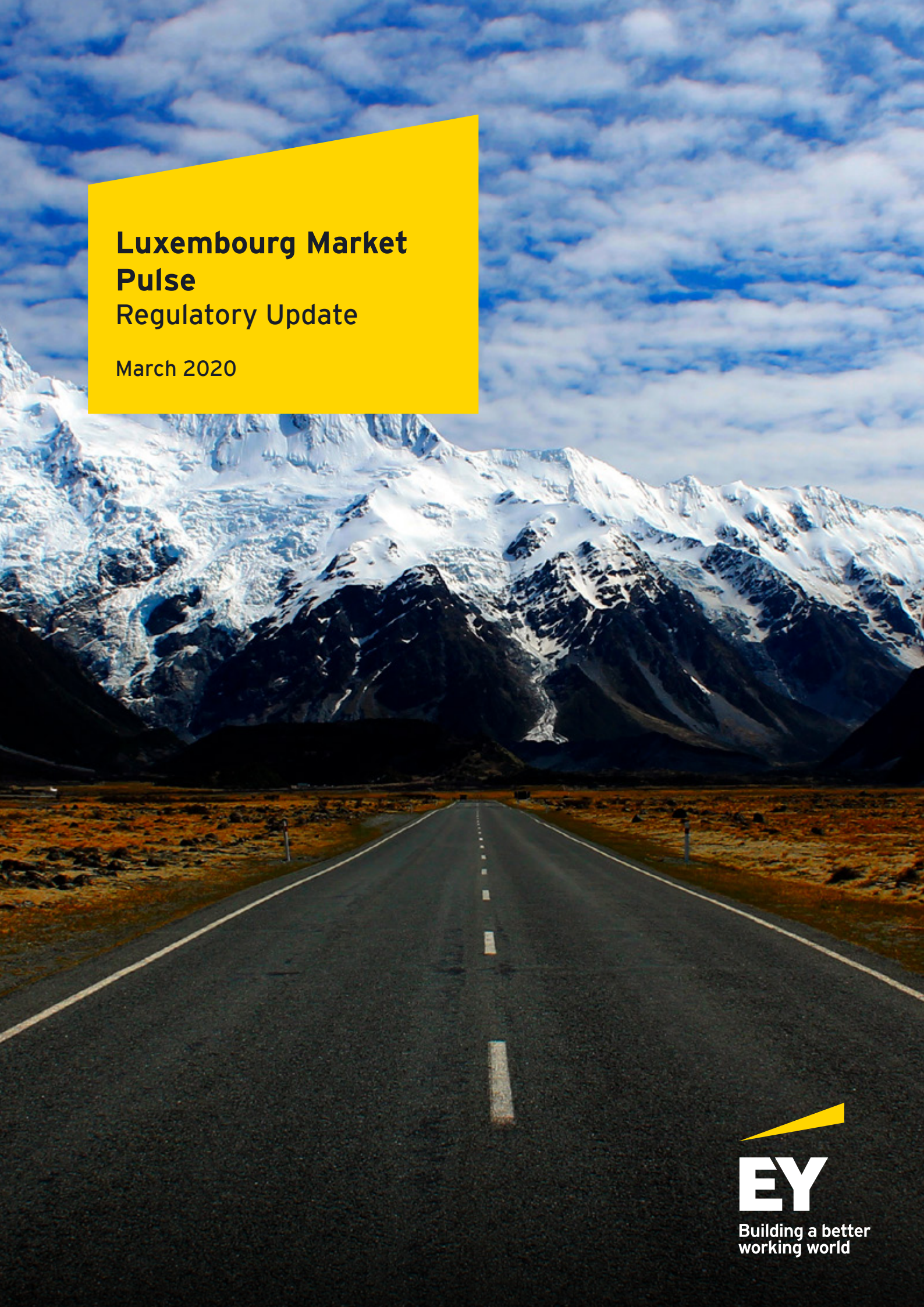
Luxembourg Market Pulse

Regulatory Update

March 2020



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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. ESG & stewardship - Key impacts of the new ESG disclosure rules for the fund ecosystem
2. Law of 1 August 2019 implementing the Shareholder Rights Directive II
3. Liquidity risk in investment funds - ESMA Guidelines on Liquidity stress testing in UCITS and AIFs and Circular CSSF 19/733; Liquidity risk management of open-ended undertakings for collective investment
4. CSSF FAQ - Swing Pricing Mechanism
5. Anti-money laundering and counter terrorist financing - Luxembourg's first ML/FT risk analysis on the collective investment sector; Circular 19/732 on UBO identification; other AML regulatory news in a nutshell and the EU Regulatory AML agenda 2020
6. Performance forecasts and cost transparency - Joint Consultation Paper concerning amendments to the PRIIPS KID and CSSF Communication on KIID benchmark disclosure for UCITS
7. IBOR transition - Recommendations from the working group on Euro risk-free rate
8. EMIR: current state of play for Investment Fund Managers - CSSF Press release on EMIR IFM questionnaire
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10. ATAD II - Impact on investment funds in Luxembourg

We also take a look at "What's next on the regulators' agenda".

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

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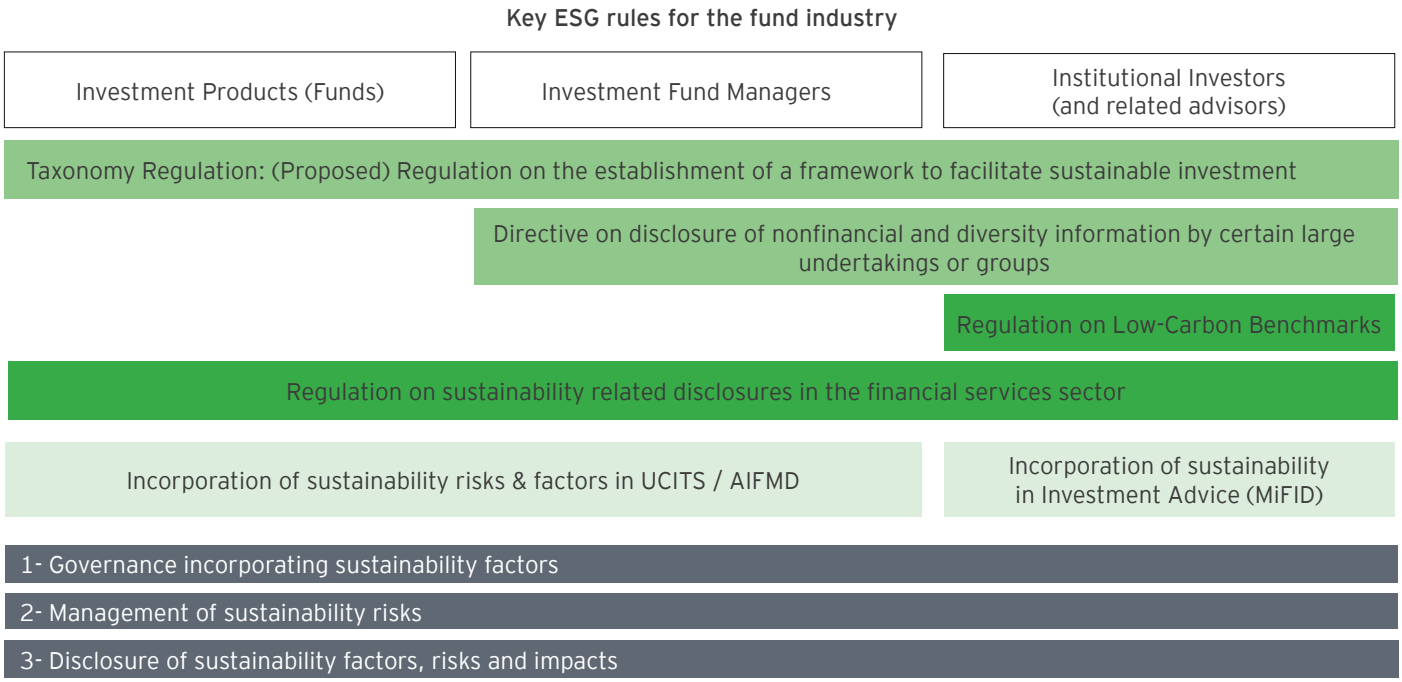
ESG & stewardship

Key impacts of the new ESG disclosure rules for the fund ecosystem

Application from 10 March 2021

Citizens and policy makers are increasingly concerned by global warming, environmental and social issues. As demand for sustainable investment products grows, we are currently seeing unprecedented regulatory developments in this space and they are likely to have a significant impact on the fund industry. The European Commission issued the action plan "Financing Sustainable Growth" in March 2018 with the ambitious objective to reorient private capital to more sustainable investments.

The first core regulation from the Commission package on the establishment of a framework to facilitate sustainable investment ("Taxonomy Regulation") will provide much needed common definitions & methodology. The regulation on sustainability-related disclosures in the financial services sector ("SFDR") introduces wide transparency requirements on fund managers who will need to demonstrate how proficient they are in embedding ESG factors in their processes. Disclosures will also be required at product level to substantiate how ESG objectives are met. In requiring benchmark administrators to provide ESG benchmarks, the Low-carbon benchmarks Regulation ("LCBR") should help managers to calibrate their product-level disclosures.



Source: Adapted from "Mapping and linkages of the EU Sustainable Finance Action Plan's 10 points", European Commission, 2018

Key definitions

Sustainable Investment: an investment is deemed to be sustainable where investment is made in an economic activity that contributes to an environmental or a social objective (...) provided that such investment **does not significantly harm** any of those objectives and that the investee company follows good governance practices.

Sustainability Factors: environmental, social and employee matters, respect for human rights, anticorruption and antibribery matters.

Sustainability Risks: environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.

Principal Adverse Impacts ("PAIs"): impacts of investment decisions and advice that result in negative effects on sustainability factors

Scope & exemptions

The regulation applies to a broad range of financial market participants, including, inter alia, UCITS management companies, AIFMs, EuVeCA and EuSEF managers and firms or credit institutions providing portfolio management. Financial advisors are also subject to certain disclosure requirements.

The SFDR does not apply to intermediaries providing insurance advice about Insurance-based investment products, unless decided otherwise by a member state, nor to investment firms employing fewer than 3 persons.

Key Practical Considerations

Planification: The SFDR contains novel and often complex requirements creating significant compliance work for Investment Fund Managers ("IFMs"). Since delegated acts are likely to be published after the application date of the SFDR, it will be necessary to launch a flexible action plan as soon as possible and to follow up closely on the RTS consultation process. It is also necessary to engage with experts, industry associations and authorities to seek technical advice, and use the existing guidance and best practices which serve as the basis for the development of some requirements, such as, inter alia:

- The OECD guidelines on responsible business conduct for institutional investors for the identification, prevention and mitigation of adverse impacts[1],
- The Guidelines on non-financial reporting on climate-related information[2] from the Commission for the main Key Performance Indicators,
- Industry best practices on disclosure of non-financial information to be published by the European Financial Reporting Advisory Group.

ESG Data: One of the challenges the industry may face will be to source the relevant data in order to assess non-financial adverse impacts of the investment decisions and to determine which of them qualify as PAIs while the understanding and analysis of such impacts on sustainability factors is not very advanced even at ESG rating agencies.

Indicators: While the SFDR does not require the disclosure of adverse sustainability impacts at entity level to be qualitative or quantitative, the IFMs will have to be able to measure and attribute impacts in order to allow objective comparison and recognition of those impacts. In the medium term, large managers will not be able to opt out of disclosures of the impacts of their investment decisions on sustainability.

Meaningful Disclosures: In any case, the disclosures they will develop should be transparent, clear and concise so the investors and authorities understand their meaning, make informed choices and take informed decisions.

Accountability, governance, remuneration: Boards should make sure ESG factors are embedded in IFMs and funds' governance processes covering product development, portfolio management, risk management and reporting. Remuneration policies should reflect how meeting sustainability risks mitigation objectives will impact senior management bonuses.

Portfolio Management & Risk Management processes: IFMs should start to re-think and develop data analytics and due diligence frameworks which enable the integration of sustainability factors and risks in the investment decision and risk management processes.

Definition of ESG objectives & product: IFMs should review features of funds promoting ESG and whether they meet principles derived from the taxonomy regulation, having in mind the specific disclosures requirements to be met at product level.

Cross-border issues: The application of new requirements to delegation structures with an extra territorial reach could be complex. IFMs will have to assess whether disclosures provided by non-EU investee companies enable them to comply with their own disclosure requirements.

Benchmark transition: IFMs and funds who already use benchmarks to attest their ESG strategy should monitor their on-going compliance with the Benchmark regulation.

[1] https://mneguidelines.oecd.org/RBC-for-Institutional-Investors.pdf

[2] Communication from the European Commission 2019/C 209/01 of 20 June 2019

Disclosure requirements

- Information intelligibility and accessibility: The information should be clear, succinct and understandable to investors and should be published in a way that is accurate, fair, clear, not misleading. Information should be available in a prominent and easily accessible area of the website.
- Transparency on amendments: Disclosures published on websites should be kept up to date. A clear explanation of any amendments should be published on the same website.

