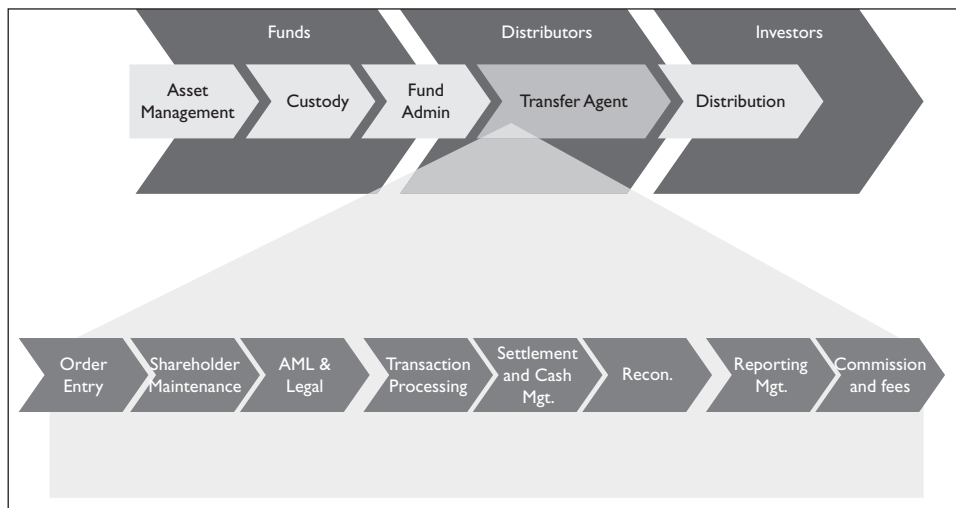


Table 3.13 – Traditional transfer agent model

Regarding shareholder register keeping, the transfer agency must determine who the investors of the fund are in order to be able to inform them of any event related to the fund's corporate life such as general meetings. Another important function of the transfer agent is to support the distribution of the investment fund. In this respect, the management of commission calculation is very important since without commission there would not be any distributor willing to distribute the investment fund. Commissions can take many different and complex forms such as redemption fees based on the number of years the investor spent in the fund. Of course, this requires keeping track of the dates at which the investors bought the shares.

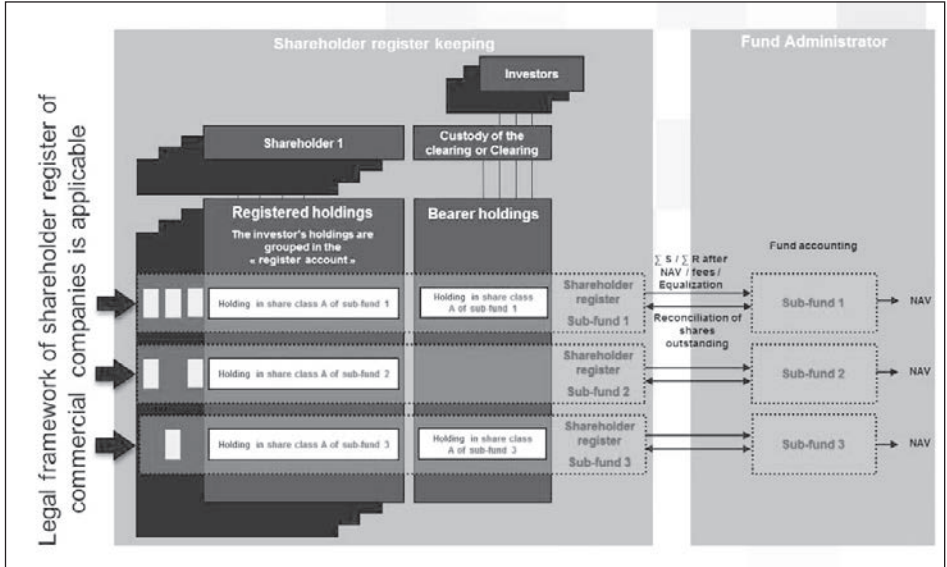


Table 3.14 – Shareholder register keeping

In Luxembourg, UCITS funds are designed to be exported, which requires highly-skilled fund administrators and transfer agents¹⁰. Close to 70% of funds in the world which are sold in at least three countries (including home state) are Luxembourg funds.

10. Requiring reporting in different languages, knowledge of different fiscal laws, etc.

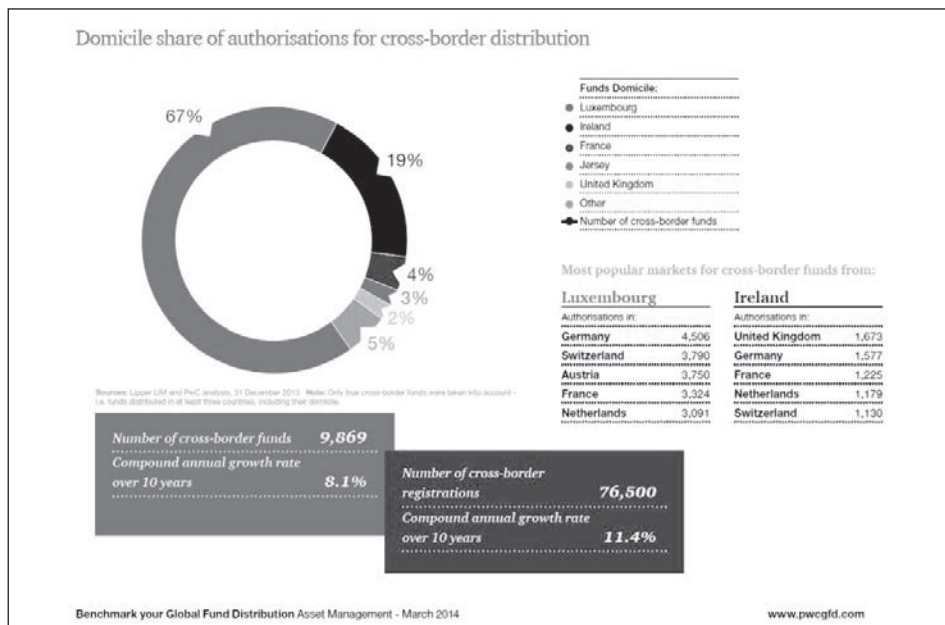


Table 3.15 – Luxembourg market share of foreign funds registered for sale – source: PwC Global Fund Distribution 2014

3.4.1 *Transfer agency operational flows*

A very important concept related to transfer agency is that of cut-off time representing very precise daily deadlines by which different operations must have been performed. First, in the standard order process, the order transmission must occur before a cut-off time. Then the transfer agency opens a new account for the investor (if the investor is new) and clearly identifies the investor. Once the account is open, the order is input in the system and the transfer agency ensures that the subscription money has been paid before the order is processed. As soon as the order is processed and the proceeds have been paid, the investor becomes a shareholder. There are certain rules within UCITS which protect the fund in case of a large redemption with respect to the size of the fund. Such redemptions may be gradually redeemed over a larger time span in order to protect the investors who remain in the fund. Another important cut-off time is related to the determination of the exact amount of new money invested in the fund once all the subscriptions and redemptions have been taken into account. This must be reported before market closing time in order for the asset manager to make investment decisions with the knowledge of the amount of money at his disposal. Eventually, the instruction is given to the bank to pay redemption proceeds to the shareholders who have sold their shares.

As mentioned before, the transfer agent also manages commissions and fees. It is interesting to note that there may exist a conflict of interest between the fund manager and the distributor of the fund. While the former has an interest in having as much invested money as possible, the latter may have an interest in having as many transactions as possible in the fund if the distributor is paid on the basis of transactions. Trailer fees allow reconciling the interest of both the fund manager and the distributor. Trailer fees are based on the money that stays in the fund. The transfer agent is also responsible for processing and instructing the payment of the fees on behalf of all the intervening parties.

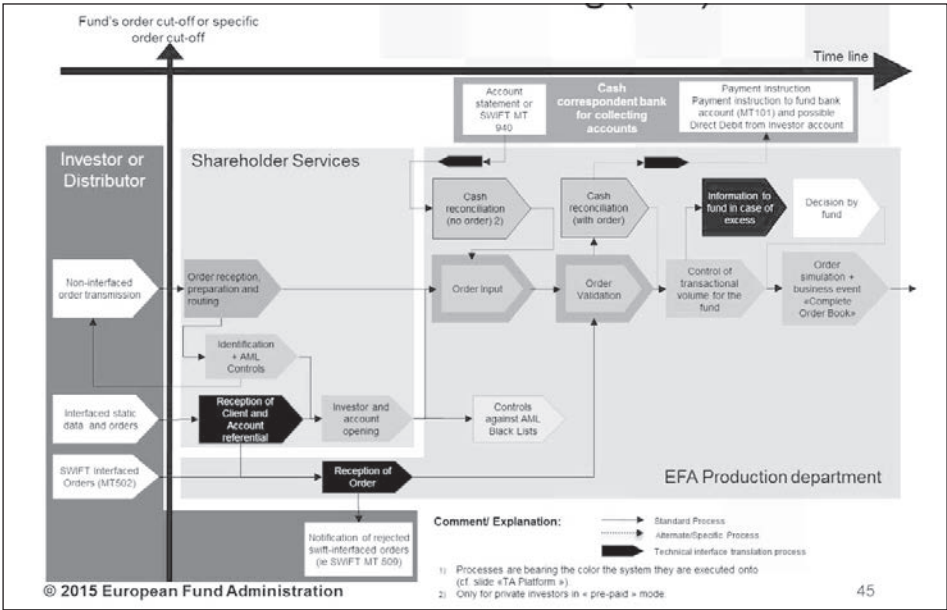


Table 3.16 – Standard order processing (1/3)

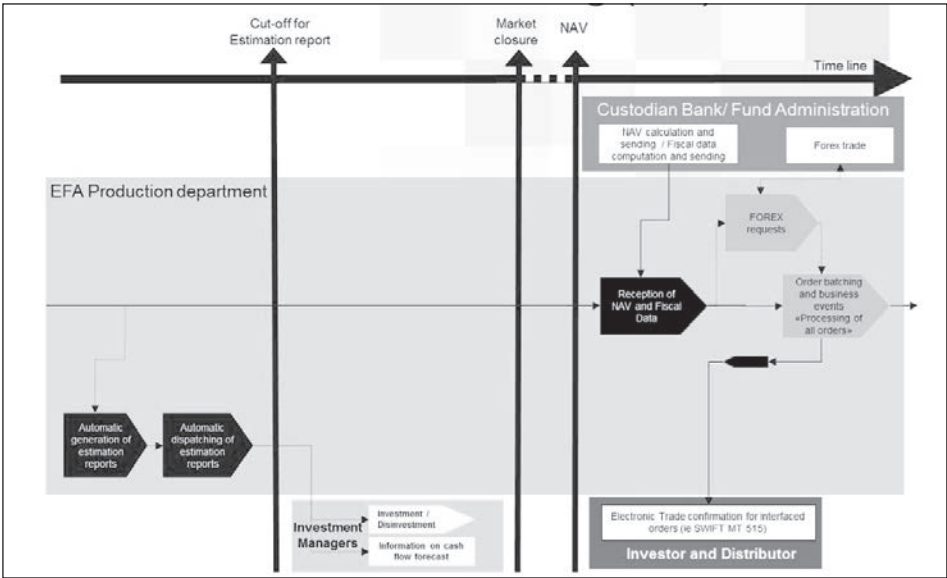


Table 3.17 – Standard order processing (2/3)

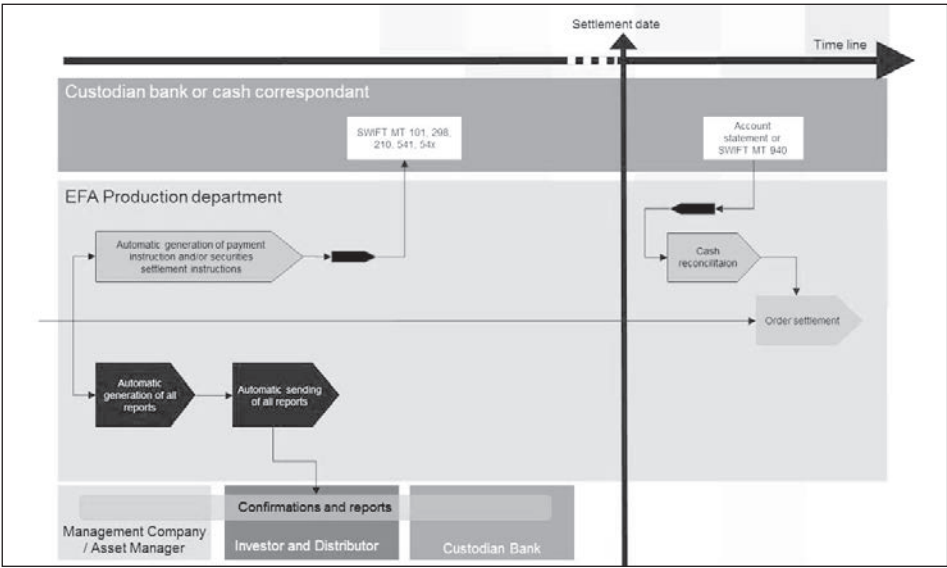


Table 3.18 – Standard order processing (3/3)

3.4.2 Late trading and market timing

The transfer agent also participates in the protection of the fund and its shareholders against among other things late trading, market timing and dilution. These concepts are related to the cut-off time corresponding with the time before which orders must be placed (typically 12.00 p.m.). The correct process requires that subscriptions and redemptions are made at an unknown price which means that the investor cannot know in advance the price at which he will buy or sell shares of the investment fund. In the example illustrated below the NAV is calculated using price information at 3.00 p.m. Late trading, which is prohibited, consists in waiting until the Net Asset Value is available and subscribing after the NAV has been released. This may allow the investor to use information which was available only after the pricing time and to harm the fund. Market timing is more complex and is a kind of arbitrage based on frequent and repetitive subscriptions and redemptions taking advantage of imperfection in the way the fund is priced. These imperfections may be due to the geographical scope of the investment strategy which may include stock exchanges which are open at different times of the day.

