Arendt NY Webinar Series

What fund managers need to know about Luxembourg regulatory developments

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Agenda

- Introduction
- UCITS investment in securitised instruments
- ESMA Guidelines on performance fees in UCITS and certain types of AIFs
- European benchmarks reform
- CSSF’s position on UCITS investment in loans
- Regulatory spotlight on robust liquidity management governance frameworks
- Q&A
- Conclusion

Introduction

Luxembourg Fund Industry

Cross-border fund distribution to 77 countries

1728 UCITS

More than **58% of UCITS funds** distributed internationally are based in Luxembourg (average registrations per true cross-border fund: 8,7 in 2019 and 7,7 between 2004 and 2019)

60 custodians

137 central administrators

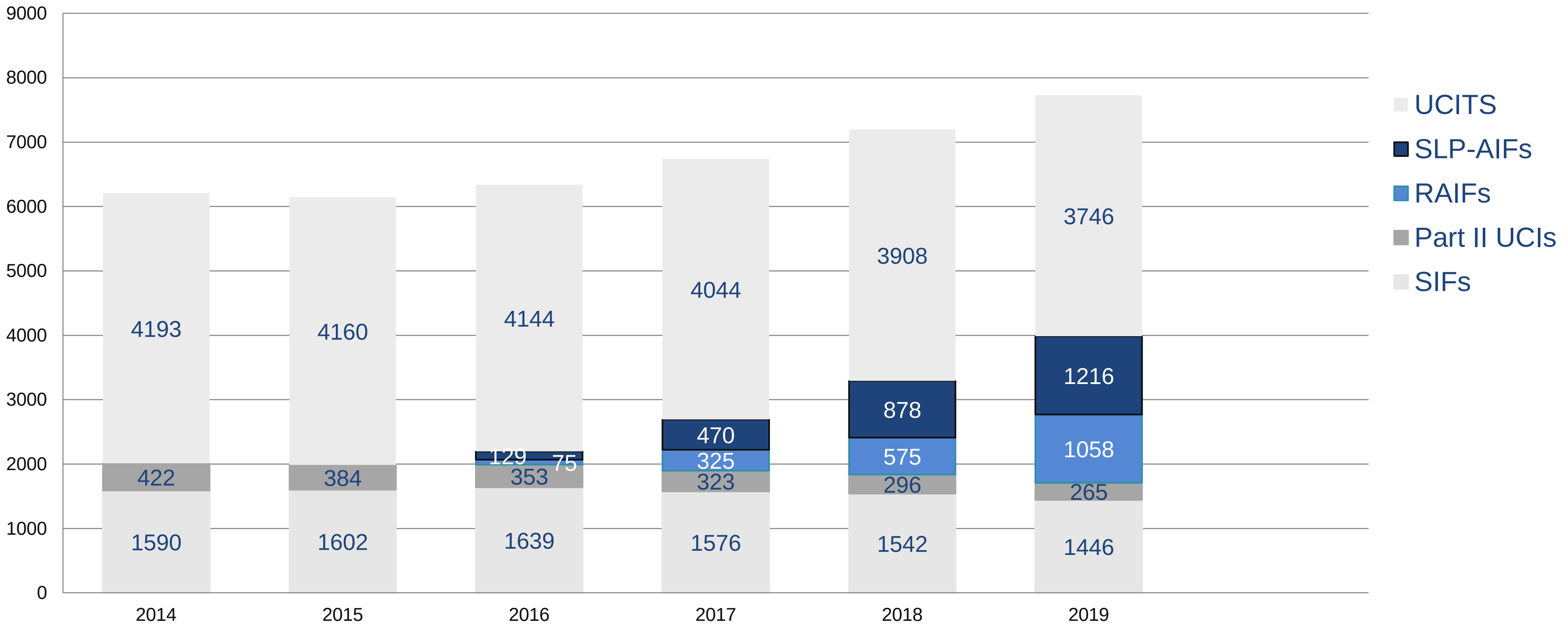
270 professional service firms

17 025 people employed in the industry

267 fully authorised AIFMs (PE/VC, real estate) and **602** registered AIFMs in Luxembourg

