Luxembourg Market Pulse

Regulatory Update

July 2020

EY

Building a better working world

Foreword

Dear all,

It's my great pleasure to present the latest edition of the EY Luxembourg Market Pulse Regulatory Update.

In this edition, we provide an update and our views on the following regulatory developments:

1. EU Taxonomy Regulation
2. Draft delegated acts on the integration of sustainability factors and risks in the UCITS Directive, AIFMD and MiFID II
3. European Supervisory Agency Joint Consultation on ESG disclosures
4. European Public Consultation on the revision of the non-financial reporting directive
5. European Commission report assessing the application and the scope of the AIFMD
6. European Systemic Risk Board considerations regarding the Alternative Investment Fund Managers Directive
7. ESMA consultation on guidelines on Article 25 of AIFMD: Assessment of leverage-related systemic risk and leverage limits
8. ESMA Guidelines on Performance Fees in UCITS and certain types of AIFs
9. ESMA supervisory briefing on the supervision of costs in UCITS and AIFs
10. CSSF FAQ on CSSF Circular 02/77
11. The Laws of 25 March 2020 – The remaining implementation of the provisions of the 5th EU AML Directive.
12. Regulatory Response to COVID 19 Crisis
13. Update on distribution & third-country investment

We look forward to receiving your feedback and questions as well as discussing the challenges and opportunities with you and our subject matter experts.

Michael Ferguson
Partner
Luxembourg Wealth & Asset Management Leader
EMEIA Wealth & Asset Management Assurance Leader

Contents

EU Taxonomy Regulation

Background

On 22 June 2020, the long-awaited Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the "EU Taxonomy Regulation"), and amending Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the "SFDR") was published on the Official Journal of the European Union.

The EU Taxonomy Regulation is the unified classification system for sustainable activities at the core of the EU action plan on financing sustainable growth published by the European Commission in March 2018.

Primary Change

The EU Taxonomy Regulation should enable investment fund managers ("IFMs") to gather reliable, consistent and comparable sustainability related indicators from in-scope investee companies and incorporate this data into their investment decision and risk management process and fulfil their disclosure duties under SFDR or applicable sectorial legislation.

The EU Taxonomy Regulation also provides further details on the content of sustainability-related disclosures required in pre-contractual and periodic reports of environmentally sustainable investment funds and investment funds promoting environmental characteristics.

Key Dates

22 June 2020	Publication in the Official Journal of the EU
31 December 2020	Adoption of delegated acts for the technical screening criteria with respect to climate-related objectives
31 December 2021	1. Adoption of delegated acts for the technical screening criteria with respect to all other environment-related objectives 2. Commission to publish a report describing the provisions that would be required to extend the scope of the Taxonomy to cover: ▸ Economic activities that do not have a significant impact on environmental sustainability ▸ Economic activities that significantly harm environmental sustainability ▸ Specific disclosure requirements related to enabling and transitional activities ▸ Other sustainability objectives, such as social objectives
1 January 2022	Application of the requirements for climate-related objectives
1 January 2023	Application of the requirements for all other environment-related objectives

Key Points

The EU Taxonomy Regulation aims to define EU-recognized criteria for identifying sustainable activities. This defines the minimum criteria that economic activities should comply with in order to be considered environmentally sustainable.

- An environmentally sustainable economic activity contributes substantially to one or more of the following environmental objectives:
  - Climate change mitigation
  - Climate change adaptation
  - Sustainable use and protection of water and marine resources
  - Transition to a circular economy
  - Pollution prevention and control
  - Protection and restoration of biodiversity and ecosystems
- It does not significantly harm ("DNSH") any of the other environmental objectives
- It is carried out in compliance with minimum safeguards set out in the Regulation (including the OECD Guidelines for Multinational Enterprises, the International Labour Organisation, etc.)
- It complies with the technical screening criteria developed by the Technical Expert Group in the form of delegated acts, applicable from 1 January 2022 for climate-related objectives and from 1 January 2023 for the other environmental objectives
- An activity, referred to as 'enabling activity', can be considered to be contributing substantially to one or more environmental objectives laid down by the Taxonomy if it directly enables other activities to contribute to these objectives, provided that such economic activity:
  - does not lead to a lock-in of assets that undermine long-term environmental goals, considering the economic lifetime of those assets
  - has a substantial positive environmental impact, on the basis of life-cycle considerations

An activity, referred to as 'transitional activity', can be considered to be contributing substantially to the environmental objective of climate change mitigation under the following conditions:

- There is no technologically and economically feasible low-carbon alternative
- It supports the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1,5°C above pre-industrial levels
- That activity:
  - Has greenhouse gas emission levels that correspond to the best performance in the sector or industry
  - Does not hamper the development and deployment of low-carbon alternatives, and
  - Does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets

The EU Taxonomy Regulation also lays down disclosure obligations that supplement the SFDR and the Non Financial Reporting Directive[1] ("NFRD") with regards to activities that contribute to an environmental objective:

- Undertakings that are required to report on non-financial information under the NFRD must include in their non-financial statement:
  - The proportion of their turnover derived from products or services associated with environmentally sustainable economic activities
  - The proportion of their capital and operating expenditures related to assets or processes associated with environmentally sustainable activities
- Financial products that invest in environmentally sustainable economic activities must disclose the proportion of investments in environmentally sustainable activities selected for the financial product, including the proportion of enabling and transitional activities, as a percentage of all investments selected for the financial product. This information shall be disclosed in the pre-contractual disclosures and in the periodic report.

The EU Taxonomy Regulation will be further developed over time to cover economic activities that are socially sustainable.

Practical Considerations

The Disclosures of investee companies should enable investment funds to report the proportion of their fund invested in Taxonomy-aligned activities for each investee company. For climate change mitigation, turnover can be recognised where an economic activity meets the Taxonomy technical screening criteria for substantial contribution to climate change mitigation and relevant DNSH criteria. For climate change adaptation, turnover can be recognised only for activities enabling adaptation but not for adapted activities.

Companies that disclose their capex investments in economic activities as part of a plan to be Taxonomy-aligned should provide invaluable information for constructing green portfolios, and for analysing companies' transition plans and/or environmental sustainability performance and strategies.

As part of their risk-based due diligence, IFMs should pay attention to what extent investee companies, and other issuers disclosures cover Taxonomy required information on whether they:

- Comply with minimum safeguards
- Embed responsible business conduct into their policies and management systems
- Identify, assess, prevent or mitigate actual or potential adverse impacts
- Gain and use leverage to prevent and mitigate the impacts
- Track performance
- Communicate and report publicly
- Enable remediation when appropriate

[1] Directive 2014/95/EU which is currently being reviewed by the European Commission to potentially expand its scope and improve granularity and standardization of disclosures

Significant challenges are expected for investments in EU companies and bond issuers that do not fall under the scope of the NFRD, and non-EU companies. In such situations, the EU Technical Expert Group recommends a five-step approach:

- Identify the activities conducted by the company or issuer or those covered by the financial product (e.g., projects, use of proceeds) that could be aligned, and for which environmental objective(s)
- For each potentially aligned activity, verify whether the company or issuer meets the relevant screening criteria – e.g., electricity generation <100 g CO2e/kWh
- Verify that the DNSH criteria are being met by the issuer. IFMs would most likely use a due diligence-type process for reviewing the performance of underlying investees and would rely on the legal disclosures of eligibility from those investees
- Conduct due diligence to avoid any violation of the social minimum safeguards
- Calculate alignment of investments with the Taxonomy and prepare disclosures at the investment product level

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Laurent Capolaghi
Partner, Financial Services
+352 42 124 8855
Laurent.Capolaghi@lu.ey.com

Renaud Breyer
Partner, Climate Change and Sustainability Services Leader
+352 42 124 8255
Renaud.breyer@lu.ey.com

Pierre-Marie Boul
Associate Partners, Wealth & Asset Management
+352 42 124 8687
pierre-marie.boul@lu.ey.com

Lena Le Gal
Senior Manager, Climate Change and Sustainability Services
+352 42 124 8171
Lena.Le-Gal@lu.ey.com

For more information, please visit:

EU Taxonomy Regulation

EU TEG Final Report on Taxonomy

Draft delegated acts on the integration of sustainability factors and risks in the UCITS Directive, AIFMD and MiFID II

Background

The European Commission has published on 8 June 2020 a set of draft delegated acts, including, inter alia:

- A draft delegated directive amending the Commission Directive 2010/43 implementing certain provisions of the UCITS Directive
- A draft delegated regulation amending the Commission Regulation 231/2013 implementing certain provisions of AIFMD
- Two delegated acts amending two delegated acts implementing MiFID II requirements on product governance, organizational requirements and operating conditions of investment firms

These delegated acts are part of a broader action plan on sustainable finance and look to streamline sectoral legislation with the emerging framework and reinforce the regulations:

- On sustainability-related disclosures in the financial services sector ("SFDR")
- On low-carbon benchmarks ("LCBR")
- On the EU taxonomy for sustainable activities ("Taxonomy")

Primary Change

The sustainable finance action plan will bring significant changes in the investment fund value chain.

The UCITS Directive and AIFMD draft delegated acts clarify notably the duties of investment fund managers ("IFMs") to take into account the social and environmental factors and risks in their governance, organisation, conflicts of interest policies, investment due diligence as well as their risk policies and procedures.

Investment firms will be required to integrate investors' sustainability preferences, i.e. the appetite of their clients for dark green and light green products, as defined in SFDR, in product governance, financial advice, portfolio management and distribution activities. Ex-post information disclosure, relying on funds and management companies disclosures, will be required to explain how a recommendation to the client to purchase an investment fund meets his investment objectives, risk profile, capacity for loss bearing and sustainability preferences.

Key Points

The UCITS Directive and AIFMD delegated acts provide very similar requirements.

UCITS (delegated directive)	AIFMD (delegated regulation)
Alignment of definition of sustainability risks with SFDR	
Requirement to consider sustainability risks in management companies or AIFMs': • establishment, implementation and maintenance of clear and document decision-making procedures and organisational structure specifying reporting lines • allocation of responsibilities with proper discharge • internal control mechanisms to ensure compliance with decisions and procedures • internal reporting and communication and effective information flows with any third party involved • maintenance of adequate and orderly records of business and internal organisation	
Requirement to maintain resources & expertise for the effective integration of sustainability risks	
Requirement to integrate sustainability risks in the management of UCITS in a proportionate manner	

UCITS (delegated directive)	AIFMD (delegated regulation)
Requirement to ensure that senior management of the management company is responsible to take sustainability risks into account in: ▸ the implementation of the investment policy in the prospectus, the fund rules, the instrument of incorporation or the offering documents ▸ the investment strategies' approval process ▸ the compliance function ▸ the investment policy/strategy/risk limits implementation/compliance for each managed UCITS ▸ the approval / periodic review of the adequacy of internal procedures for undertaking investment decisions for each managed UCITS ▸ the approval / periodic review of the risk management policy, arrangements, processes and techniques, including the risk limit system	Requirement to ensure that senior management of the AIFM is responsible to take sustainability risks into account in: ▸ the implementation of the investment policy in the prospectus, the fund rules, the instrument of incorporation or the offering documents ▸ the investment strategies' approval process ▸ the valuation policies ▸ the compliance function ▸ the investment policy/strategy/risk limits implementation/compliance for each managed AIF ▸ the approval / periodic review of the adequacy of internal procedures for undertaking investment decisions for each managed AIF ▸ the approval / periodic review of the risk management policy, arrangements, processes and techniques, including the risk limit system ▸ the remuneration policy
Requirement to identify conflicts of interest arising from the integration of sustainability risks in processes, systems and controls	
Consideration of sustainability risks and, where applicable, principal adverse impacts of investment decisions on sustainability factors when applying investment due diligence requirements	
Requirement to consider sustainability risks in the risk management policy	

Practical Considerations

IFMs should conduct their analysis jointly with the project carried out to reach compliance with the SFDR and the Taxonomy.