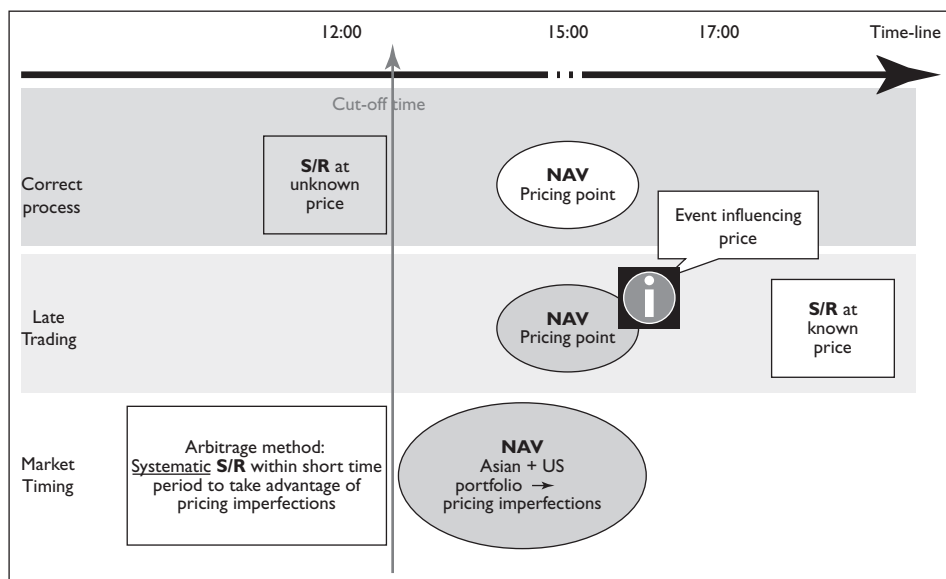


Table 3.19 – Late trading and market timing

Process	Transaction fees in favour of the fund	Bid and offer (dual) pricing	Anti dilution levy (ADL)	Swinging single price (SSP)
Activation	Always	Always	<ul style="list-style-type: none"> Always or Transaction threshold test. Transaction amount \geq % of fund net assets or Net in/outflow threshold test. Net in/outflow amount \geq % of fund net assets 	<ul style="list-style-type: none"> Always (= Full SSP) or Net in/outflow threshold test. Net in/outflow amount \geq % of fund net assets (= Partial SSP)
Description	Pre-defined transaction fee levied by the TA in favour of the fund on any specified transaction type.	Bid and offer spread calculated on each NAV. Subscriptions are traded at offer, redemptions at bid price by the TA.	The ADL will be calculated by the TA individually <u>on each single transaction</u> and will be provided as a commission revenue to the fund accounting. Different dilution levy rates may be defined by transaction type. Dilution levy rates could be periodically reviewed by the fund's board.	The NAV will be increased (if net inflow) or lowered (if net outflow) by a pre-defined swinging factor. Different swinging factors may be defined for net inflows or outflows. Swinging factors could be periodically reviewed by the fund's board.
Fund pricing method	Single pricing, however comparable to dual pricing	Dual pricing	Single pricing, however comparable to dual pricing	Single pricing
	NAV price +/- commission rate * NAV price	BID price and OFFER price	NAV price +/- dilution levy rate * NAV price	NAV price or Swung NAV price (NAV price +/- swinging factor * NAV price)
Price publications	NAV only	<ul style="list-style-type: none"> Bid and offer prices for trading Eventually NAV price for valuation / statistical purposes only 	NAV price only	<ul style="list-style-type: none"> Swung NAV price or NAV price for trading Eventually NAV price for valuation / statistical purposes only
Investor CN	<ul style="list-style-type: none"> NAV price Commission amount 	Bid / offer price	<ul style="list-style-type: none"> NAV price Dilution levy amount 	Swung NAV price / NAV price
Covered by EFA	Yes	Yes	Yes	Yes

Table 3.20 – Anti-late trading and market timing mechanisms

Since a fund has to be priced at a specific point during the day, there will always be a part of the portfolio for which the underlying prices are known at the time of subscription. Market timing is also not authorized. There exist several mechanisms which act to restrain late trading and market timing such as bid-offer pricing which is the spread between the price at which an investor can buy and sell an investment fund. Examples of anti-late trading and market timing mechanisms are given in Table 3.20.

3.4.3 Anti-money laundering (AML)

The Transfer Agent (TA) has to know who the investors are. The international nature of the Luxembourg financial center is such that the investors are located all around the globe and the fund administrator has probably never seen directly the different shareholders of the investment fund. Consequently, fund administrators have designed a system in which the “Know Your Customer” rule and investor identification can be delegated to fund distributors under certain circumstances. Indeed, since the distributor is in charge of selling the shares of the fund, he is the most likely counterparty to have met the customer physically. Delegation is based on a strict system of rules and more particularly the transfer agent can only delegate to an entity which is itself properly regulated. If the distributor is considered as an intermediary allowed to execute AML/KYC controls which are “equivalent” to Luxembourg standards, the TA may consider investors linked to this particular distributor as AML compliant and does

generally not perform any additional or specific KYC controls. In the context of retail distribution networks, the TA informs the regulated distributor specifically of its anti-money laundering obligations, if not already specified within a dedicated distribution agreement in place with the fund. In case of direct investors or if the distributor linked to the investor is not considered as “equivalent” to Luxembourg standards, the TA has to directly identify the investors in the fund.

Once the identity of the investor and/or the beneficial owner is known, the name is screened. New clients are systematically screened. All clients are re-screened on a regular basis against defined watch lists. All clients are screened against Politically Exposed Persons (PEP) lists once a month. Official watch lists are automatically updated. In addition, suspicious transactions are controlled through automated queries based on TA data. The number and amount of transactions linked to investors qualified as “nonequivalent” are regularly checked in order to detect any unusual movement. If the TA detects suspicious transactions, it has to cooperate with the authorities. Any suspicious elements when opening an investor or distributor or during the investment period are immediately reported to the compliance officer who is the contact person for the authorities.

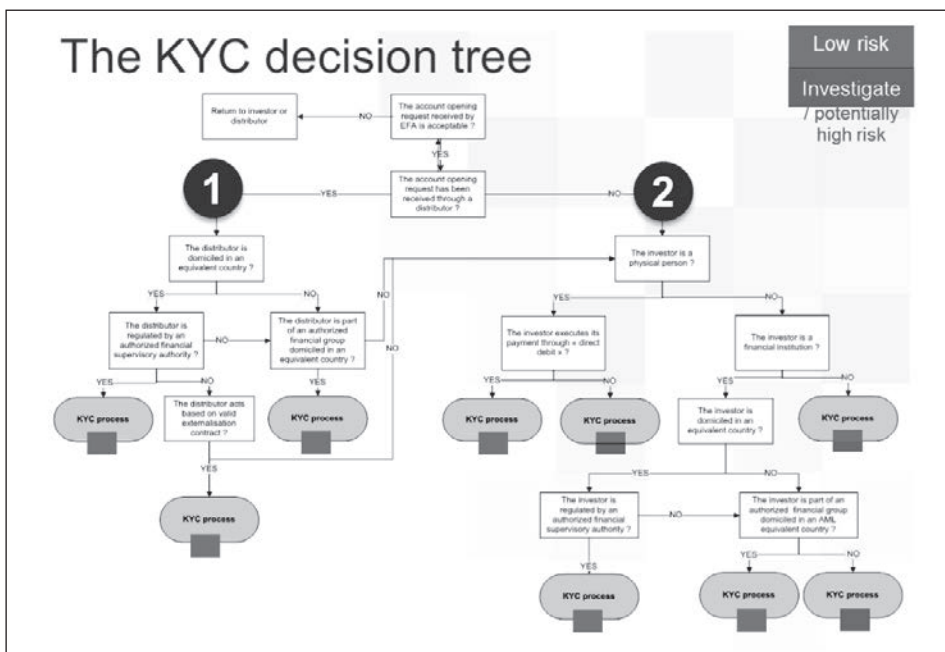


Table 3.21 – The “Know Your Customer” decision tree

3.4.4 New distribution patterns and fund supermarkets

Typically, funds are sold through banks and financial intermediaries (independent financial advisors). Very often banks only sell their own products but, over the last years, there has been a trend to what is called open architecture which means that banks do not only sell their funds but also funds of their competitors to be credible. As a consequence, the investor has access to a larger range of funds. This nevertheless creates a problem since connections must be created between multiple funds and multiple transfer agents. Supermarkets and platforms were created as a solution to this problem. They support transfer agents and distributors to access multiple funds. Another recent trend is the creation of centralized transfer agent (global transfer agent) which deals with large variety of investment funds based in several locations.

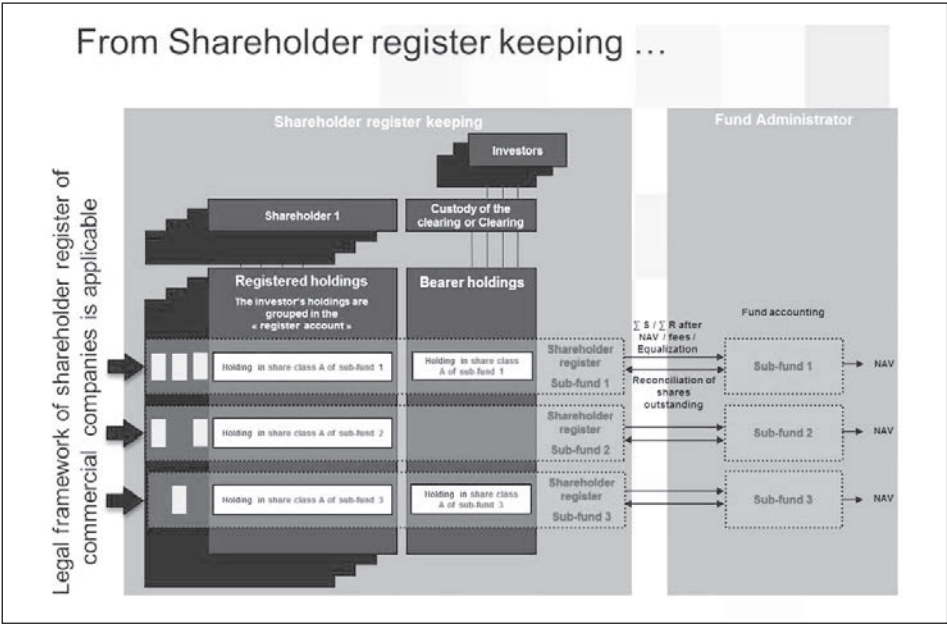


Table 3.22 – Back office position of transfer agents in investor servicing chain

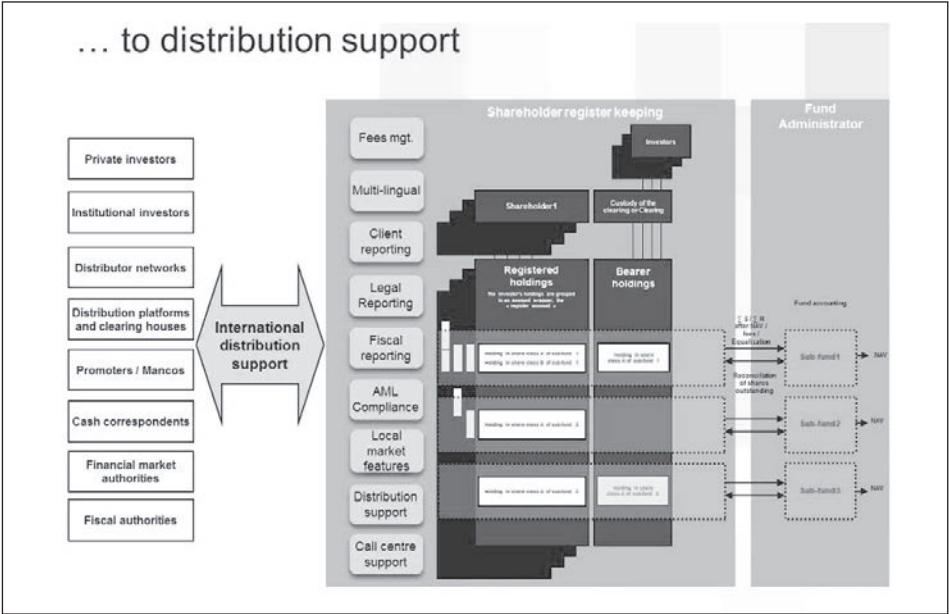


Table 3.23 – Transfer agency evolution: from back office to value-added middle office

4. Depositary bank and Management Company (ManCo) of a UCI

This chapter focuses on the Luxembourg regulation of two major intervening parties in UCIs (Undertakings for Collective Investments), namely, the Depositary and the Management Company (ManCo).

First part of the chapter is devoted to the Depositary of Luxembourg UCIs and sheds light on the general requirements pertaining to its: appointment, eligibility, duties, conduct of business rules, liabilities and delegation abilities. The second part focuses on the ManCo of UCIs and gives an overview on its: legal forms, cross-border passport, scope of activities and its setting up and operating requirements.

4.1 Depositary

4.1.1 Appointment

Each Luxembourg UCI (and Sicar) must appoint a single Depositary. The appointment must be approved by the CSSF and evidenced by a written contract¹¹. The contract is between the UCI and the Depositary and should include the different liabilities and duties of the depositary. In addition, in order to ensure the principle of independence, neither a ManCo nor an AIFM can act as a Depositary.

4.1.2 Eligibility

Requirements on Depositaries of UCITS and AIFs:

- **The depositary of a UCITS fund** must be a credit institution with its registered office in Luxembourg or established in Luxembourg if its registered office is in another EU member State. A Luxembourg branch of a non-EU credit institution, for example, would not satisfy this requirement and therefore, may not act as a Depositary of a UCITS. *(The legislator – CSSF – wants to have direct access to the depositary of UCITS funds. For a branch in Europe the CSSF can rely on their colleagues in EU but outside the EU, the CSSF will not have enough impact on the branch).*
- **The depositary of an AIF** (Part II UCI, SIF or a Sicar) is also in general a credit institution or an investment firm. Under certain conditions, a specialized PSF Called “Professional Depositary of assets other than financial instruments” may act as Depositary but only for AIFs that have

11. For the list of required elements to be included in the written contract, see the Circular 14/587, July 2014.

no redemption rights exercisable for at least five years after the date of the initial investment, and have assets that cannot be held in custody (mainly private equity and real estate).

4.1.3 Duties

The depositary serves four broad functions: (1) Safekeeping of UCI assets (2) Day-to-day administration of the assets (3) Cash flow monitoring and (4) Oversight duties.

Safekeeping of assets

The depositary's safekeeping duties differ depending on the type of assets:

- The Depositary must **hold in custody** all financial instruments belonging to the UCI which may be physically delivered to the depositary or may be registered in an account with the Depositary in the name of the UCI. The account must be segregated from the depositary's own assets. Typically such financial instruments include cash, listed equities, bonds, money market instruments...
- For other assets that may not be held in custody, the depositary must **verify that they are owned by the UCI and maintain an up-to-date record of them**. Typically such assets include OTC derivatives, equities of non-listed companies, real estate, luxury goods, intellectual property...

Safekeeping of the assets of a UCI implies that the Depositary knows at any time how the assets of the UCI have been invested and where and how these assets are available.

The Depositary may delegate its safekeeping duties to third parties, normally forming his sub-custodian network.

Day-to-day administration of assets

The depositary performs the day-to-day administration of the assets of the UCI. These tasks may include, for example, the collection of dividends, interest, proceeds of matured securities, the exercise of options, the execution of Corporate Actions (exercise of rights, conversions, splits,...), and in general any other operation concerning the day-to-day administration of the assets of the UCI.

Cash-flow monitoring

The depositary must also monitor the UCI's cash flows. These cash monitoring duties are currently only foreseen in the AIFMD, but the new directive UCITS V will integrate the same provisions for UCITS by spring 2016. In order to ensure these duties, the Depositary must be informed of all existing/new cash accounts opened on the name of the UCI/ManCo/or AIFM and must be

provided with all information related to these cash accounts. Overall, in carrying out its cash monitoring functions, the Depositary is expected to:

- Ensure that all cash of the UCI is booked with entities that are subject to prudential regulation and supervision under/equivalent to **EU law**.
- Implement effective and proper procedures to **reconcile all cash movements** on a daily basis.
- Implement appropriate procedures to **identify unusual cash flows** that are not consistent with the UCI's operations.
- **Review periodically** the adequacy of these procedures including a full review of the reconciliation process at least once a year.
- **Monitor the outcomes of the reconciliations** and actions taken when discrepancies occur and **notify** the ManCo/AIFM or the competent authorities if the irregularity is not resolved without undue delay.

Oversight duties

The depositary is required to carry out a list of oversight duties. It is not required to execute these duties itself but must ensure that they are correctly performed. Overall, when carrying out its oversight duties, the Depositary has the following responsibilities:

- **Assessing the risk** associated with the nature, scale, complexity of the UCI's strategy and organization.
- **Performing ex-post controls** of processes and procedures under the responsibility of the UCI, AIFM or an appointed third party.
- Implementing an **escalation procedure** for situations where an anomaly is detected in the course of its oversight duties.
- Being **provided with all information** and being able to **review certifications** and **perform on-site visits**.

The Depositary must fulfill the following 5 key oversight functions:

- Ensure that the **subscription and redemption of shares** are carried out in accordance with the law and the constituting documents of the fund.
- Ensure that the **value of the units/shares** is calculated in accordance with the law and the constituting documents of the fund.
- Carry out **the instructions of the ManCo** unless they conflict with the constituting documents of the fund.
- Ensure a **timely settlement of transactions**.
- Ensure that **the UCI's income** is applied in accordance with the constituting documents.

4.1.4 *Conduct of business and conflict of interest rules*

The Depositary must comply with the applicable **rules of conduct** and rules on handling conflicts of interest. It should:

- Act honestly, fairly, and independently, solely in the interest of the UCI and its investors.
- Be of good repute and sufficiently experienced in relation to the UCI
- Not be appointed as a delegate to provide the core function of the portfolio management.
- Not carry out activities for the UCI that may create conflicts of interest between the UCI, the ManCo/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 AIF.