Source: ALFI/CSSF Oct 2020

Number of Luxembourg alternative funds / UCITS



Source: ALFI. For the SLP: Monterey reports 2017, 2018, 2019 and 2020

Evolutions in the Luxembourg UCI sector in 2019

Consolidation trend with preference to umbrella structures

- Decrease of registered UCIs from 3,908 (31 Dec 2018) to 3,746 (31 Dec 2019)
  - 2,452 with umbrella structure (decline of 84 entities)
  - Single-compartment UCIs decreased by 78 entities

Total increase of net assets of Luxembourg UCIs by EUR 654.3 billion to reach EUR 4,718.9 billion (+ 16.1%)

- Positive development on financial market (EUR 520.5 billion)
- Strengthened by inflow of new capital (EUR 133.8 billion)

UCITS sector benefited from positive balance between mergers in which receiving UCITS were domiciled in Lux (87 projects) and those where UCITS were domiciled in another EU MS (27 projects)

UCITS investment in securitised instruments

CSSF's position on UCITS investment in securitised instruments

- **What ?**
  - All types of securitised instruments (ABS, MBS, CLOs)
- **Background : Former regulatory position**
  - Following to the sub-prime crisis, regulatory "*soft rules*" for investment to ABS/ MBS
- **New CSSF's position**
  - Specific questionnaire to be filled in as soon as there is an investment above 20% to securitised instruments (in aggregate)
    - Exception may apply and extent of the CSSF' scrutiny may vary

CSSF's position on UCITS investment in securitised instruments

- **Scope of the CSSF's scrutiny**

  - Investment process
  - Organisation of the risk management function
  - Eligibility
  - Valuation
  - Market risk management
  - Credit risk management
  - Concentration risk management
  - Liquidity risk management

+ *For instruments falling under the EU securitization regulation ("**Regulation**") review of the due diligence obligations imposed by article 5 of the Regulation*

Securitisation Regulation & CSSF's position on Lux ManCo' DDO

- **Impact of the Regulation on the fund industry**
  - **What ?**
    - Securitised instruments subject to a contractual subordination ("*tranching*") irrespective of the localisation of the issuer
      - CLOs
      - Subordinated securitised instruments
  - **Which type of investor ? *Institutional Investors ("II")***
    - UCITS Management Company
    - AIFM
    - MiFID Firm
  - **What's new for UCITS**
    - Initial and on going due diligence (DDO) *(Article 5 of the Regulation)*
    - Obligation to take corrective actions in case of exposure to non- compliant instrument *(Article 38 of the Regulation)*

Securitisation Regulation & CSSF's position on Lux ManCo' DDO

- **CSSF's scrutiny on the due diligence obligations ("DDO") – *LUX UCITS ManCo***
  - Initial and ongoing due diligence procedure
  - Summary of the monitoring procedures
  - Evidence of the experience of the persons performing the DDOs
  - An example of the internal reporting
  - A description of the stress testing program for the underlying instruments

2.2. CSSF's position on delegation of the UCITS DDO's to non-EU manager

- **What if the Lux ManCo delegate the portfolio management** *(Art. 5.5 of the Regulation)*
  - CSSF's position:
    - If the delegation is made to an II, then the DDO can be likewise fully delegated to that II (with full discharge of the Lux ManCo)
    - If the delegation is **not** made to an II, then the DDO **cannot** not be delegated to the PM

No delegation of the DDO outside of the EU (excl. non-EU AIFMs (?))

2.2. CSSF scrutiny of delegation of the UCITS DDOs

- **CSSF's scrutiny on the delegation of the DDOs**
  - Verification of the II qualification of the delegated PM
  - Where the PM does not qualify as II, delegation is not be permissible
    - summary of the procedure to perform the initial due diligence
      - *ex-ante screening and analysis*
      - *who performs the DDOs*
      - *based on which information and documentation*
      - *procedure for the ex-ante approval and final decision*

ESMA Guidelines on performance fees in UCITS and certain types of AIFs

Scope – Who is concerned?