The practical reach of the rules in terms of organisation, governance, policies, and operational procedures will need to be proportionate to strategic choices and size (in terms of consideration of principal adverse impacts of investment decisions) as well as the extent to which the investment funds managed by the IFM pursue sustainability-related objectives or promote environmental or social characteristics.

However, some minimum standards stemming from upcoming UCITS Directive, AIFMD and SFDR rules will also be applicable to fund managers who do not consider principal adverse impacts and do not manage light green or dark green products. In particular, all IFMs need to review and update their governance structures, resources and allocation of responsibilities, their investment decision-making and due diligence policies as well as their risk policies and control framework to adapt them in a proportionate manner to the scope of their activities.

Consideration should also be given notably to the legislation applicable to benchmark administrators, investee companies and distributors or advisors in order to set up appropriate communication and data flows.

For more information, please visit:

Draft UCITS delegated directive as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities

Draft AIFMD delegated regulation as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers

Draft MiFID delegated directive as regards the integration of sustainability factors and preferences into the product governance obligations

Draft MiFID delegated regulation as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Renaud Breyer
Partner, Climate Change and Sustainability Services Leader
+352 42 124 8255
Renaud.breyer@lu.ey.com

Rafael Aguilera
Associate Partner, Business Consulting
+352 42 124 8365
rafael.aguilera@lu.ey.com

Pierre-Marie Boul
Associate Partner, Wealth & Asset Management
+352 42 124 8687
pierre-marie.boul@lu.ey.com

European Supervisory Agency Joint Consultation on ESG disclosures

Background

Regulation 2019/2088 on sustainability-related financial disclosures ("SFDR") was adopted on 27 November 2019 with the objective to improve transparency in relation to Environmental, Social and Governance (ESG) factors, risks and impacts. It is applicable notably to fund managers ("entities") and investment funds ("products"). On 23 April 2020, the European Supervisory Agencies ("ESAs") launched a consultation with respect to draft regulatory technical standards ("draft RTS") discussing:

- The disclosure of principal adverse impacts ("PAIs") of investment decisions, required for all entities:
  - Who are employing 500 persons or are the parent company of a group employing 500 persons on a consolidated basis from 18 months after the date of entry into force of SFDR
  - Other entities which do not publish a clear explanation why they do not consider PAIs
- Precontractual, website and periodic disclosures required at product level for both:
  - Products with environmental or social characteristics among other characteristics ("light green products")
  - Products with a sustainable investment objective ("dark green products")

Investment fund sponsors and managers need to make strategic business and policy decisions well ahead of any applicable disclosures which will have to comply with SFDR and the final RTS.

Primary change

The draft RTS provide granular requirements for the content, the methodology and the presentation of disclosures and a template for principal adverse impacts and metrics to be used by entities. While the objective is to improve standardization and comparability of the information provided to investors, the proposed template is likely to bring significant changes to fund managers.

The ESAs also intend to develop templates for precontractual and periodic report disclosures, but they are not included in the draft RTS.

Timeline

The consultation closes on 1 September 2020 and the ESAs must submit all RTS to the Commission by 30 December 2020, except those in relation to sustainability indicators in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters which must be submitted by 30 December 2021. Most disclosure requirements will apply from 10 March 2021.

However, funds' periodic report disclosures will start applying in respect of financial years commencing 1 January 2022. Disclosure of principal adverse impacts in funds' offering documents and periodic reports will become applicable as from 30 December 2022.

Key Points

Principal Adverse Impacts

Context, scope and implications:

The overall objective of the RTS is to ensure that the entities disclose relevant information regarding their adherence to the "do not significantly harm" principle where their financial products invest in sustainable investments. The objective is to inform end-investors about how the product does not significantly harm the environmental objectives it is not contributing to. The ESAs are of the view that this should be facilitated for those entities which consider the PAIs of their investment decisions since they will already have incurred the costs of assessing their investment decisions against the indicators provided in the annex 1 of the RTS.

According to the upcoming Taxonomy Regulation art. 19(1)e, the technical screening criteria developed by the Technical Expert Group to assess under which conditions an economic activity contributes to a sustainable environmental objective should, where feasible, use these sustainability indicators to assess PAIs from these RTS.

Information on PAIs is required to be disclosed first on the entities websites as from 10 March 2021. Any entities that employ less than 500 persons or that are parent undertakings of a group employing less than 500 persons on a consolidated basis during the financial year may opt not to consider PAIs. If they decide to not consider PAIs, they will still need to make a clear statement about this decision, explain the reasons and whether and when they intend to comply. Consideration of PAIs is compulsory for large entities which must disclose on their website the statement in the format prescribed by European Securities and Market Authority Commission (ESMA).

Disclosures of PAI will also be required in offering documents and periodic statements as from 30 December 2022. Where information in periodic reports includes quantifications of principal adverse impacts on sustainability factors, that information may also rely on the provisions of these RTS[1].

Elements of disclosure

Annex 1 provides a PAI statement template structured in three parts including adverse sustainability indicators and associated metrics. One table provides 16 mandatory environmental indicators and 16 mandatory social indicators. Two tables provide 11 additional environmental indicators and 7 additional social indicators. Entities must disclose metrics for all mandatory indicators, at least one additional environmental indicator and one additional social indicator as well as any other PAI deemed to be relevant.

[1] Art. 7(1) SFDR

The content is proposed to be structured as follows:

Section	Disclosure item	Specifications
Summary	(i) name of the entity	Maximum 2 pages for the summary
	(ii) statement that PAIs are considered	
	(iii) reference period of the statement	
	(vi) summary of the PAI statement	
Description of principal adverse sustainability impacts	(i) mandatory PAIs	‣ Mandatory metrics expressed in market value for (i), (ii) and (iii) ‣ Historical comparison with the shortest of: a. The previous 10 years b. From the date the IFM considered first a PAI c. From 10/03/2021
	(ii) at least one additional PAI on a climate or other environment-related sustainability factor	
	(iii) at least one additional PAI on a social, employee, human rights, anti-corruption or anti-bribery sustainability factor	
	(iv) any other adverse impact that qualifies as principal	
Description of policies to identify and prioritise adverse sustainability impacts	(i) date of approval of the policies by the governing body	Where information related to indicators is not readily available, entities should disclose: a. Best efforts used to obtain information from investee companies b. If this is not possible, best efforts used to assess PAIs, including a description of any reasonable assumptions used, additional research carried out, cooperation with third party data providers or use of external experts
	(ii) allocation of responsibilities for the implementation within organisational strategies and procedures	
	(iii) description of the methodologies used to assess PAIs, their probability of occurrence and severity, including their irremediable character	
	(iv) an explanation of any associated margin of error within those methodologies	
	(v) description of the data sources methodologies used to assess PAI, their probability of occurrence and severity, including their irremediable character	
Description of actions to address principal adverse sustainability impacts	(i) description of actions taken during the reference period and planned for the next period to avoid or reduce PAIs	
	(ii) explanation of the reduction in PAIs achieved by the actions taken	
Engagement policies	brief summaries of engagement policies required pursuant to SRDII, any other relevant engagement policies and an explanation of the reduction in PAIs achieved of the actions taken during the reference period	
References to international standards	description of the adherence to responsible business conduct codes and international standards for due diligence and reporting and their degree of alignment with objectives of the Paris agreement, including at least forward-looking climate scenarios.	Adverse indictors used in PAI assessment should be specified
No consideration of PAIs statement	(i) clear reasons	
	(ii) whether it intends to comply and if so when	

Disclosures applicable to light green and dark green products

General framework and interaction with the upcoming Taxonomy Regulation

The draft RTS provide a comprehensive list of information and sections to be included for precontractual documentation, website information and periodic report for both dark green and light green products. Most disclosure items are common to each support or closely related: logically, pre-contractual information focuses on the description of product features, the definition of investment strategy indicators and the means used to attain the investment objective. Website information provides more information on the data used, the methodological aspects and policies. Periodic reports focus on metrics and sustainability performance measures.

At present, it must be noted that the definition of sustainable investments in SFDR includes both environmental and social objectives while the draft taxonomy is only limited to environmental objectives. Article 25 of the draft taxonomy constitutes an occasion for the ESAs, through the RTS they are empowered to develop, to strengthen the link between sustainable investments as defined under SFDR and investments financing taxonomy-compliant activities but there is no full correspondence between both yet, hence the proposed requirement to disclose proportion of investments in taxonomy-compliant activities.

Elements of disclosure

Light green color requirements apply only to light green products and dark green color requirements apply only to dark green products. Other requirements are substantially the same for both types of product.

Category	Information to disclose		Pre-contractual	Website	Periodic report
Environmental or social characteristics (E/S characteristics) or sustainable investment objective	summary of the information contained in website disclosure of a maximum length of two sides of A4-sized paper when printed			x	
	a description of the E/S characteristics or the sustainable investment objective of the product		x	x	x
	graphical representation of investments	total of sustainable investments with a breakdown between E/S objectives	x	x	x
		total of investments contributing to the attainment of the E/S characteristics promoted by the investment product with a breakdown between E/S characteristics	x	x	x
		remainder of investments	x	x	x
	narrative representation of investments	planned (or actual) proportions with a breakdowns between direct holdings/other exposures	x	x	x
		purpose of the planned (or actual) remainder, including any minimum safeguards and whether these investments are used for hedging, relate to MMIs[2] or are investments for which there is insufficient data	x	x	x
		the planned (or actual) proportion of investments in different sectors and sub-sectors, including the fossil fuel sector	x	x	x
		25 top investments constituting on average the greatest proportion of investments of the financial product during the reference period, including the sector and location of those investments or, investments constituting on average 50% if they are less than 25			x
	reference to PAI statement		x		
No significant harm to the sustainable investment	Statement that the product does not have as its objective sustainable investment		x	x	
	explanation of how a sustainable investment does not significantly harm the other sustainable investment objectives	how indicators for adverse impacts are taken into account	x	x	x
		No significant harm to the sustainable investment objectives and disclaimer	x	x	x