Sustainability disclosures applicable at entity level

Disclosure support	Disclosure item	Description	Technical standards	Application date
Website	Integration of sustainability risks	▸ Information on how policies embed sustainability risks in the investment decision-making process ▸ Information on how the remuneration policies are consistent with the integration of sustainability risks	no RTS	10/03/2021 Have to comply
	Consideration of principal adverse impacts	▸ Information on whether PAIs are considered and a statement on due diligence policies with respect to those impacts (identification, prioritization, mitigation actions, engagement policy, reference to conduct codes or standards for due diligence and reporting)	Draft RTS by 30/12/2020 for environmental impacts and 30/12/2021 for social impacts-	10/03/2021 Comply or explain 30/06/2021 Large firms[1] have to comply
Offering document	Integration of sustainability risks	▸ Information on how policies embed sustainability risks in the investment decision-making process. Where IFMs deem sustainability risks not to be relevant, a clear and reasonable explanation of the reasons should be provided through pre-existing disclosures as referred to in the relevant sectoral legislation (e.g.,, AIFMD/UCITS/MiFID)	no RTS	10/03/2021 Comply or explain

Sustainability disclosures applicable at product level

Disclosure support	Disclosure item	Description	Technical standards	Application date
Website	Financial products with environmental or social characteristics or with a sustainable investment objective	▸ Description of the environmental or social characteristics or their sustainable investment objective ▸ Information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investment, including the data sources, screening criteria and the relevant sustainability indicators ▸ Information which is required in pre-contractual documentation and the periodic reports	Drafts RTS by 30/12/2020	10/03/2021 Have to comply

[3] Firms who employ 500 persons or are the parent undertaking of a group employing 500 persons on a consolidated basis during the financial year

Disclosure support	Disclosure item	Description	Technical standards	Application date
Offering document	Integration of sustainability risks	▸ Information on how policies embed sustainability risks in the investment decision-making process. Where IFMs deem sustainability risks not to be relevant, a clear and reasonable explanation of the reasons should be provided through pre-existing disclosures as referred to in the relevant sectoral legislation (e.g., AIFMD/UCITS/MiFID)	n/a	10/03/2021 Comply or explain
	Consideration of principal adverse impacts	▸ IFMs, whether they consider PAIs on a voluntary or mandatory basis, should provide a clear and reasoned explanation of whether, and if so how a fund they manage considers PAIs. Offering documents should include a statement that information on PAIs is available in periodic reports. For IFMs who do not consider PAIs, each fund offering document should include a statement that the IFM does not consider PAIs and the reasons therefor	n/a	30/12/2022 Comply or explain
	Financial products with environmental or social characteristics or with a sustainable investment objective	▸ Information on how these characteristics are met should be included in the offering documentation ▸ Where an index has been designated as a reference benchmark, information should be provided on whether and how this index is consistent with those characteristics or this objective. Offering documents should indicate where the methodology used for the calculation of that index can be found. Where an index is not designated for a product with a sustainable investment objective, an explanation on how that objective is to be attained should be included ▸ Where the objective of the fund is to reduce carbon emissions, disclosure should include the objective of low carbon exposure in view of achieving the long-term global warming objectives of the Paris Agreement. Where no EU CTB or EU PAB is available, a detailed explanation must be provided concerning the continued effort undertaken to attain the objective to reduce carbon emissions in view of achieving the long-term global warming objective of the Paris Agreement	Draft RTS by 30/12/2021	10/03/2021 Have to comply
Periodic reports	Financial products with environmental or social characteristics or with a sustainable investment objective	▸ Where a fund is promoting environmental or social characteristics, the periodic report should include a description of the extent to which those characteristics are met ▸ Where an index has been designated as a reference benchmark, a comparison between the overall sustainability-related impact of the fund with the impact of the designated index and of a broad market index through sustainability indicators ▸ Luxembourg funds may use the information in management reports in accordance with Article 1720-1(1) of the Law of 10 August 1915, as amended, or the information in non-financial statements in accordance with Article 1730-1(2), where appropriate	Draft RTS by 30/12/2020	01/01/2022 Have to comply

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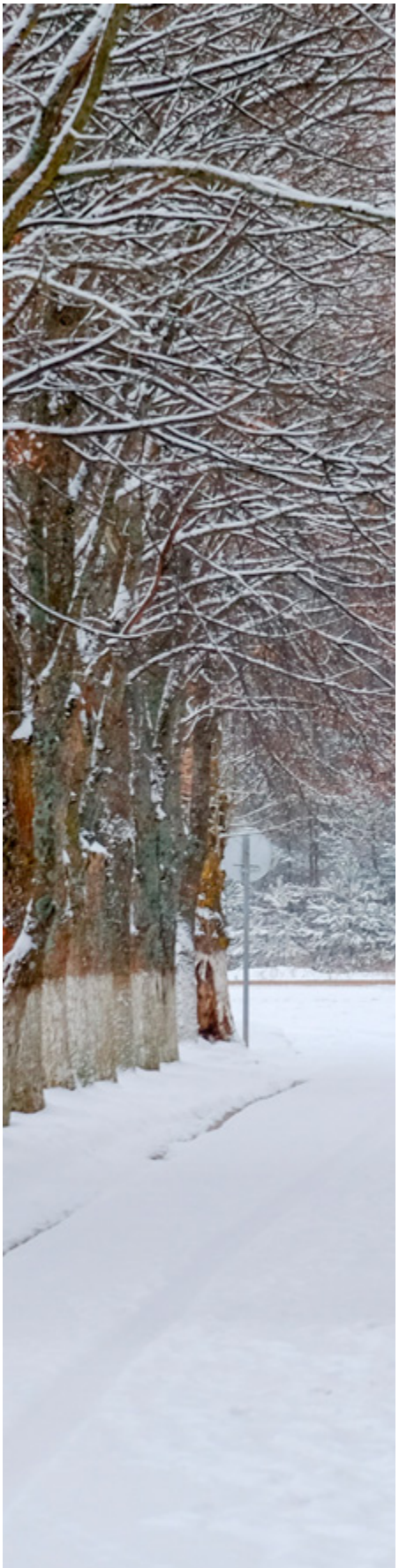
Law of 1 August 2019 implementing the Shareholder Rights Directive II

Act of 1 August 2019 (the "Act") implementing the Shareholder Rights Directive II (SRDII)

Application date
24 August 2019

According to the European Commission, the financial crisis revealed, inter alia, that significant shareholder short-termism, lack of monitoring of investee companies and complexity of the custody chain undermined shareholders' engagement. The purpose of the revised Directive is to address these shortcomings and improve corporate governance standards across the EU.

The Act introduces new obligations on various entities, including UCITS management companies, self-managed UCITS and AIFMs ("the IFMs"), as shareholders in companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State. These entities must comply, or publicly disclose, a clear and reasonable explanation as to why they have chosen not to comply, with the requirement to publicly disclose free of charge on their website (1) their engagement policy and, (2) on an annual basis, how their engagement policy has been implemented in practice (typically via the chosen voting behavior). Specific arrangements are required where pension funds or life assurance undertakings invest in a fund.



Key points

If they do not choose to publicly disclose a clear and reasonable explanation as to why they have chosen not to comply, Luxembourg UCITS and AIFs must fulfil the transparency obligations provided for in Chapter 1st ter of the amended Act of 24 May 2011 on the exercise of certain rights of shareholders.

Engagement policy

- IFMs should establish an engagement policy outlining how shareholder engagement is embedded in the fund investment strategy. Such policy must describe how they monitor investee companies' strategies, financial and non-financial performance, risks, capital structures, ESG impacts and how they engage with these companies, exercise voting rights, communicate with stakeholders, cooperate with other shareholders and manage potential conflicts of interests related to their engagement.
- IFMs should, on an annual basis, publicly disclose how their engagement policy has been implemented, including a general description of their voting behavior, an explanation of the most significant votes and the use of the services of proxy advisors. They shall publicly disclose how they have cast votes in the general meeting of the investee companies, at least when the subject matter of the vote or the size of their holding is significant.

Above-mentioned disclosures must be made available free of charge on the fund manager's website.

Arrangements between IFMs and institutional investors[4]

- Such arrangements should be publicly disclosed by institutional investors and should outline how the IFM is incentivized:
  - To align its strategy and decisions with the profile and duration of the liabilities of the institutional investor
  - To make investment decisions based on assessments about medium and long term financial and non-financial performance of the investee company
  - To engage with these investee companies in order to improve their performance in the medium to long-term.
- Arrangements should indicate their duration, describe how remuneration and performance evaluation of the IFM are aligned with longer term objectives of the institutional investors and how portfolio turnover costs are monitored.
- Specific annual reports should be provided, publicly, or directly to those institutional investors, outlining how the investment strategy implementation complied with the arrangement, emphasizing longer term risks, portfolio composition, portfolio turnover and turnover costs, policy on securities lending and how it has been applied to fulfil engagement activities.

Transparency and approval of related parties

Provisions on transparency and approval of transactions with related parties are not directly applicable to undertakings for collective investment. However, the IFMs may, as decision-makers on behalf of funds holding shares of EU listed companies, be provided with disclosures on material transactions between the investee companies and their related parties and be proposed to vote in order to approve or object to such transactions. Although various working groups led by industry bodies are currently trying to establish common market practice, there is limited guidance on what constitutes a significant vote in the Act. However, it is rather likely that the vote the IFM would cast should be included in the annual disclosure and should be aligned

[4] Defined as pension funds and life assurance undertakings in the Act

with the engagement policy. In such situations, the national act transposing SRDII of the country where the investee company is domiciled applies for the definition of materiality. For investee companies domiciled in Luxembourg, the legislator did not set a quantitative ratio for material transactions but rather defined them as transactions which are likely to have a significant impact on economic decisions of the shareholders and could potentially create a risk for the investee company and its shareholders, notably the minority shareholders.

The asset manager voting on behalf of a fund could also be a related party of a listed company in a material transaction between that fund and that listed company. In such situation, public disclosure of the rationale provided by the asset manager to support his vote should be aligned with the communications of the listed company, including the disclosures made in the notes to the financial statements on related party transactions.

Practical considerations

Luxembourg based IFMs were already required to maintain strategies and records for exercising voting rights by CSSF Regulation 10-4 and Commission Delegated Regulation 231-2013, and to provide them to investors upon request. Since the Act provides for a choice to **comply or explain**, IFMs need to carefully assess whether they will have the operational capability to track their shareholder engagement for the purpose of a regular annual public disclosure carrying more extensive requirements. Should they decide to comply, the IFMs which are part of a group or are using delegation arrangements will need to assess at which level disclosures need to be made.

IFMs managing several products will need to assess whether they wish to set out product-level or general policies. Since additional details, such as the securities lending policy and how it ties with longer-term objectives, are required where institutional investors' money is managed by a fund, IFMs need to make sure that they can identify such institutional investors and decide if it is more practical to make disclosures only to them or more broadly.

IFMs will also need to ensure proper alignment and coordination of their annual disclosures with their engagement policies and related party disclosures in situations where the UCIs they manage are shareholders of companies engaging in related party transactions or are themselves parties to such transactions. It should also be noted that the national legislators had significant leeway to transpose the Directive, notably as regards to the definition of the materiality thresholds or the option to provide for some reports to be disclosed together with the fund annual report. Therefore, IFMs with significant cross-border operations may have to comply with different standards, regulatory expectations and local interpretations.

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Liquidity risk in investment funds

ESMA Guidelines on Liquidity stress testing in UCITS and AIFs

Application from 30 September 2020

Upon recommendation from the European Systemic Risk Board (hereafter "ESRB"), ESMA has developed guidance addressed to fund managers that are legally required to carry out liquidity stress tests (hereafter "LST") as part of their risk management. These tests are undertaken to mitigate risks arising from liquidity mismatches and the use of leverage which can be harmful to the individual funds, but also to the financial system if they materialize on a larger scale.

While complementing the existing framework already applicable to UCITS, AIFs, MMFs and ETFs, the ESMA Guidelines introduce minimum standards to be applied across the EU. The approach remains essentially principle-based, but the Guidelines go a step further in terms of detail, in particular as regards the frequency of LST, LST aggregation and reverse stress tests (hereafter "RST"). ESMA called for a proportionate application of the Guidelines, based on the nature, scale and complexity of the fund. The Guidelines will be applicable as from 30 September 2020.

Practical Considerations

Most managers of in-scope UCITS and AIFs already undertake LST. However, for those who don't, significant efforts are expected to be deployed to find and purchase liquidity management tools which are not widely available yet, or to develop them within the short time frame imposed by ESMA. Sourcing the relevant data may also prove challenging given its scarcity and cost.

For management companies who already undertake LST, a number of the features of the Guidelines may need further investigation and development in order to meet the minimum standards set by ESMA. This includes, but is not limited to:

- Assess if existing systems are flexible enough to:
  - Stress-test both assets and liabilities
  - Be adapted to different funds, with different assumptions, scenarios, data sources, risk factors and frequencies
  - Incorporate investment compliance considerations in the process of the liquidation
  - Manage both gross and net redemption data
  - Deal with cross linkage between multiple indicators/factors
- Check which framework components and data sources which have to be implemented across the value chain to enable:
  - Historical simulation (data sourcing).
  - Investor redemption behaviors simulation (data collection, assumptions validation).
  - Stress-testing of other liabilities.
  - Incorporate price uncertainty or second round effects in the LST.
  - Reverse stress-testing (optional).
- Determine:
  - The assumptions required to model a liquidation process "reflecting how a manager would and does liquidate assets during normal and stressed conditions".
  - The relevant circumstances which can justify a more/less frequent or ad hoc employment of LST, set reliable data sources and metrics to monitor them, and design the processes and governance required to undertake LST, analyze the results and take actions.
- Design processes and governance for LST aggregation.
- Make available and maintain resources and competencies to adequately assess and oversee third party LST models.

The Guidelines do not impose precise technical standards, but fund managers need to demonstrate to their competent authority how the LST policies and models they implement effectively mitigate liquidity risks, protect investors and contribute to financial stability. Should they identify serious deficiencies while overseeing the LST processes, regulators and supervisors may deem it necessary to call for more granular rules imposing specific methodologies and/or metrics.

Key points of the ESMA guidelines

ESMA Guidance covers four main topics:

LST models and scenarios

- LST model must be adapted to each fund. Specific liquidity risk factors should be determined, including ***difficult-to-model parameters*** such as second round effect or price uncertainty for less liquid assets.
- LST scenarios must be sufficiently severe and should not overly rely on historical data. **Historical and hypothetical scenarios should be employed**, including optional RST where appropriate, particularly for funds with strategies exposed to low-probability risks with a potentially high impact.
- Combination of LST results on both sides of the balance sheet must be done after separately testing assets and liabilities. On the **liability side, scenarios must simulate gross & net redemption patterns and incorporate risk factors such as investor types, concentration, location and strategies. All relevant items on the liability side, such as capital commitments, derivatives margin calls, debt or interest should be subject to LST**.
- Managers are expected to overcome limited data availability by exercising sound expert judgement and avoiding overoptimistic assumptions or **excessive reliance on third party models**.
- **LST must be carried out at least annually**; however the Guidelines recommend a quarterly frequency and ad hoc LST should also be undertaken when material liquidity risk must be addressed in a timely manner. All stages of a fund's lifecycle must be covered.
- Managers should aggregate LST across their funds with similar strategies or exposures to better ascertain the liquidation cost or time to liquidity of each security.