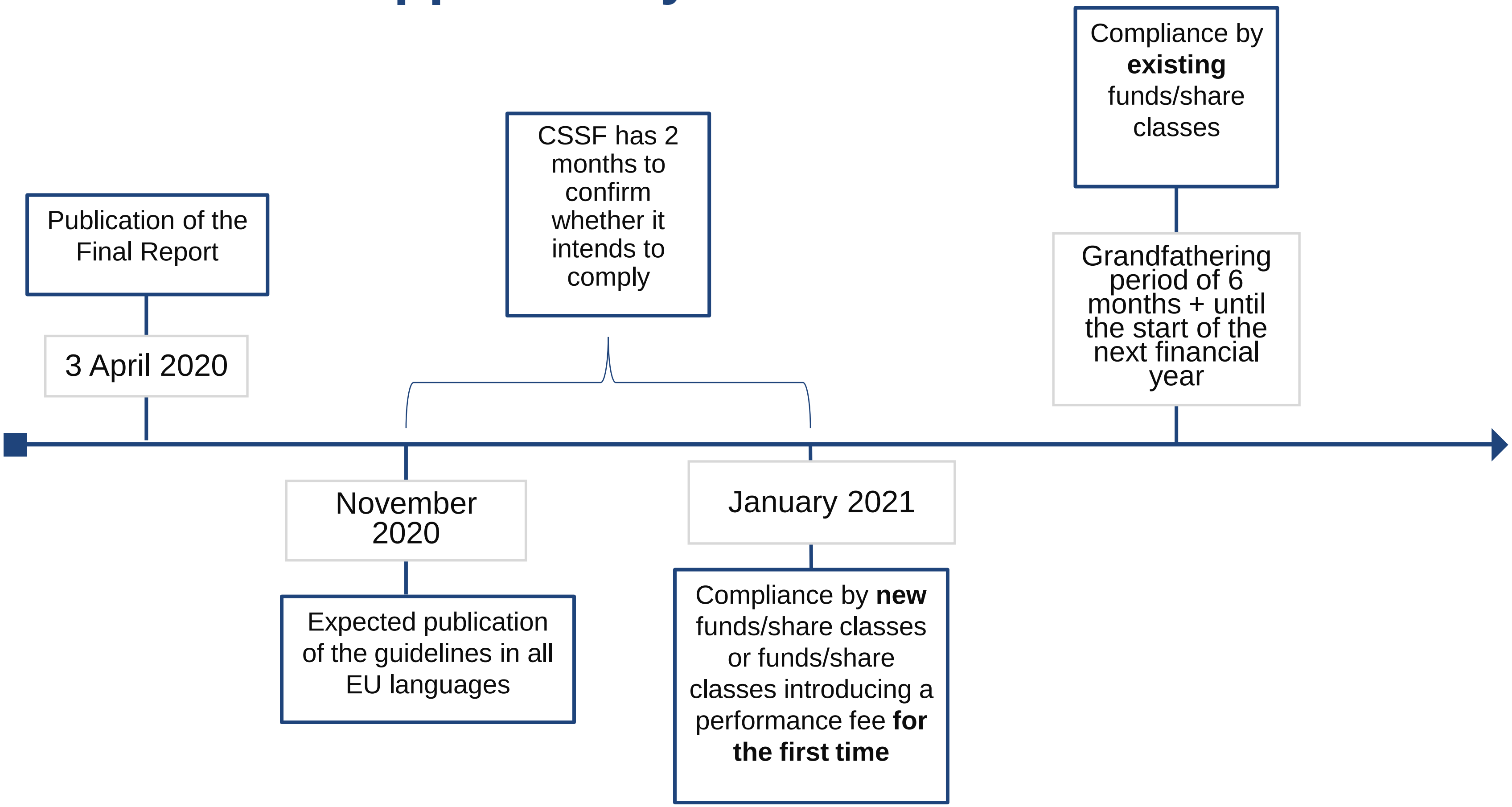
- Applies to managers (UCITS management companies, self-managed UCITS and AIFMs)

- Who manage:
  - UCITS
  - AIFs which are marketed to retail investors in accordance with article 43 of the AIFMD, except for:
    - Closed-ended AIFs; and
    - Open-ended AIFs that are EuVECAs, EuSEFs, private equity AIFs or real estate AIFs

What impact?