[2] Money Market Instrument

Category	Information to disclose		Pre-contractual	Website	Periodic report
Investment strateg	description of the strategy, its binding elements and how it is implemented in the investment process on a continuous basis		x	x	
	the rate, where there is a commitment to reduce the investment universe prior to the application of the strategy by a minimum rate		x	x	
	Investment strategy		x		
	description of the policy to assess good governance practices of the investee companies...			x	
		...in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance		x	
Sustainability indicators	list of sustainability indicators used to measure attainment of each E/S characteristics or the sustainable investment objective		x	x	
	monitoring of E/S characteristics or the sustainable investment objective (sustainability indicators) throughout the lifecycle of the financial product and the related internal or external control mechanisms			x	
	Sustainability indicators				x
	historical comparison (shortest of previous 10 years, from the date sustainability indicators were considered or 1/01/2022) between the reference period and previous reference periods (if indicator excluded from previous report or pre-contractual document, explanation and justification of the use of that indicator should be provided)	annual average performance net of fees, including identification of charges and fees included or excluded from the calculation figures			x
		where quantitative disclosures are made, figures with a relative measure such as the impact per euro invested			x
		whether each indicator is subject to an assurance provided by an auditor or a review by a third party			x
		the proportion of underlying assets which are not sustainable or enabling investments			x
Due diligence	description of due diligence carried out on the underlying assets, including internal and external controls on that due diligence			x	
	description of the index designated as a reference benchmark, including the input data, the methodologies used to select that data, the rebalancing methodologies, the underlying components, how the index is calculated and the effect of leverage within the index. In case part or all of that information is published on the website of the administrator of the reference benchmark, a hyperlink may be provided to that information.			x	
Engagement policy	if engagement is part of the environmental or social investment strategy, a description of the engagement policies implemented including any management procedures applicable to sustainability-related controversies in investee companies			x	
	actions taken within the reference period to attain the E/S characteristics promoted by the financial product or the sustainable investment objective , including shareholder engagement as defined in Article 3g of Directive 2007/36/EC and any other relevant shareholder engagement.				x
data sources and processing	data sources used to attain each of the E/S characteristics or sustainable investment objective			x	
	measures taken to ensure data quality			x	
	data sources and processing			x	
	the proportion that is estimated			x	

Category	Information to disclose	Pre-contractual	Website	Periodic report
Limitations to methodologies and data	description of any limitations to the methodologies and the data sources used to measure the attainment of the E/S characteristics promoted by the financial product or the sustainable investment objective as well as how such limitations do not affect the attainment of the E/S characteristics promoted by the financial product or the sustainable investment objective, including the actions taken to address such limitation		x	
Use of derivatives	information on how the use of derivatives meets each E/S characteristic or the sustainable investment objective	x		
Website reference	reference to product information available on the website	x		
Benchmark (where a product has a designated index as a reference benchmark. If no index has been designated, an explanation on how the objectives/characteristics to be attained should be provided)	explanation of how the reference benchmark is continuously aligned with each E/S characteristic or the sustainable investment objective and the investment strategy	x		
	Website referen-ce	x		
	Benchmark (where a product has a designated index as a reference benchmark. If no index has been designated, an explanation on how the objectives/characteristics to be attained should be provided)	x		
	indication whether an index is designated as a reference benchmark, including the input data, the methodologies used to select that data, the rebalancing methodologies, the underlying components, how the index is calculated and the effect of leverage within the index; (may be hyperlink to the benchmark administrator website)		x	
	an explanation of how the index designated as a reference benchmark differs from a broad market index, including at least the performance during the reference period of the			x
	sustainability indicators deemed relevant by the financial market participant to determine the alignment of the index with the sustainable investment objective and the sustainability factors referred to in the benchmark statement of the benchmark administrator			x
	a comparison of the performance during the reference period of the financial product with regard to the indicators measuring the sustainability factors of the index (table or graphical)			x
	if the number of investments constituting on average 50 percent of the investments of the index during the reference period is less than 25, the section referred to in point (c) of Article 43 shall contain a list of those investments, in descending order of size, including the sector and location of those investments			x
Products with a CO2 emissions reduction objective	a statement that the reference benchmark qualifies as a CTB/PAB[3] Benchmark	x	x	
	Products with a CO2 emissions reduction objective			x
financial products with underlying investment	summary list of those investment options with a clear distinction between options qualifying as products with E/S characteristics or the sustainable investment objective and options with a sustainable investment objective + cross references to the disclosures required by sectoral legislation	x		
	information provided by those options with a clear indication to which options the information relates to	x		
	summary of information required for periodic report by selected investment that qualify as a product with E/S characteristics or have a sustainable investment objective, with a clear indication to which options the information relates			x

[3] Climate Transition Benchmarks and EU Paris-Aligned Benchmark, as defined in Regulation (EU) 2019/2089 of 27 November 2019

Practical considerations

Investment fund managers ("IFMs) should carefully consider the final RTS but also review, decide and formalise whether and to what extent they have to or wish to comply with the disclosure principal adverse impacts of their investment decisions. Factors to consider include, inter alia:

- Whether the funds managed by the IFM qualify as light green, dark green or other funds
- The greater transparency arising from other mandatory requirements applicable to all IFMs such as the establishment of a policy on the integration of sustainability risks in the investment decision-making process and the consistency of such policy with the remuneration policy

Where they comply with the disclosure of PAIs, a comprehensive action plan should be launched to create or update the policies, the procedures, the data flows, the methodologies, the systems and disclosures which have to be implemented both at entity and product level. Should they decide not to disclose PAIs, IFMs will still need to review their documentation to ensure that the mandatory SFDR requirements which are not covered by these draft RTS are met.

Fund managers should notably:

- Determine whether the products they manage qualify as a light green or dark green product
- Assess how the product promotes E/S characteristics or contributes to a sustainable investment objective
- Establish the list of the sustainability indicators to be used, the data sources, and the methodologies (including the use of benchmarks) for monitoring and reporting purposes
- Prepare disclosures and ensure their consistency with any marketing material

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Laurent Capolaghi
Partner, Financial Services
+352 42 124 8855
Laurent.Capolaghi@lu.ey.com

Renaud Breyer
Partner, Climate Change and Sustainability Services Leader
+352 42 124 8255
Renaud.breyer@lu.ey.com

Pierre-Marie Boul
Associate Partner, Wealth & Asset Management
+352 42 124 8687
pierre-marie.boul@lu.ey.com

Lena Le Gal
Senior Manager, Climate Change and Sustainability Services
+352 42 124 8171
Lena.Le-Gal@lu.ey.com

For more information, please visit:

ESAs consultation on draft RTS

European Public Consultation on the revision of the non-financial reporting directive[1] ("NFRD")

Background

Disclosures of non-financial information by fund managers are set to increase significantly over in the future in order to meet the demand from investors and the requirements of the regulation on sustainability disclosures in the financial services sector[2]. Based on the statement that publicly available non-financial information is inadequate for users but also difficult to determine, complex and costly to produce for companies, the European Commission ("EC") launched a public consultation. Stakeholders are invited to provide feedback before 11 June2020 on the policy options envisaged to address the short comings of the current NFRD regime applicable to Public Interest Entities ("PIEs") which include large listed companies and large banks and insurance companies, listed or not, provided that they have more than 500 employees.

Primary Change

One of the objectives of the revision of the directive is to ensure investors have better access to adequate non-financial information from investee companies to be able to take account of sustainability-related risks, opportunities and impacts in their investment decisions. Going beyond the current approach of non-binding guidelines, the EC explores the endorsement of existing or possible future standards and a broader strengthening of the provisions of the NFRD.

[1] Directive (EU) 2014/95, amending the Accounting Directive (EU) 2013/34
[2] Regulation (EU) 2019/2088

Key Points

The high-level policy options summarized below are being discussed to address current pain points for asset managers.

Issue	Policy option under discussion to address the issue
Mismatch between information provided and information needed by users	▸ More detailed specification of information reported ▸ Use of a reporting standard ▸ Scope extension of the NFRD
Lack of information reliability and comparability	▸ More detailed specification of information reported ▸ Use of a reporting standard ▸ Strengthening provision on assurance of information reported ▸ Strengthening enforcement regime and supervisory convergence
Information is difficult to find / access / use	▸ Clarification and harmonization of information location (management report vs separate report) ▸ Provision of information in a digital/machine-readable format

Stakeholders are invited to provide feedback, inter alia, on whether:

- current **NFRD requirements** are sufficient to enable them to meet their own new non-financial information disclosure requirements
- environmental disclosures should be aligned with the six objectives set-out in the **taxonomy regulation**
- any additional **new metrics** (e.g., scenarios, analyses, targets, more forward-looking information, contribution to society) required should be reported
- additional disclosure on **intangible assets** (e.g., intellectual property, software, customer retention, human capital) or related factors should be made
- a **common standard** is needed, if it should contain sector-specific elements and to what extent existing standards and frameworks[3] meet the current NFRD requirement or should be incorporated
- a **simplified standardized approach** is needed to bring proportionality **for Small and Medium Enterprises** and if it should be mandatory or voluntary
- **a contribution to the development of common standard** is needed, and to what extent, from investors, preparers of financial statements, auditors, accountants, civil society representatives, NGOs, academics, European and national public bodies and authorities to ensure connectivity or integration between financial and non-financial information
- an alternative definition of the **materiality principle** or additional guidance is needed in the context of non-financial reporting
- **assurance of non-financial reporting** is justifiable, appropriate[4], dependent on companies reporting against a specific non-financial reporting standard, and if it should be performed based on a common assurance standard
- assurance providers should perform **reasonable or limited assurance engagements** in this respect, if they should assess the company's materiality assessment process, identify and publish the key engagement risks, their response to these risks and any related key observations
- the **costs of** introducing **tagging**[5] **of non-financial information** would be proportionate to the benefits
- non-financial statements should be included and consolidated[6] in the **management reports** or, in case they are allowed to be published separately, if information should be subject to appropriate supervision, filed in Officially Appointed Mechanisms[7] and published at the same date[8]
- **the scope** of NFRD should be extended to PIEs with more than 250 employees, subsidiaries of parent companies subject to NFRD, large EU companies listed outside the EU, large non-EU companies listed in the EU, other large unlisted entities or all limited liability companies regardless of their size
- banks should be subject to different thresholds since they have larger balance sheets than non-financial corporations

The consultation also aims to gather information on the costs, time and resources associated with the current reporting regime and the uncertainties, pressures, complexities and difficulties faced by the reporting entities.

[3] Both holistic frameworks (Global Risk Initiative, Sustainability Accounting Standards Board, International Integrated Reporting Framework) or frameworks focusing on a limited set of non-financial issues (recommendation of the Task force on Climate-related Financial Disclosures, United Nations Guiding Principles Reporting Framework, Carbon Disclosure Projects questionnaires, standards of the Carbon Disclosure Standards Board, the Organisation Environmental Footprint and reporting under the Eco-management and Audit Scheme) are considered

[4] Non-Financial reporting is explicitly excluded from the audit scope by art 34 of the Accounting directive

[5] Listed companies are required to submit their annual financial statements in XHTML format, according to European Single Electronic Format ("ESEF") since 1 January 2020 and the XHTML document should be tagged using iXBRL elements specifies, allowing the information to be machine-readable

[6] Non-financial information is also already required in the corporate governance statement

[7] They are out of the legal mandate of the national competent authorities and are not required to be filed in the OAM at the moment

[8] Currently, companies can be allowed by national legislation to publish non-financial information up to six months after the balance sheet date

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Kerry Nichol
Partner, Wealth & Asset Management
+352 42 124 8975
Kerry-Jane.Nichol@lu.ey.com

Renaud Breyer
Partner, Climate Change and Sustainability Services Leader
+352 42 124 8255
Renaud.breyer@lu.ey.com

Jean-Marc Cremer
Associate Partner, Wealth & Asset Management
+352 42 124 8304
Jean-Marc.Cremer@lu.ey.com

For more information, please visit:

EC Consultation

European Commission report assessing the application and the scope of the AIFMD

Background

Most provisions of the Alternative Investment Fund Managers Directive (AIFMD) have been applicable since mid-2013. The European Commission has been mandated to establish the degree to which the objectives pursued by the AIFMD have been achieved and report to, inter alia, any shortcomings impacting investors, alternative investment funds (AIFs) and their managers (AIFMs) as well as financial system stability.