4.1.5 *Liability*

The current liability rules applicable to the Depositary of UCITS are different from those applicable to the Depositary of full AIFM regime AIFs:

- **For UCITS**, the Depositary is responsible for any loss resulting from its “improper performance” or “unjustifiable failure” to perform its duties. However, anyone suffering damage must prove the depositary’s negligence and the link between cause and effect. In addition:
 - Duty of supervision may be considered as performed if the Depositary is satisfied that the third parties with whom the assets of the UCITS are on deposit are reputable, competent and have sufficient financial resources.
 - If assets are physically in deposit with the Depositary, liability is governed by the law applicable to deposit agreements (art. 1915 of Code Civil).
- **For full AIFM regime AIFs**, The Depositary is subject to a strict liability regime coupled with the reversed burden of proof. The Depositary is liable for any loss of financial instruments held in custody by the Depositary itself or by its sub- custodian. In case of such loss, the Depositary is required to return to the AIF (or its AIFM acting on behalf of the AIF) a financial instrument of identical type or the corresponding amount, without undue delay.
 - The Depositary may discharge its liability in case of loss, if it can prove that the event that led to the loss was “external and beyond reasonable control and unavoidable despite all reasonable efforts to the contrary”.

- The Depositary is also liable for any loss or error in connection with its oversight functions.
- The Depositary may transfer the liability for loss of financial instruments held in custody to a third party. This transfer of liability must be agreed in written contract between the Depositary and sub-custodian that details the “objective reason” justifying contractual transfer of liability.

4.1.6 *Delegation*

The Depositary of a UCI is permitted to **delegate its safekeeping duties** to a third party, but not its oversight duties (nor its cash flow monitoring for a full AIFM regime AIF). It must select its delegate after performing rigorous and comprehensive due diligence including:

- A satisfactory analysis of the financial situation and rating of the delegate.
- A satisfactory analysis of the operational and professional competences of the delegate.
- Due diligence on the risk of reputation of the delegate.
- Verification of the legal separation of duties if the investment manager and the delegate belong to the same group.
- Verification that the delegate has contracted a sufficient insurance against fraud, errors and omissions.
- Verification that the delegate separates, in its books, between its own assets and those deposited by or for the account of the fund.

4.2 *Management Company*

4.2.1 *Types of authorized Management Companies*

Regulatory environment of investment funds in Europe distinguishes between 3 types of management companies (ManCo's):

- Chapter 15 ManCos: their regular business being the management of UCITS funds.
- AIFM: their regular business being the management of alternative investment funds (AIFs).
- Chapter 16 ManCos: being limited in scope to the management of some non-UCITS funds. Examples of these funds are pension funds, single investors and employee schemes. Chapter 16 ManCos can also manage AIFs whose assets under management are under the foreseen thresholds of the AIFM.

4.2.2 Cross-border Management Passport

The **Management Company Passport** allows a Management Company domiciled in one EU country to set up and manage UCITS/AIF funds domiciled in other EU countries.

The Home Member State Authority of the ManCo supervises its organization, including risk management processes, conflict of interest and delegation arrangements...etc.

The Authority of the Home Member State of the UCITS/AIF only authorized to supervise the constitution and functioning of the UCITS/AIF.

4.2.3 Scope of activities

The Management Company (ManCo) is responsible for three main activities: (1) distribution (2) administration and (3) investment management.

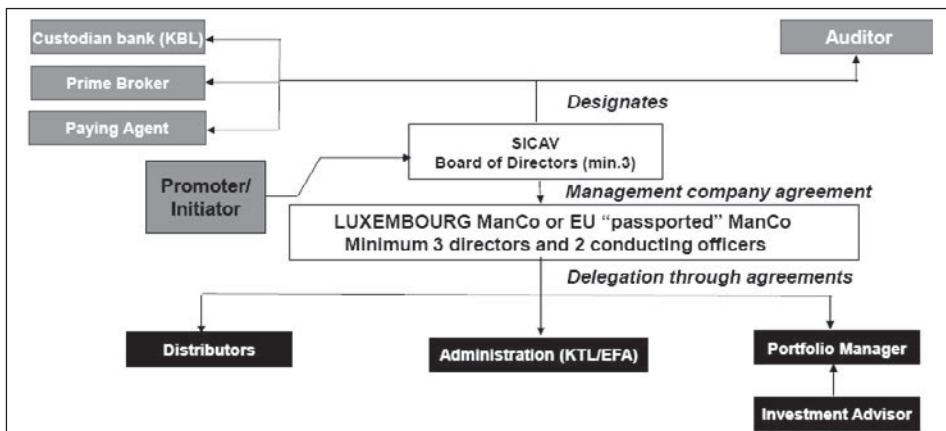


Table 4.1 – Management Company activities

The ManCo can delegate parts of all three functions and then it has to establish again control procedures to supervise to whom they are delegating it. Investment management is very often delegated through agreement.

The ManCo is responsible toward the SICAV board of directors.

4.2.4 Setting up and Operating a Management Company

Setting-up and operating a Management Company involves the compliance with a wide variety of legal and regulatory requirements. This section summarizes these requirements for the case of a **Chapter 15 Management Company**:

- The ManCo must obtain **authorization** from the CSSF before starting business. Such authorization is valid for all Member States of the EU. The ManCo authorized in another Member State may carry out its activity in Luxembourg. The establishment of a branch does not require authorization.
- The ManCo can be established under three main **legal forms**: Public limited Company (S.A.), Private limited Company (Sàrl), or Partnership limited by shares (société en commandite par actions).
- The ManCo is authorized to perform mainly three **functions**: Investment Management, Administration and Distribution. However, as a derogation, the ManCo can also provide discretionary portfolio management, investment advice and safekeeping and administration in relation to shares or units of UCIs.
- The **minimum initial capital** at the date of incorporation amounts to € 125,000 mios. However, the capital should be increased if the value of managed portfolios exceeds € 250 mios. The additional capital is equal to 0.02% of the amount of the portfolios in excess of € 250 mios with a cap of € 10 mios.
- The ManCo must appoint at least **two conducting officers** with sufficiently good repute and experience and provide them with all technical and IT equipment necessary to enable them to perform their functions. In principle, one of the conducting officers must be based in Luxembourg and be joinable by the CSSF. Conducting officers may not be employed by the Depositary of a UCITS under their management.
- The manCo requesting authorization from the CSSF must provide them with a **Business plan** including information on, inter alia: its organizational structure, the scope of services planned for the next 3 years, the investment policies of the UCITS under management, together with the financial instruments and markets concerned and the risk management process. The business plan should also include indications on the discretionary portfolio management activities and any non-core services to be offered.
- The ManCo must inform the CSSF of the identities of its shareholders or members that have **qualifying holdings** (>10%) and of the amounts of those holdings.
- **Consultation** with other member states.
- Both the **central administration** of the ManCo and its registered office should be located in Luxembourg. The central administration must be understood in the broadest sense and includes infrastructure, accounting and information systems. Necessary human resources must be in Luxembourg but can be outsourced under specific authorization by

the CSSF. The ManCo must demonstrate that it has sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and internal control mechanisms. The CSSF requests the communication of the persons in charge of the monitoring of certain aspects of the day-to-day management like risk management, internal audit...etc. The CSSF also requests information on the computer hardware, software and data sources in use.

- The ManCo may **delegate parts of its functions** to a third party. However, it remains responsible for the delegated duties. In addition, the ManCo can delegate its activities only if a set of preconditions is fulfilled:
 - CSSF has been informed upfront of the delegated tasks, who is the entity to which the duties are delegated and what are the procedures in place to monitor the delegated activities.
 - The ManCo may effectively supervise the delegated activities and must be able to access the accounting data for the managed UCITS.
 - The mandated entity must be qualified and capable of undertaking the delegated functions; it must also be able to produce evidence that it has the appropriate human and technical resources.
 - Investment management duties should be delegated to only authorized and supervised entities in principle to be disclosed in the prospectus of the UCITS.
- The ManCo must all the time be in compliance with the applicable **rules of conduct** and rules on handling conflicts of interest. The ManCo should:
 - Act honestly and fairly in the best interests of its clients.
 - Act with due skill, care and diligence in the best interests of its clients
 - Try to avoid conflict of interest, and where they cannot be avoided, ensure that its clients are fairly treated
 - Comply with all regulatory requirements so as to promote the best interests of its clients
- The ManCo is required to submit **financial reports** to the CSSF on a quarterly basis. The reports have to be received by the 20th day of the following month.
- The ManCo should have in place **risk management** procedures and processes that allow monitoring and measuring the risk of its positions at any time. These procedures must comply with the risk management requirements provided in the CSSF Circular 11/512:
 - The circular gives guidelines for the implementation of a risk management framework and cover organizational requirements, the scope of risk management relating to each type of risk identified and details of risk limits. The circular focuses on financial risks, namely global

risk, counterparty risk and concentration risk (no longer the notion of “sophisticated” or “non-sophisticated”).

The risk management function must be independent of the unit responsible for making marketing portfolio management decisions. In addition, all or part of its process may be delegated to a third party, recognized in this type of activity. The ManCo remains, however, responsible for ensuring the correct implementation of an adequate risk management process.

Chapter 16 Management Companies may only manage UCIs that are non-UCITS. This type of ManCos will disappear because they are just exceptions managing pension funds, single investors, employee schemes that do not fall under the AIFM or the UCITS fund.

- Limitations comes from former directive 85/611 stipulating that the scope of a ManCo should be limited to the management of UCITS, the aim being to protect the interests of the share/unitholders by assuring a maximum specialization of the ManCo and avoiding conflict of interests with other activities. This limitation has been extended to non-coordinated UCIs under the 1998 law.
- Activities generally cover the intellectual management of the UCI, can also encompass all the tasks linked to the central administration of a UCI and may be extended to the keeping of the register of the share/unitholders and the distribution of those shares/units.
- Providing certain conditions are met, the CSSF permits Chapter 16 management companies to manage UCIs, which are not subject to EU-equivalent supervision.
- Similar rules as for Chapter 15 Management companies concerning authorization, legal form, central administration and registered office.

5. Organization and supervision of UCIs

5.1 *Introduction*

In this chapter, we present the basic principles of the organization of the supervision of investment funds with reference to the Luxembourg regulatory framework. We also widen the analysis started in previous chapters by giving additional details on the different parties which are involved in the life of investment funds.

A specific focus is given on the role of the auditor of the investment fund as well as the role and responsibilities of the custodian banks. These two actors are playing an active role in the protection of the interest of the investors and have seen their duties and obligations significantly enlarged recently and are expected to continue to evolve in the coming years.

5.2 *Context*

At the end of 2014, the total net assets worldwide of the investment fund industry amounted to around EUR 28 280 billion with almost half this amount managed in the United States. Over the period 2005-2014, the size of the global investment fund industry has more than doubled.

Table 5.1 highlights that Luxembourg is the largest fund services market in Europe and the second largest in the world after the United States. The top 10 players represent a market share of more than 90% of the total investment fund industry in 2014, a value which is almost unchanged with respect to the situation in 2005. Luxembourg has seen its market share increasing by 2% during the period where the United States were quite stable. Besides the United States and Luxembourg, this top 10 is composed, among others, by Ireland, France, Germany and Australia.

It is worth noticing that even if the global investment fund industry show a significant growth over years, the proportion of household wealth invested in investment funds is still modest (less than 10%) and generally acquisition of financial assets has decreased since the bust of the financial crisis.

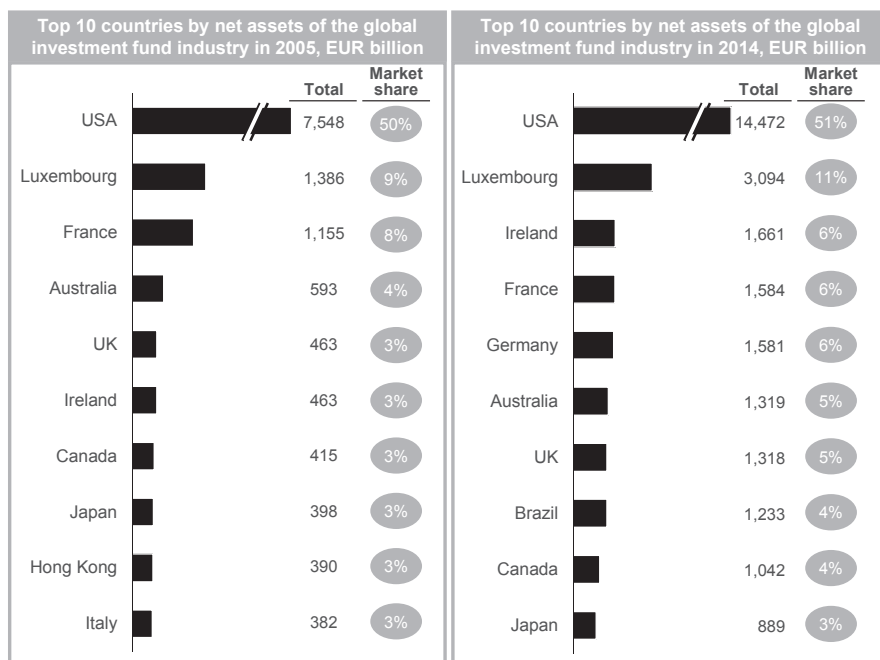


Table 5.1 – Evolution of the global investment fund industry from 2005 to 2014 – source: EFAMA, Deloitte analysis

In addition, Table 5.2 shows that top 50 worldwide asset managers account for more than 60% of the market with Black Rock, Vanguard and Allianz at the top of the list. This proportion has slightly decreased over the last years.

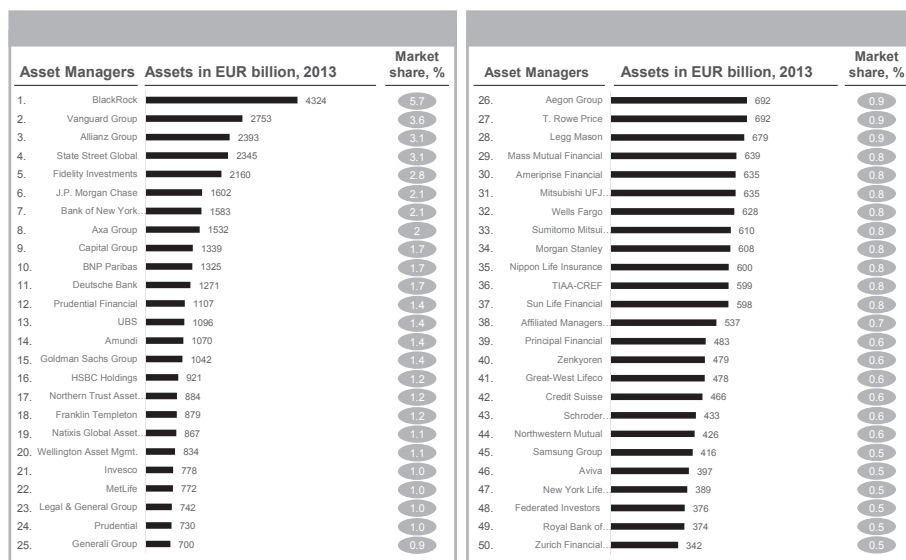


Table 5.2 – The World’s 500 Largest Asset Managers – 2013. Source: investment & pensions Europe

5.3 Organization of an investment fund: basic principles

As we have already explained, a fund must satisfy several conditions, among which we can mention the use of savings for the purpose of collective investments, the collection of savings from the public (not restricted to specific investors) and the management of the fund in accordance with the principle of risk spreading. There exist two different legal forms for funds: FCP and SICAV. An FCP is not a legal entity but an investment vehicle run by a management company on behalf of joint owners who are liable only up to the amount contributed by them and whose rights are represented by units intended for placement with the public. As a consequence, investors are not shareholders but unit holders and there is no General Assembly of unit holders and no Board of Directors meetings other than the Board of Directors of the Management Company. On the other hand, a SICAV is a legal entity which must have its registered offices in Luxembourg. Investors are shareholders of the company and their rights are represented by their shareholdings in the SICAV. As for any incorporated entity, there is a General Assembly of shareholders and there are meetings of the Board of Directors. As indicated by its name, a SICAV has a variable capital. Its capital is always equal to its Net Assets. Consequently, unlike for other companies, a change in its articles is not required each time the level of capital issued changes.