LST policy and governance

- LST must be documented in a **LST policy**. LST processes should be embedded in the fund's risk management framework and subject to appropriate governance, oversight, reporting and escalation.
- **Initial model and assumptions validation should be independent from the portfolio management function**, including where the manager delegates such function to a third party. Conflicts of interests must be effectively managed, in particular when arising from undue influence of the portfolio management function over the execution of LST or from disclosing stress tests results to clients.
- LST indicators and outputs should:
  - Facilitate liquidity management in the best interest of the investors and in compliance with the fund rules.
  - Help identify potential liquidity weaknesses of an investment strategy.
  - Assist decision-making, including setting relevant limits by the manager.

Interactions with National Competent Authorities ("NCA")

- At product development stage, **a manager of a fund** which requires authorization from an NCA **should be able to demonstrate that its strategy and dealing frequency enable the fund to remain sufficiently liquid in normal and stressed conditions**. Where appropriate, managers should undertake LST, using a model portfolio and expected investor profiles at all stages of the fund's lifecycle.
- Managers should **notify NCA of material liquidity risks and actions undertaken to mitigate them**. NCA may also request managers to provide their LST models and their results.

Depositaries obligations

Depositaries have a duty to control that a manager of a fund has documented procedures for its LST program, but not to challenge the LST.

Circular CSSF 19/733 – Liquidity risk management of open-ended undertakings for collective investment ("UCIs")

Application date
20 December 2019

The Circular implements into Luxembourg regulation the IOSCO recommendations published in February 2018 on liquidity risk management which have been designed to mitigate the risk of liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units . The CSSF expects investment fund managers ("IFMs") to implement a robust and effective liquidity risk management ("LRM") process for all the regulated open-ended UCIs they manage. The main elements covered by the Circular are (1) the design process of UCIs, (2) the day to day liquidity management of UCIs and (3) the contingency planning.

In a context of growing concerns about liquidity risk in the investment fund sector, the Circular strengthens liquidity management requirements applicable to UCIs. The Circular remains essentially principle-based and does not prescribe a detailed methodology but emphasizes the need to establish contingency plans, an aspect which was not included in the 2013 IOSCO recommendations. Contingency plans should be implemented and periodically tested to ensure that any applicable liquidity management tools ("LMTs") can be used where necessary and, if activated, can be used in a prompt and orderly manner.

Practical Considerations

Most IFMs in scope of the Circular are already subject to liquidity risk management requirements which are specific to the different UCI legal regimes applicable to UCIs (money market funds, UCITS, AIFs) and somewhat proportionate to investment restrictions and minimum redemption frequency requirements. However, the implementation of IOSCO recommendations sets **harmonized minimum standards applicable to all regulated open-ended UCIs**, including UCITS whose liquidity promise to investors can be impaired in case of a redemption run.

Furthermore, the **Circular has entered into force with immediate effect on 20 December 2019**, as opposed to the ESMA Guidelines on liquidity stress testing in UCITS and AIFs which will be applicable from 30 September 2020.

A key practical issue for the IFMs is the definition of appropriate and consistent dealing frequency and liquidity limits. While the **dealing frequency** is a critical parameter defined on set up on the basis of data derived from a model portfolio and prospective investor information, liquidity measures or limits may require adjustments during the lifecycle of the fund to reflect actual and foreseeable circumstances with accuracy. This requires not only access to reliable data but also flexible models, systems and resources to ensure liquidity shortages are anticipated as early as reasonably possible.

The response to liquidity pressures is another key point for IFMs who need to maintain investor confidence by making proportionate **use of appropriate LMTs in a fair and transparent manner** in order to avoid fire sales and therefore minimize price impacts and second round effects. Testing of such contingency plans is likely to prove a difficult exercise given the number of factors to consider, their interconnectivity, the uncertainty inherent in certain parameters and the limits of the data available for modelling.

Key Points

Scope

The Circular applies to UCITS management companies (subject to chapter 15 of the Law of 17 December 2010 (the "2010 Law")), other IFMs (subject to chapter 16 of the 2010 Law), Luxembourg branches of IFMs (subject to chapter 17 of the 2010 Law), self-managed SICAVs (subject to article 27 of the 2010 Law), authorized alternative investment fund managers (subject to chapter 2 of the Law of 12 July 2013 (the "2013 Law")) and self-managed alternative investment funds. The CSSF also "recommends open-ended UCIs subject to Part II of the 2010 Law which are not managed by an authorized alternative investment fund manager as defined in the 2013 Law to consider the provisions of the Circular."

Design Phase

- IFMs are required to implement a **LRM process which is effective in both normal and stressed conditions and is supported by strong and effective governance**.
- Dealing frequency arrangements should be appropriate with regards to the investment strategy and underlying assets through the entire life cycle of the UCI. On the asset side, current and historical liquidity of target assets and instruments must be considered. On the liability side, UCIs should take reasonable steps to understand the target investor base, the concentration thereof and the expected redemption patterns.
- Following this analysis, UCIs are required to consider an appropriate range of liquidity management tools ("LMTs") built in the dealing policies or contingent to the occurrence of certain events such as redemption requests above a predetermined threshold. The appropriateness of LMTs should be considered during the authorization process with the objective to improve LRM in exceptional market conditions. The IOSCO recommendations provide a list of LMTs which can be contemplated to the extent they are compliant with the legal regime applicable to the UCI. These include, inter alia, exit charges, limited redemption restrictions, gates, anti-dilution levies, swing pricing, in specie transfers, lock-up periods, contractual limitations of redemption rights, notice periods, side-pockets and suspensions.
- Consideration should also be given to how planned marketing and distribution impacts on liquidity. For example, IOSCO recommendation 5 suggests **contractual arrangements with nominees to secure access to investor concentration data or other investor information as appropriate**. As a matter of principle, UCIs should be able to access all information which is relevant for LRM.
- The **explanation of the liquidity risks** the UCI might be exposed to, the **description of the LRM process, the LMTs and the impact of their use on UCI liquidity and investors redemption rights should be disclosed** to investors/prospective investors in a manner which is effective, adapted to the nature of underlying assets, adapted to the degree of sophistication of the investors' profile and proportionate to the risks. IOSCO recommends entities to commit, in the offering document, to provide at least aggregate information on portfolio / asset classes on a periodic basis to allow investors to assess the UCI liquidity risk. The approach the UCI will take in situations of liquidity pressure should also be disclosed but balanced against maintaining the confidentiality of market strategies.

The Circular makes it clear that disclosure of liquidity risks and LRM must not be considered as a substitute for the actual operation of an effective policy.

Day-to-Day LRM:

- The effective performance and maintenance of a LRM process should take account of the investment strategy, liquidity profile, redemption policy and all liabilities obligations (margin, creditors, etc…). The s**ystem used should remain flexible enough to adapt to alterations of underlying assumptions to reflect current circumstances** (IOSCO recommendation 9).
- Liquidity should be regularly measured, monitored and managed against appropriate liquidity thresholds, giving due care to the interaction with other risks, such as market risk or reputational risk. The LRM process should integrate relevant data and factors in order to have a holistic view of the potential risks. In assessing portfolio assets liquidity, due care should be given to compliance with defined liquidity limits and the redemption policy. **Indicators to monitor include, in particular,time-to-liquidate assets, price, financial settlement lags and interdependence with other market risks and factors** (IOSCO recommendation 10).
- The **investment decision making process should integrate LRM**, taking into consideration the impacts of the instrument types, transactions, investment techniques and strategy on the overall liquidity, so as they do not compromise the ability of the UCI to comply with their obligations arising from redemption requests or other liabilities. Before transacting, UCIs should estimate time to sell the position without affecting the asset price. They should also assess the liquidity quality of securities accepted as collateral and should take exceptional care in relation to temporary borrowing (IOSCO recommendation 11).
- LRM should facilitate the **identification of emerging liquidity pressures/ shortages**, allowing prompt and appropriate remedial actions with the objective to protect investors' interests. UCIs should manage future cash flows on a best effort basis. For example, they may negotiate a pre-notice period with brokers before changes in margin formulae or negotiate longer periods for REPO agreements (IOSCO recommendation 12).
- Ongoing liquidity assessments should include **stress testing** to strengthen LRM in the best interest of investors. Stress testing should be commensurate to the size, investment strategy, underlying assets of the UCI. Stress tests should be based on reliable and up-to-date information and carried out on a frequency relevant to the specific UCI, especially in anticipation of reasonably foreseeable stressed market conditions to which the UCI could be sensitive. Stress tests should be conducted based on both normal and stressed scenarios. As already highlighted in the ESMA guidelines on liquidity stress testing in UCITS and AIFs, both backward-looking historical scenarios and forward-looking hypothetical scenarios should be included.
- The **effectiveness of the LRM process should be reviewed on a regular basis** and updated as appropriate, notably in case of certain events such as an investment in a new type of asset. IOSCO recommends effective oversight or controls, appropriate escalation procedures, and due consideration to the inter-relationship between valuation and liquidity (IOSCO recommendation 8).
- As per IOSCO recommendation 15, it is also necessary to keep **appropriate records** and make relevant **disclosures** on the performance of LRM.

Contingency planning

- Contingency plans should be implemented and periodically tested to ensure that any applicable LMT can be used where necessary and if being activated, can be used in a prompt and orderly manner. Testing of operational capacity should be such that, to the extent possible and on a reasonable basis, UCIs can use all available LMTs, including in stressed market conditions that will allow for the continued orderly functioning of the UCI and for maintaining investor confidence in the management of the UCI.
- The implementation of available LMTs should be considered by UCIs during stressed market conditions in order to protect investors from unfair treatment or prevent significant divergence from the UCI investment strategy. Effective investor communication is recommended to mitigate reputational risk associated with the use of LMTs.

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CSSF FAQ – Swing Pricing Mechanism

Swing pricing is a well-established practice in Luxembourg used by many investment fund managers ("IFMs") to counter dilution effects caused by significant capital movements. The FAQ published by the CSSF on 30 July 2019 addresses some of the questions IFMs may have on the regulatory obligations relevant to the implementation of a swing pricing mechanism by undertakings for collective investment ("UCIs").

Application date
30 July 2019

While the UCITS and the AIFM laws required governing bodies of asset managers / UCIs to have sound accounting policies and internal control mechanisms in place, specific guidance from the Luxembourg supervisory authority on swing pricing was yet to be issued. The FAQ gives backing to several recommendations included in the ALFI[5] guidelines published in December 2015 as well as clarifying the CSSF 's[6] expectations in terms of governance, disclosure, operations and NAV corrections.

Key Points

1. Constitutional documents

The CSSF confirmed that Articles of Incorporation for UCIs in corporate form or Management Regulations for FCPs should permit NAV adjustment mechanisms to counter dilution effects of capital activity.

2. Disclosure

The FAQ builds on the market best practices advocated by ALFI and requires **both prospectus and annual and semi-annual reports[7] to include**:

- A clear **description of the swing pricing mechanism**, e.g., the methodology used to adjust the NAV and to trigger these adjustments where a partial swing mechanism is used (subscription/redemption thresholds)
- The **maximum swing factor** in quantitative terms (% of the NAV or monetary value). It is possible to differentiate between normal and unusual market conditions as long as a clear definition of unusual market conditions is provided

The prospectus should also:

- Provide the **rationale** for using a swing pricing mechanism, notably the benefit for investors
- **Assess impacts** of the mechanism, with an emphasis on the fact that swing pricing does not address each individual investor transaction but is applied to the capital activity at the level of the UCI
- Indicate the **components underlying the swing factor** (bid/ask spread, transaction costs & taxes, market impact, etc.)
- Delineate the **product scope** of the mechanism for umbrella funds
- Highlight that **performance fees will be calculated on the basis of the unswung NAV**

[5] Association of the Luxembourg Fund Industry
[6] Commission de Surveillance du Secteur Financier
[7] In the annual and semi-annual report, information can be provided either directly in the report or by referencing an appropriate website

It **remains possible to keep the threshold level confidential albeit the prospectus must provide information on the decision process** and the decision makers **driving swing factor application**.

3. Governance & operational aspects

Implementation of d**etailed and robust policies, processes and procedures** governing the application of swing pricing policies as well as the related operational risk is a **pre-requisite to any use of a swing pricing mechanism**.

The CSSF clarifies that the swing pricing policy should be **approved at board level**.

Specific operational procedures should document at a minimum:

- The governance process for the application of the mechanism and the periodic assessment of the policy, processes & procedures
- On-going monitoring, including delegate oversight, where applicable, of the consistent application of the mechanism within the set limits (e.g., the maximum swing factor, any exception to the mechanism application such as the grace period on initial launch)
- Treatment of specific events such as corporate actions or updates of the swing factors or thresholds (methodology and implementation of changes)

The CSSF clarifies that Circular 02/77 should be applied in case of an **administrative error** in relation to the application of the swing pricing mechanism. The **UCI should be compensated** every time it was not protected from the level of dilution it should have been, for example when the applied swing factor is lower than instructed, **regardless of the materiality threshold set in Circular 02/77**. Transacting shareholders have to be compensated only in case of material impact on the NAV.

Practical considerations

Changes that would be required in the constitutional documents or the prospectus should be included at the next update.

IFMs which fully adhered to the recommendations made by the ALFI in the 2015 Swing Pricing Guidelines should already comply with most of the guidelines provide in the FAQ. It is worth emphasizing the fact that **IFMs cannot reserve themselves the right to decide whether to invoke the swing on a discretionary basis**. They should draft a robust swing pricing policy, approved at board level, covering all disclosure, governance and operational aspects of the mechanism.