Based on input from various sources and stakeholders, the European Commission provided a report to the European Parliament and the Council on 10 June 2020 including the results of the AIFMD framework assessment and possible areas for improvement.

Primary Change

The report recognizes the role of AIFMD in creating an internal EU market, reinforcing the regulatory and supervisory framework and enhancing transparency for both investors and supervisors on AIFM activities. The issues raised in the report mainly relate to distribution aspects, the depositary regime, reporting, supervision, valuation and remuneration rules.

Some responses to certain issues have already been implemented recently or are being subject to consultation processes while further legislative, regulatory or supervisory actions might be expected for the others, most probably by the first quarter 2021.

Key Points

Supervision

Shortcoming reported	Legislative / regulatory action
Lack of clarity, harmonization of the NCAs'[1] possibility to impose leverage limits or suspend redemptions in the public interest	ESMA[2] consultation on guidance to assess leverage risk and operationalization of leverage limits under Art.25 of AIFMD
Lack of cooperation between NCAs in cases where suspensions of redemption have cross-border implications	May be subject to further action

Valuation

Shortcoming reported	Legislative / regulatory action
Combined use of internal and external valuers is excluded and there is uncertainty around the liability of external valuers, determined under national law	May be subject to further action

Depositary

Shortcoming reported	Legislative / regulatory action
Lack of clarity in situations where AIFMs use tri-party collateral management	May be subject to further action
Lack of clarity where CSDs[3] act as custodians	May be subject to further action
Concentration risk due to the lack of a depositary passport in smaller markets	May be subject to further action

Reporting

Shortcoming reported	Legislative / regulatory action
Reporting overlaps with other sectorial law requirements	May be subject to further action
Missing data reporting on leveraged loans, CLOs[4] and indirect linkages between banks and non-banks	May be subject to further action
Adjustments may be required on leverage calculation methods	May be subject to further action
Lack of harmonization of forms, processes and central management of databases	May be subject to further action

Remuneration

Shortcoming reported	Legislative / regulatory action
Lack of harmonization of remuneration rules with regimes provided in Banking legislation (smaller institutions and small variable amounts may be exempted from payment deferral[5])	Directive 2019/878, providing that AIFMs belonging to a corporate group in scope of CRD only have to apply AIFMD rules on remuneration May be subject to further action

[1] National competent authorities
[2] European Securities and Markets Authority
[3] Central securities depositaries
[4] Collateralized loan obligations
[5] Directive 2019/878 of 20 May2019 amending directive 2013/36/EU (CRD IV)

Distribution

Shortcoming reported	Legislative / regulatory action
Efficiency of the EU AIFM impaired by national marketing rules, particularly detrimental for smaller AIFMs unable to bear compliance cost	Cross-border Fund Distribution package Directive (EU) 2019/1160 Regulation (EU) 2019/1156
Limitation of AIFM passport to marketing to professional investors	Could be subject to further action
AIFs offered to retail investors predominantly through banks and insurance companies promoting mainly in-house funds	May be subject to further action
Investors unable to access non-EU AIFs in member state without NPPR	May be subject to further action
Un-level playing field created by NPPR between non-EU AIFMs subject to lighter requirements and EU AIFMs	May be subject to further action
National barriers encountered by private equity fund managers who do not adhere to AIFMD or EuVECA regulation	Regulation (EU) 2017/1991 opening up the use of the designation EuVECA and expanding investment parameters May be subject to further action

The report confirms there was no evidence found that the AIFMD was not technology neutral or preventing the automation of operations or the application of innovative technologies. However, further regulatory development or supervisory actions are not excluded to respond to new technological developments.

Practical considerations

The overall assessment and potential outcomes may present opportunities in the longer term:

- to reduce overly burdensome requirements of the current framework, notably in terms of cross-border distribution and reporting
- to foster cross-border distribution of AIFs to non-professional investors
- to set more flexible remuneration rules
- to enhance legal certainty around depositary, prime broker and CSD liability
- to have a more robust valuation process

However, increased scrutiny and additional or revised reporting for supervisory purposes could generate additional compliance costs.

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Kerry Nichol
Partner, Wealth & Asset Management
+352 42 124 8975
Kerry-Jane.Nichol@lu.ey.com

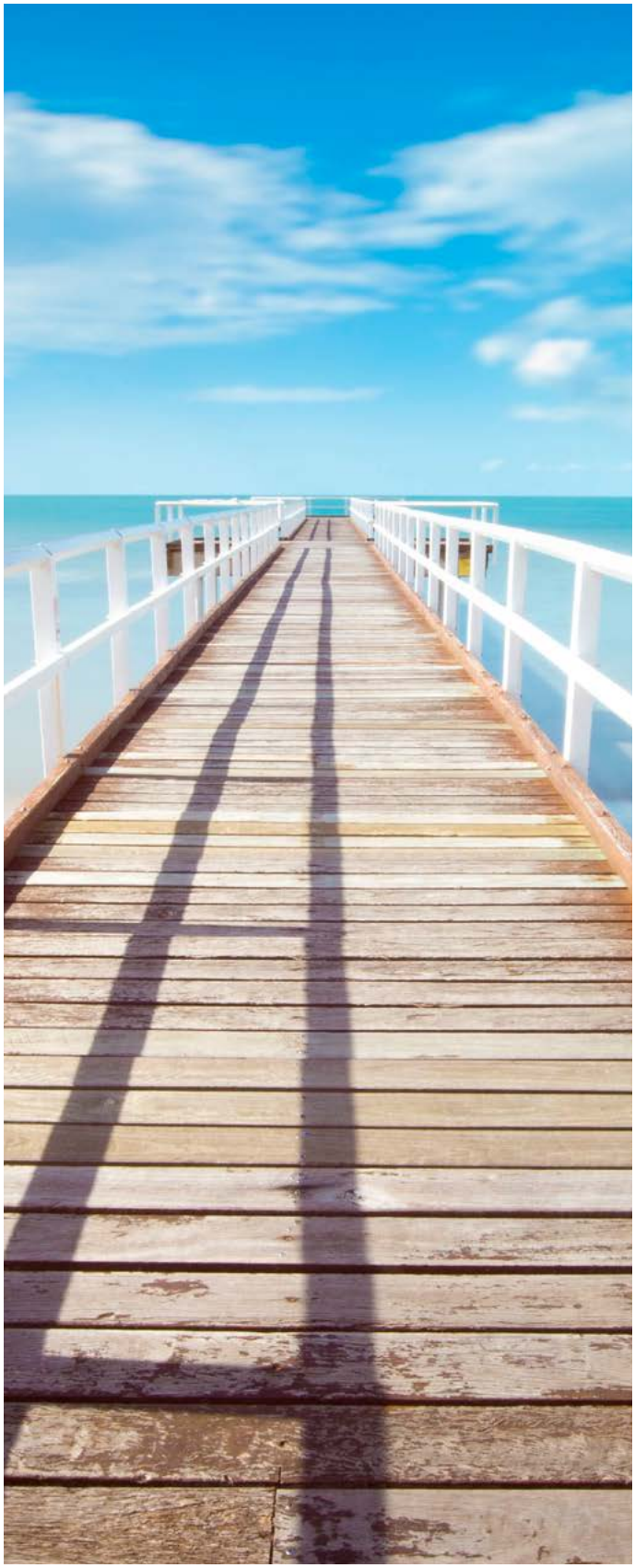
Jean-Marc Cremer
Associate Partner, Wealth & Asset Management
+352 42 124 8304
Jean-Marc.Cremer@lu.ey.com

For more information, please visit:

European Commission Report

[6] The European Venture Capital Fund Regulation, 345/2013, as amended

European Systemic Risk Board considerations regarding the Alternative Investment Fund Manager Directive



Objective

The AIF market represents 40% of the EU fund market and is due to grow further with the Capital Market Union's ambitious target to increase non-bank financing. In a letter issued on 3 February 2020, the European Systemic Risk Board ("ESRB") provided the European Commission with a list of shortcomings identified in the Alternative Investment Fund Manager Directive ("AIFMD") from a financial stability perspective. Although other stakeholders' views will be expressed and might conflict with ESRB recommendations, they are likely to influence the legislative proposals the European Commission ("EC") is mandated to make to the European Parliament and Council in the context of the AIFMD review conducted this year.

Primary Change

Building upon ESRB experience with the scope and application of AIFMD, recommendations aim (i) to improve the suitability of the reporting framework for monitoring systemic risk, (ii) to operationalise existing macro prudential policy instruments , and (iii) to improve the macroprudential policy framework.

Key points

Reporting framework

ESRB outlined the following considerations:

- **Legal Entity Identifier** should not be an optional item in AIFM reporting template. Such inconsistency limits the understanding of complex group structures and the interaction with other regulatory reporting such as under EMIR or SFTR.
- The approach to **fund classification** should be revised to better reflect the type of funds registered as AIFs and where the "Other" category is reduced in size.

[8] According to the Glossary of FATF Recommendations, express trust refers to a trust clearly created by the settlor, as opposed to a constructive trust, which comes into being through the operation of the law.

- A **more complete portfolio breakdown**, using international identifiers (e.g. ISIN, LEI) and going beyond current reporting of aggregate holdings and top five instruments, would enhance systemic risk analysis.
- The **geographical breakdown** of investment exposures by asset classes, investors, counterparties and sponsorship arrangements could be reported at country level rather than at continental level in order to allow for a more comprehensive assessment of potential contagion risks.
- AIFMD reporting should provide sufficient data to enable **computation of leverage** by national competent authorities ("NCA") in order to facilitate comparisons and data quality assessments. Reporting of **additional metrics** capturing potential losses and liquidity demands stemming from leverage would facilitate identification of vulnerabilities.
- Reporting of the **liquidity** management tools that are available to fund managers and under which conditions. The objective is to allow supervisors to better understand contagion risk in crisis scenarios. The measurement of the liquidity of investments and investors' ability to redeem their shares/units should be harmonized and more objective.
- The **reporting frequency** should be harmonized and the lag for data provision could be reduced in order to improve timely monitoring of risks. The ESRB also suggests to build upon the EC's recent fitness check to align further data reporting requirements and improve data quality.
- Access to AIFMD reporting datasets should be granted to all ESRB member institutions with a financial stability mandate.

Operationalisation of existing policy instruments

In order to mitigate the risk of regulatory arbitrage, the ESRB:

- reiterates the recommendation made to ESMA on 30 April 2018 to operationalise **leverage limits** by providing guidance on how NCAs should apply article 25(3) AIFMD. ESMA has launched a consultation on this topic on 27 March.
- suggests to define **"public interest"** in the context of the power granted to NCAs to suspend redemptions in the public interest provided for by article 46(2) AIFMD, with the objective of helping NCAs to consider this legal instrument as a macroprudential tool.
- calls for the extension of the **liquidity management tools** available across Member States.

Further policy proposals

The ESRB suggests that IOSCO's ongoing peer review on liquidity risk management should contribute to the reflection of policymakers on the appropriate **alignment between portfolio assets and redemption terms**.

Practical considerations & next steps

The European Commission provided a report to the European Parliament and the Council on 10 June 2020 (see also Page 20 of this publication). It should be followed by a consultation and the publication of a legislative proposal in the first quarter of 2021.

Development of additional metrics (e.g. leverage) or reporting fields (e.g. exposures) would drive significant compliance costs across the alternative investment fund value chain. Increasing the frequency of reporting would also bring additional burden and costs, in particular for smaller firms.