From these two types of funds, we can further distinguish within the legal framework Part I and Part II funds¹². Part I funds (or UCITS funds) are open-ended funds (i.e. funds in which subscriptions and redemptions are possible at any time) which benefit from a European Passport¹³ which allows them to be sold all across Europe. They face more restrictive investment policy and higher investor protection. Part II funds are more flexible funds which do not benefit from a European Passport like UCITS. This may be due among other things to the fact that they are close-ended (restrictions on redemptions), that capital is raised outside the European Union, or that they have special investment policy and invest in assets which are not eligible under the UCITS framework.

Some of Part II funds can be qualified as AIF (Alternative Investment Funds) and are managed by an AIFM. Under this regime, they can also benefit under some conditions indirectly from the European Passport that is granted to the AIFM (please refer to chapter 1 and 2).

Within an investment fund, different sub-funds, for instance focusing on different investment policies in terms of assets (equity, bond or money market sub-fund, etc.), can be created. The rights of the investors or debtors toward one sub-fund are exclusively limited to the assets of this sub-fund. Each sub-fund has its own separate subscriptions, accounting, investment objectives and portfolio of investments. No compensation of losses is possible between sub-funds of the same fund.

Within sub-funds, there can be different asset classes which may be sold to different kinds of investors (i.e. retail or institutional investors). They may differ by the specific expenses charged to the investors. Lastly, shares can be split in terms of their distribution (dividends) or capitalization and currency denomination characteristics.

12. See also chapter 3.

13. See also chapter 7 on the distribution of investment funds.

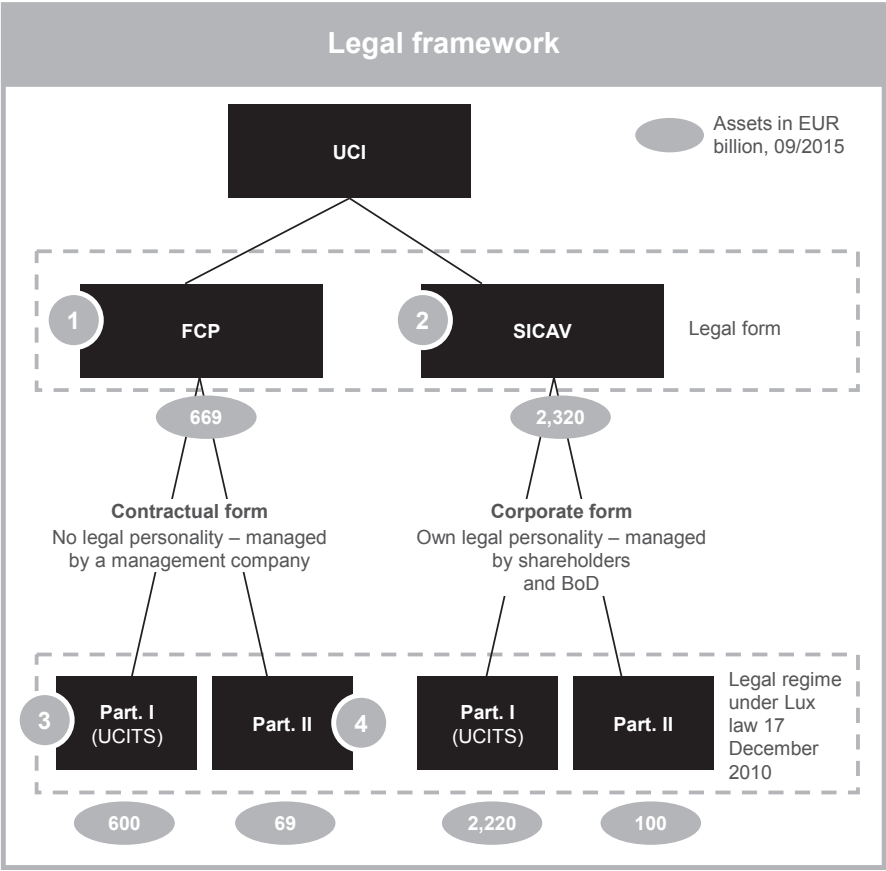


Table 5.3 – Legal framework of UCIs under the 2010 law – source: CSSF

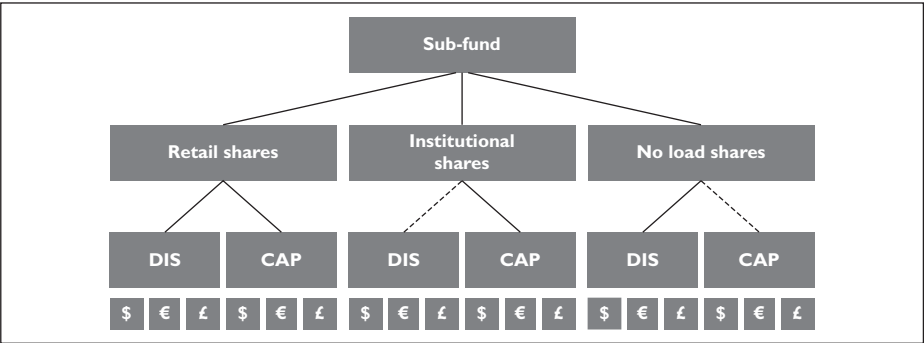


Table 5.4 – Sub-fund structure

5.4 The investment fund industry in Luxembourg

Luxembourg is a relatively small country with around 550 000 inhabitants. GDP growth over the last few years has been significant (average annual increase of 2.2% over the last 5 years) with an unemployment rate of 7% in 2015. Luxembourg has been largely affected in 2009 by the financial crisis because of the huge concentration of the Luxembourg economy around financial services.

Luxembourg Economic Data		
• Population :	549,680 inhabitants (Jan. 2014)	
• Inflation :	0.6% (2014)	
• GDP (in value) :	EUR 45.288 bn (2013)	
• GDP in % of growth :	3.2% (2010) 3.1% (2011) -0.2% (2012) 2.0% (2013) 2.9% (2014)	
• Unemployment rate :	7.0% (Jan. 2015)	

Luxembourg Financial Centre		
Categories	Data	Date
• Number of SICARS	• 290	• 31 Jan. 2015
• Number of PSF	• 314	• 31 Jan. 2015
• Balance sheet total	• EUR 15.5 bn	• 31 Dec. 2014
• Net profit	• EUR 0.55 bn	• 31 Dec. 2014
• Employment	• 14,749 persons	• 30 Sept. 2014

Table 5.5 – Luxembourg economic data – source Statec, CSSF and Deloitte

Regarding investment funds, there are almost 4.000 funds (amounting to 14 000 sub-funds) active in Luxembourg at the end of 2014.

A great majority of funds are UCITS. We see however, over the last years, a consolidation of the number of UCITS and an emergence of other type of funds such as SIF (specialized investments funds – most of them falling under the AIF regime). Even if the number of SIF is increasing sharply, the volume of assets remain modest. Detailed breakdowns are given in Tables 5.6 and 5.7:

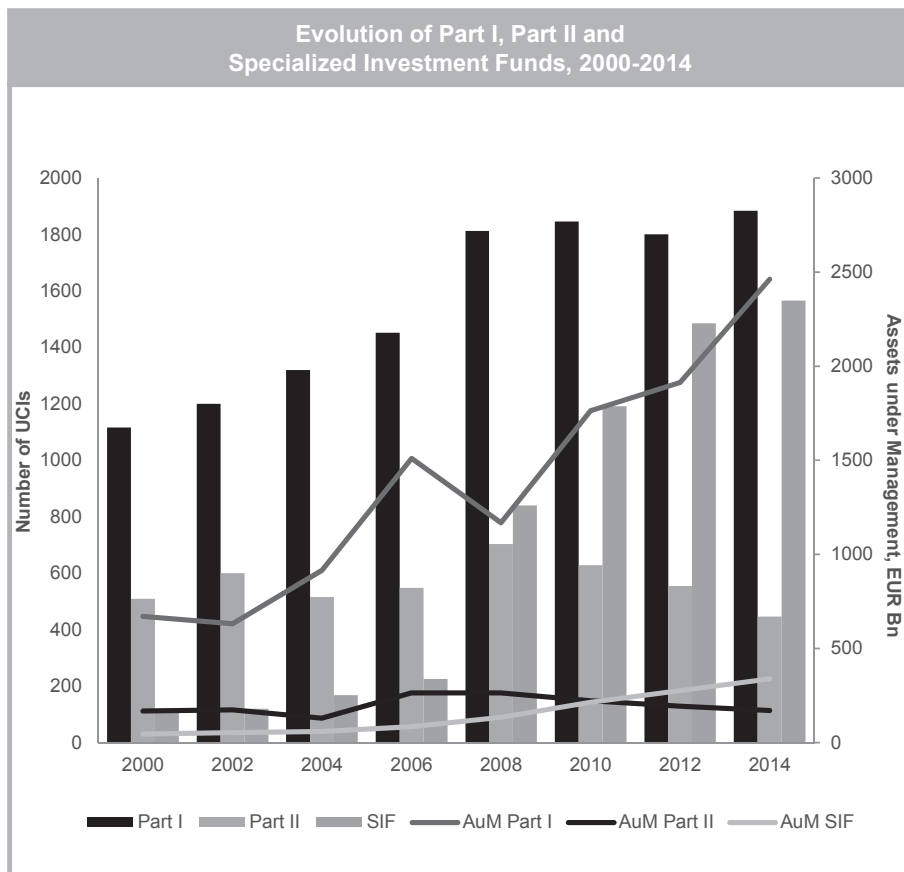


Table 5.6 – Evolution of number of investment funds and assets under management in Luxembourg – source: ALFI

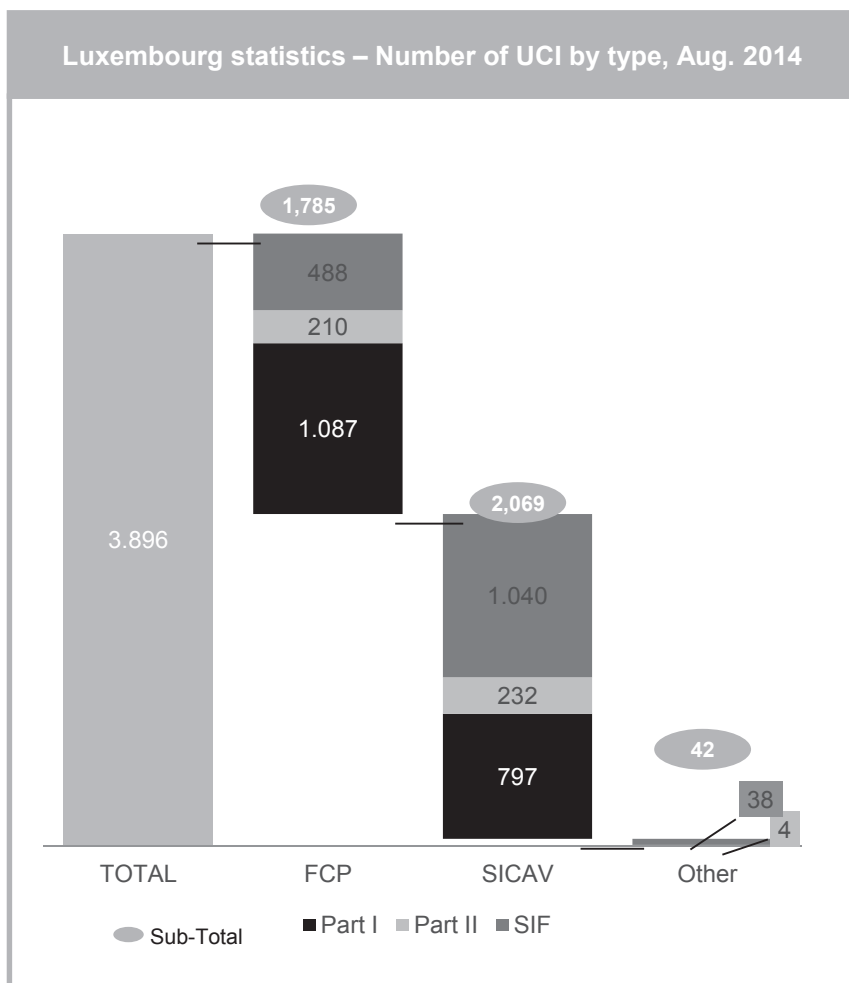


Table 5.7 – Number of UCIs by type, 2014 – source: CSSF

5.5 *Parties involved in the life of an investment fund*

There is a large number of parties involved in the life of a fund among which the management company for UCITS and the AIFM for AIFs that will manage globally the fund, the investment manager who manages the financial assets, the investors and the distributors, the regulator, the external auditor and the depositary bank (see Table 5.8).

The CSSF must first approve and then supervise any existing fund in Luxembourg. In practice, when a financial entity or a management company

wants to launch a fund, it has to provide the CSSF with the required documents for their approval. These documents include the articles of the incorporation, the prospectus (a commercial document for investors describing the investment fund), the Key Information Document (a summary of the prospectus)¹⁴, all the contractual agreement between the fund and all the intervening parties in the life of the investment fund, the proof that the central administration is located in Luxembourg, the names and CVs of the directors and the marketing strategy. Once the fund is launched, the CSSF supervises the fund on a continuous basis. In practice, every change to the documents and information which are submitted for authorization are to be submitted to the CSSF. A copy of the fund annual reports is to be forwarded to the CSSF in addition to financial reporting. The CSSF also has the right, either directly or through intermediaries, to examine the books and records of a fund. All these requirements are intended to protect investors.

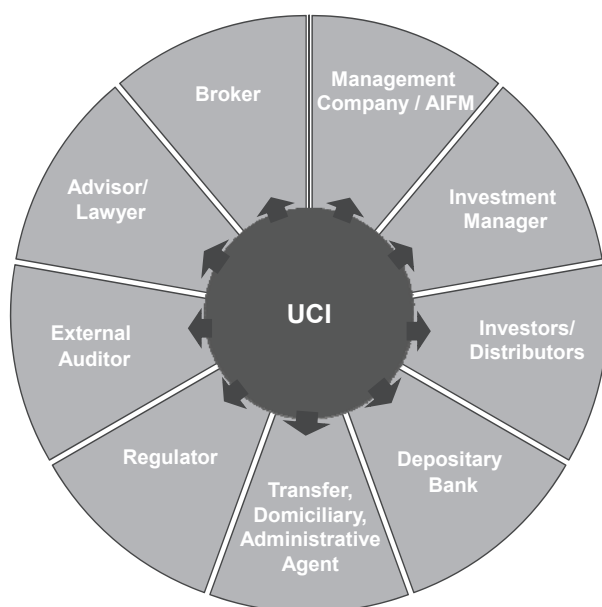


Table 5.8 – Parties involved in the life of an investment fund

In practice, in addition to local inspections, the supervisor heavily relies on the external auditor of the investment fund after that it has been initially approved. Every fund in Luxembourg has to appoint an external auditor approved by the CSSF. The auditor will audit the annual accounts. The auditor has the obligation to notify the CSSF when it notices any irregularities in the investment fund. Irregularities can entail for instance incorrect valuation, non-conformity

14. Readers are referred to chapter 2 for additional details.

to investment restrictions and policy, etc. The auditor can also ask for corrective actions from the investment fund.

The role of the Custodian Bank is to ensure the safe-keeping of the investments. It must have knowledge at any time of how and where the assets of the fund have been invested.

The Custodian Bank has also an oversight duty. To perform this role, it has to ensure the regularity of the operations and the compliance with the investment policy of the fund. In addition, it has to ensure that the sale, issue, purchase of shares or units are made in accordance with the prospectus.

Registrar and transfer agents¹⁵ hold the register of shareholders of the fund and organize the subscription / redemption process. It also play a role in supervising the activities of the fund, notably in performing anti-money laundering checks relating to investors.