- Common criteria for supervisory convergence in the following areas:
  - general principles on performance fee calculation methods
  - consistency between the performance fee model and the fund’s investment objectives, strategy and policy
  - frequency for the performance fee crystallisation and payment
  - circumstances where a performance fee should be payable
  - disclosure of the performance fee model

Timeline for applicability



CSSF and industry position

- The CSSF has indicated that it will probably endorse the guidelines in full
- In current files, the CSSF reviews new (and existing) performance fee models to ensure consistency with the IOSCO principles
  - Does not include the reset period of minimum 5 years for benchmark and HWM models (point 40 + 41 of the Guidelines)

  AND requests a confirmation as to whether the model is already compliant with the ESMA Guidelines
- Industry bodies have expressed their opposition to points 40 and 41 of the Guidelines
- Questions have been submitted to ESMA by ALFI to clarify certain points
  - ESMA will not update its Guidelines to clarify nor issue a Q&A for the time being

European benchmark reform – LIBOR, EONIA and beyond

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- LIBOR and EONIA are both due to be discontinued by the end of 2021
- EURIBOR is planned to continue for the foreseeable future
- ISDA issued a Benchmarks Supplement and a corresponding adherence protocol
- Slow uptake of the transition amongst asset manager, in particular those not forming part of banking groups
- ARRC Recommended Best Practices for Completing the Transition from USD LIBOR and FSB Global Transition Roadmap for LIBOR available

European benchmark reform – LIBOR, EONIA and beyond

- Draft amendment to the EU Benchmarks Regulation proposes to introduce mandatory replacement rates for contracts referencing LIBOR and EONIA with no contractual fallbacks; Other jurisdictions expected to follow suit
- Currently compounded in arrears methodology favoured for term rates used in derivatives contracts
- Ongoing work on development of forward looking term rates in key jurisdictions
- Transitional period for third country benchmarks expected to be extended until the end of 2025

CSSF's position on UCITS investment in loans

CSSF's position on UCITS investment in loans

- **Former CSSF's position**
  - Assimilation to MMIs
- **New CSSF's position**
  - Loans are ineligible as they do not qualify as:
    - MMIs
    - Transferable securities

→ **Divestment is required by 31 December 2020, *taking into the interest of shareholders***

→ **Prospectus reference and disclosure shall be removed by 31 March 2021**

- **What ?**
  - All types of loans (corporate and/or retail whatever the issuer)
  - Investment through loan participation and/or assignment

CSSF's position on UCITS investment in loans

- **Indirect exposures ?**
  - Derivatives
    - *TRS, CDS, etc*
  - Indices on loans
  - Transferable securities
    - *securitised loans (participation loan notes, CLOs), exposure via structured products, eligible closed ended-funds*
  - Eligible open-ended funds

Regulatory spotlight on robust liquidity management governance frameworks

Liquidity Risk Management

- CSSF Circular 19/733

  - Implements into Luxembourg regulation the IOSCO recommendations and good practices on liquidity risk management for UCIs

  - 3 main elements:
    1. The design-process of UCIs
    2. The day-to-day liquidity of UCIs
    3. Contigency planning

- Who?
  - UCITS management companies, Chapter 16 management companies, AIFMs and self-managed AIFs
  - Who manage open-ended UCIs

- When?
  - Entered into force on 20 December 2019

Liquidity Stress Testing

- ESMA Guidelines on liquidity stress testing in UCITS and AIFs
  - Entered into force on 30 September 2020
  - CSSF Circular 20/752 confirms the application of the ESMA Guidelines and their integration in the CSSF’s administrative and regulatory approach
- Who?
  - Chapter 15, 16 and 17 management companies, self-managed UCITS, AIFMs and internally-managed AIFs
- What impact?
  - IFMs must adapt their liquidity stress testing policies
  - Inform the CSSF in case of material risks which might threaten the ongoing liquidity of a fund, together with the remedial actions
  - Include information on their LST policy in the annual update of the RMP

Q & A

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