It is likely that the fund industry will advocate for progressive, technical updates rather than the introduction of new reporting methodologies and requirements during the consultation process.

Implementation of the public interest suspension could make the risk of suspension more difficult to quantify since interventions imposed by the supervisors might be difficult to anticipate by investors. Public interest needs also to be delineated where institutional investors (such as pension funds and insurance companies which are mandated to manage the interests of a significant portion of the "public") are investors in a fund.

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Kerry Nichol
Partner, Wealth & Asset Management
+352 42 124 8975
Kerry-Jane.Nichol@lu.ey.com

Jean-Marc Cremer
Associate Partner, Wealth & Asset Management
+352 42 124 8304
Jean-Marc.Cremer@lu.ey.com

Bernhard Bittner
Associate Partner, Advisory
+352 42 124 8913
Bernhard.Bittner@lu.ey.com

Norman Finster
Associate Partner, Risk
+352 42 124 8730
Norman.Finster@lu.ey.com

For more information, please visit:

ESRB letter

ESMA consultation on guidelines on Article 25 of AIFMD: Assessment of leverage-related systemic risk and leverage limits

Background

In response to a recommendation from the European Systemic Risk Board[1], ESMA has issued a consultation on proposed guidance aimed to improve assessment of leverage-related systemic risk and operationalization of risk limits by national competent authorities ("NCA"). The objective is to identify as early as possible and mitigate potential spill-over effects, such as the amplification of price movements, the contagion to the banking sector and the interruption in direct credit intermediation, resulting from the funds deleveraging during a financial crisis. Contributions can be submitted to ESMA until 1 September 2020.

Primary Change

While leverage data is already reported by AIFMs, the proposed guidelines promote a consistent approach to be taken by NCAs when assessing whether the conditions for imposing leverage limits are met. The guidelines under consultation include a common minimum set of indicators, of which calculation instructions are based on the currently reported data as well as qualitative and quantitative descriptions of the interpretation of the indicators. The guidelines also draw a macroprudential framework with a description of the leverage limits and the principles to be considered when calibrating and imposing leverage limits.

[1] see page 23 of this publication

Key Points

Assessment of leverage-related systemic risk

The risk assessment should be performed by NCAs on a quarterly basis and follows the two-step approach described below:

Step 1: Level, source and different usages of leverage

All AIFs

- Gross leverage
- Commitment leverage
- Adjusted gross leverage
- Financial leverage
- Regulatory AuM

Indicators →

AIFs qualifying for step 2

A. AIFs employing leverage on a substantial basis (commitment leverage > x3)
B. AIFs employing leverage, but not on a substantial basis and whose regulatory AuM > EUR 500mn
C. Other AIFs employing leverage, whose use of leverage differs significantly from:
- The median or average value of leverage of AIFs of the same type
- The AIF's historical median or average of leverage value

↓

Step 2: Assessment of leverage-related systemic risk

AIFs/AIFMs possibly in scope of leverage limits

- AIF(s) whose deleveraging could have a market impact (size)
- AIFMs whose fire sales could contribute to a downward spiral in the prices of assets in a manner that threatens such assets' viability
- AIF(s) whose exposures could constitute an important source of market, liquidity or counterparty risk to a financial institution (spill-over)
- AIF(s) which are funding the real economy whose deleveraging could cause interruption in direct credit intermediation

← *Indicators*

AIFs in scope of in-depth assessment

- Net exposure
- Market footprint on the underlying market
- Investor concentration
- Liquidity profile
- Share of less liquid assets
- Potential liquidity demands resulting from market shock
- Other potential liquidity demands
- Linkages to financial institution via investments
- Counterparty risk
- Linkages to financial institutions via investor base
- Fund investments in credit instruments of non-financial institutions

Leverage limits imposed by NCAs

When deciding to impose leverage limits, NCAs should consider.

I. risks posed by funds according to their type and risk profile as defined by the risk assessment

II. risks posed by common exposure. Where a group of funds of the same type and similar risk profiles may collectively pose leverage-related systemic risks, NCAs should apply similar limits to all funds in that group

NCA should carefully implement leverage limits, both in terms of timing and phasing in and out. Limits should be:

I. maintained as long as the risks do not decrease

II. released when the change in market conditions or fund behaviour stop being procyclical, when measures have been implemented to limit the build-up of risks

III. implemented progressively in a way which avoids procyclicality

IV. cyclical limits, where appropriate, in order to dampen the build-up and materialisation of risks in the upswing and downswing of the financial cycle

When setting the level of leverage limits, NCAs should assess their effectiveness in addressing the relevant systemic risks.

I. when risks are directly related to size, leverage limits should reduce the risks accordingly

II. when risks are partially related to size and leverage limits are not sufficient, NCAs should consider imposing other restrictions on investment policy, redemption policy or risk policy

III. when leverage limits may temporarily result in an increase of risks, NCAs should impose restrictions on the proportion of certain assets to avoid sales of lower risk assets to meet the new requirement. In order to address liquidity mismatches, NCAs should impose a reduction of the frequency of redemptions or impose notice periods

NCAs should evaluate the efficiency of leverage limits by taking into consideration the.

I. proportionality of the limits to ensure that the sector remains able to provide valuable services to the economy

II. robustness to gaming and arbitrage

Practical considerations

The ESMA guidelines under consultation aim at providing NCAs enhanced supervisory tools to assess the extent to which the use of leverage within the AIF sector contributes to the build-up of systemic risk in the financial system, and impose macroprudential leverage limits on AIFs where and when needed to prevent leverage from contributing to procyclicality, especially in times of economic cycle-downturn or increase in market volatility.

On the one hand, cyclical limits could dampen the implementation of certain investment strategies and packages of measures could reduce the flexibility left to managers to adjust their fund strategies in case of supervisory intervention. On the other hand, the lack of visibility on the negative spill-overs which could result from leverage used by other AIFs may limit the ability of managers to anticipate systemic risks caused by collective behavior eventually detrimental to all financial market participants.

Fund managers employing leverage should carefully consider the criteria, indicators and methodologies to be used by NCAs for the purpose of imposing leverage limits. Notably they should integrate contingency plans in their investment policy, redemption policy and risk policy in order to retain control of the way they conduct their activities to the largest extent possible, should a leverage limit be imposed.

Your EY Contacts

Vincent Galand
Associate Partner, Risk
+352 42 214 8683
Vincent.Galand@lu.ey.com

For more information, please visit:

ESMA Consultation

ESMA Guidelines on Performance Fees in UCITS and certain types of AIFs

Background

The value for money delivered by actively managed funds has come under increased scrutiny over the recent years. While requirements are becoming stricter in terms of disclosure of performance against benchmarks[1], ESMA released its Guidelines on performance fee in UCITS and certain types of AIFs on 3 April 2020. The guidelines are more prescriptive than the principle-based 2016 IOSCO good practices applied by most national competent authorities, notably in terms of consistency between the performance fee model used and the fund's investment objective, where a fund is managed by reference to a benchmark index, or as regards to the minimum performance reference period.

Scope

All UCITS are in scope of the guidelines. The guidelines will also apply to open-ended AIFs marketed to retail investors. However, EuVECAs or other types of venture capital AIFs, EuSEFs, private equity and real estate AIFs remain out of scope.

Primary Change

For Luxembourg-based funds, the five-year performance period prescribed by ESMA is aligned with the German BaFIN's practice and is likely to have a significant impact. The selection of a benchmark index for the performance model is also heavily restricted.

[1] See question 8 of UCITS Q&A, ESMA34-43-392

Key Points

ESMA's report comprises five guidelines:

1. The calculation of a performance fee should be verifiable and the method should include at least:
   - a performance reference indicator, i.e. an index, a high-water mark ("HWM"), a hurdle rate or a combination
   - the crystallization frequency and the crystallization date
   - the performance reference period
   - the performance fee rate
   - the calculation methodology
   - the computation frequency which should match with the NAV calculation frequency

   Performance fees should be proportionate to the fund's performance. Artificial increases arising from new subscriptions should not be taken into account when calculating fund performance.

   Managers should be able to demonstrate that managers` and investors` interests are aligned.

   It is permissible to calculate performance fees on a single investor basis.

2. The performance fee model implemented must be and remain consistent with the fund's investment objectives, strategy and policy.
   - The manager should implement and maintain a periodic review process to ensure that the performance fee model is consistent with the fund's investment objectives, strategy and policy.
   - As a general principle, a fund which is managed by reference to a benchmark, or where the fund's portfolio does not deviate materially from a benchmark index portfolio, should use the same benchmark in the performance fee model
   - Where the fund is managed by reference to a benchmark, but the fund's holdings are not based upon the holdings of the benchmark index, the benchmark used for the calculation of the performance should be consistent with the benchmark used for the portfolio composition, according to a non-exhaustive list of consistency indicators:
     - Expected return
     - Investment universe
     - Beta exposure to an underlying asset class
     - Geographical exposure
     - Sector exposure
     - Income distribution of the fund
     - Liquidity measures (e.g. daily trading volumes, bid-ask spreads, etc)
     - Duration
     - Credit rating category
     - Volatility and/or historical volatility
   - Performance should be calculated net of all costs but may be calculated without deducting the performance fee as long at this would be in the investor's best interest
   - If the reference indicator changes during the performance reference period, the performance should be calculated by linking the benchmark index that was previously in force until the date of the change and the new reference indicator used afterwards.

3. Crystallization frequency
   - It should allow for the alignment of the managers "and the investors" interests
   - It should not be more than once a year, except for the high water-mark model or high-on-high model where these cannot be reset during the whole life of the fund and fulcrum fee model and other models which provide a symmetrical fee structure
   - It should be the same for all share classes of a fund with a performance fee
   - Performance fee should crystallize in due proportion in case of closure/merger of funds or upon investor's redemption. However, where both merging and receiving funds are managed by the same manager, crystallization should be presumed to be contrary to investors' best interests, unless justified otherwise by the manager
   - Generally, it should coincide with the end of the financial year of the fund

4. Loss recovery
   - Any loss or underperformance previously incurred during the performance reference period should be recovered before a performance fee becomes payable
   - A performance fee could be payable in case the fund outperformed the benchmark but had a negative performance
   - The performance reference period should be, as far as possible, consistent with the recommended investor holding period. Where the performance reference period is shorter that the whole life of the fund, it should be set equal to at least five years (on a rolling basis for funds using a HWM)

5. Disclosures
   - Investors should be adequately informed about the performance fees and their impact on return
   - All ex-ante documents (prospectus, KIID, marketing documents) should clearly set out all information necessary to understand the performance fee model and the computation methodology, including the main elements and parameters, the payment date. Concrete computation examples should be included in the prospectus
   - Where a performance fee model uses a different but consistent benchmark, the explanation of the choice of benchmark should be included in the prospectus
   - Where a performance fee is payable in times of negative performance a prominent warning must be included in the KIID
   - Where applicable the KIID and the prospectus should display the name of the benchmark index and disclose past performance against it
   - The annual and semi-annual reports and any other ex-post information should indicate for each relevant share class the amount of performance fees and the percentage of the share class NAV they represent

Timeline

The CSSF must notify ESMA of its intention to comply or not within two months of the date of publication of the official translations of the guidelines into all EU official languages. At the end of this period, the guidelines may become immediately applicable in Luxembourg for all in scope funds introducing a performance fee after the application date. Managers of funds with a performance fee existing before the application date should comply by the beginning of the financial year following six months from the application date.