Lastly, the domiciliary agent provides the registered office and fulfills several responsibilities among which the provision of office accommodation and other facilities to the fund, the payment of invoices on behalf of the fund, the provision of assistance with the fund's legal and regulatory reporting obligation including shareholders and board of directors meeting and the safeguard of the fund's prospectus and related documents.

5.5.1 *Organization of investment fund supervision*

In this section, we present in more details the organization of the supervision of the investment fund and of the three main players of the supervision i.e. the regulator or the CSSF, the external auditor and the Custodian Bank. The Management Company and the AIFM play also a critical role in the supervision – we refer to chapter 4 for more details.

The scope of the regulator intervention is defined in the Law of December 2010 relating to undertakings for collective investments. It defines the functions carried out by the CSSF, the purpose of the supervision, the authorization process and the other missions of the regulator. The main functions of the regulator are the general organization, management and operation of databases and information systems, the macro-prudential supervision of UCIs, the review and management of particular situations of UCIs, the analysis of specific economic aspects and the instructions and supervision of UCIs. The purpose of the supervision of UCIs is to verify the compliance with the regulations and constitutive documents. Furthermore, the prudential supervision is based on the analysis of financial reporting transmitted by UCIs, the on-site inspections and the scrutiny and follow-up of reports provided by the approved statutory auditor. The CSSF is also in charge of reviewing the authorization requests to exercise UCI

15. See also chapter 3.

activity. As regards UCIs, these conditions mainly concern the legal form of the entity, the central administration, the reputation of the members of the administrative, management and supervisory bodies as well as that of the shareholders, the financial bases and the custodian and the control of annual accounting documents by the auditor with adequate professional experience. At the international level, the CSSF ensures the follow-up of all the international files in relation to UCIs and participates in the analysis and drawing-up of advice to EU working documents. The CSSF has in 2015 more than 500 staff members to ensure these functions.

In practice, the CSSF relies on the following documents to organise the supervision:

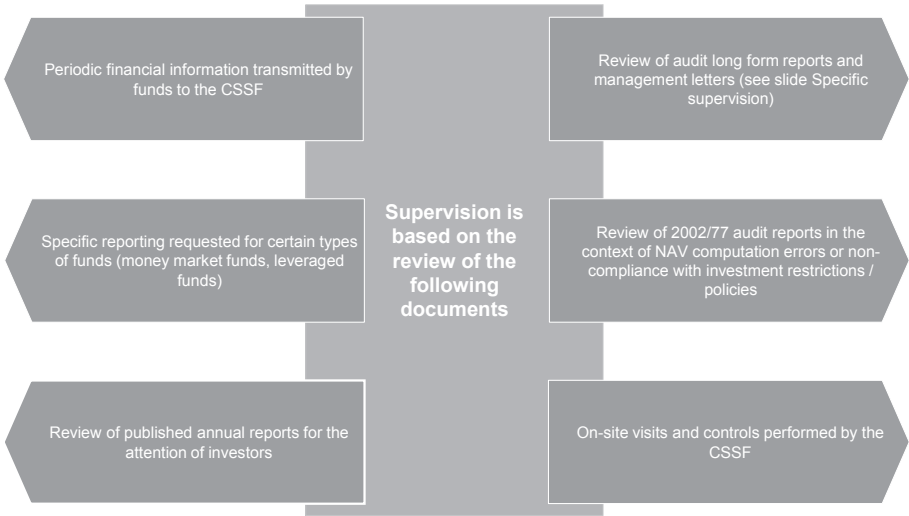


Table 5.9 – Documents made available to the CSSF to organize its supervision

In the organization of its supervision, the CSSF has performed in 2014, 142 on-site visits and controls pursuing the following objectives:

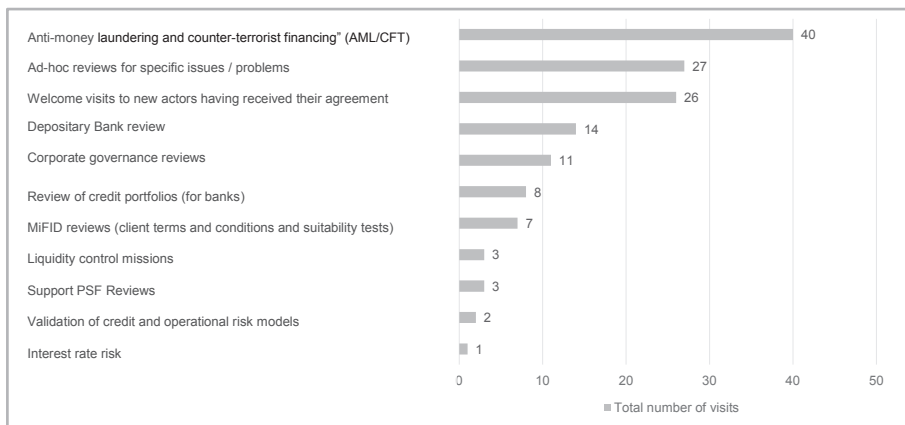


Table 5.10 – Details on on-site visits organized by the CSSF in 2014

The number of on-site visits is increasing over years.

It has also to be noted that in 2014, CSSF had sent to management companies nearly 200 letters as a result of weaknesses identified by the external auditor in either the long form report or the management letter. The themes covered were, among others:

- CSSF circular 2002/77 on NAV computation and compliance breaches (see additional information infra)
- Fight against money laundering and terrorist financing
- Valuations
- Fees and commissions
- Legal considerations
- Reconciliations
- Prospectus
- Transmitted information

During the same year, the CSSF has received more than 1300 declarations based on the above mentioned circular that have incurred significant indemnifications for the benefit of investors.

The auditor of an investment fund is appointed by the general meeting of shareholders of the fund (SICAV) or by the board of directors of the management company (FCP). It issues an opinion on the truth and fairness of the financial position of the fund as presented in the annual report. It is required to report to the CSSF all material breaches of the Law or regulations, every problem affecting the continuous functioning of the UCI and/or leading to a

refusal to certify the accounts. It must also inform the CSSF when it becomes aware that the information given to the CSSF and/or unitholders is incomplete or incorrect. It issues a review report on any material NAV computation error or breach of investment restrictions and their correction and attests the effective payment of the resulting compensation of the UCI and the unit holder. The auditor also provide a Long Form Report whose purpose is to report on the analysis of the operation and procedures of the UCI. The long form report is an important source of information for the CSSF in the performance of its supervisory functions.

The approach and the main objectives of the auditor can be summarized as follows:

Assertions	Classes of Transactions and Events for the Period under Audit	Account Balances at the Period End	Disclosures
Completeness	All transactions are input and processed once (i.e., transactions such as purchase/sale on investment, corporate actions, subscriptions/redemptions ...)	Assets, liabilities, or equity interests are not recorded (i.e., portfolio, capital, income, ...are missing).	Relevant transactions, events, or other matters are not disclosed (i.e., matters required to be disclosed are missing).
Occurrence	Recorded transactions or events are not valid (i.e. transactions are not booked on relevant UCI)		
Accuracy	Transactions or events are inaccurately recorded (i.e. wrong number of shares purchased, wrong price, wrong currency....).		Transactions, events, or other matters are inaccurately disclosed.
Cutoff	Transactions or events are recorded in the wrong accounting period (i.e. dividend recorded at pay date instead of ex-date).		
Valuation		Assets, liabilities, ... are not valued correctly (i.e. UCI portfolio is not valued correctly)	
Classification	Transactions or events are inappropriately classified or presented in the financial statements (ie. Cash and receivable or portfolio).		Transactions, events, or other disclosed matters are not classified and presented in the financial statements in an understandable manner.
Existence		Assets, liabilities and off balance sheet do not exist	
Occurrence and rights and obligations		Funds no longer have right to an asset or obligation to settle a liability	Disclosed events, transactions and other matters have not occurred and not pertain to the Fund

Table 5.11 – Eight audit assertions

The law requires that the Funds have the accounting information given in their annual report audited by an approved statutory auditor.

Regarding Net Asset Value calculation, the auditor is responsible for verifying the validity of the calculated NAV. In practice, auditors apply a risk-based

approach which consists in identifying for all kinds of funds what are the main kinds of risk regarding NAV calculation errors (investment portfolio composition, exchange rate, over-the-counter financial assets, etc.).

The auditor's objective is also to verify whether there are internal controls to ensure that an investment fund complies with its investment objective and restrictions. The auditor must check internal controls over eligibility of the assets held by the investment fund. In the case of UCITS, eligible assets are transferable securities, money market instruments, recently issued securities, units of UCITS and UCIs, cash and deposits, derivatives and government and public securities (ancillary liquid assets are also allowed). These assets must be traded in a regulated market i.e. a market that is regulated, operates regularly, is recognized and open to the public. The maximum share of other assets in the investment portfolio of a UCITS is limited to a maximum of 10% (trash ratio). Furthermore, UCITS are prohibited to invest in physical real estate and precious metals.

The auditor must also check the internal controls over diversification limits imposed to investment funds (UCITS). Especially, among others, a UCITS must not invest more than 10% of its total net asset in instruments issued by one corporate body and the value of all corporate investments which exceed 5% of its total net asset must not, in aggregate, exceed 40% of total net assets. Other investment restrictions concern the weight of government and public securities (maximum 35%), the bonds issued by an EU credit institution (maximum 25%), the counterparty exposure by over-the-counter derivatives (maximum 10% by counterparty if a credit institution or 5% otherwise) and the amount invested in cash balances and companies appearing in the same consolidated accounts (maximum 20%).

The auditor can be involved in different type of audit and can issue different kind of opinions and reports. Those reports can be requested by law (ie Financial Statements or long form report) or by an actor involved in the governance (i.e. ISAE 3402 report for Custodian Bank) or by parties interested in specific financial information (ie ad hoc report in the context of the distributions activities).

In case of significant weakness in internal controls the auditor will perform detailed testing of these limits.

A focus on CSSF circular 02/77

The CSSF circular set out the minimum rules of conduct to be followed by collective investment professionals in Luxembourg in case of errors and breaches in the administration or management of UCIs (UCITS, Part II and by analogy for SIF).

An error will result from the incorrect calculation of the net asset value (NAV). The NAV is incorrectly calculated when the rules provided for its determination

in the constitutive documents and prospectus are not strictly followed. This can occur in case of inadequate internal control procedures, management shortfalls, imperfections or deficiencies in the IT operations or in the accounting or communications systems. A breach will occur in case of non-compliance with investment rules defined in the prospectus or with investment restrictions or borrowing limits provided by the law or the prospectus.

The NAV calculation process is not an exact science. Indeed, some UCI can imbed complexity, some financial markets are highly volatile and availability of appropriate information is not always guaranteed. As such, to reflect this reality, the circular has introduced some tolerance thresholds to activate a remediation process that will depend from the nature of the underlying investments of the UCI (ie from 0.25% of the NAV for money market funds to 1% for equity funds).

It is worth to be noted that those thresholds do not apply for breaches. In that case, we will distinguish between an active breach which consist in a breach in case of an active investment decision, to the passive breach which can result from financial market evolution or significant movement in the subscription / redemptions. Remediation will only be required in case of active breaches.

The governance bodies of a UCI are responsible to ensure that those errors or breaches are correctly dealt with and the auditor plays a key role in this remediation mechanism. Indeed, we distinguish between a full procedure where a specific audit report is requested when the remediation action plan is set-up and a simplified procedure where auditor intervene during its annual review.

Full procedure	Simplified procedure
Reporting of the material error/active breach to the Promoter, custodian and the supervisory authority and submission to the initiator and the supervisory authority of an action plan to solve the problem	Applies to both NAV errors and active breaches and is possible when: <ul style="list-style-type: none"> • The total amount to compensate < €25.000 • The amount to compensate per investor < €2.500 <p>If only one of the conditions is met, the full procedure applies</p>
Remedial action plan provides precision on the proposed or already taken actions <ul style="list-style-type: none"> – categories of investors affected, – NAV re-computation, – amount to be paid to the fund / investors, – notification to the authorities where the fund is registered, – communication to injured investors 	No such remedial action plan needed as for full procedure
Put into place the improvements to the administrative and control structures which are necessary to avoid a subsequent re-occurrence of the problem	
Specific audit report	No specific audit report needed, compensation process audited during the year end statutory audit and reported in the Long Form report

Table 5.12 – CSSF 02/77 procedure and implication of the auditor

The Custodian bank plays also an active role in the supervision of the activities of the investment funds.

Before analyzing in more details the duties and the role of the Custodian Bank, it is interesting to review some situations where its responsibility has been recently questioned and has led the EU regulator to review and update its regime.

Madoff and Lehman Brothers Affairs	
<p>Madoff</p> <p>① Billions of assets lost (Ponzi scheme) that were managed by a SEC-registered company, B. Madoff Investment Securities LLC</p> <ul style="list-style-type: none"> • Three activities performed in the US by Madoff: broker-dealer, investment manager and depositary (for individuals and several investment funds, including Luxembourg) • Luxembourg investment funds appointed Luxembourg financial institutions as depositaries that delegated the safekeeping of certain assets to B. Madoff Investment Securities LLC <p>② Conflicts of interest (asset management vs depositary)</p> <ul style="list-style-type: none"> • Responsibility to return assets unclear and varying practices in EU under UCITS framework (hierarchy of the potential liabilities) • Many actors in the investment value chain in multiple jurisdictions 	<p>Lehman Brothers</p> <p>① Some French investment managers using LBIE (Lehman Brothers International Europe) as prime broker for 3 hedge funds, with two financial institutions acting as depositaries</p> <ul style="list-style-type: none"> • September 2008: default of Lehman Brothers <ul style="list-style-type: none"> – no segregation of client assets by LBIE – expected lengthy, uncertain process after the bankruptcy for the return of the client assets <p>② The French supervisory authorities AMF requested the two financial institutions to reconstitute the assets; the request was refused.</p> <ul style="list-style-type: none"> • AMF filed case in the French courts to require restitution. • In April 09, French courts demanded full and immediate restitution of assets with Lehman Brothers as prime brokers, by the fund depositaries of the hedge funds

Table 5.13 – Situations where custodian responsibility has been involved

The current custodian (or depositary) bank duties derive from the law of 2010¹⁶ and the EU UCITS directive. It will be soon updated to take into consideration the transposition of the UCITS V directive that will be effective in March 2016.

The core responsibilities of the depositary bank are the safekeeping and supervision of assets. Regarding safekeeping, the depositary bank takes care of the investment fund assets under management and has to return them upon demand – even if some derogation can be invoked under strict conditions. From the supervision perspective, the depositary bank needs to know at any time where and how the client's assets are kept in custody and how the client's assets are invested. The DB also needs to ensure that its sub-custodian network meets the required quality standards and financial soundness. Custodian banks also have control responsibilities. For FCPs and SICAVs, the custodian has the duty to ensure that subscriptions, redemptions and cancellations of shares or units comply with the law and the UCIs constitutive documents. It also has to ensure that the fund receives investment proceeds within acceptable timeframe

16. See also chapter 4

and that income is distributed to the share- or unit holders in line with the constitutive documents. There are two additional control responsibilities for the custodian bank of FCPs. First, it must process and validate instructions of the management company with respect to the law and the FCP management regulations. In addition, it has the duty to ensure that the NAV is calculated according to the law and the FCP management regulations. A custodian bank can delegate the safekeeping of assets but cannot delegate its supervision mission. In particular, UCITS V will extend those two last obligations to the SICAV. Hence, there will be a single regime applicable to both SICAVs and FCPs.