In practice, swing factors/thresholds may need frequent updates, due to changing market liquidity conditions or transaction costs. This process includes ensuring that appropriate data inputs, structure and resources are available to allow for timely reaction and application of factors/threshold review procedure.

Swing pricing process needs to be mechanical to a large extent. An appropriate controls framework should be designed to monitor consistent application of the swing factors according to the thresholds as well as timely communication and recording of any change to the factors/thresholds to all parties involved, notably the fund administrator. The IFM should develop a depth of knowledge of the administrator's accounting model in order to ensure that any timing constraints for the swung NAV calculation are considered in the updated process.

Careful consideration should also be given to the **consolidation of capital activity information received from the transfer agent on any given dealing day**. A process and related controls may need to be established or further enhanced to deal with administrative errors in accordance with CSSF Circular 02/77.

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Anti-money laundering and counter terrorist financing

Luxembourg's first ML/FT risk analysis on the collective investment sector.

The CSSF issued on 17 January 2020 and assessed the collective investment sector as highly exposed to ML/FT risks. The assessment highlights the best practices and most frequent shortcomings identified in the AML/CFT. High level recommendations are provided as well as examples to help investment fund managers to demonstrate compliance.

What?	Who?	How?
Definition of AML/CFT risk appetite and strategy	BoDs	▸ Detailed written document including all factors taken into consideration to define risk appetite at board level
Engagement on AML/ CFT strategy, policies and processes	BoDs	▸ Board minutes demonstrating engagement with AM/CFT (e.g., action points)
Integration of sectorial risk assessment in internal risk assessments	IFMs (Risk/ Compliance)	▸ Clear reference to sectorial assessment in internal risk assessment
Promotion of strict compliance culture	BoDs and IFMs (Compliance)	▸ Training program with relevant typologies
Robust risk assessment processes for channels of delivery risk	IFMs (Risk)	▸ Matrix of distribution channels with risk scoring incl. (type of distributors, countries, ...)
Cross-border group compliance	IFMs (Compliance/ Legal)	▸ Clearly documented policies and procedures at group and branch/ subsidiary level ▸ Evidences of control of effective implementation
Collaboration with authorities	IFMs (MLRO)	▸ Prompt and accurate response to requests ▸ Share best practices ▸ Prompt STR/SAR/TFAR/TFTR reporting
Formalized enhanced due diligence on cross-border intermediaries	IFMs (Compliance/ Oversight)	▸ Summary sheets including documents collected and conclusions of the analysis at the level of the IFM or the delegate
Timely name screening against targeted financial sanction lists	IFMs (Compliance)	▸ Daily screening or measure to ensure screening is done immediately after a new list is released
Effective transaction monitoring process adapted to the number and the type of investors	IFMs (Compliance)	▸ Automated transaction monitoring rules if they are too many investors for manual monitoring
Consideration of Asset-side ML/FT risks in the overall risk assessment	IFMs (Compliance/ Risk)	▸ Matrix detailing computation of the risks with several criteria including assets

Source: adapted from CSSF Press Release 17 January 2020, ML/TF Sub-Sector Risk Assessment, Collective Investments, P40

Boards of Directors or Governing Bodies are required to exercise oversight for all items and retain final responsibility for compliance with all applicable legal requirements

Circular 19/732 on UBO identification

Application date
20 December 2019

The Circular provides a practical overview of already established laws and circulars adding guidance and examples of identification of Ultimate Beneficial Owner(s) ("UBO") in particular for legal arrangements. Life insurance policies are explicitly not regarded as similar legal arrangements and guidance is provided on the conditions to apply the exemption to shares of companies listed on an EU or third-country regulated market. The Circular also provides further guidance on aspects of concert ownership and presumed control.

Practical considerations

Transfer agents should ensure their internal UBO identification procedures are aligned with the requirements of the Circular. Additional controls/actions may be necessary to ensure their existing records contain up-to-date know you customer ("KYC") and UBO files which are proportionate to the ML/FT risk associated with the customers and result in the identification of natural person(s) as UBOs.

Where appropriate, professionals should implement measures to verify that the markets outside of the EEA have disclosure obligations equivalent to EU transparency rules and that they record formally the outcome of their assessment before they make use of the exemption to identify UBO(s) for issuers of shares admitted to trading on regulated markets. In cases where effective control is difficult to establish, professionals should have procedures in place to control who is/are the natural person(s) who actually use(s), enjoy(s) or benefit(s) from the asset(s) owned by a legal person or a legal arrangement.

Since delegation does not affect liability of the governing body of the investment company and/or the external investment fund manager, such bodies should obtain evidence that UBOs have been identified for all investors in the funds they manage and that necessary remedial measures are undertaken where appropriate.

Key Points

General Considerations

The Circular makes a clear distinction between legal and beneficial owner. The Financial Action Task Force ("FATF") **expands the Luxembourg legal definition of the UBO by stating that a UBO** a natural person who ultimately owns or who exercises ultimate effective control over the customer, in particular over a legal arrangement, or on whose behalf a transaction or activity is being conducted. It is to be distinguished conceptually of the beneficiary of a contract or a transaction, notably in the context of insurance contracts or trusts.

The extent and depth of the measures needed to ascertain beneficial ownership should be commensurate with the complexity and location of the customer. In particular, professionals should understand the purpose of a complex legal structure and should be satisfied that it has a legitimate rationale. Due consideration should also be given to the dynamic nature of UBO(s) who can change over time.

Professionals are required to make use of different means to identify the UBO(s) and to cross-check information collected to ensure that all customer due diligence obligations contained in Article 3(2) (a), (b), (c) and (d) of the Law of 12 November 2004 as amended (the "AML/CFT Law") are fulfilled:

- Collection of a proof of registration or an excerpt of publicly available records such as the national registers on beneficial ownership
- Request to the customer for relevant data or the source of data
- Collection of evidence of the beneficial owner's identity by other means

Legal Arrangements

Legal arrangements are defined broadly and include express trusts[8], fiducies, treuhand and fideicomiso which are not necessarily foreseen in the Luxembourg law. The settlor, the trustee, the protector, the beneficiaries and any natural person exercising ultimate control or influence over a trust by means of ownership or by other means should be all identified as UBOs. However, in case the beneficiaries have not been determined yet, the class of persons in whose main interest the arrangement operates is to be identified. Here, control means the power to take certain actions on a standalone or collegial basis. These actions include dealing with trust property, terminating or varying a trust, adding or removing beneficiaries, appointing or removing trustees. Where a legal person is entirely or partially owned by a trust, the rules applicable to trust and legal entities apply simultaneously.

Exemptions

The Circular provides **exemptions for life insurance policies and issuers of shares admitted to trading on regulated markets** located in the European Union, the European Economic Area or a third-country jurisdiction applying disclosure obligations for major shareholders subject to equivalent international standards. It is important to note that **issuers of debt instruments admitted to trading on regulated markets do not qualify for any exemption**. Evidence of admission to trading and, where applicable, measures to ascertain the equivalence should be recorded. Markets such as multilateral trading facilities which are not subject to the necessary transparency obligations do not qualify as regulated markets and the UBO should therefore be identified.

Threefold procedure to determine the UBO

UBO determination must follow a threefold procedure of **cascading** measures. Each step must be completed and **formalized before** the application of the next step:

1. Identify the natural person(s) holding or controlling at least 25%+1 share of the shares, interests or voting rights; the threshold can be lowered where the professional identifies higher ML/FT risk
2. Identify the natural person(s) controlling the entity by other means
3. Identify any person holding the position of senior managing official ("SMO") where no UBO could be identified through (i) and (ii) or in case of any doubt that the person(s) identified is/are the beneficial owner(s)

(i) In a **multiple-layer structure**, ownership must be determined by looking through legal persons/arrangements. Shares or voting rights should be cumulated where appropriate.

Where persons act or have an arrangement to acquire or transfer voting rights in a company or exercise such rights in the same way ("**acting in concert**"), each person should be treated as owning the sum of shares/voting rights of all persons acting in concert. However, this is only applicable when such arrangement is known by the professional. Illustrative examples can be found in the Circular.

(ii) The professional should acquire a good understanding of the management and governance structure of the customer to identify natural persons exercising dominant influence or effective control over a legal entity or legal arrangement. Various examples of "**control by other means**" are provided and to be considered on a case by case basis inter alia personal or family relationships, former participation in the company capital or management, or ownership of assets central to the running of the customer. Cases where effective control over decisions of the legal entity is achieved by control over the decisions made by another beneficial owner must be considered. The Circular also envisages situations where the **control is presumed** and never actually exercised, for example where a natural person uses, enjoys or benefits from the property owned by the legal person.

In case a natural person controls de facto a legal person exceeding the threshold through a majority holding of shares of that legal person, this natural person should be considered as the UBO even if his own indirect participation in the customer does not exceed the threshold. Absolute decision rights or veto rights of a shareholder also trigger UBO status where the percentage of shares/voting rights does not.

(iii) This step should be understood as an express fallback or default option. In principle 1 SMO (natural person) is to be retained, in case of a collegial or jointly responsible body more than one can be designated. The SMO is to be determined and documented on the basis of the responsibilities and tasks performed and not job titles. The SMO can be the executive

[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.

official or the member of the board of directors to whom the daily management has been delegated, and if no such delegation has taken place, the members of the board of directors. In case no beneficial owner is identified during the first two steps and there are grounds for suspicion, the business relationship cannot be established or should be terminated. In such situation, consideration should be given to filing a report for Money Laundering / Financing Terrorism in accordance with Article 3(4) of the AML/CFT Law.

The Circular also provides the rules applicable to the identification of the UBO for **Non-Profit Organizations** ("NPO"), emphasizing the need to understand the governance structure of the NPO enabling mitigation of the risk of misuse of such entities. Extra vigilance is also expected for **bearer shares** of foreign companies that are not subject to disclosure regulations equivalent to Luxembourg; in such situations, professionals should adopt procedures to identify holders and transfers of shareholder and/or UBO.

Where a **Pension Fund** is an employee scheme providing retirement benefits funded via employers' contributions by way of deduction from the employees' salaries with non-assignable interests, the SMO of the vehicle can be identified as the UBO if the risks are considered as low. In any other case, the threefold procedure must be applied.

Guidance is also provided for the identification of UBO of **Public Authorities**.

Documentation and verification

The Circular sets out the information to be collected for beneficial owners and legal persons or arrangements in between the customer and the UBO, the verifications which are required and the conditions applicable in determining if controls needs to be re-performed.

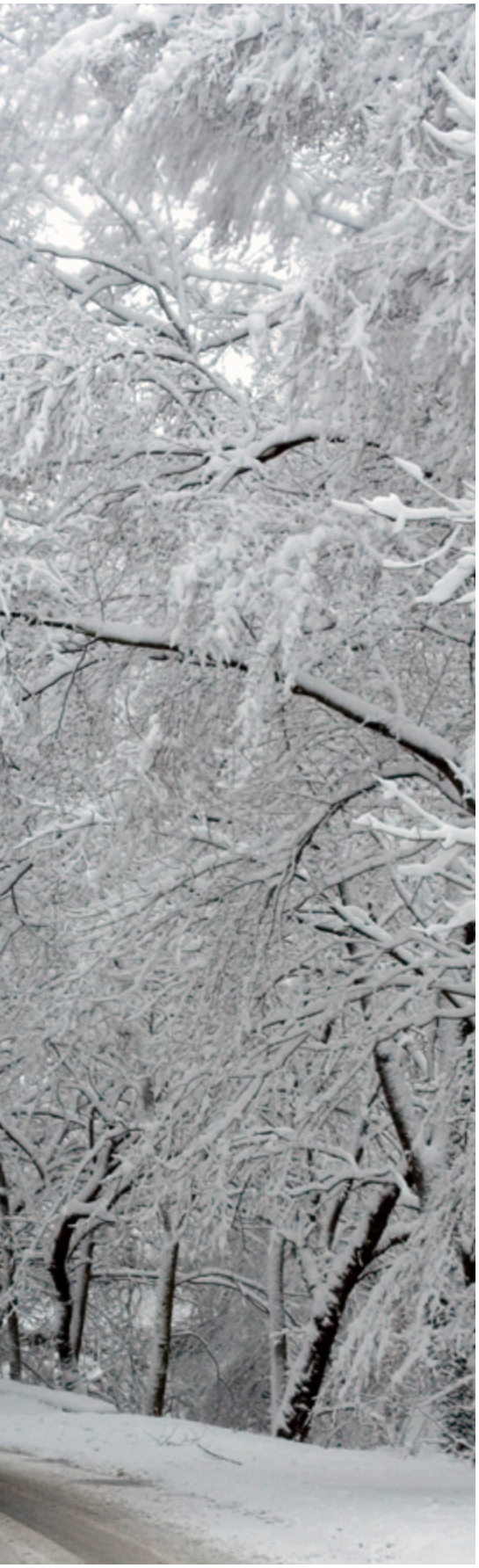
Professionals should take into account the ML/FT risk associated with the business relationship to determine the extent of information needed and whether it is appropriate to:

a. make use of records of UBOs in the public domain
b. ask their customer for relevant data
c. require evidence of the UBO's identity based on documentation or information from a reliable source independent of the customer
d. obtain the information by other means

Information provided by the customer is deemed sufficient in low risk situations as long as the declaration whether they act on their own behalf has been signed. In other cases, further evidence needs to be collected, for example certified copies of share registers, share transfer agreements, etc. All appropriate information should be **formalized** to enable professionals to demonstrate that they know all their customers and their respective UBOs.

UBO information should be **updated** when appropriate. Collection of new information can be based on periodic or risk-based customer due diligence review cycles, as well as on trigger events such as changes in the legal structure, mergers and acquisitions or adverse media reports.

The Circular also includes **indicators of concealed beneficial ownership** identified by the FATF Egmont Report Group.