Practical Considerations

Fund managers may need to review the way they design the charging structure of their funds. On one hand, the introduction of a minimum performance reference period, combined with tighter requirements in terms of benchmark index selection and disclosure could incentivize managers to increase their fixed remuneration. On the other hand the comparison with cheaper, passively managed funds should limit such increase to maintain attractiveness of actively managed products.

In practice, a benchmark index used in a performance fee model may need to be changed to align with the benchmark index used for performance objective or portfolio composition. In case the fund is managed by reference to a benchmark, but the fund's holdings are not based upon the holdings of the benchmark index, a different benchmark may still be used in the performance fee model, but specific governance arrangements and processes will be required to demonstrate the ongoing consistency of that benchmark versus the prescribed consistency indicators.

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Kerry Nichol
Partner, Wealth & Asset Management
+352 42 124 8975
Kerry-Jane.Nichol@lu.ey.com

Michel Feider
Partner, Private Equity
+352 42 124 8797
Michel.Feider@lu.ey.com

Robert White
Partner, Real Estate
+352 42 124 8882
Robert.White@lu.ey.com

Jean-Marc Cremer
Associate Partner, Wealth & Asset Management
+352 42 124 8304
Jean-Marc.Cremer@lu.ey.com

Jérôme Cardinaud
Senior Manager, Wealth & Asset Management
+352 42 124 8027
Jerome.Cardinaud@lu.ey.com

For more information, please visit:

ESMA Guidelines

ESMA supervisory briefing on the supervision of costs in UCITS and AIFs

Background

ESMA's first annual statistical report published in 2019 showed the significant impact of costs on the final return for investors. On 4 June 2020, ESMA published a supervision briefing in order to remediate to the lack of convergence of the interpretation of the notion of "undue cost" stemming from provisions contained in UCITS and AIFMD frameworks and the related supervisory practices among the national competent authorities ("NCAs")

This briefing is also meant to give market participants an indication of NCAs' expectations and compliance practices regarding the cost-related rules included in UCITS and AIFM Directives.

Primary change

ESMA has developed non-binding criteria that NCAs should use in:

- Assessing the notion of "undue costs"
- Supervising the obligation to prevent undue costs being charged to investors

On 25 June, the CSSF issued a press release drawing investment fund managers' attention to the ESMA briefing highlighting the requirement to put in place a structured pricing process that takes into account the above-mentioned criteria.

Key points

Undue costs should be assessed against what should be considered the best interest of the fund or its unit holders. Supervisors should ensure that:

- The costs are consistent with the investment objective of the fund and do not prevent the fund to achieve this objective, in particular – but not limited to- where these costs are paid to third parties, including depositaries
- The pricing process adopted by the management company allows a clear identification and quantification of all costs charged to the fund and/or directly paid by the investors, in order to avoid hidden costs

NCAs are expected to scrutinize:

1. Whether the costs are necessary for the fund to operate in line with its investment objective (e.g. portfolio management fees, transaction and settlement fees) or strictly functional to the ordinary activity or to fulfil regulatory requirements (audit fees, taxes, NCA levies)
2. Whether the costs are proportionate to market standards and the type of service provided, notably in the context of potential conflicts of interest where payments are made to third parties, intragroup delegates or depositaries
3. Whether the fees are proportionate to the complexity of assets, strategies and activities performed
4. Whether the fees are sustainable in light of the expected net return of the fund
5. Whether the costs ensure investors' equal treatment, except for AIFs not distributed to retail investors disclosing a preferential treatment, where such treatment is allowed under the applicable legislation
6. Whether there is no duplication of costs and costs are properly identified and accounted for
7. Whether a cap on fees, if any, is applied and disclosed to investors
8. Whether the performance fee model and its disclosure is compliant, where applicable, with the ESMA Guidelines on performance fees in UCITS and certain types of AIFs, see page 29 of this publication
9. Whether all costs disclosures to investor comply with applicate EU and national rule
10. Whether the pricing process and all charged costs are based on reliable and documented data and verifiable at a single portfolio level

NCAs should supervise the management companies' pricing process during one or more of the following:

- fund authorization
- approval of material changes to the fund
- off-site supervision, on-site inspections, thematic reviews
- assessment of investor complaints

During their supervisory activity, NCAs should ensure, inter alia, that the existence, nature and amount of charges are clearly disclosed to investors and that the costs charged are consistent with the fund's rules, documentation, offering document and marketing material.

NCAs are also expected to monitor that the pricing process:

- clearly sets responsibilities among the management body in determining and reviewing the costs
- prevents the risk of damage to investors' interests in case of conflicts of interest
- is clearly documented and periodically reviewed

In case of materialization of undue costs being charged to investors, NCAs should assess the possibility to undertake the following actions:

- investor compensation, where allowed under the national provisions
- reduction of fees
- review of disclosure document
- communication of good and poor practices by NCAs to the market, the stakeholders or the press

Practical considerations

While the ESMA briefing does not bind NCAs to comply with the recommendations, it still sets the best supervisory practice.

Therefore management companies should carefully benchmark the fee structures of the funds they manage against funds with similar investment policies. They are also expected to have proper governance in place for the determination and the review of costs charged to the funds.

Accounting procedures need to allow granular disclosures which are necessary to prevent any impression of excessive or duplicate costs being charged to investors, in particular where conflicts of interests have been identified, notably as a result of third-party payments .

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Kerry Nichol
Partner, Wealth & Asset Management
+352 42 124 8975
Kerry-Jane.Nichol@lu.ey.com

Jean-Marc Cremer
Associate Partner, Wealth & Asset Management
+352 42 124 8304
Jean-Marc.Cremer@lu.ey.com

Bernhard Bittner
Associate Partner, Advisory
+352 42 124 8913
Bernhard.Bittner@lu.ey.com

For more information, please visit:

ESMA Supervisory Briefing

CSSF Press Release

CSSF FAQ on CSSF Circular 02/77

Background

CSSF Circular 02/77 (the "Circular") issued on 27 November 2002 concerns the protection of investors in case of NAV calculation error and the compensation of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment ("UCI").

Primary Change

On 7 July 2020, the CSSF issued a Frequently Asked Questions document ("FAQ") describing how CSSF Circular 02/77 should be applied by investment fund managers ("IFMs", i.e. UCITS management companies, authorized alternative investment fund managers, self-managed UCITS and internally-managed AIFs).

The FAQ clarifies the scope of application of the Circular, the process to select the method of correction for NAV errors and the circumstances in which tolerance thresholds are applicable.

Key Points

1. General clarifications on the scope of the Circular

- In the case of an active investment breach that **corrects itself through market evolution or new subscriptions**, the unrealized loss generated by the holding of the excess security position during the breach period should be compensated to the UCI.
- **Intraday** active investment breaches and breaches that occur between two official NAVs should be notified to the CSSF and compensated in accordance with the provisions of the Circular.
- CSSF notification or remedial action plan are not required in case of investment breaches beyond the control of the UCI (**"passive breaches"**) but the remediation of the investment breach should be a priority for the IFM.
- In cases where (i) there are **no subscriptions and redemptions occurring during the NAV error period**, or (ii) the corrective action resulted in a gain for the UCI, only a notification including the financial impact calculation, **and not a Remedial Action Plan**, is required to be sent to the CSSF. However, the notification should include corrective measures to avoid the recurrence of the same type of error/breach and the external auditor of the UCI has to review the correction process during its annual audit of the UCI and provide the related results in the Long Form Report and/or the Management letter.
- In case of an active investment breach where the compensation amount for the UCI exceeds EUR 25,000 and no compensation is due to investors, both the notification and the Remedial Action Plan are required. The external auditor of the UCI has to report on the Remedial Action Plan pursuant to the Circular.
- When the UCI makes use of the ***de minimis amount*** for compensating the investors which are financially impacted by a material NAV error calculation, prior approval from the CSSF is not required but the CSSF may request the UCI, on an ex-post basis, to provide documentary evidence that such amount represented the bank charges necessary to transfer the compensation amount to investors (notably where the "*de minimis*" amount exceeds EUR 25). The IFM's internal policy should provide for the use and the level of the "*de minimis*" amount.
- The FAQ clarifies that the **CSSF will not confirm in writing closure of an incident based on the action taken** as disclosed in the notification, but may, on an ex-post basis, raise additional questions or require further remedial action if the corrective actions are not deemed sufficient or compliant with the Circular.
- The FAQ also clarifies that a breach of UCITS and AIFs **leverage limits** does not need to be notified to the CSSF in the context of the Circular. However, adequate monitoring and correction in accordance with applicable internal procedures is expected.
- The CSSF clarifies that **specialized investment funds** ("SIFs") may either opt for the application of the Circular or set specific internal rules. In the absence of specific internal rules, the Circular applies. All material NAV errors and active investment breaches have to be notified to the CSSF, whether the SIF applies the Circular or specific internal rules. When SIFs opt for the application of the Circular, a remedial action plan is not required but the external auditor has to review the correction process and the related compensation and confirm in the management letter that they complied with the provisions of the Circular.

2. Clarification on certain types of investment rules

- In case of a breach of compliance with the **UCITS 5/40% rule**, the UCITS does not necessarily have to sell the securities that caused the breach. The FAQ describes three acceptable methods (impact by reference to security which caused the breach (use of accounting method), impact by reference to other security sold to correct the breach (use of accounting method) or impact by reference to the performance of the reference portfolio (economic method). However, where the method is not laid down in writing in the internal policy of the IFM, the impact should be calculated by reference to the security which caused the breach, by applying the accounting method in proportion to the amount in breach.
- A breach of the **UCITS 20% deposit limit** is considered to be active every time the event which caused the breach, such as a settlement date mismatch (between the capital activity and the portfolio transactions or between several portfolio transactions) or the maturity of security, is predictable and avoidable. The organization of the portfolio management function by the IFM at the level of the UCITS (i.e the investment operations, the cash management and subscription/redemption flows) should provide for ongoing compliance with the 20% deposit limit.
- Where the **UCITS 20% deposit limit is breached and the deposit returns negative interest**, the UCITS should be indemnified in relation to the interest rate and other charges borne by the UCITS. Financial impact cannot be derived from a comparison with interest rates between different bank accounts.
- The CSSF also confirmed that the Circular applies in case of breach of the **UCITS collateral diversification rules and other criteria that the collateral has to observe**, but a financial impact calculation is only necessary in case of a counterparty default.

[11] International Capital Market Association – European Report and Collateral Council

3. Governance and organizational requirements

- The CSSF considers that the organization of IFMs managing Luxembourg domiciled UCIs should provide for **robust policies, processes and procedures** governing the treatment of NAV calculation errors and investment breaches and, in particular a detailed policy approved by the Board of Directors of the IFM and, if applicable, by the Board of Directors of the UCI.
- The policy and related procedure should cover, *inter alia*:
  - The governance process, together with the different stakeholders involved, applied in relation to NAV calculation errors and investment breaches
  - The oversight of the delegates where NAV calculation and investment compliance are delegated
  - The definition of active vs. passive investment breaches and applicable criteria (considering notably which events are or are not beyond the control of the UCI)
  - The different steps and the timeline in relation to the correction of errors and breaches
  - The NAV error threshold applicable for each sub-fund
  - The use and the level of *de minimis* amounts
  - The methodology used by the sub-fund for the financial impact calculation: accounting (e.g. Average Weighted Cost, LIFO, FIFO) vs. economic method (setting the comparative reference index to be used by sub-fund)
  - The application of the compound or non-compound method used by the sub-fund for the financial impact calculation
  - The periodic review of the adequacy and the effectiveness of the policy, processes and procedures.