In Luxembourg, CSSF issued circular 14/587 that implement in advance the key features of UCITS V. In particular, the following new elements that will come into force when UCITS V is effective (i.e. March 2016) are considered and will be transposed in the Luxembourg law:

Eligibility and appointment	<ul style="list-style-type: none"> • Depositary must be an EU Credit institution, a national central bank or other authorized entities subject to CRD VI and equivalent supervision • Must have registered office or branch in UCITS Member States • Written contract appointing one unique depositary
Safekeeping	<ul style="list-style-type: none"> • Distinguishes financial instruments from other assets • Full safekeeping for Financial assets • Ownership verification and record keeping for other assets • UCITS assets to be segregated from Depositary Bank's own assets, including cases of safekeeping delegation • Re-use must be in the interest of UCITS, collateral must be of high quality with transfer title and permanently represent equivalent market value of re-used assets including premium
Cash monitoring	<ul style="list-style-type: none"> • Monitoring of all UCITS cash flows • UCITS cash must be registered in the name of the UCITS, of the Management Company (on behalf of UCITS) or in the name of the depositary (on behalf of the UCITS) • Cash correspondents must be eligible under EU Directive 2006/73/EC • Depositary must be informed of all UCITS cash accounts opened
Oversight, delegation and conflicts of interest	<ul style="list-style-type: none"> • Oversight on subscription / redemption, NAV, Investment Guidelines Monitoring, portfolio transactions timely settlement and income distribution • Depositary can only delegate safekeeping functions under objective reason and with due diligence (third party must comply to safekeeping requirements, including case of cascading delegation)
Liability and Governance	<ul style="list-style-type: none"> • Depositary is liable to UCITS for loss of financial assets (including when delegated) • Return lost assets of identical type and amount without undue delay • No assets return in case of external reason beyond depositary control • Liability for any loss suffered as a result of depositary's negligence

Table 5.14 – High level overview of CSSF 14/587 on depositary duties under UCITS V

It is important to note that the custody / depositary regime for AIF has been implemented in 2013 with the transposition of the AIFM Directive. The framework is similar to UCITS V. The major difference lies in the responsibilities in case of loss of an asset where under the AIFM regime some waiver can be invoked and under UCITS, such waiver do not exist.

6. Admission to trading of a UCI

6.1 *Introduction*

Investment funds are fundamentally long term investments and are as such not designed for trading on a regulated market. Nonetheless and to respond to specific needs they can be traded on stock exchanges as any other investment vehicle. In this chapter, we present the advantages of investment fund trading on stock exchanges as well as the regulatory environment related to the admission of investment funds to official listing and trading.

6.2 *Exchanges and regulated markets*

Historically, stock exchanges in Continental Europe were created mainly under the principles of the Code Napoleon and followed originally a monopolistic model with unity both in terms of time and location. The trading took place in a particular place (the exchange building) and was done at a given time by very specific professionals who published binding prices on an official list. Stock exchanges developed during the 19th century as well as the first half of the 20th century following this framework all over Europe. The main function of the exchanges was to provide a regulated capital market whose primary role is to help finance the economy by providing for a meeting place of demand and supply in securities and for price information about this market. Nowadays, the Napoleonic Code model has come to an end. The development of new technologies (mainly Information Technology) has led to a gradual shift to a broader concept of Regulated Market and today multipurpose Market Undertakings replaced the traditional stock exchanges.

The recent Markets in Financial Instruments Directive (MIFID I) defines the European framework related to regulated markets. Under this directive, a “Regulated Market” means a multilateral system operated and/or managed by a market operator, which brings together and facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its nondiscretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorized and functions regularly.

The modern exchange acts as a market undertaking with highly diversified business fields. This includes admission to the market (primary market), trading (secondary market), market surveillance, provision of market data, exchange indices publication, information technology services, education of the public and, in certain cases, central counterparty, clearing and settlement.

In a modern exchange, a Trading Member Firm (TMF) first brings in orders to be executed on the exchange. However, for each order to buy or sell a 1000 shares a TMF willing will probably not (except in extreme cases) find a unique buyer or seller for exactly the same number of shares but for instance 5 different counterparties buying or selling 200 shares each. Because of the complexity of all the deals involved, the payment and delivery of the securities can only take some time after the price was made at the exchange. In practice this is now two days after the moment the transaction was made on the exchange. But shares will no longer be physically delivered but this will take place thanks to a Central Security Depository (CSD) which keeps an electronic record of all securities held by investors (in book entry-form). When transactions take place the ownership of the securities will only be passed from one customer's account to another one in parallel with the transfer of the cash position. Thus at the end of the two days, the single position of 1000 shares is replaced by 5 new positions of 200 shares each in the records. In addition, major exchanges have introduced the concept of the Central Counter Party (CCP) which allows the TMF to deal with a single central counterpart instead of 5 different ones. The advantages of the CCP are depicted in Table 6.2.

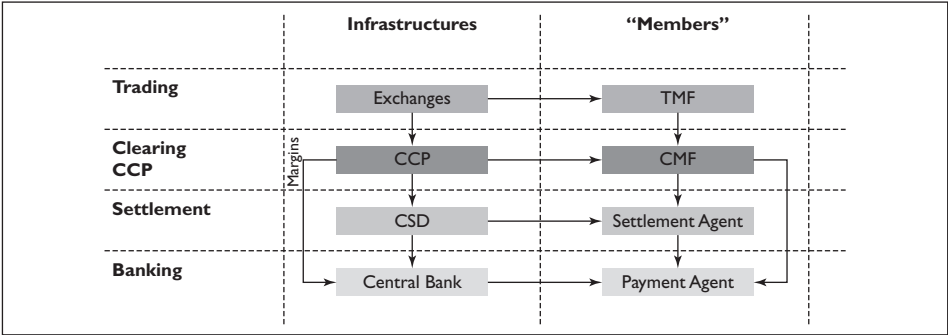


Table 6.1 – The modern exchange market infrastructure – source: LCH Clearnet – central counterparty March 2011

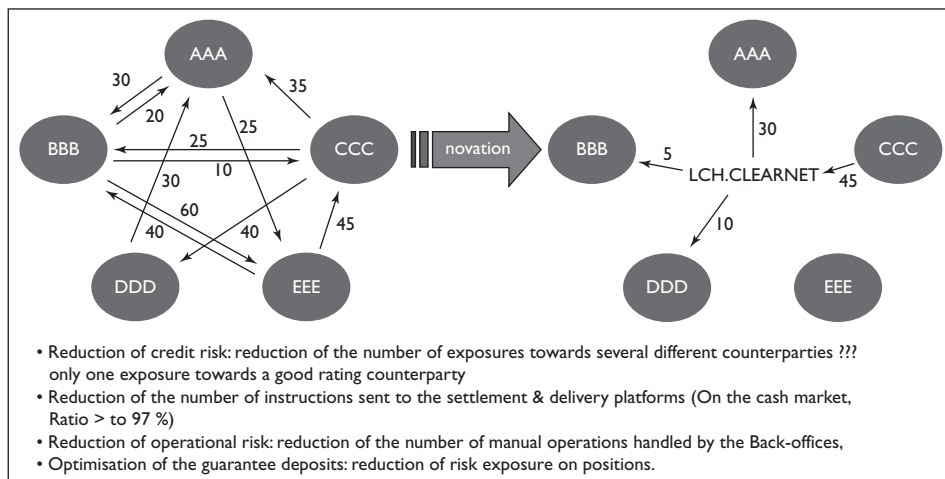


Table 6.2 – Multilateral netting – source LCH Clearnet – central counterparty March 2011

Regarding the legal framework, the MIFID outlines the rules which regulate the carrying out of market activities in Europe (see Table 6.3). It defines a very broad scope for exchanges and harmonized transparency rules which are supposed to protect investors. In particular, the investor must have the best execution of his order which requires that all transactions be reported to the central authorities. MIFID also imposes that market data be published as close to real time as possible in a format that facilitates consolidation with a real time monitoring to ensure data integrity.

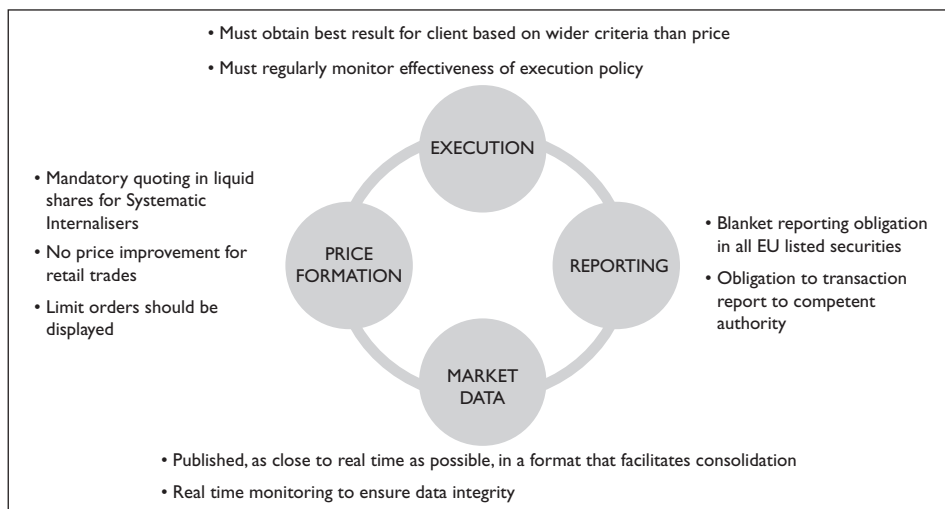


Table 6.3 – Main requirement of MIFID – source: London Stock Exchange

However, MIFID unexpectedly created several adverse consequences such as a decrease in transparency due to the increased variety of trading modes, an increased resort to Over the Counter Markets (which also decreases transparency) and a fierce competition between the different types of markets or market venues. As a consequence, MIFID is currently being revised. Tables 7.4 and 7.5 show an example of how the introduction of MIFID led to more complex interactions between market players.

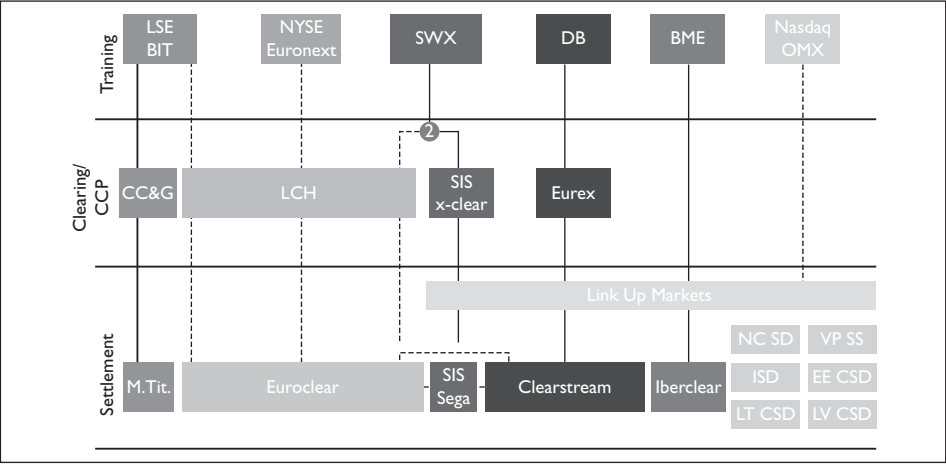


Table 6.4 – European equity landscape before MIFID – source: FESE

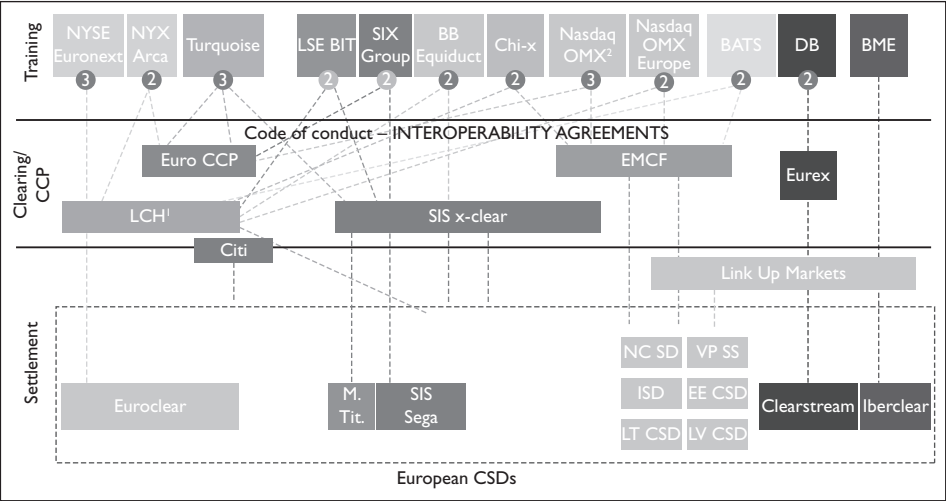


Table 6.5 – Fragmentation of European equity market after MIFID – source: FESE

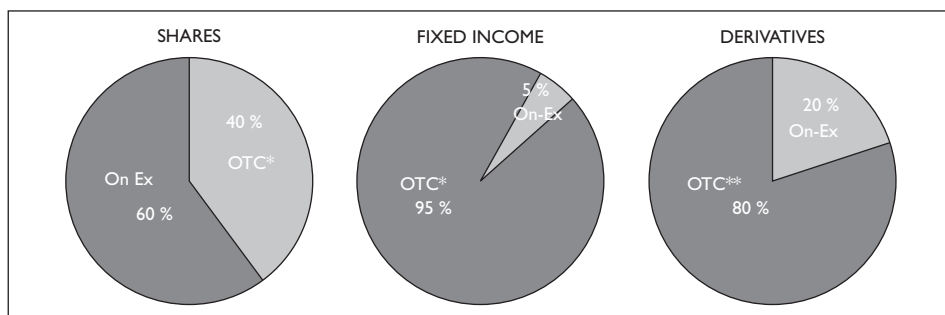


Table 6.6 – Exchanges and OTC markets – source: FESE

By early 2017 a new EU regulatory framework will come into force with two different pieces of legislation a MIFID II a Directive and MIFIR a Regulation. The regulated market activities will be impacted mainly by the creation of a new category of trading venue and by measures to push more trading onto regulated trading venues. Furthermore, the pre- and post-trade transparency will be increased and extended to new categories of securities and there will be measures taken to promote access to clearing facilities and benchmarks will be established to improve competition between central counterparties (CCPs) and trading venues. This reform will counter most of the negative consequences of MIFID I. And overall, the role of regulated markets, stock exchanges included, will be strengthened.

6.3 Advantages of listing a UCI at the exchange

Now that we have briefly introduced the basics of the functioning of exchanges in general, we can focus on the advantages of investment fund listing on exchanges.

Legal structure	Nr. of Share Classes	%	
Part I (law 2002)	27042	73.60%	
Part II (law 2002)	4413	12.01%	
Law 22 March 2004	21	0.06%	
Law 15 June 2004	10	0.03%	
SIF	3788	10.31%	
Non-LUX UCIs	1470	4.00%	
Total		36744	

Table 6.7 – Share classes by legal structure in Luxembourg - source Luxembourg SE

Table 6.7 displays the distribution of share classes in Luxembourg. Most share classes (almost all Part I funds) perform their NAV calculation every day while more sophisticated funds can have NAV Calculation on a less frequent basis (weekly, monthly or even quarterly). Although it may seem unnecessary to list on an exchange investment funds which are valued on a daily basis, there exist several reasons related to share distribution, redemption and commission which can make the listing of investment funds on exchanges advantageous. Luxembourg investment funds are sold all over the world, which requires setting up complex distribution networks. Investment funds can either have their own distribution network or rely on networks of banks and of specialized, independent distribution agents. If investment funds are not traded on exchanges, investors have to go through a lengthy process which includes banks, distributors and order agents (see Table 6.8). In addition, the purchase or redemption price is calculated only once a day (for investment funds with daily NAV Calculation) and depends on the order being placed before or after the cut-off time. Lastly, subscription and redemption are subject to commissions which may be a function of the investment size and/or the duration of the investment.

