

Investment Funds L u x e m b o u r g Newsletter

May/June 2008

In spite of a wavering economic context, Luxembourg, during the May / June 2008 period, consolidated its position of a leading investment funds hub. Indeed, according to the Commission for the Supervision of the Financial Sector (CSSF), on 31 May 2008, total net assets of undertakings for collective investment and specialized investment funds reached EUR 1,996.959 billion compared to EUR 1,964.076 billion as at 30 April 2008, i.e. a 1.67% increase. The news of the investment funds market has been dominated by the debate over the concept of UCITS IV and by the issuance of CSSF Circular 08/356, as well as by less crucial legal updates.

Summary

1. Implementation in Luxembourg of EC Directive 2007/16/EC of 18 March 2007 (implementing the UCITS Directive as regards the clarification of certain definitions) and of the CESR guidelines concerning eligible assets for investments by UCITS
[\[read more\]](#)

2. CSSF Circular 08/356 concerning rules applicable to UCIs which employ certain techniques and instruments relating to transferable securities and money market instruments
[\[read more\]](#)

3. Clarification on the information to be provided by UCITS to the CSSF concerning the risk management process according to CSSF Circular 07/308
[\[read more\]](#)

I- Implementation in Luxembourg of EC Directive 2007/16/EC of 18 March 2007 (implementing the UCITS Directive as regards the clarification of certain definitions) and of the CESR guidelines concerning eligible assets for investments by UCITS

Two particularly relevant pieces of legislation in the context of eligible assets for investments by UCITS have recently been implemented in Luxembourg. The first one is the Grand-Ducal Regulation dated 8 February 2008, which amends certain definitions specified in the 2002 Law, and which replicates closely the EC Directive 2007/16/EC.

The other piece of legislation is the groundbreaking CSSF Circular 08/339 (released on 19 February 2008) which points out, inter alia, that the provisions of the above Grand-Ducal Regulation must be read in conjunction with the CESR guidelines.

Investors should first note that UCITS already set up at the time of the implementation of the guidelines will benefit from an extension until 23 July 2008 at the latest to comply with the guidelines.

However, more fundamentally, what should be raised is the somewhat more flexible attitude adopted by the CSSF, particularly in circumstances where there is further need of interpretation of the provisions of the Grand-Ducal Regulation and the CESR guidelines. The impact of this Circular

should however not be overestimated since the CSSF already fully applied the provisions of the Directive and the related CESR advices, and hence no significant changes are to be expected in practice. However, this evolution of the CSSF's practice is especially remarkable throughout the appreciation of the circumstances in which a security embeds a derivative or permitted investment within the 10% trash ratio (e.g possibility to include regulated open-ended hedge funds, funds of hedge funds, real estate funds and commodity funds). This more flexible attitude of the CSSF is also to be noted in its administrative practice (see section II of this Newsletter).

II- CSSF Circular 08/356 concerning rules applicable to UCIs which employ certain techniques and instruments relating to transferable securities and money market instruments

A new regime applicable to securities lending operations performed by UCITS - and, in principle, by other UCIs subject to the 2002 Law – was introduced by the CSSF Circular 08/356 released on 4 June 2008. The main point of this new regime is, by reforming the previous one (referred to in the Commission Directive 2007/16/EC, and the corresponding CESR guidelines) set out in 1991 (by CSSF Circular 91/75) to take into account the fast growing number of securities lending transactions Luxembourg UCITS and UCIs have recently been engaged in.

This Circular lays down the techniques and instruments which may be used by UCITS, comprising in particular securities lending transactions. The criteria to be fulfilled by the techniques and instruments subject to the Circular are threefold, namely that:

- they are economically appropriate (= realised in a cost-effective way);
- they are entered into for one or more of the following specific aims
 - reduction of risk
 - reduction of cost
 - generation of additional capital or income for the UCITS with a level of risk which is consistent with its risk profile and the

risk diversification rules applicable to it; and

- the risks they entail are adequately captured by the risk management process of the UCITS.

The Circular provides broad guidelines on, inter alia, how the fund may lend its securities, which assets are eligible as collateral, and on the content of the prospectus of the fund addressed to investors, which overall reveals a more flexible administrative attitude adopted by the CSSF.

Crucial points to be noted may be summarized as follows:

- A Fund may lend its securities
 - Directly;
 - Via a standardized lending system organized by a recognized securities lending institution; or
 - Via a lending system organized by a financial institution subject to prudential supervision rules considered by the CSSF as equivalent to those laid down by Community law and specialized in that type of transactions.
- The assets eligible as collateral include:
 - Liquid assets (cash and short-term banking deposits, money market instruments, and letters of credit or guarantees on first demand issued by a first class credit institution non affiliated to the counterparty);
 - Bonds issued or guaranteed by an OECD Member State or a first class issuer offering adequate liquidity; and
 - Shares or units issued by daily valued money market UCIs (assigned a rating of

AAA or its equivalent) or a UCITS investing in bond / shares referred to in the Circular.

- The prospectus of the fund must indicate:
 - That the Fund intends to enter in securities lending operations;
 - The purpose of such securities lending transactions;
 - The conditions and limits of such securities lending transactions;
 - The conditions and limits of collateral cash re-investment if the Fund intends to do so; and
 - As the case may be, a description of the risks inherent to such securities lending operations.

III- Clarification on the information to be provided by UCITS to the CSSF concerning the risk management process according to CSSF Circular 07/308

In its Circular 07/308, the CSSF dwelt on the required procedure concerning the use of financial derivative instruments and the management of financial risks by UCITS.

A crucial element enabling the CSSF to play its supervisory role is obviously the information that UCITS need to communicate to the CSSF, and especially towards its risk management process.

The CSSF recently re-affirmed the importance of such elements and set out a list of them in its annual report, list which may be summarized as follows:

- name of the UCITS;
- risk profile of the UCITS (sophisticated or non-sophisticated);
- global exposure calculation method (commitment, relative Value at Risk (VaR), absolute VaR);
- the maximum limit, which must not exceed the regulatory limit as determined in the Circular (100% for the commitment approach, 200% relative VaR, 20% absolute VaR);
- reference portfolio (if relative VaR limitation); and
- exposure (i.e. use of maximum limit).

However, the CSSF later on clarified a few of these elements. It stated for instance that the global exposure limit set by the UCITS should be in

line with its given risk profile. Consequently, this may mean that a UCITS making use of the VaR methodology will have to determine, because of its given risk profile, a VaR limit lower than the maximum regulatory limit the investment policy of a UCITS. The CSSF will therefore not accept that UCITS, regardless of their risk profile, apply and report in all cases a VaR limit which corresponds to the highest permitted limit.

Investors shall be informed furthermore that the information has to be drawn up and filed with the CSSF on an annual basis, the CSSF however reserving itself the right to request those information on a higher frequency.

CHEVALIER & SCIALES

law firm

51, route de Thionville
L-2611 Luxembourg
Tel : (+352) 26 25 90 30
Fax : (+352) 26 25 83 88
www.cs-avocats.lu

For further information, please contact :

Rémi Chevalier, founding partner
E-mail : remichevalier@cs-avocats.lu

Olivier Sciales, founding partner
E-mail : oliviersciales@cs-avocats.lu

This Newsletter of Chevalier & Sciales is designed to provide information on recent developments in the area of investment funds. Please note that the information contained herein is not intended to be a comprehensive study or to provide legal advice, and do not substitute for the consultation with legal counsel required before any actual undertakings. We undertake no responsibility to notify any change in law or practice after the date of this document.