Other AML regulatory news in a nutshell

CSSF Market Entry Forms

Application date
7 November 2019

The AML/CFT investment fund market entry form was created on 23 May 2019 and mu st be provided in complement of the application questionnaire each time a licensing application is submitted for a new fund supervised by the CSSF. The first version was only required for SIFs, Part II UCIs, SICARs or ELTIFs. The updated version is available since 7 November 2019 and is required for all new regulated UCIs. A form is also created for IFMs who submit applications for setting-up authorized or registered IFMs.

These forms must be re-submitted when requesting approval of an additional subfund, when outdated information previously submitted is updated, when an additional license or a license extension is requested and when there is a change in the shareholder structure of the IFM.

CSSF Q&A on Persons Responsible for AML/CFT Compliance

Application date
25 November 2019

The Q&A clarifies the requirement laid down in art 4(1) of the Law of 12 November 2004 as amended ("the AML Law") to appoint two different persons in charge of AML/CFT for supervised Investment Funds and Investment Fund Manager ("IFMs") and clarifies requirements for both appointees.

- Le responsable du respect des obligations ("RR") who can be the board of directors (or other governing body depending of the legal structure of the fund/ ("IFM")) acting as a collegial body, or an individual member of that board/body.
- Le responsable du contrôle du respect des obligations ("RC") or the AML/CFT Compliance Officer:
  - For investment funds, the RC can be a member of the board with appropriate experience, a contractually appointed third party or a staff member of the appointed IFM, mandated intuitu personae by the board of directors (or other governing body) of the fund.
  - For IFMs, the RC should be the compliance officer at appropriate hierarchical level of the IFM. The RC should be available in Luxembourg, except where the IFM and the relevant staff member are not domiciled in Luxembourg.

Both the RR and the RC should have sufficient knowledge of the Luxembourg legislation, of investment and distribution strategies of the fund / about the services offered by the IFM, and they should be available without delay upon request from the competent authorities. If the RR is a collegial body, at least one of its members must fulfill the availability requirement. The RC should have access to all internal documents and systems which are necessary to perform its tasks and comply with skills & duties requirements from articles 40 (3) to 43 of CSSF regulation 12-02.

The EU Regulatory AML agenda 2020

Policy maker agenda

The highlight of the final agreement by European Council ("EC") on 5 December 2019 in strengthening the measures to fight money laundering in the banking sector was the granting of new powers to the European Banking Authority ("EBA").

In short, the EBA will be entrusted the powers to investigate breaches of EU anti-money laundering rules and national supervisors' compliance with EU law, while collecting and sharing information on AML risks and trends, plus managing cooperation with non-EU countries. This falls short of the original EC plan to give the EBA sharper, more direct supervisory powers over banks.

The final agreement acknowledges that in the light of the consequences for financial stability arising from abuses of the financial sector for money laundering or terrorist financing purposes, and taking account of the fact that the banking sector is the most vulnerable to money laundering and terrorist financing risks – potentially having an systemic impact - EBA is empowered to take a leading, coordinating and monitoring role at EU level to prevent the use of the financial system for such purposes.

The EBA will thus be called upon to:

- Further develop guidelines and best practices in terms of AML supervision, which do not need any legislative changes
- Collect all relevant information on weaknesses in relation to money laundering and terrorist financing activities identified by the relevant EU and national competent authorities
- Store such information in a centralised database and foster cooperation among authorities by ensuring appropriate dissemination of relevant information
- Develop draft regulatory technical standards regarding the collection of information
- Where appropriate, transmit evidence in its possession that could give rise to criminal proceedings to the national judicial authorities of the Member State concerned

The EU Institutions are still debating whether to set up an independent, central EU AML agency with statutory powers to investigate, review and sanction individual financial firms on breaches of AML rules.

Consideration will also be given to the EC proposal to consolidate all existing AML directives – including 5AMLD[9] – into a 'omnibus' Regulation, in order to ensure less divergent interpretation, late transposition, gold-plating across the 27EU, a perennial challenge in the EU anti-money laundering regulatory space.

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[9] Directive (EU) 2018/843 Of The European Parliament and of the Council of 30 May 2018 - the 5th Anti-Money Laundering directive

Performance forecasts and cost transparency

Joint Consultation Paper concerning amendments to the PRIIPS KID

Final report expected Q2 2020

Intermediaries distributing investment products to retail investors are required by the PRIIPS regulation to provide a Key Information Document ("KID"). All undertakings for collective investments which were using a UCITS Key Investor Information Document ("KIID") as of 1 January 2018 benefit from an exemption to provide a UCITS KIID until 31 December 2021. In the context of the ongoing PRIIPS review, a consultation paper was issued by the European Supervisory Agencies ("ESAs") to seek feedback on a proposal to revise the EC Delegated Regulation before the 13 January 2020. The amendments are designed to allow the appropriate application of the PRIIPS KID by UCITS and relevant non-UCITS funds once the UCITS KIID has been phased out. The objective is to address the main regulatory issues and stakeholders' concerns, notably in relation to performance scenarios and cost disclosures which were reported to be misleading for investors.

The proposal

ESAs propose draft amendments to the PRIIPs Delegated Regulation. The dividend yield methodology is presented as the preferred option for probabilistic performance scenarios to address the current methodology pro-cyclicality. Stress and intermediate scenarios would no longer be required and a possible alternative to present illustrative performance scenarios for structured products is discussed. The past performance information should be included in the KID for linear PRIIPs and for linear investment options. Different options to change the methodology to calculate and present costs are described, but the ESAs preferred option remains the reduction in yield ("RIY") methodology with some adjustments. A principle-based approach is also included for comments in the draft proposal, but the prescriptive arrival price methodology remains the preferred option to calculate transaction costs for funds investing in liquid assets. However, adjustments are proposed for OTC transactions and a simplified approach is introduced for funds having a low turnover. The paper also proposes amendments arising from the end of the exemption for UCITS.

Key points

Future performance scenarios

The ESAs are considering **removing the stress and intermediate performance scenarios** to improve the intelligibility of the KID.

The **new methodology** looks at reducing the pro-cyclicality of performance scenarios caused by the utilization of historical returns to estimate the growth return, especially in the moderate scenario. The new methodology uses the same mathematical model (Cornish Fisher) but replaces the mean return by the sum of:

- A single reference rate across all asset classes, given by the interest rate curve derived from sovereign bond prices and capturing the country-specific risk
- An asset-specific risk premium such as the dividend rate for equity instruments and real estate funds which invest in property, the coupon rate less the reference rate for bond instruments or the expected forward rate less the reference rate for FX instruments and commodities.

A fund would use the average dividend yields for each country/sector, weighted according to their representation in the portfolio. The variance, skewness and excess kurtosis of the distribution are still directly calculated and used in the Cornish-Fisher expansion from which the quantiles can be deduced where the funds are purchased at a single point in time. Quantiles are obtained from a Monte Carlo generated return distribution where the amount invested in the funds accrues over time.

The specific methodology based on implied volatility of options on German Bund is favored by the ESAs for money market funds since volatility of historical daily returns did not provide a good estimate of the variance of returns over a longer time frame.

A **compensation mechanism** is also foreseen to correct over optimistic/pessimistic results produced with the proposed methodology.

According to studies already conducted by the ESAs, this methodology provided meaningful results and does not experience pro-cyclicality. Therefore, it stands as the preferable option so far, but further tests will be carried out to establish if implementation is straight forward and gives reasonable results for all PRIIPS.

Illustrative scenarios

The ESAs propose to use illustrative scenarios for structured funds (category 3 PRIIPs) both on a standalone basis and jointly with probabilistic scenarios.

The proposal builds on the approach currently used for structured UCITS[10] but requires the returns to be shown net of costs and prescribes certain narratives to explain the nature of the scenarios.

Past performance

Inclusion of information on past performance is considered for linear PRIIPs and for linear investment options (category 2 and 4 PRIIPs) in the form of a bar chart adapted from the UCITS Delegated Regulation 583/2010 or the average past returns for longer term products

The ESAs are considering if such additional information would require an amendment of article 6(4) of the PRIIPS regulation on the maximum length of the KID.

Cost disclosures

The RIY methodology is maintained but the ESAs propose to **amend the structure of the cost disclosure** with the aim to improve the compatibility with MiFID II disclosures and to clarify the main cost types and RIY percentage figures. In view of this, the ESAs support a proposal which clearly separates the impact on return figure by moving the total monetary cost figures in a separate table, which also includes a monetary breakdown of costs at different time periods and incorporates specific descriptions of the different costs and how they are calculated.

The **arrival price methodology is maintained** for the computation of transaction costs where the fund has been operating for at least 3 years and invests in assets which are sufficiently liquid. With the aim to address stakeholders' concerns, the ESAs propose disclosure of a minimum of explicit transaction costs where the implicit costs are negative. A **proportionality threshold** is also introduced where a fund undertakes fewer than 250 transactions in a 3 year period or where the total consideration for all transactions carried out over 3 years is less than 25% of the fund Net Asset Value. In such circumstances, the investment fund manager would be able to use the **half-spread methodology** prescribed for OTC transactions. Where quotes are not available, the spreads of previous transactions for similar assets can be used. A simpler principle-based approach to identify reference price is also presented but is not favored by the ESAs since it would carry a material risk of inconsistent application.

Conflicts between the UCITS directive and PRIIPs regulation

The ESAs analyze which parts of the UCITS Regulation 583/2010 should be integrated in the PRIIPs regulation to address issues related to the potential end of the exemption for UCITS funds in Article 32 of the PRIIPS regulation. The ESAs request feedback on, inter alia, (i) the continuation of the UCITS KIID, (ii) whether the requirement to produce a UCITS KIID for professional investors should be removed, or (iii) whether the requirement to produce a UCITS KIID for professional investors should be replaced by a requirement to provide them with a PRIIPs KID.

[10] Article 36, Commission Delegated Regulation (EU) N°583/2010 of 1 July 2010

Practical considerations

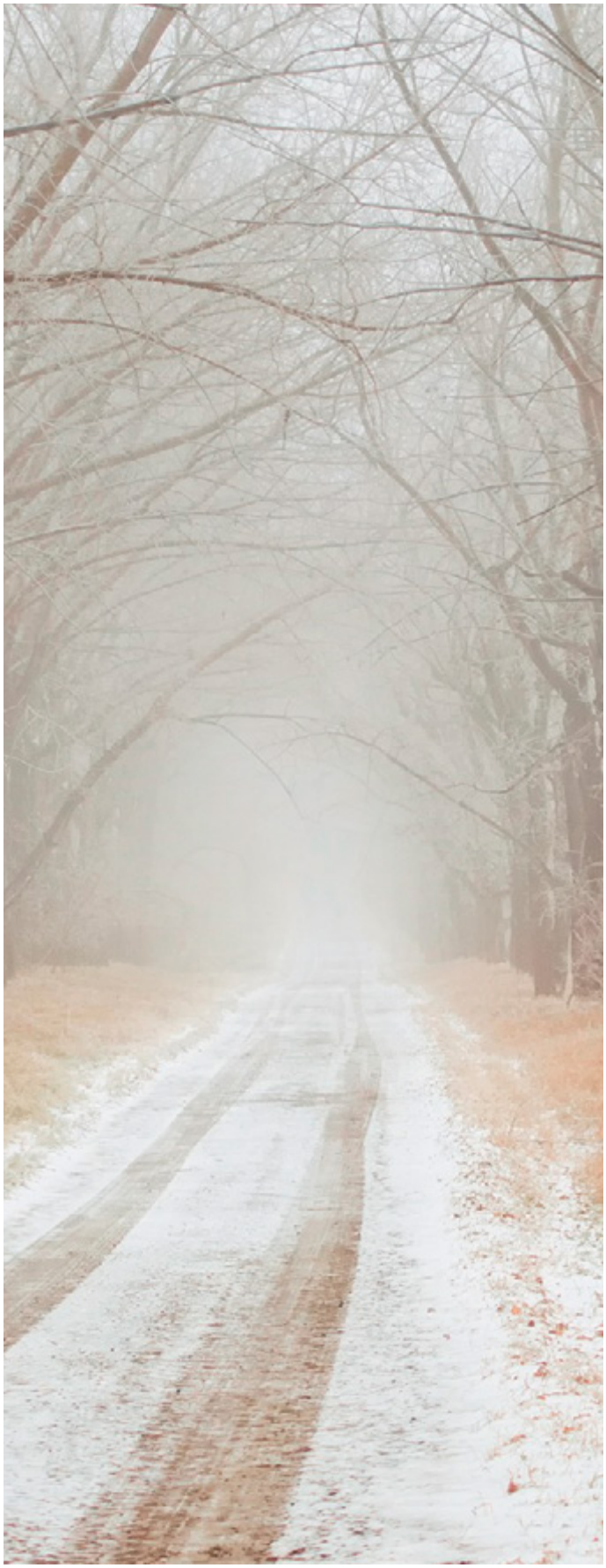
The changes foreseen in the KID structure, template and methodology are likely to bring material one-off implementation costs for the PRIIPS manufacturers. These changes will entail costs for production of the KID as well as its integration in the distribution chain.

Inclusion of past performance in the KID may be seen as beneficial since it provides additional information for investor decision-making and may reduce complaints. Manufacturers who are currently producing a UCITS KIID already provide such historical data but other manufacturers should expect additional one-off and ongoing costs to implement, review and update this information and would need to prepare systems to present it in a compliant manner.

The revised methodology for performance scenarios should reduce the risk that retail investors acquire unrealistic return expectations and should potentially reduce complaints. However, this approach requires looking through the PRIIPS to calculate underlying assets specific premia and will require resources to obtain the relevant data from a market data provider, introduce additional procedures to apply the methodology and monitor the impact of changes in asset allocation.

The use of illustrative scenarios for structured funds may provide more accurate information to investors provided that the different likelihood of the different scenarios is understood. However, the discretion left to manufacturers for the selection of scenarios could reduce comparability between different PRIIPs.

The derogations to the arrival price methodology provide a welcome alternative, where appropriate, for the manufacturers to report meaningful transactions costs but will require new procedures and one-off implementation costs to identify appropriate reference prices or justify use of third-party data.