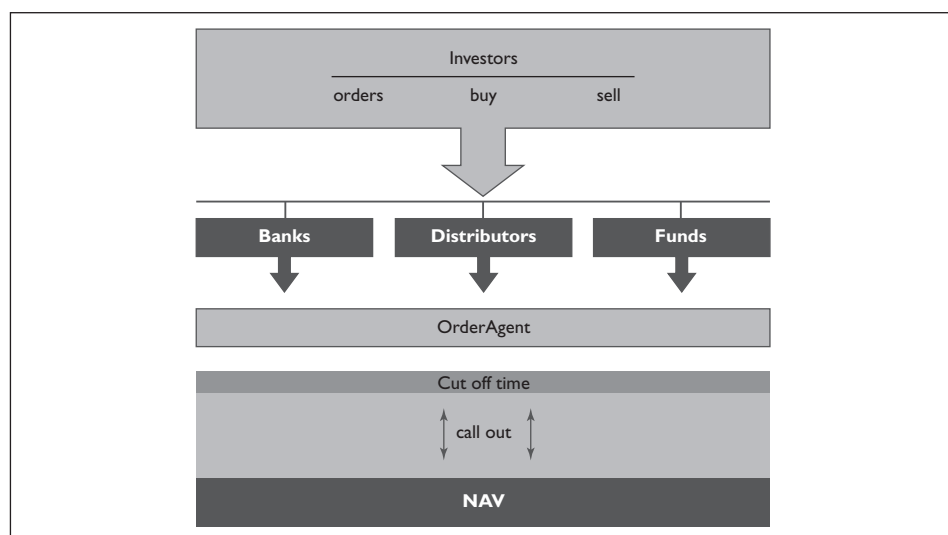


Table 6.8 – Traditional process for investment in an investment fund

The advantages of listing funds are threefold. First, some institutional investors are required to exclusively invest in listed securities. As a consequence, they cannot invest in funds unless these are traded (listed) on an exchange. In addition, the existence of a secondary market for mutual fund shares allows for a shorter required period of time to buy or sell mutual fund shares as they can be directly traded on the market. The secondary market also allows the investors of closed-end funds (funds with a limited number of shares which

are not redeemable before fund maturity) and investors of funds with less-frequent NAV calculations and redemptions to sell their shares on the market at any time. Moreover, the transaction price is an immediate price (the market price) instead of the next NAV if the shares are to be redeemed by the fund. Other advantages of the existence of a secondary market can be lower transaction costs (subscription and redemption commissions), the immediate and best execution of the order, the possibility of using various techniques related to execution of such orders such as limit orders and the transparency of the execution conditions. Lastly, with respect to the international distribution of mutual fund shares, intermediaries can be avoided through the direct purchase or sale of mutual fund shares on the exchange and the network of its international trading members.

1. Benchmark evaluation	Evaluation of statistical analysis of correlation for all funds in order to determine a benchmark with the highest correlation. Example: cominvest Fondak P – DAX Index: Correlation 0,94267														
2. Beta coefficient evaluation	Example: cominvest Fondak P – DAX Index: Beta coefficient 0,77937														
3. Quotation	<p>Last NAV +/- continuous real-time change of the benchmark * Beta coefficient</p> <p><u>Simplified example:</u></p> <table> <tr> <td>cominvest Fondak NAV yesterday 1pm</td><td>100 Euro</td></tr> <tr> <td>DAX Index today compared to yesterday 1pm</td><td>+1,54 %</td></tr> <tr> <td>Adjustment according to beta coefficient</td><td>(1,54 % * 0,77937)</td></tr> <tr> <td>Expected increase of NAV today</td><td>+1,20022 %</td></tr> <tr> <td>Bid cominvest Fondak today</td><td>101,20 Euro</td></tr> <tr> <td>+ Spread 0,5 % (max. 1,5 %)</td><td>0,506 Euro</td></tr> <tr> <td>Ask cominvest Fondak today</td><td>101,71 Euro</td></tr> </table>	cominvest Fondak NAV yesterday 1pm	100 Euro	DAX Index today compared to yesterday 1pm	+1,54 %	Adjustment according to beta coefficient	(1,54 % * 0,77937)	Expected increase of NAV today	+1,20022 %	Bid cominvest Fondak today	101,20 Euro	+ Spread 0,5 % (max. 1,5 %)	0,506 Euro	Ask cominvest Fondak today	101,71 Euro
cominvest Fondak NAV yesterday 1pm	100 Euro														
DAX Index today compared to yesterday 1pm	+1,54 %														
Adjustment according to beta coefficient	(1,54 % * 0,77937)														
Expected increase of NAV today	+1,20022 %														
Bid cominvest Fondak today	101,20 Euro														
+ Spread 0,5 % (max. 1,5 %)	0,506 Euro														
Ask cominvest Fondak today	101,71 Euro														

Table 6.9 – Example of mutual fund quotation – source: Clearstream

In order to have a continuous quotation for mutual funds which are by definition not valued more than once a day, market makers use statistical approaches. For instance, they select a benchmark¹⁷ whose performance is highly correlated to that of the investment fund of interest. They can then calculate a measure called the “beta” which can be defined as a measure of how the Net Asset Value of the fund and the value of the benchmark move with respect to each other. For instance, if a fund has a beta of 0.8 with respect to its benchmark, the Net Asset value of this fund is 0.8 times the value of the benchmark. Thanks to this measure, it is possible to make estimations of the value of the mutual fund based on the performance of the benchmark which is known on a continuous basis and propose binding bid and ask prices during the opening hours of the exchange. This process is illustrated in Table 6.9.

17. Which is usually an index representing a given geographical market, security type and/or sector for instance.

6.4 *The stock exchange in Luxembourg and Brussels: some key figures*

The Luxembourg stock exchange was created in 1928 as a for-profit organization and is still an independent stock exchange whose shareholders are principally Luxembourgish, Belgian and French banks. Though it is a medium-size stock exchange, it is internationally recognized as a leader for listing of international securities. It employs some hundred persons (all in Luxembourg) and signed a partnership with NYSE Euronext in April 2006 following a cross-membership agreement in 2000. It is a founding member of the World Federation of Exchanges (WFE) in 1961 and of the Federation of European Securities Exchanges (FESE) in 1974. With regard to listing, the Luxembourg stock exchange is an international center with 3 000 issuers coming from 100 countries. Among these issuers, there are 70 sovereign states and 12 supranational institutions. The Luxembourg stock exchange is the European leader in the listing of international bonds and second after NYSE Euronext for the listing of Depositary Receipts. Those figures are summarized in tables 6.10 through 6.12

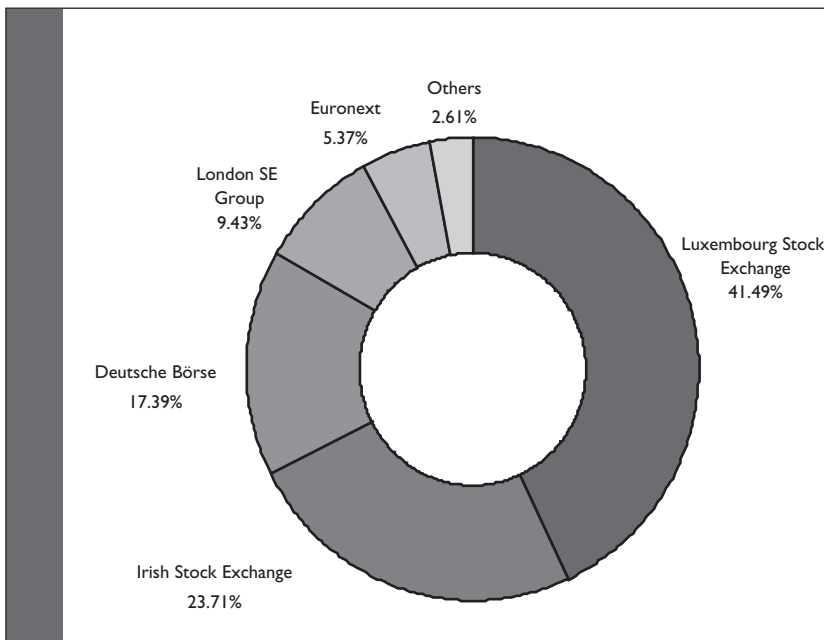


Table 6.10 – Distribution of the listing of international bonds by stock exchange

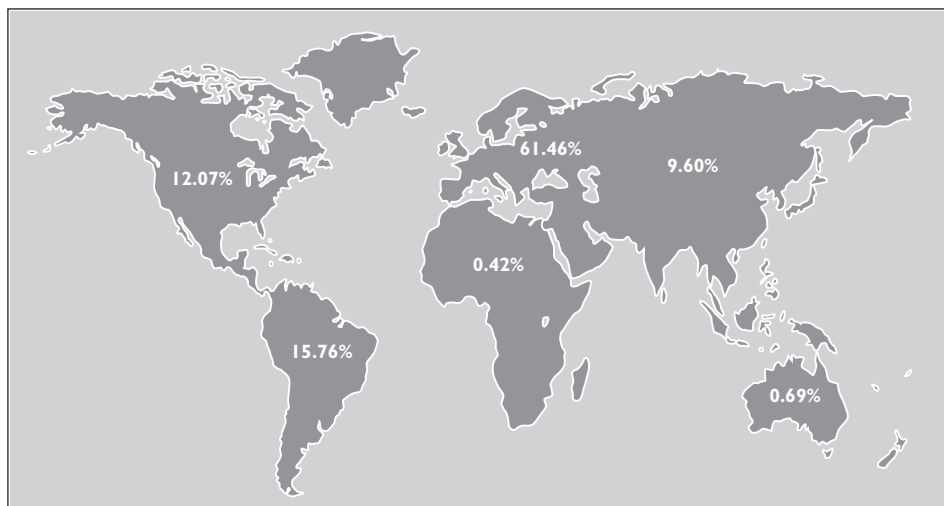


Table 6.11 – Issuers by region - source Luxembourg SE

Quotation lines (March 2015)	
Bonds	26,065
Warrants	5,524
Shares/DRs	236
Luxembourg	30
Foreign	206
UCITS	6,664
Luxembourg	6,522
Foreign	142
Total	38,489

Breakdown by currency (bond issues)

50% EUR 27% USD Other 23%

Table 6.12 – Number of quotation lines by type of instruments - source Luxembourg SE

L A R C I E R

The Luxembourg stock exchange can be further split into two different types of markets. The BdL Market (since May 1929) and the EURO MTF (since July 2005). The BdL market is governed by European Union rules which imply that securities traded on this market have a European passport and can be listed and traded in any other European exchange. Next to this market, the EURO MTF market is mainly for non-EU issuers of listed securities and is less tightly regulated. These two markets share several characteristics such as the absence of restriction to market access (any type of investor of any size), the trading platform and the mechanism for investor protection via MIFID, the market abuse law, the CSSF as regulatory authority and the use of multi-language regime. They mainly differ in the disclosure policies and rules. For the BdL market, European rules apply regarding prospectus approval, information to be published and disclosure requirement while on the EURO MTF market, standards of the issuer's country can be used instead (see Table 6.13).

	European regulated market (BdL Market)	Exchange regulated market (Euro MTF)
Authority for prospectus approval and regulatory framework	<ul style="list-style-type: none"> • Commission de Surveillance du Secteur Financier (CSSF) • Prospectus law and EU regulations 	<ul style="list-style-type: none"> • The Luxembourg Stock Exchange • Prospectus law plus Rules and Regulations of the Exchange
Pan-European passport	<ul style="list-style-type: none"> • Yes 	<ul style="list-style-type: none"> • No
Information to publish	<ul style="list-style-type: none"> • Transparency law • Market abuse law 	<ul style="list-style-type: none"> • Rules and Regulations of the Exchange (consisting of former requirements regarding the official list)
Disclosure requirements	<ul style="list-style-type: none"> • IFRS or equivalent obligations 	<ul style="list-style-type: none"> • IFRS obligations, US GAAP or obligation of the country of the registered office

Table 6.13 – Differences between BdL and EURO MTF markets

In 2005, the Luxembourg stock exchange in association with the Association of the Luxembourg Fund Industry (ALFI) and 30 Luxembourg financial institutions launched a subsidiary dedicated to UCIs called Finesti now called Fundsquare. In 2002, it became a 100% subsidiary of the Luxembourg stock exchange. Its goal is to provide the industry with a unique tool to enhance access and distribution of Luxembourg data and documents. Fundsquare operates as a communication hub between the producers and the consumers of investment fund data. It collects information from varied sources and transmits it to the investing public and to the Luxembourg supervisory authority (CSSF). It also guarantees the quality of the available information on Luxembourg mutual funds. Over the years the services of now Fundsquare have been extended as can be seen

from the two following tables. The functioning of the hub is reproduced in table 6.14.

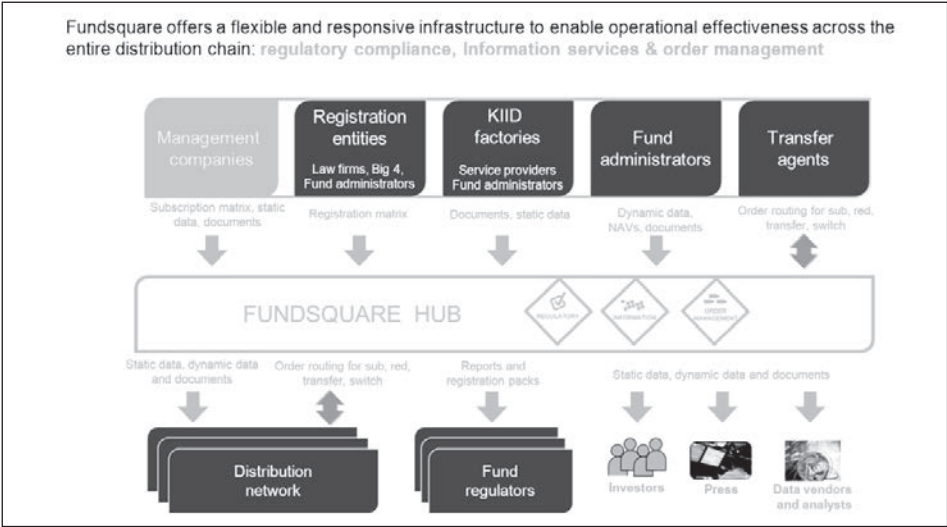


Table 6.14 – Fundsquare as a communication hub - source Fundsquare

The role of Fundsquare in cross border distribution of funds is reproduced in table 6.15

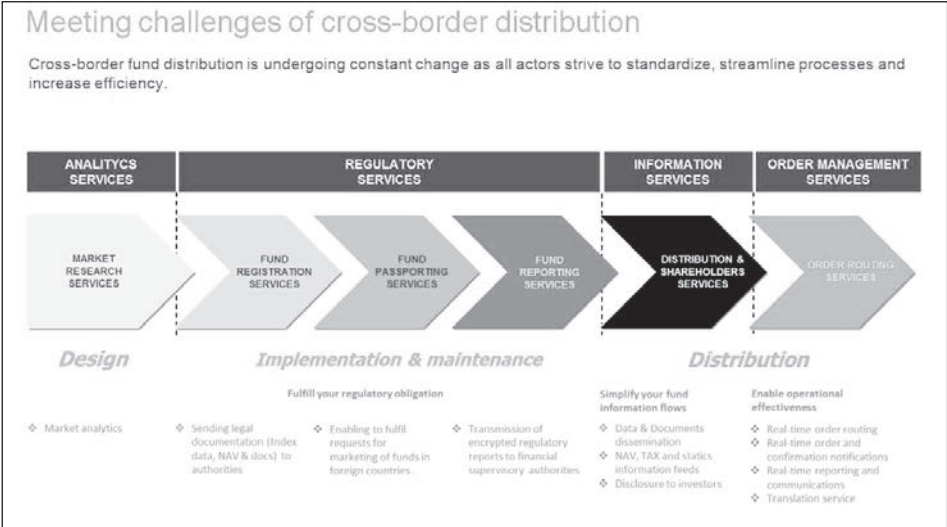


Table 6.15 – Fundsquare's role in the cross border distribution of funds - source Fundsquare

The Brussels stock exchange was created in 1801 on the French model. It progressively grew throughout the 19th century and supported industrial development in Belgium. During the 20th century, it experienced several reforms and a gradual liberalization. In 1999, the Brussels Exchange SA was created and merged one year later with Paris and Amsterdam exchanges to create Euronext. Brussels exchange is mainly focused on equities and especially on gold mines. In 2002, Euronext acquired LIFFE (London future market) and merged with Lisbon. They further merged with NYSE (New-York Stock Exchange) in 2006 but tried unsuccessfully to merge with the Deutsche Börse in 2011. In 2013 ICE (Intercontinental Exchange from the US acquired NYSE Euronext and in 2014 a spinoff from the merged entity was made with Euronext (Belgium, France, Netherlands and Portugal). Thanks to an IPO, Euronext is now back to its roots.