SIFs which are not managed by an AIFM should also establish and implement such a policy. The CSSF also recommends UCIs subject to Part II of the Law of 17 December 2010 which are not managed by an AIFM to establish and implement such a policy.

4. Conditions required for the application of the economic method to determine the financial impact

- As per Circular CSSF 02/77 the economic method calculates the compensation by reference to the performance which would have been realised in case the non-compliant investments would have had the same fluctuations as the portfolio invested in compliance with the investment policy and the investment restrictions provided for by law or the prospectus
- The use of the economic method is only permitted if it is defined in the internal policy that governs the UCI, approved by the Board of Directors of the IFM and, if applicable, by the Board of Directors of the UCI. This policy must include the **reference benchmark** index used to measure the comparative performance against the non-eligible asset. The reference benchmark index should be a **fair representation of the investment policy**, or a part thereof laid down in the UCI prospectus. IFMs should be able to demonstrate and to evidence with necessary documentation that the comparative performance and the method does not prejudice the investors and has not been selected with the objective of minimizing compensation payments.
- The CSSF confirmed that it is not acceptable to compare the performance of the non-eligible asset with a corresponding eligible asset having the same characteristics
- In case of an **umbrella fund**, the choice of the methodology is possible at the entity level or at sub-fund level.
- It is possible, within the same UCI, to use different methods (accounting/economic) for different types of active investment breaches if this is formally laid down in the internal policy of the IFM and applied on a consistent basis.

- Any **change of the method** used to correct investment breaches is only possible if there is an adequate justification and if it has been approved by the Board of Directors of the IFM and, if applicable, by the Board of Directors of the UCI. It is in principle not permitted to change the correction method applied when it has been previously determined to use a given method for a certain type of breach. It is only possible, upon approval by the Board of Directors of the IFM and, if applicable, the Board of Directors of the UCI, to change the method prospectively, i.e. for the next investment breach of the same type.

5. Tolerance thresholds

- The **over charging of fees/costs to the UCI have to be reimbursed to the UCI in all cases**, irrespective of the materiality threshold laid down in the Circular. However, the recalculation of NAV is only necessary where the reimbursed fees/costs exceed the materiality threshold.
- **Where no tolerance threshold is applied by an UCI** or the tolerance threshold defined in the internally approved policy is **lower than the threshold laid down in the Circular**, NAV calculation errors should be notified to the CSSF and all provisions of the Circular apply based on the lower thresholds as determined for the UCI.
- In order to determine the materiality threshold applicable to a **fund of funds**, an **index tracker** or a **feeder fund**, a UCI should consider the investment policy of the target investments on a look-through basis, i.e. the investment policy of the target funds or master fund or the investment policy of the assets/funds in the tracking index.

Practical considerations

IFMs should assess their current governance, policies, processes and procedures to make sure they match the CSSF's expectations in terms of correction of NAV errors and investment breaches.

Your EY Contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Kerry Nichol
Partner, Wealth & Asset Management
+352 42 124 8975
Kerry-Jane.Nichol@lu.ey.com

Jean-Marc Cremer
Associate Partner, Wealth & Asset Management
+352 42 124 8304
Jean-Marc.Cremer@lu.ey.com

For more information, please visit:

CSSF FAQ on Circular 02/77

AML Laws

The Laws of 25 March 2020 – The remaining implementation of the provisions of the 5th EU AML Directive.

Background

Although some provisions of the 5th EU AML Directive have already been transposed under the law of 13 January 2019 regarding the establishment of a register of beneficial owners, on 25 March 2020 the Luxembourg legislator adopted 2 separate laws to implement the remainder of the provisions set out in the 5th EU AML Directive. The first law, the Law of 25 March 2020 transposing certain provisions the 5th AML Directive in Luxembourg, introduces a serie of amendments to the Law of 12 November 2004 in the fight against money laundering and terrorist financing, as amended (the "AML Law"), hereinafter the "2020 Law". The second law, the Law of 25 March 2020 establishing a central data retrieval system concerning IBAN accounts and safe-deposit boxes is also amending the AML Law. Both laws entered into force as of 30 March 2020.

Primary change

The most notably changes to the AML Law are :

- The scope of professionals subject to AML/CFT obligations has been extended to include, Inter alia, real estate developers, exchange platforms for virtual currencies (including exchanges dealing with fiat currency and virtual currency), custodian wallet providers, rental brokers (when the value of the monthly rent is equal or superior to 10.000 Euros), art dealers (or persons who act as intermediaries in the trade in works of art including galleries and auction houses, when the amount of the value of the transaction(s) is equal to or exceeds 10.000 Euros) in the scope of the AML Law
- Clarification and extension of customer due diligence (CDD) measures and enhanced due diligence (EDD) measures to be applied, most notably, regarding high-risk countries;
- Further specifications clarifying the methodology for identification and verification of beneficial owners (following CSSF Circular 19/732)
- Additional details regarding internal management requirements and group-wide policies and procedures
- Enhanced cooperation framework between the various competent authorities and self-regulated bodies

Key points

Summary of the changes having the most impact for IFMs and UCIs:

Customer and Enhanced due diligence measures

- PEP: The notion that institutions should not consider persons who have ceased to be entrusted with a prominent public function for over one year as a Political Exposed Person (PEP) has been erased, therefore institutions now need to continue to take risk-sensitive measures for each PEP and preceding PEP for at least 12 months and evaluate accordingly the continuing risk posed by that person. The risk-sensitive measures have to be taken until that person does not pose any further risk related to his/her PEP status.
  Furthermore, the definition of PEPs has been extended to include natural persons appearing on the list published by the European Commission (the "EU PEP List"). This list has not yet been published at the date of this article. Institutions will thus be obliged to include this new EU PEP List in their customer screening processes.
- High-risk Jurisdictions: The definition of a high-risk country has evolved. The current changes now consider that a high-risk country should at least include countries considered to be a) high-risk third countries by the European Commission, b) higher risk countries by the International Financial Action Task Force (FATF), c) high risk countries by the Luxembourg supervisory authorities. Additionally, the professional shall take into consideration reports established by international organizations and standard-setting bodies responsible for preventing money laundering and combating the financing of terrorism, with regard to the risks certain countries hold. Furthermore, it has now been clarified that for each country considered as high risk, enhanced due diligence measures should be applied which include, at least:

  1. Obtain additional information on the Beneficial owner(s) and update the identification data more frequently of
  2. Obtain additional information on the envisaged nature of the business relationship
  3. Obtain information on the origin of funds/assets of the client and beneficial owner
  4. Senior management authorization
  5. Obtain information on the reasons for planned or already performed transactions
  6. Enhanced monitoring of the business relationship (incl. increasing number and frequency of checks and determining transaction patterns that require further examination)

  The 2020 Law also foresees that professionals apply, where appropriate, additional enhanced measures to persons and entities that execute transactions involving high-risk countries.
- Correspondent Banking relationships: The 2020 Law has removed the notion that additional measures for correspondent banking relationships should only be taken in case of higher-risk situations. Instead, now, the risk rating of the respondent financial institution is irrelevant and the additional customer due diligence measures should be taken in each case. Professionals should, therefore, review their current portfolio to understand whether there are cases for which further information/documentation should be requested to satisfy regulatory requirements.
- New factors evidencing high risk are added to the Annex IV of the AML Law:
  - A third-country national customer applying for residence rights or citizenship through capital transfers, the purchase of property or government bonds, or investments in private companies.
  - Transactions relating to petroleum, arms, precious metals, tobacco products, cultural goods and other objects of value archaeological, historical, cultural and religious, or of rare scientific value, as well as ivory and protected species.

[12] Since 2 October 2019, EONIA has been recalibrated as the €STR (Euro Short-Term Rate) plus a fixed spread of 8.5 basis point and both the €STR and EONIA will be published at 09:15 CET on T+1 until 3 January 2022, when the publication of EONIA will cease.
[13] Regulation No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending regulation No 648/2012

Customer due diligence measures

The 2020 Law clarifies the measures which are related to any person acting on behalf of the customer/investor specifically related to the authorization required to act in place of this person as well as the identity and verification requirements that apply.

Secondly, a framework has been introduced to provide flexibility in the electronic identification and verification of the customer/investor (EU Regulation 910/2014 on electronic identification and trust services for electronic transactions in the internal market).

Lastly, the 2020 Law also has introduced measures that are in line with the CSSF Circular 19/732 for the identification and verification of beneficial owner information. This includes as well the obtaining of proof of beneficial ownership through an extract of the relevant BO register in Luxembourg or abroad (where accessible).

Third-party due diligence

A clarification has been introduced concerning situations in which a third party can be used to perform due diligence procedures including the certainty that third parties provide, without delay, upon request, the necessary documents concerning CDD, including identification and verification data obtained by electronic means. The same eligibility criteria as set out under the AML Law still apply including that the third party should be subject to regulations and uphold document retention mechanisms that are compatible with the AML Law.

Lastly, the 2020 Law provides for a new aspect for professionals using their group program. Such professionals should, in addition to the conditions already set out, mitigate risks linked to high-risk countries following the AML Law.

How can we help?

- Gap analysis of internal processes and procedures
- Support with workshops and tailor-made learning events
- Remediation exercise for high-risk cases including PEPs
- Process and procedure calibration
- AML/CFT robotic process automation
- Managed services (AML/CFT) through EY PFS

Your EY Contacts

Christophe Wintgens
Partner, Extended Assurance Leader
+352 42 124 8402
Christophe.Wintgens@lu.ey.com

Christine Frentz
Senior Manager, Extended Assurance
+352 42 124 8087
Christine.Frentz@lu.ey.com

Joachim Polfliet
Senior Manager, Extended Assurance
+352 42 124 8645
Joachim.Polfliet@lu.ey.com

For more information, please visit:

Law of 25 March 2020 transposing certain provisions the 5th AML Directive in Luxembourg

Law of 25 March 2020 establishing a central data retrieval system concerning IBAN accounts and safe-deposit boxes

Regulatory Response to COVID 19 Crisis

Among the emergency measures taken by the EU and Luxembourg legislators, and regulators to alleviate certain operational pressures, some specific developments may bring longer-term clarifications or temporary relief.

CSSF FAQ COVID-19

Position on passive investment breaches and breaches of the VAR limits for UCITS

Passive investment breaches of the global exposure limit (and more generally of applicable investment restrictions) do not need to be notified to the CSSF.

The CSSF considers that breaches of the VaR limit (either the maximum limit laid down in regulation (20% for absolute VaR or 200% for relative VaR as the case may be) or any other more restrictive internal limit set below the above regulatory thresholds, as laid down in the sales prospectus) by UCITS as a result of the increase of volatility in financial markets (in the absence of any new positions increasing the risk of the portfolio) may be considered as passive breaches.

Upon occurrence of a passive breach, any additional risk exposure taken by the UCITS increasing the overall level of risk of the portfolio (i.e. VaR usage increasing) should be viewed as an active investment breach.

Investment fund managers should take reasonable steps to meet the limit within a reasonable time period, thereby taking due account of the prevailing market conditions and of the best interests of investors. For that purpose, they have to closely monitor the situation of the UCITS as well as the defined remediation plan.

Question 16.D) also clarifies the content of the notification to the CSSF in relation to an active breach of the VaR limit.