CSSF Communication on KIID benchmark disclosure for UCITS

Application from 19 February 2020

According to ESMA Q&A UCITS update by 19/02/2020, all UCITS KIID should now take account of changes foreseen by 29/02/2019 ESMA Q&A UCITS. **KIID and prospectus must be aligned** and where the prospectus needs to be updated, update should be filed until the earlier of the next revision of the prospectus or the end of the year 2020.

Benchmark disclosure should specify whether the UCITS is actively or passively managed, the indication of the benchmark index or indices the UCITS is tracking or making reference to, and the **disclosure on the use of the benchmark** (e.g., outperformance objective, performance comparison, risk limitation, definition of investment universe), the degree of freedom from the benchmark and the past performance against the benchmark when the investment approach of the UCITS include or implies a reference to a benchmark. The description of the underlying investment universe of the UCITS should indicate to what extent the target investments are part of the benchmark or not and the KIID should indicate the **level of deviation of the UCITS in regard to the benchmark**, thereby considering the quantitative and/or qualitative deviation limitations underlying the investment approach as well the narrowness of investment universe.

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Recommendations from the working group on Euro risk-free rate

3 January 2022
at the latest

Since 2 October 2019, EONIA has been recalibrated as the €STR 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. In August 2019, the working group on euro risk-free rate ("the WG") published a report providing recommendations to market participants on how to smoothen the transition.

Funds which, inter alia, invest in EONIA-linked derivatives, EONIA-based securities or secured cash products, or use EONIA to discount cash flows, are expected to adopt effective fallbacks and review their procedures, systems and models in order to avoid any disruption due to the transition. Managers of money market or fixed income funds using EONIA as a benchmark or as a reference index will be required to change their benchmark policy and to adjust prospectuses. Where EONIA is used as a hurdle rate for performance fee calculations, calculation formulas and adjustments of systems and prospectuses are also anticipated.

Key Points

The WG issued product-specific and model-specific transition recommendations.

Product-specific transition recommendations

Derivatives

- **Floating rate options** ("FRO"): Market participants can adjust the FROs in existing EONIA contracts following either a fallback approach or an active transition approach. Under the fallback approach, contractual fallbacks are introduced and references to EONIA are deemed to be references to the €STR+8.5 basis points. Under the active transition approach recommended by the WG, legacy derivative contracts are amended so that the €STR FRO replaces the EONIA FRO. This approach is likely to require a compensation mechanism (either by cash, by a spread adjustment in the compounding formula or by a subsequent adjustment of the fixed leg) for the difference in present values.
- **Collateral remuneration and discounting transition**: the WG recommends a phasing-out of legacy books discounted using EONIA to a "clean" discounting regime where a single €STR discounting curve is used with a given counterparty and a given central counterparty clearing house ("CCP"). An alignment of discounting switch dates, preferably towards the end of the second quarter of 2020 is recommended for CCPs. A phased approach, starting as early as possible, is recommended for bilateral trades relying on credit support annexes ("CSA").
- **Dual-strap curves**, where the projection and discount curves are different, **should be avoided** in order to minimize potential price disputes. The WG also recommends to align, to the largest possible extent, the timelines of bilateral conversions with the changes in the cleared derivatives space.
- **Options on derivatives with physical settlement**: After the discounting switch date, the option refers to a €STR-discounted derivative, which triggers re-evaluation and compensation measures.

Securities (negotiable European commercial paper or medium-term notes, certificates of deposit using EONIA)

Issuers should avoid issuing new securities indexed to EONIA with maturities going beyond 2021 and market participants should introduce all necessary modifications to be able to trade and manage new securities indexed to the €STR.

Secured cash products

Where firms agree to transact on a floating rate basis (using EONIA or the €STR), recommended practice is to apply the fixing of the penultimate accrual date of the transaction to the final repurchase date (i.e., "crystallising" the penultimate fixing into a fixed rate for the final business day).

Such practice will create discrepancies between the price calculated and the price that would have applied had it been possible to instruct after the final fixing. In this instance, the disadvantaged party can claim the difference from the advantaged party as long as the difference is equal to or greater than an agreed threshold per transaction (to be determined by the ICMA ERCC[11] shortly). Any claim should be made immediately, once the final fixing is known, with reimbursement to follow on the next business day. In any event, any claims or reimbursements should be made no later than 30 days after the repurchase date.

Investment Funds

Managers of money market funds, liquid strategies and total return/absolute strategies **funds using EONIA as a benchmark or a hurdle rate will have to ensure calculation formulae and operational procedures are amended** across the value chain.

Transition will also trigger **prospectus updates**.

Model-specific transition recommendations

The report includes a general recommendation to map all models exposed to EONIA and to design a transition plan for these models. Among the models used by asset managers, the WG has identified potential impacts of the EONIA-€STR transition on interest rate curve construction, interest rate term structure models and discounted cash flow models ("DCF models).

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

Structural and conceptual changes are not expected in **DCF models**, but the transition will have an impact on input parameters and discounting curves used in models. Several scenarios should be envisaged by accounting and valuation models because €STR-linked derivatives prices and €STR swap curves are expected to become available progressively, and transition will affect EURIBOR par swap rates, but could also affect implied forward rates. Market participants are invited to assess both model valuation and compensation scheme impacts under bilateral CSAs.

Valuation adjustment models (xVA) will need to be recalibrated with new market data. Given that the market widely uses EONIA Overnight Index Swap as an input in discounting future cash flows related to assets or liabilities subject to fair valuation, the WG recommends managers:

- To monitor the corresponding derivatives markets and their transition from EONIA-linked derivatives to the new €STR-linked derivatives.
- To assess the impact on valuation of the discounting switch, i.e., verify which market price of curve parameters might need to be recalibrated to current market price (e.g., credit spreads that will be computed from comparable instrument market prices using a new discounting framework).

Practical considerations

Fund managers should screen their legacy exposures to EONIA-liked products and identify valuation or performance calculation models using EONIA as a reference rate. Careful consideration should be given to **repapering of contracts, accounting and tax repercussions**.

On the basis of the impact assessment and deep dive gap analysis results, a dedicated implementation program might need to be set up to address all related issues. These will cover market liquidity, uncertainty and valuation modelling, risk management, product design, legal work, processes and technology supporting operations, data, accounting and tax treatments and communications.

It will also be important to consider the impacts on the whole value chain and the broader financial industry, communicating with banks, issuers, financial market infrastructures and enabling vendors. The response will need to be flexible to adapt quickly to new developments in the market which are likely to speed up with the phasing out of EONIA and other interbank offered rates.

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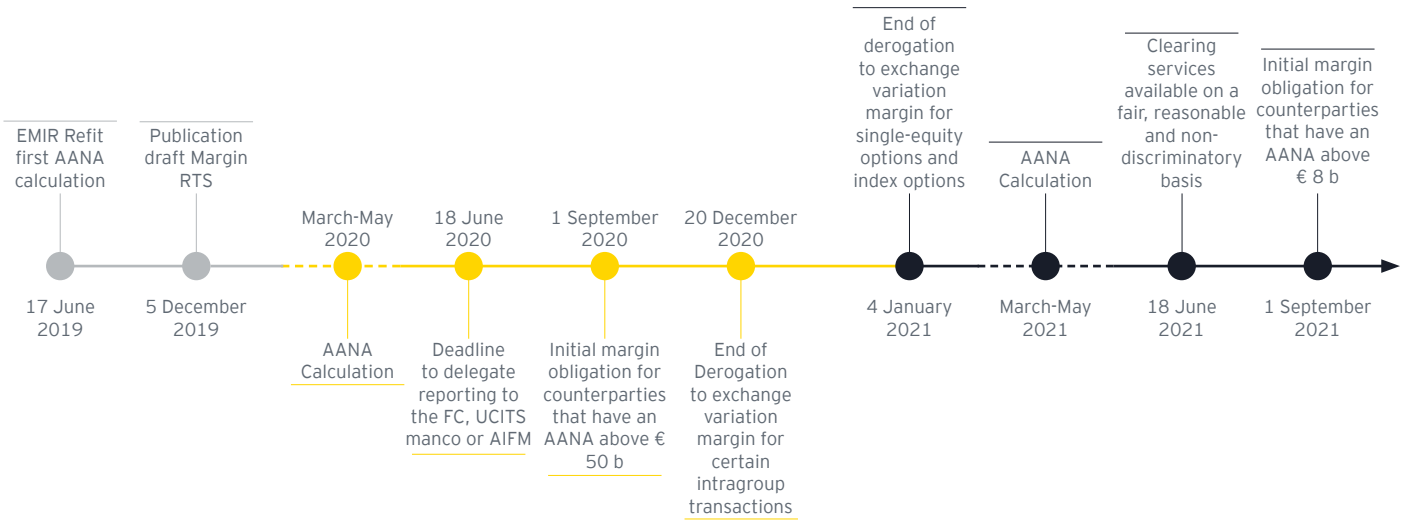
EMIR: current state of play for Investment Fund Managers



The primary objectives of EMIR are to bring transparency in the OTC derivative markets, and to monitor and mitigate risks posed by OTC derivatives to financial stability. The regulation, recently amended by EMIR Refit, requires certain types of counterparties to report their derivatives to trade repositories, centrally clear certain standardized derivatives contracts and mitigate risks, notably through margin exchange, for non-cleared OTC derivatives they entered into. On 5 December 2019, the European Supervisory Agencies ("ESA") issued revised draft RTS on margin exchange to align with Basel Committee on Banking Supervision and IOSCO international framework and a Joint Statement regarding contractual fallbacks developed by counterparties to anticipate the transition from interbank offered rates to newly introduced risk-free rates. It is important to note that the proposed changes to the RTS on margin exchange are still in draft status and subject to review and endorsement by the European Commission as well as the European Parliament and Council. However, a swift adoption and publication in the Official Journal is likely in light of some soon approaching deadlines.

In Luxembourg, the CSSF issued a press release on 14 October 2019 calling for Investment Fund Managers ("IFMs") to improve their compliance with applicable EMIR obligations highlighted by CSSF Circular 18/698.

Primary change

The EMIR Refit (i) clarifies that UCITS management companies and AIFMs must report on behalf of funds they manage, (ii) harmonizes the classification of all AIFs as financial counterparties ("FC") or third country entity ("TCE") FCs, and (iii) introduces an exemption from the clearing obligation for FCs below a certain volume threshold. The updated Q&A (1) provides clarification for IFMs who need to perform a clearing threshold test for the funds they manage or their counterparties and (2) gives technical guidance on reporting of positions containing trades executed at different venues and reporting of €STR-based derivatives[12]. The ESAs joint statement confirms that fallbacks introduced in contracts to set actions taken by counterparties in the event the benchmark used ceased to be provided should not create new margining obligations.

The revised RTS postpone by one year the application of initial margin ("IM") requirement to counterparties with an aggregate month-end average notional amount ("AANA") greater than 8 billion EUR. Amended margin RTS also extend derogations for certain intra-group transactions and for equity and index options. Variation margin is no longer required to be collected for physically settled FX forward contracts and swap contracts where a counterparty does not qualify as an institution according to the CRR[13] definition.

In their press release, the CSSF voiced concerns as regard to identified deficiencies and urges the IFMs to better formalize their processes, procedures and oversight of delegated obligations to ensure full compliance with all EMIR-related requirements where relevant.

Key points

AIF classification

As a consequence of the EMIR Refit, EU AIFs managed by a third country AIFM are now classified as FC instead of non-financial counterparties ("NFC"); non EU AIFs with non EU AIFMs move from being TCE NFCs to being TCE FCs. However, existing exemptions remain for securitization vehicles, special purpose entities & employees share purchase plans.

Clearing obligation

- A new category has been introduced for **small financial counterparties** ("FC-"). Financial counterparties may choose not to clear their derivative contracts when the AANA they calculate every end of May for the previous 12 months remains below the clearing thresholds (which are similar to the thresholds for NFCs). However, it is important to highlight that FC- will not be exempted from other EMIR requirements such as risk mitigation techniques, reporting and margining of non-cleared OTC trades. For the fund industry, the calculation can still be made at fund level or sub-fund level when the assets and liabilities represent a distinct and appropriately segregated pool. When counterparties exceed the clearing thresholds over such period or choose not to calculate their positions, they have to notify ESMA and the CSSF immediately and they must clear all OTC derivative contracts, novated or new, within 4 months. The EMIR Q&A has been updated on 2 October 2019 to clarify that newly created entities or counterparties which start taking positions in OTC derivatives and which choose to calculate their AANA need to determine the results of that calculation 12 months after they started taking positions in OTC derivatives.
- NFCs do not need to consider OTC derivatives entered into for hedging purpose, while **FCs need to include all their OTC derivatives irrespective of whether they were entered into for hedging or investment purposes**. The EMIR Refit introduced a lighter regime for NFCs, who are only required to clear OTC derivative transactions for the asset classes where the clearing threshold has been exceeded and no longer for all asset classes. Nevertheless, NFCs must also implement margining processes for non-cleared OTC derivatives.
- The Q&A clarifies that positions should be calculated at group level for the purpose of calculating if a TCE FC would be subject to the clearing obligation. If the group comprises at least one EU FC, FC+ or FC- status should be assumed to be the same as that of the EU FC.
- The obligation to clear OTC derivative contracts subject to the clearing requirement but entered into or novated prior to the relevant clearing effective date ("frontloading") has been removed by EMIR Refit.
- The Q&A confirmed that counterparties that are not subject to the clearing obligation do not need to obtain representations from their counterparties since they are exempted from the obligation regardless of the status of their counterparties.

Entities providing clearing services are required to do so on a fair, reasonable, non-discriminatory and transparent commercial terms (FRANDT).