6.5 Admission to official list and trading and continuing obligations

Before explaining the procedure to be admitted to the official list and trading, we must emphasize the difference which may exist between admission to the official list and admission to trading. The notion of admission to the official list dates back to the Code Napoleon under which only securities on the official list were given an official price. This notion remains in many regulations. When the European regulation was introduced, it was no longer question of admission to the list but of admission to trading, which may have created some confusion. Some exchanges (mainly Anglo-Saxon ones) have kept this notion of admission to the list and allow securities to be on their official list although they cannot be traded on their trading platforms (but only through other intermediaries). They nevertheless fall under the regulatory framework of the exchange (e.g. MIFID in Europe). In Luxembourg, both concepts coexist but admission to the list automatically encompasses admission to trading so that all securities admitted to the Luxembourg stock exchange list can be traded through its trading platform.

The Luxembourg exchange is second in Europe in terms of the number of investment funds listed (see Table 6.16) after Dublin. The main difference between the Luxembourg and the Irish exchanges lies in the fact that the former mainly lists domestic funds while the latter mainly lists foreign funds.

Exchange	2011	2012	2013	2014	2015
	December	December	December	December	February
Luxembourg SE	6 440	6 383	6 274	6 613	6 608
Irish SE	7 488	7 510	7 130	7 367	7 408
BME Spanish Exchanges	3 083	3 064	3 066	3 271	3 291
Deutsche Börse	2 802	2 816	2 926	3 097	3 111
NYSE Euronext (Europe)	189	194	210	192	191
London SE Group	26	26	25	25	25

Situation for the Luxembourg SE per 30 September 2015: 6.664

Table 6.16 – UCI listed on European stock exchanges - source Luxembourg SE and FESE

Theoretically, the fund admission procedure starts with introduction of a file by the central administration of the fund. In practice, this function is usually delegated to a listing agent (member of the Luxembourg stock exchange) or to specialized law firms. The competent authority for the approval of public offer and marketing is the CSSF while the Luxembourg exchange is in charge of the approval of admission to the official list and to trading. The regulatory aspects related to admission to trading are governed by the Article 36 of Regulation EC 1287/2006 of the European Commission which implements the Article 40 of MIFID. The Luxembourg stock exchange applies the same principles to the case of admission to EURO MTF market. The regulatory aspect related to the admission to the official list and trading in Luxembourg is dealt with in the Grand Ducal Regulation of 13 July 2007 on the holding of an official list. Closed funds are subject to a specific regulation which is comparable to that applied to ordinary share companies.

Luxembourg UCIs, UCIs with the European passport and authorized (by the CSSF) non-European UCIs automatically fulfill the requirement for listing and trading on the Luxembourg exchange. In these cases, the fund prospectus is complete enough to be used as the listing/trading prospectus. One of the most important issues for a fund to be listed is that it has to be registered in an international central security depository (CSD) since to be listed a fund's shares have to be freely transferable. There are currently two international CSD which are recognized by the Luxembourg stock exchange i.e. Clearstream (Luxembourg) and Euroclear (Brussels). LuxCSD, the Luxembourg CSD has been created to provide Luxembourg's financial community with issuing and central bank settlement as well as custody services for a wide range of securities including

investment funds. The European Central Bank (ECB) approved LuxCSD for its Securities Settlement System (SSS). LuxCSD can also serve as recognized CSD.

The Luxembourg regulation defines the required files which have to be filled by an investment fund to be considered for admission to the official list and trading. These files include, among other things, the application form, a copy of the prospectus, the articles of incorporation of the fund, the security code assigned by a recognized ICSD and the confirmation of the eligibility of the securities by the CSD as well as the latest financial reports.

Once listed, investment funds are obliged to provide to investors a certain amount of information (for instance changes in the legal structure of the fund). The definition of the continuing obligations is provided in the regulation. Corporate actions such as share splits, amount of dividends paid, payment date, paying agent, etc. These information have to be reported by the fund on a continuous basis. The market abuse directive and law obviously apply to listed investment funds. In particular, all investment funds are concerned by insider trading and market manipulation. Mutual funds also have the obligation to publish any price-sensitive information. Transparency rules apply to closed-end and non-European investment funds.

Exchange	2012			2013			2014			February 2015		
	Domestic	Foreign	Total	Domestic	Foreign	Total	Domestic	Foreign	Total	Domestic	Foreign	Total
Irish SE	4 751	2 814	7 565	4 841	2 289	7 130	5 860	1 507	7 367	6 011	1 397	7 408
Lux. SE	6 218	124	6 343	6 141	133	6 274	6 476	137	6 613	6 468	140	6 608

Situation for Luxembourg as per 30 September 2015.

Domestic: 6.522

Foreign: 142

Total: 6.664

Table 6.17 – Domestic and Foreign UCIs listed on the Luxembourg and the Irish SEs - source Luxembourg SE and FESE

7. Distribution of UCIs

7.1 Introduction

This final chapter investigates the distribution of investment funds in Luxembourg. The chapter covers the basic facts about distribution of funds in Luxembourg, statistics, public/private offer, the notification procedure, distribution networks and the remuneration scheme of placement agents.

7.2 Distribution

The ease of distribution of investment funds in Luxembourg is an increasing function of the regulation which applies to each specific kind of funds. For instance, UCITS funds are the most regulated types of investment funds in Luxembourg but, at the same time, they are also the investment funds which are the easiest to distribute (least restriction). Because of the stringent guidelines imposed to UCITS, it is not only easier to sell them but also to convince investors to buy UCITS shares. At the other end of the spectrum, funds from non-regulated jurisdiction (such as the Cayman Islands) represent the most difficult kind of investment fund to sell and can only be distributed on a private placement basis. SIFs and Part II funds lie in-between.

In particular, outside Luxembourg, UCITS funds can normally be sold on a private or public placement basis while Part II funds which do not benefit from the European Passport are usually sold on a private placement basis and SIFs are only available on a private placement basis.

Key criteria	UCITS	UCI	SIF
Investment restriction (eligible assets)	Restricted	Flexible	Flexible
Risk diversification	High	Medium	Low
Ease of public distribution	High	Medium	Low
Supervisory framework	Targeted to retail investor protection	Targeted to retail investor protection	More flexible
Time to establish	Low – Medium	Medium	Very low
Target investors	All	All	Institutional / HNWI

Table 7.1 – Comparison of the three main investment fund regimes in Luxembourg

The distributors of a SICAV are appointed by and under the supervision of the board or directors of the SICAV (or by its management company if the SICAV has designated a management company). The distributors of the FCP are appointed by and under the supervision of or the management company of the FCP. In addition to the supervision of the board, distributors of a UCITS are also supervised by the conducting officers of the fund or of its management company (if any).. In practice, the decision of the target investors and distribution network rests on the fund initiator.

7.3 Statistics

Luxembourg is the first financial center for the distribution of global funds (cross-border distribution) thanks to, among other things, its economic and political stability. Luxembourg is also characterized by an outward looking and collaborative approach between government, regulator and fund industry. The flexibility of the regulator makes it receptive to propositions arising from the fund industry which can enhance the efficiency of the investment fund industry while not being detrimental to investor's protection. The quality of the infrastructure, support and experience in global fund distribution also make Luxembourg a recognized "brand" and the first financial center for cross-border fund distribution.

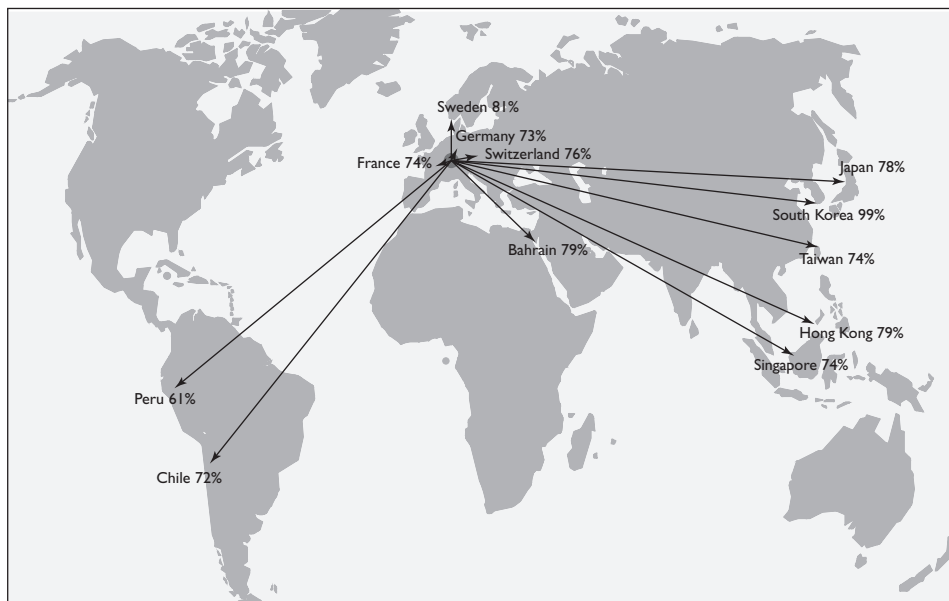


Table 7.2 – Luxembourg share of cross-border funds for public distribution

Management group name	Countries of sale at group level	First choice Fund domicile / Countries of sale	
FRANKLIN TEMPLETON	50	Luxembourg	48
HSBC HOLDINGS	42	Luxembourg	39
BLACKROCK	40	Luxembourg	36
SCHRODER	38	Luxembourg	25
BNP PARIBAS	33	Luxembourg	32
FIL INTERNATIONAL	33	Luxembourg	32
SOCIETE GENERALE	32	Luxembourg	30
BARCLAYS	30	Ireland	22
JPMORGAN CHASE & CO	30	Luxembourg	30
INVESCO LTD	29	Luxembourg	29
ALLIANZ GROUP	28	Luxembourg	27
DEUTSCHE BANK	28	Luxembourg	20
SWISS & GLOBAL ASSET MANAGEMENT	28	Luxembourg	22
UBS	28	Luxembourg	28
FORTIS GROUP	27	Luxembourg	27
LEGG MASON	27	Ireland	22
PIONEER INVESTMENTS	26	Luxembourg	26
BNY MELLON / WESTLB MELLON	25	Ireland	21
ABERDEEN ASSET MANAGEMENT	24	Luxembourg	24
CREDIT AGRICOLE	24	Luxembourg	24
CREDIT SUISSE GROUP	24	Luxembourg	23
ING GROEP	24	Luxembourg	24
HENDERSON GROUP PLC	23	Luxembourg	22
LLOYDS TSB GROUP	23	Jersey	10
MORGAN STANLEY	23	Luxembourg	22

Table 7.3 – Leading cross-border management group

7.4 *Public offer/ Private offer*

An offer is the invitation made to someone to subscribe to a fund. A public offer is an offer made to the public. Each country has its own criteria to determine what a public offer is. In Luxembourg, the rule is based on the methods used to advertise the fund. Public offers can be done for instance through the media or through the public distribution of information. On the other hand, if the distributor directly contacts institutional investors and has meeting face to face with potential investors, this is considered as a private offer. In Luxembourg, this distinction is not clear-cut. In many other countries, the distinction is made

on the basis of the number of investors which are approached by the distributor (beyond a certain number of investors, the offer is considered as being public), the type of investors which are targeted – i.e. retail investors for public offers and institutional investors for private offers - or the number of investors who actually invested into the fund. For the time being, there is no harmonization on the definition of public vs. private offers even at the European level.

7.5 *Notification procedure*

This section describes the procedure which must be followed when a distributor wants to sell a Luxembourg fund abroad. A UCITS (benefiting from the European Passport), has to tell the regulator of its country of origin that it wants to distribute its fund in a foreign country. The home regulator is responsible for informing the foreign country regulator. Translation of documents is no longer required (if they are in English) except for the Key Investor Information Document (KIID). Distribution in the foreign country is then authorized on the day following the notification to the foreign regulator. This new process only applies in the European Union even if some countries outside the European Union (such as Hong Kong, Singapore and Bahrain) also facilitate the distribution of a UCITS in their jurisdiction.

Part II funds (no European Passport) are usually sold on a private placement basis but some countries such as the Netherlands, Switzerland, etc. accept that Luxembourg Part II funds be registered for public distribution. However, in this case the foreign regulator scrutinizes the documentation in more details (investment policy, risk diversification, service providers) to ensure that the mutual fund is similar to a national fund. If they conclude that the Part II fund is equivalent to their national funds, they may accept the distribution of the Luxembourg Part II fund in their country. Because of the absence of the European Passport for Part II funds, this process is much longer than for UCITS funds.

SIFs cannot be sold on a public placement basis outside Luxembourg. In case of private placement (for UCITS, Part II and SIFs), the fund has to comply with the private placement rules of the jurisdiction in which it places its shares. It is worth noting here that certain countries, including Luxembourg, do not allow foreign UCITS to be distributed on a private placement basis.

7.6 *UCIs marketed in Luxembourg*

This section deals with the case of funds which are intended to be sold in Luxembourg. Luxembourg UCIs can always be distributed on public placement basis in Luxembourg as they have been subject to Luxembourg regulation. Even

Luxembourg SIFs can be publicly distributed in Luxembourg even if they can only be sold to well-informed investors i.e. the characteristics of the investor must be checked but the way through which investors are contacted can be public. Foreign European UCITS can obviously apply the same procedure as the one described in Section 7.5.

Other foreign funds could be sold to the public in Luxembourg provided that they are regulated. In this case, Luxembourg regulator verifies the characteristics of the fund. A non-regulated fund cannot be sold to the public in Luxembourg.

Regarding private placement, open-ended non-UCITS can be sold on a private placement basis. Closed-end fund are subject to clear criteria for distribution. Surprisingly, UCITS cannot be sold on a private placement basis in Luxembourg.

7.7 *Distribution network*

The first possibility is to sell fund shares on a private placement basis. The fund promoter can sell the shares within its own group (internal network). Alternatively, it can have an agreement with several foreign banks and be sure that these banks will sell the fund shares to clients on a private placement basis (third party distributors). Large promoters usually use the internal network alternative. Regarding public placement, funds usually appoint an entity (the distributor) that will itself go to the public.

When a fund decides to appoint one or more third party distributors, it has to negotiate distribution agreements. Of course these distributors require to be remunerated and one difficulty may arise from the need to reconcile the interest of both parties in the agreement.

The role of distributors and nominees is defined in the IML Circular 91/75¹⁸. A nominee is also someone in charge of placing fund shares with his clients but the nominee is considered as being a client of the fund. In other words, the nominee is supposed to be the one who buys the shares of his clients. As a consequence, the names of the clients do not appear in the fund's shareholder register (the name of the nominee does) so that their identity is kept secret and confidential. The role of the nominee can be twofold. One possibility is that the nominee is appointed by its client to buy shares in a fund. In this case, this is purely an arrangement between the nominee and its client which does not directly concerns the mutual fund. Another reason why a nominee can intervene is due to the desire of the fund to appoint the nominee as an agent and request investors to subscribe through the specified nominee. In this case, it is an agreement between the fund and the nominee. Nowadays, distribution of UCITS funds is usually done through nominees.

18. Revision and remodeling of the rules to which Luxembourg undertakings governed by the Law of 30 March 1988 on undertakings for collective investment («UCI») are subject.

7.8 *Remuneration of placement agents*

There are three ways through which distributors can be remunerated: the sales charge, distribution fees and retrocessions.

The sales charge is a remuneration which is based on a certain percentage¹⁹ which is added to the price (NAV) of the fund share when the investors subscribe to the fund and is kept by the distributor as a remuneration. While these charges may be applied to retail investors, institutional investors generally refuse to pay this kind of subscription charges. Distribution fees are taken on the values of the shares on an annual basis. The most commonly-used remuneration scheme is the retrocession. The manager of the fund receives management fees. The manager then pays a part of these fees to the distributor (up to 50% of the management fees). Management fees are a percentage of the total assets of the fund. Consequently, the interest of the distributor is to increase the size of the fund as much as possible which is in line with the interest of the manager.

19. Maximum 5% in Luxembourg.

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