EY Contact:
Michael Ferguson
Michael.Ferguson@lu.ey.com

Jean-Marc Cremer
Jean-Marc.Cremer@lu.ey.com

Vincent Galand
Vincent.Galand@lu.ey.com

Clarification on swing pricing

The CSSF confirmed that Undertakings for Collective Investment ("UCIs") using Swing Pricing as an anti-dilution mechanism can increase the swing factor:

(i) Up to the maximum laid down in the prospectus without prior notification to the CSSF;

(ii) Beyond the maximum laid down in the prospectus where the prospectus offers this possibility to the board of directors of the UCI, provided that such decision is duly justified and takes into account the best interests of the investors. Investors must be informed and the CSSF provided with a detailed notification of the resolution, including a specific explanation of the reasons;

(iii) Beyond the maximum laid down in the prospectus where the prospectus does not offer this possibility to the board of directors of the UCI, provided that conditions laid down in (ii) are met and that the prospectus is updated to offer this possibility at the earliest convenience.

The CSSF does not set a quantitative maximum but the revised swing factors must be the result of a robust internal governance process and must be based on a robust methodology. Revised swing factors must be communicated to investors and the CSSF may request justification for the revised swing factors on an ex-post basis.

Where the prospectus does not offer the possibility to the Board of Directors of the UCI or the management company to go beyond the maximum level laid down in the prospectus, the CSSF clarified on 7 April that communication to investors has to be made prior to the implementation of the increased swing factor.

EY Contacts:
Michael Ferguson
Michael.Ferguson@lu.ey.com

Kerry Nichol
Kerry-Jane.Nichol@lu.ey.com

Jean-Marc Cremer
Jean-Marc.Cremer@lu.ey.com

European Supervisory Agencies (ESAs) Joint Committee amendment of the draft margin regulatory technical standards (RTS) and call to national competent authorities to low-action relief

The draft RTS amend the Delegated Regulation on risk mitigation techniques for non-centrally cleared OTC derivatives and the implementation of Initial Margining phase 5 and phase 6.

I. Initial margin phase 5 and phase 6

On 3 April, IOSCO and the Basel Committee announced a one-year deferral of the final implementation phases of the initial margin requirements for non-centrally cleared derivatives.

With this one-year extension, the final implementation phase should take place:

- on 1 September 2021 for entities with an aggregate average notional amount ("AANA") of non-centrally cleared derivatives greater than €50 billion
- on 1 September 2022 for entities with an AANA of non-centrally cleared derivatives greater than €8 billion

II. Physically settled FX and swaps

A new amendment exempts not only physically settled FX forwards, but both physically settled FX forwards and swaps.

III. Single-stock equity options or index options transactions in the EU framework.

The draft joint RTS also proposes to extend by one year the current deferred application of the margin requirements for single-stock equity options or index options transactions in the EU framework.

The ESAs cannot disapply EU law. Subject to endorsement by the European Commission, the draft RTS will be adopted as a Delegated Act and be subject to the scrutiny of the European Parliament and the Council.

EY Contacts:
Olivier Maréchal
Olivier.Marechal@lu.ey.com

Jens Schmidt
Jens.Schmidt@lu.ey.com

Update on distribution & third-country investment

ESMA consults on standardized information to facilitate cross-border funds distribution

On 31 March 2020, the ESMA issued a consultation paper on the standard forms, templates, and procedures that National Competent Authorities (NCAs) should use to publish information on their websites to facilitate cross-border distribution of funds.

The deadline for providing comments was 30 June 2020.

ESMA invites external stakeholders and interested parties to comment on implementing technical standards (ITS) regarding:

- the determination of standard forms, templates and procedures for the publication and notification that NCAs are required to make in relation to national provisions concerning marketing requirements applicable within their jurisdictions (article 5(3) of Regulation (EU) 2019/1156 of 20 June 2019)
- the specification of the information to be communicated, as well as the standard forms, templates and procedures for the publication and notification that NCAs are required to make in relation to national provisions concerning fees and charges levied by them in relation to activities of AIFMs, EuVECA managers, EuSEF managers and UCITS management companies (article 10(3) of Regulation (EU) 2019/1156 of 20 June 2019)
- the specifications of the information to be communicated, as well as the standard forms, templates and procedures for communication of the information by the NCAs which is necessary for the creation and maintenance of the central database on cross-border marketing of AIFs and UCITS, and the technical arrangements necessary for the functioning of the notification portal into which each NCA shall upload all documents necessary for the creation and maintenance of such central database (article 13(3) of Regulation (EU) 2019/1156 of 20 June 2019)

ESMA will consider the feedback it receives to this consultation and expects to publish a final report by 2 February 2021.

AMF Recommendation on the information to be provided by collective investment schemes incorporating non-financial approaches

On 11 March 2020, the French Market Authority (AMF) published an official Recommendation, "position recommendation DOC-2020-03" (Recommendation), regarding the sustainable information to be disclosed by UCIs integrating non-financial approaches.

Through the Recommendation, the AMF aimed at clarifying its expectations in terms of quality of information provided for investors and its consistency with the non-financial investment management approaches adopted by fund managers.

The Recommendation not only concerns French domiciled UCIs but it also has implications for foreign UCIs marketed in France.

The requirements contained within the Recommendation have the following timeline:

- immediate applicability (11 March 2020) for new UCIs and existing UCIs that are marketed in France, whose domiciliation is in France or in a third country
- 30 November 2020, for sub-funds to change their denomination and existing KIIDs accordingly
- 10 March 2021 for funds to update their prospectuses with the necessary disclosures

According to the Recommendation, asset managers marketing UCIs in France, which include investor disclosure of non-financial approaches and techniques, need to decide whether to opt for a "significantly engaging approach", or, on the contrary, a "weak approach".

Asset managers which opt for a "significantly engaging approach" will disclose non-financial characteristics as a key aspect of communication to investors; whereas, asset managers adopting a "weak approach" do not make use of references to non-financial characteristics as a key aspect of communication to investors.

UCIs marketed in France whose investor disclosure includes information on non-financial approaches and techniques under a "significantly engaging approach", must include in both the KIID and the Prospectus of the UCI, a minimum level of information and disclaimers regarding:

- Non-financial investment objectives
- Type of approach(es) implemented (e.g. best-in-class, best-in-universe, best-effort, thematic, etc...)
- Description of the processes of stock picking and sequencing in relation to the financial strategy
- Example of non-financial criteria
- Warning on the limits of the approach adopted

Further disclaimers and more granular information are requested to be included in the Prospectus. The requirements contained in the Recommendation may be refined in the future depending on the evolving European regulation and the changing market practices and to have a finer distinction between the various non-financial investment management approaches.

Liechtenstein: update of the local AIFM Law

On 1 February 2020, the Financial Market Authority of Liechtenstein (FMA) published the update of the local AIFM law for alternative investment fund managers.

The updates of the local AIFM law for alternative investment fund managers were effective as of 1 February 2020.

The updates of the local AIFM law for alternative investment fund managers affects a number of provisions, including alternative investment fund managers (AIFM) marketing alternative investment funds (AIF) on a cross-border basis in Liechtenstein, and, in particular with regard to:

- The cancellation of the notification fees (CHF 750) due to FMA for the marketing of EEA AIF (sub-fund and/or single fund) in Liechtenstein. (The amount of the fees due to FMA for the marketing of EEA AIF and UCITS (sub-fund/or single fund) remains CHF 500))
- A simplified notification process for AIFM which are registered in an EEA Member State, and that distribute EEA AIF to professional investors in Liechtenstein
- A new notification process for EEA and non-EEA AIFM that market AIF to retail investors in Liechtenstein

PBOC & SAFE new measures to promote participation in China's financial market

The People's Bank of China (PBOC) and the State Administration of Foreign Exchange (SAFE) have issued the Regulations on Funds of Securities and Futures Investment by Foreign Institutional Investors - PBOC & SAFE Announcement (2020) No. 2 - (the Regulation) aiming to further promote the steady and sound development of the securities and futures markets in China.

On 7 May 2020, the PBOC and the SAFE have issued the Regulation which standardizes and simplifies administrative requirements on the remittance and repatriation of funds as well as currency exchanges by foreign institutional investors in order to better facilitate foreign investors' participation in China's financial market.

The Regulation is addressed to Qualified Investors, which include Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors

The main points of the Regulation include:

- The removal of the restrictions on investment quotas for Qualified Investors
- The possibility for Qualified Investors to choose the currency and the timing of inward remittance on their own decisions
- The simplification of the procedures concerning the repatriation of securities investment income for Qualified Investors. This implies also the replacement of the special audit report on investment returns issued by a Chinese certified public accountant and tax clearance or tax filing certificates with Tax commitment letters signed by Qualified Investors
- The limits on the number of custodians are eliminated. Consequently, a Qualified Investor may choose multiple domestic custodians, and appoint one custodian as the main custodian
- The foreign exchange risk and investment risk management mechanisms for Qualified Investors' domestic securities investment are further reinforced
- The strengthening of the on-going and ex-post supervision by PBOC and SAFE

ASIC new regulatory framework for foreign financial services providers

On 10 March 2020, the Australian Securities and Investments Commission (ASIC) published a new regulatory framework for foreign financial services providers (FFSPs) providing financial services to Australian wholesale clients (Regulatory Guide 176).

The new regulatory regime will enter into effect starting from 1 April 2022.

Further to extensive consultation with industry players and overseas regulators, ASIC released a new regulatory framework and exemptions instruments for FFSPs providing financial services to Australian based customers.

The new framework has two main parts:

- A new foreign Australian financial services (AFS) licensing regime for FFSPs
- Licensing relief for providers of fund management financial services seeking to induce some types of professional investors

From 1 April 2020 new FFSPs may apply to obtain a foreign AFS license to provide financial services in Australia to wholesale clients. To be eligible for the foreign AFS license, the FFSPs must be regulated in a foreign jurisdiction that the ASIC has determined as being of a sufficiently equivalent level of regulation to Australia.

On the other hand, FFSPs that currently rely on an AFS licensing exemption granted by ASIC may continue to rely on this exemption until 31 March 2022, provided they comply with all applicable conditions set out in the Regulatory Guide 176.

Fund management licensing relief will also commence on 1 April 2022. The relief is available to offshore providers inducing certain types of Australian professional investors to use the fund management financial services it provides. Under the relief, a license is not needed for such inducements.

Your EY Contacts

Rafael Aguilera
Associate Partner, Business Consulting
+352 42 124 8365
rafael.aguilera@lu.ey.com

Bernhard Bittner
Associate Partner, Advisory
+352 42 124 8913
Bernhard.Bittner@lu.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world owwver. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com/en_lu

Your EY Luxembourg contacts

Michael Ferguson
Wealth & Asset Management Leader and EMEIA Wealth & Asset Management Audit Leader
+352 42 124 8808
Michael.Ferguson@lu.ey.com

Kerry Nichol
Partner, Wealth & Asset Management
+352 42 124 8975
Kerry-Jane.Nichol@lu.ey.com

Nicolas Bannier
Partner, Wealth & Asset Management
+352 42 124 8132
Nicolas.Bannier@lu.ey.com

Jean-Marc Cremer
Associate Partner, Wealth & Asset Management
+352 42 124 8304
Jean-Marc.Cremer@lu.ey.com

Pierre-Alexandre Coipeault
Senior Regulatory Advisor
+352 42 124 7108
Pierre-Alexandre.Coipeault@lu.ey.com