Reporting obligation

- Subject to prior notification to the CSSF, intragroup transactions involving a NFC where the parent entity is not a FC are exempted from reporting provided that both counterparties are included in the same consolidation and have established a centralised risk management framework.
- **Where a FC has entered into derivative transactions with a NFC-, the FC is responsible for reporting on behalf of both parties.** The NFC- must however provide relevant information to the FC for them to submit a comprehensive report. The management body, UCITS' management company or AIFM is now liable for proper trade reporting of the fund data.
- EMIR Refit removed the requirement to report derivatives that were outstanding on or after 16 August 2012 and

[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

terminated before 12 February 2014 ("backloading").

- The Q&A clarified that, at position level, the venue of execution field should be populated with the MIC code of the venue where the highest number of derivatives that are included in the reported position were executed. The position should not be reported as being the result of compression simply because it contains different trades.
- The Q&A also tackles **impacts of the upcoming transition from IBORs to nearly risk-free references rates** ('RFR'). The counterparties need to report the ISO 20022 4-letter code in the free-text field for floating reference rates, such as €STR, which did not exist at the time the Commission Implementing Regulation 2017/105 was developed. Should the rate be reported as the underlying of the contract, counterparties need to use the ISIN assigned to that rate, or, if it is not available, the full name of that index as assigned by the index provider. When counterparties agree to change the reference index of the outstanding derivative from EONIA to €STR, they need to send the report with the action "modify". Similarly, once EONIA is discontinued, the counterparties that either actively transition to €STR or rely on a contractual fallback, will need to send the modification reports to the TRs. The joint statement issued by ESAs on 5 December 2019 clarifies that amendments made to outstanding uncleared OTC derivative contracts for the sole purpose of introducing such fallbacks should not create new margining obligations on these legacy contracts.

Margin requirements

- Further to EMIR Refit, the **variation margin requirement** ("VM") for both FX swaps and FX **forward is now limited to the Global Systematically Important Financial Institutions listed by the Financial Stability Board** and therefore does not apply to funds. This has been clarified further by amended margin RTS. The amended RTS should be endorsed by the European Commission and follow the non-objection procedure. The ESAs invite National Competent Authorities to apply the EU framework in a risk-based and proportionate manner until the RTS become legally binding.
- Should its AANA exceeds EUR 50 billion during the second quarter 2020 (Phase 5 AANA measurement period), a fund may be caught by the IM exchange requirement for certain uncleared OTC derivatives (FX swaps and FX forward are exempted) as from 1 September 2020. An additional phase has been introduced by the amended margin RTS for counterparties having an AANA greater than EUR 8 billion which will be required to exchange IM as from 1 September 2021.
- The amended RTS also extend the IM derogation for intragroup transactions within groups with third-country entities until 20 December 2020 and the VM derogation for single equity and index options until 4 January 2021
- IM must be exchanged on a gross basis and segregated from the insolvency risk of the receiving party. The IM models used are required to be validated, back-tested and audited. An independent legal opinion is required to assess both the compliance of the segregation arrangements and the enforceability of the new IM documentation. The margin RTS[14] prescribe the frequency (article 9 (2)) and the methodology (Annex II or III) for IM calculation as well as concentration limits (article 8) in respect of collateral received.
- As from 18 December 2019, EMIR Refit will oblige CCPs to provide their clearing members with a simulation tool allowing them to determine the amount of additional initial margin, on a gross basis, that the CCP may require upon the clearing of a new transaction.

[14] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016

CSSF Press release on EMIR IFM questionnaire

Based on responses received to a questionnaire sent to IFMs in August 2018, the CSSF issued a press release calling IFMs to improve their supervision and oversight of EMIR obligations. According to the CSSF, a small portion of IFMs show significant deficiencies:

- Lack of formalization (procedures, arrangements, documentation of applicable obligations assessments, regular review of the adequacy of their oversight procedures)
- Absence of adequate oversight of delegated obligations (due diligence, clarity of delegation agreements allowing for adequate ongoing oversight)
- Confusion regarding scope of EMIR for some IFMs/AIFMs

IFMs with significant deficiencies have been notified individually, but the CSSF noticed that in general, current monitoring and oversight are not compliant with requirements of CSSF circular 18/698 on EMIR where relevant.

The **CSSF will now focus on compliance with EMIR requirements and improvement of data quality of the reported trades. The CSSF reminds new requirements introduced by EMIR Refit**.

Practical considerations

IFMs need to assess whether the universe of derivatives they use or intend to use is covered by the market of cleared derivatives and to balance the clearing costs versus the capital charges, risks and burden of bilateral margining in order to assess whether it is worth calculating their AANA in order to voluntarily elect to have the newly created FC- status. It should be noted that all IFMs that have not performed the calculation and notified CSSF by the end of May 2019 are currently considered to be FC+ and thus have to comply with the full set of requirements.

Should they choose to not calculate their AANA or exceed the clearing thresholds, the governing bodies of the IFMs will be responsible for the notification of their FC+ status to ESMA and the CSSF at the latest 12 months after they first started taking OTC derivatives positions. Delegated functions do not affect the liability for the notification.

Similarly, TCE FCs can be subject or not to the EMIR clearing obligation for their derivative transactions with FC+. However, if such TCE FCs have an EU branch which is already classified, they must be assigned the same status. For international groups, attention should be paid to cross-border impacts of EU branches status determination where an IFM not qualifying as a group entity can and need to maintain the possibility to enter into OTC transactions with the TCE parent company (of the EU branches) for derivative contracts subject to the clearing obligation.

Initial margin requirement is likely to carry significant challenges for in scope UCIs. IFMs should anticipate the short time frame between AANA measurement's period and the start date of the IM requirement to allow sufficient time for negotiating legal documentation with dealers and custodians and building operational capacity.

Since IFMs remain liable for the EMIR reporting performed for the account of the UCIs they manage where the reporting has been delegated, IFMs need to make sure that the technical guidance provided in the Q&A is embedded in their reporting procedures or oversight framework.

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Securitization reporting requirements

March 2020 TBC

Supplementing EU Regulation 2017/2402 (the "Securitization Regulation") which aims to provide a stronger framework in terms of transparency, governance and oversight in the securitization market, the European Commission (EC) published on 16 October 2019 the Transparency RTS[15] ("RTS") specifying the information and details to be made available to various parties by originators, sponsors and securitization special purpose entities (SSPEs). These transparency requirements participate to the increased granularity of the information provided to investors and potential investors who need to perform their due diligence and risk monitoring, but also to the competent authorities who execute their prudential oversight mandate.

Entities which perform periodic reporting of information on the underlying exposures required by article 7 of the Securitization Regulation should use reporting templates prescribed in the RTS. The reporting frequency is monthly in the case of asset-backed commercial paper transactions and quarterly for any other types of underlying assets. The reporting templates are available in the XML format on European Securities and Markets Authority's ("ESMA ") website, and ESMA Questions & Answers ("Q&As") on the Securitization Regulation have been updated as of 15 November 2019 to include detailed reporting instructions. Since the RTS are expected to enter into force in February 2020 once the 3-month objection period has expired and 20 days after their publication in the Official Journal of the EU, in-scope reporting entities should prepare to map and integrate data in their reporting platforms in accordance with the new templates.

[15] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016

Key Points

The obligations under the RTS are not specifically limited to EU-established originators, sponsors and SSPEs and, therefore, have potential extra-territorial effects. Since inactive underlying exposures no longer contribute to the risk profile of the securitization and are therefore less useful to existing and potential investors, more granular information is not required to be provided.

A detailed description of the structuring of the securitization is expected, to enable performance of the securitization and pricing of related tranches to be assessed. Hence, the RTS require up-to-date information on the securitization itself, the programme, the transaction, the tranches/bonds, the accounts, the counterparties as well as additional features of relevance for synthetic and/or Collateralized Loan Obligation securitizations. Basic information should be provided for all securitizations and additional information should be reported only for public securitizations -for which a prospectus has been drawn up.

For all securitizations

Dedicated templates, whose terms and practices have been derived or inspired from the existing EU legislation where possible, have been tailored for the most prominent underlying exposures types. An esoteric asset template is also provided as a catch-all for any securitized assets that do not fall within a class of assets for which a dedicated template exists. Another template specifies the information to be added for non-performing exposures, on top of the information laid down in the relevant dedicated template. Two different types of investor reporting templates are provided for asset-backed commercial paper ("ABCP") securitizations and non-ABCP securitizations.

For public securitizations

Additional templates are provided to report inside information or significant event information for public ABCP and non-ABCP securitizations. Item codes should be assigned to the information made available to securitization repositories in order to facilitate tracking of documentation and items which have been submitted.

Granularity of disclosures

As longer-term exposures require greater detail to adequately understand and monitor the risk and the performance, the information to be disclosed for underlying exposures is much more granular for long-term securitizations. Reflecting this, the number of fields to be reported ranges from 50 for ABCP securitization to 244 for commercial real estate.

Common provisions

European System of Accounts (ESA) codes and Service Watchlist codes must be used for certain fields. The information reported should be complete and consistent. A corrected report should be made available without undue delay where the reporting entity identifies factual errors. Rationale of use of the no data options ("ND") should be explained by originators, sponsors and SSPEs and the competent authorities should be permitted to verify the correct use of this option at any time. The **use of ND is limited to specific fields of the annexes and should not be used to circumvent a reporting requirement**.

A maximum of 2 months is set between the data cut-off date and the submission date of the report. However, this delay is reduced to one month for non-transaction-related information in the investor report (Annex XIII referred to in the Article 3 of the RTS) and the inside information/significant report (Annex XV referred to in the Article 6 of the RTS) for ABCP transactions.

In order to facilitate tracking of information and to allow for on-going monitoring, each securitization should be assigned a unique and permanent identifier.

ESMA reporting instructions and Q&A

July 2019 update

ESMA clarified that **trade receivables securitized as a non ABCP transaction should be reported using the esoteric asset template**. ESMA confirmed that the template should be reported once per each conduit that is co-funding an ABCP transaction, on a pro rata basis according to the amount of underlying assets transferred to the SSPE.

ESMA provided some guidance in respect of the use of the ND options and reporting of inactive exposures and presents the methodology to report certain amounts such as interest rates, interest rate indices, margin, currency swaps, partial bullet repayments and loan-to-value ratios. ESMA also describes as well how triggers, tests and other events are expected to be reported in the investor reports.

November 2019 update

ESMA clarifies further that **securitization repositories** should request reporting entities to confirm their report is complete upon each submission, and that corrections for one underlying exposure should be accompanied with corrections of other affected templates, as referred to in the RTS.

In respect of **STS notification**, the first point of contact for investors and authorities should be the sponsor or the originator who carry together shared responsibility. Delegation of certain tasks is not prevented but the delegating entity will remain liable.

Disclosure requirements and templates

- Loan-to-value, debt service coverage ratios and debt to income ratios are expected to be calculated even where no covenant or trigger referring to these ratios exists in the underlying exposure documentation. Fees billed or accrued should be included in the default amount which is reported, unlike fees which are only anticipated but not accrued. The same principle applies to liquidation expenses. A negative index reference rate should still be reported even in case a contractual floor applies.
- Guidance is provided for individual fields in respect of trade receivables within one month, deposit amount, dilution, mandatory payment holiday schemes, conditional principal grace period, interest rate floor, credit impaired obligor, balloon amounts and multiple prepayment fees with different end dates related to a single underlying exposure.
- For residential real estate underlying exposures, ESMA clarified that any types of insurance in which protection is given to the value of collateral should be reported, even where the originator is not the beneficiary of payouts.
- Guidance provided for commercial real estate underlying exposures covers, inter alia, non-payment on equal ranking exposures, noteholders consent in certain restructuring contexts, reserves held for capital expenditures and payment date. Where the sponsor is an externally managed fund with multiple investors, it is expected that the external manager will be reported as the sponsor. The date of the most recent operating statements should be reported as the date of financial statements of the securitization. Any overhead expenses should be allocated proportionately to each property, according to its operational expenses.
- With regard to corporate underlying exposures, ESMA indicates that if debtors are exempted from producing financial statements, an estimate based on tax statements should be reported as the enterprise value.
- ESMA confirms that every cash flow item must be reported in the investor report, even if their sum is equal to zero. Each waterfall must be reported one after the other without any separation where securitizations (e.g., Master Trust structures) contain several waterfalls. The outstanding principal balance should aggregate all principal balances that securitization investors have recourse to. Where different risk weight approaches are used for different underlying exposures, the approach associated with the highest share of underlying exposures in terms of value is expected to be reported.
- In the Q&A related to inside information and significant event information, ESMA indicates that the Legal Entity Identifier ("LEI") of the entity a branch belongs to should be reported regardless of whether that branch is eligible for a LEI. ESMA also clarifies that the periodic updates of the investor report and underling exposures are not "Material Amendments to Transaction Documents" as such.

Practical considerations

The reporting entities need to identify data entry points, map and integrate such data in their reporting platform in accordance with the new templates. The significant granularity of information which is required may cause challenges in accurate reporting, depending on the age of the portfolio and other factors, especially for non-bank entities.

Many data fields of the esoteric asset template, such as collateral type, credit granting criteria and ongoing performance are not relevant for trade receivables. The multiple options and restrictions on ND reporting should also be taken into consideration for entering the appropriate value where no data is generated.

The RTS are expected to enter into force in February 2020 without any transitional period. In the interim, reporting entities are bound to use the templates in annexes I to VIII of the RTS of the Credit Rating Agency Regulation ("CRA3") where a template exists for the underlying asset class.

In the absence of any securitization repositories authorized by ESMA, disclosure of a public transaction should be made on a website that (i) includes a reliable data quality control system, (ii) is governed, operated and maintained in order to ensure continuity and functionality, (iii) is subject to systems, controls and procedures to mitigate operational risk and (iv) archives information for at least 5 years after the final maturity date of the transaction.

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ATAD II - Impact on investment funds in Luxembourg

Luxembourg draft law implementing EU ATAD II: latest developments and impacts for investment funds

Applicable from
1 January 2020

Following the generally positive opinion and the acknowledgment of the government's legislative choices by the State Council, the draft law (Draft Law) implementing Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 (ATAD) as regards hybrid mismatches with third countries (ATAD II) has been adopted by the Luxembourg Parliament on 19 December 2019 ("The Law") and has been published in the Official Gazette (Mémorial) on 23 December 2019. For financial years starting on or after 1 January 2020, the already existing provisions dealing with intra-European Union (EU) hybrid mismatches will thus be extended to third countries and to further types of hybrid mismatches not initially covered by ATAD.

Broadly speaking, the purpose of the anti-hybrid mismatch rules of ATAD II is to ensure that the same payments, expenses or losses are not deducted both in the country of the payer and of the payee (double deduction), or that a payment is not deducted in the payer's country without a corresponding inclusion for tax purposes in the recipient's country, or that a relief for tax withheld at source on the same payment cannot be claimed by more than one of the parties involved in the transaction. For a detailed discussion of the various provisions of the Law, please refer to our EY Tax Alert Luxembourg submits draft law implementing EU ATAD II to Parliament.

Key points

In a context of investment funds with underlying Luxembourg Special Purpose Vehicles, the most frequent hybrid mismatches situations should consist of the use of (i) a hybrid financial instrument and/or of (ii) a reverse hybrid entity or (iii) disregarded entity. As it relates to (i), given the differences in the tax systems of the various parties involved (investors, investment fund and one or more companies holding the investment assets), it can happen that for example, the jurisdiction of one investor considers a financial instrument issued by a company as equity and thus grants an exemption for the return (dividend) on the instrument, while the jurisdiction of the paying company considers the instrument to be debt and allows a tax deduction for the return that is paid. Similarly, under (ii), the jurisdiction of one investor may consider for example, a Luxembourg fund incorporated as a limited partnership as an opaque entity based on its domestic legislation and thus not taxing the profits until they are distributed to the investor, while Luxembourg considers the limited partnership as a transparent entity, resulting in the profits not being taxed at the level of the partnership but should be taxed, based on Luxembourg law, at the level of the investors up to their share of profit. Finally, under (iii), a payment by a company may be disregarded in the payee jurisdiction. All such situations give rise to a deduction at the level of one taxpayer without corresponding inclusion at the level of another taxpayer - exactly the kind of situations that ATAD II intends to tackle.

A hybrid mismatch as described above does not however automatically trigger corrective tax adjustments. Indeed, as it is already the case under the intra-EU provisions of ATAD, the extended anti-hybrid provisions target arrangements that are designed to be hybrid or hybrid arrangements arising between associated enterprises, i.e.,, between enterprises exceeding for example 25% (in presence of a hybrid mismatch arising from a hybrid financial instrument) or 50% (for all other hybrid mismatches) of voting rights, capital rights or entitlement to profits. ATAD II however further expands the scope by introducing the concept of "acting together". In the context of investment funds, this concept leads to aggregating the voting rights or capital ownership that the various investors hold in the same fund. As a result, each investor may be considered as an associated enterprise – and thus subject to the anti-hybrid provisions – since the aforementioned thresholds would be exceeded due to the aggregation (in spite of the fact that investors' individual and indirect voting rights, capital rights or entitlement to profits may be lower than 50%/25%).

As stated in the final report on Action 2 of the Base Erosion and Profit Shifting (BEPS) of the Organisation for Economic Co-Operation and Development (OECD), the aim of this provision is to prevent taxpayers from avoiding the related party test by transferring their voting or capital rights in an entity to another person, who continues to act under their direction in relation to those rights. In an investment fund context however, the investors do not have effective control over the investments made by the fund, nor are they actually "acting together" among themselves or with respect to the underlying investments. Based on this observation, the Law contains a derogation according to which a person who, directly or indirectly, owns less than 10% of an investment fund and is entitled to less than 10% of the profits of the investment fund will, unless there is proof to the contrary, not be considered as "acting together" with another person participating in the fund. For the purpose of this derogation, an investment fund is defined as a collective investment undertaking that raises capital from multiple investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

Where nevertheless investors in an investment fund would qualify as associated enterprises and thus be subject to the anti-hybrid provisions, there are provisions in ATAD II and the Law that mitigate or exclude a corrective tax adjustment in presence of certain fact patterns.

First, with respect to financial hybrid instruments, the deduction shall in principal be denied if the payment is not included by the payee, or if it qualifies for a tax exemption, a reduction in the rate of tax or any credit or refund of tax. In line with the provisions of ATAD II, the Law provides that a payment made under a financial instrument should not be treated as giving rise to a hybrid mismatch if the tax relief granted in the payee jurisdiction is due to the tax status of the payee. In other words, if the payment is received by a tax-exempt investor (e.g.,, by an investment fund or a sovereign fund that is tax exempt), the payment will remain deductible in the payer jurisdiction. Furthermore, the Law also considers timing differences. The payment does not necessarily need to be included in the same tax year: the deduction is still granted if the payment is included by the payee in a tax period beginning within 12 months of the end of the payer's tax year, or where it is reasonable to expect that the payment will be included in the payee jurisdiction in a future tax period and the terms of the payment are those that would be expected to be agreed between independent parties.

In addition, in case of a payment by a hybrid entity (e.g.,, a Luxembourg corporate taxpayer on which an entity classification election has been made in the United States to treat it as a disregarded entity), the deduction shall be denied in Luxembourg if the mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction. As with hybrid financial instruments, no hybrid mismatch should arise where the payee is exempt from tax under the laws of the payee jurisdiction. The deduction will furthermore not be denied to the extent of the amount of dual inclusion income, i.e., of the amount of the payment included under the laws of both jurisdictions where the mismatch outcome has arisen.

Finally, an important derogation for the fund industry is also foreseen with respect to reverse hybrid entities, to which a specific provision will apply as from 2022. According to this provision, a transparent entity incorporated or established in Luxembourg (e.g.,, Luxembourg limited partnership (société en commandite simple; SCS) or a special limited partnership (société en commandite spéciale; SCSp)) will be treated as a corporate taxpayer if one or more associated nonresident entities holding in aggregate a direct or indirect interest of at least 50% of the voting rights, capital interests or rights to profit are located in a jurisdiction/jurisdictions that regard the entity as opaque. Again, according to the Law and in line with ATAD II, the provision will not apply to collective investment vehicles. The commentaries to the Law list the various vehicles that are covered, namely undertakings for collective investment in the sense of the Luxembourg law of 17 December 2010 as amended, Specialized Investment Funds (SIFs) in the sense of the Luxembourg law of 13 February 2007 as amended and Reserved Alternative Investment Funds (RAIFs) in the sense of the Luxembourg law of 23 July 2016 as amended. Also covered are alternative investment funds covered by the law of 12 July 2013 on alternative investment fund managers provided they are widely held, hold a diversified portfolio of securities and are subject to investor protection requirements.

Practical considerations

ATAD and ATAD II introduce an unprecedented change in direct taxation and have a significant effect on the taxation of businesses operating in and outside the EU, including for investment funds. Nevertheless, one can note that the Law has taken into account to some extent the specificities of the investment funds sector of the, and in many cases the impact of the new measures will be limited. Stakeholders are however well advised to carefully analyse their investment structures and be ready to provide adequate proof that the anti-hybrid mismatch provisions are not applicable in a particular case.

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What's next on the regulators' agenda

Equivalence Determination

Objective: The objective of the equivalence determination process is to maintain an as-close-as-possible partnership between the EU and the UK and to avoid a cliff-edge exit at the end of the 11 month transitory period. Parties committed to preserve financial stability, market integrity, investor protection and fair competition but keep their ability to take equivalence decision in their own interest.

Timeline: Product & manager passports will expire when EU legislation ceases to apply in the UK as from 1 January 2021. According to the political declaration setting out the framework for the future relationship, both parties endeavour to conclude their equivalence assessment before the end of June 2020. Even if there is very little doubt that the UK will be fully equivalent at the end of the transitional period since the UK will mirror the EU regulation, the question will become more sensitive in case of divergence in the medium term.

Coverage: Each country's rulebooks will be assessed, considering tax and AML aspects, financial stability, market size and interconnectivity, compliance, enforcement and risk of circumvention of EU rules. Equivalence decisions are likely to affect market infrastructures, central clearing counterparties and central securities deposits.From an EU perspective, equivalence assessments can potentially impact eligibility of deposits with UK credit institutions for UCITS and money market funds, eligibility of UK-domiciled UCI shares for UCITS, and the possibility to enter OTC derivatives, securities lending and REPO transactions with UK counterparties. Eligibility of guarantees provided by UK entities to EU management companies as a partial substitute for their own funds requirements will be also conditional to equivalence of UK prudential rules for credit institutions and insurers. AML/CFT rules are also in scope of the mutual assessment with potential consequences on reliance on due diligence performed by distributors, intermediaries and delegates.

UK-based AIFMs will have to rely on the EU assessment of the UK prudential/supervisory framework in order to be authorized to manage EU AIFs as non-EU AIFMs or market non-EU AIFs in the EU.

Possible impacts on reporting: Additional regulatory reporting requirements could apply for both EU and UK entities managing or marketing funds on a cross-border basis as a means to comply with each other's local requirements.

UCITS Review

Objective: The UCITS framework should continue to be adapted through transversal acts, technical standards and regulatory guidance with the aim of addressing particular concerns or loopholes. ESMA may be required to provide technical advice to the EC during the year to assess if a more comprehensive review of the directive is needed to maintain investor confidence in the UCITS brand as well as fostering market integration and supervisory convergence.

Timeline: There is no clear timeline for the review of the directive at this stage. ESMA will conduct a common supervisory action throughout 2020 to assess adherence of fund managers to UCITS liquidity management rules. Guidance on performance fees is also expected as well as scrutiny on benchmark disclosures by funds. An industry expert group is being launched to assess reporting fragmentation and pro-actively contribute ideas to reduce the regulatory reporting burden and to foster convergence.

Expected coverage: One of the key priorities of the regulators is to mitigate liquidity risk. Consideration will be also given to funds and fund managers' disclosures of stress tests, indices/benchmarks used and performance fees. Whether or not the directive will be re-discussed will likely be determined by the results of the assessments conducted on the implementation of the actual rules and guidance. Harmonization of reporting and substance requirements could also be scrutinized.

Possible impacts on reporting: Harmonization of reporting is a key driver of operational efficiency, product comparability and supervisory convergence. More consistent disclosure requirements are already being developed or implemented in pre-contractual documentation and periodic reports, notably with regard to performance fee impacts, liquidity stress tests, benchmarks and indices, ESG characteristics. For other aspects, it is difficult to predict changes at this stage, but a greater harmonization of national regulatory requirements will certainly be supported by the fund industry.

AIFMD Review

Objective: The AIFMD entered into force on 22 July 2011 and is due to be officially reviewed in 2020. The European Commission was mandated to review the application and the scope of the Directive, assess whether the objectives to (1) reduce and control the risks caused by the activities of AIFMs and (2) foster market integration have been met without causing major market disruption and propose legislative amendments to improve its efficiency.

Timeline: First step was completed in January 2019 with a survey conducted by KPMG on behalf of the European Commission. The timeline for next steps is yet to be confirmed, but the Commission could publish a report during the first quarter 2020, followed by a consultation and publication of a proposal in the first quarter 2021.

Expected coverage: The key topics are expected to be the review of the NPPR/third country passport, the rules on remuneration, liquidity risk management, leverage, reporting, loan origination and depositary rules.

Possible impacts on reporting: Calculation and reporting of leverage metrics are likely to be aligned with the latest IOSCO recommendations. Prescriptive reporting requirements may be proposed for stress test results to increase data comparability. Discretion left to member states to request additional reporting could be revisited to reduce the reporting burden for AIFMs. The current categorisation could also be amended to enable more granular statistics on AIFs reported as "other AIFs" as of today.

ESMA's Technical Advice to the Commission on the effects of product intervention measures

Background

One of the most noticeable innovations of MiFIR was the introduction of a product intervention framework enabling ESMA and national competent authorities to prohibit or temporarily restrict marketing, distribution and sale of certain financial instruments, or a type of financial activity or practice which raises significant investor protection concerns. ESMA's technical advice provides an overview of the measures taken since July 2018, describes their practical effects on market participants and proposes legislative changes which may be appropriate to consolidate such measures and close gaps in the rulebook.

Primary Change

ESMA advises the European Commission to extend the mandate of ESMA and NCAs and to enable them to exercise the MiFIR intervention powers to Alternative Investment Fund Managers ("AIFMs") authorized under Directive 2011/61/EU and UCITS management companies authorized under Directive 2009/65/EC, including self-managed UCITS and AIFs (all together designated as "IFMs"), in order to ensure a level playing field between them and MiFID firms.

Key Points

Currently, IFMs can potentially continue to market directly shares or units of funds they manage that would be subject to product restrictions or ban. IFMs also remain out of scope of product intervention measures affecting specific financial instruments they market, distribute or sell under the permissions they may have obtained to carry out MiFID activities or ancillary services, such as individual portfolio management, investment advice, reception and transmission of orders (AIFMs only) or safekeeping and administration of assets in relation to fund shares or units.

In order to address the risk of arbitrage between MiFID firms and IFMs, ESMA asks the European Commission to consider vesting ESMA and National Competent Authorities with the powers to apply restrictions and prohibition available under MiFIR directly to IFMs.

ESMA also formulates other recommendations to:

- Introduce a legal mechanism to consolidate the temporary measures into permanent measures or at least extend them
- Clarify in the legislation the application of product intervention measures to firms acting on a cross-border basis when overlapping measure are taken by Authorities from different member states, as well as the distribution of responsibilities of supervision and enforcement in such situations
- Simplify the adoption of a product measure by a National Competent Authority already adopted by ESMA

Practical Considerations

In practice, IFMs are already heavily regulated and ESMA does not provide any evidence that the loophole identified in the rulebook has already been exploited to circumvent product ban.

If ESMA's recommendation to apply restrictions to IFMs is taken forward by the European Commission, IFMs will need to properly monitor any restriction/prohibition decisions taken by ESMA and national competent authorities in order to freeze marketing, distribution and sale of the products subject to intervention measures in a timely fashion.

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