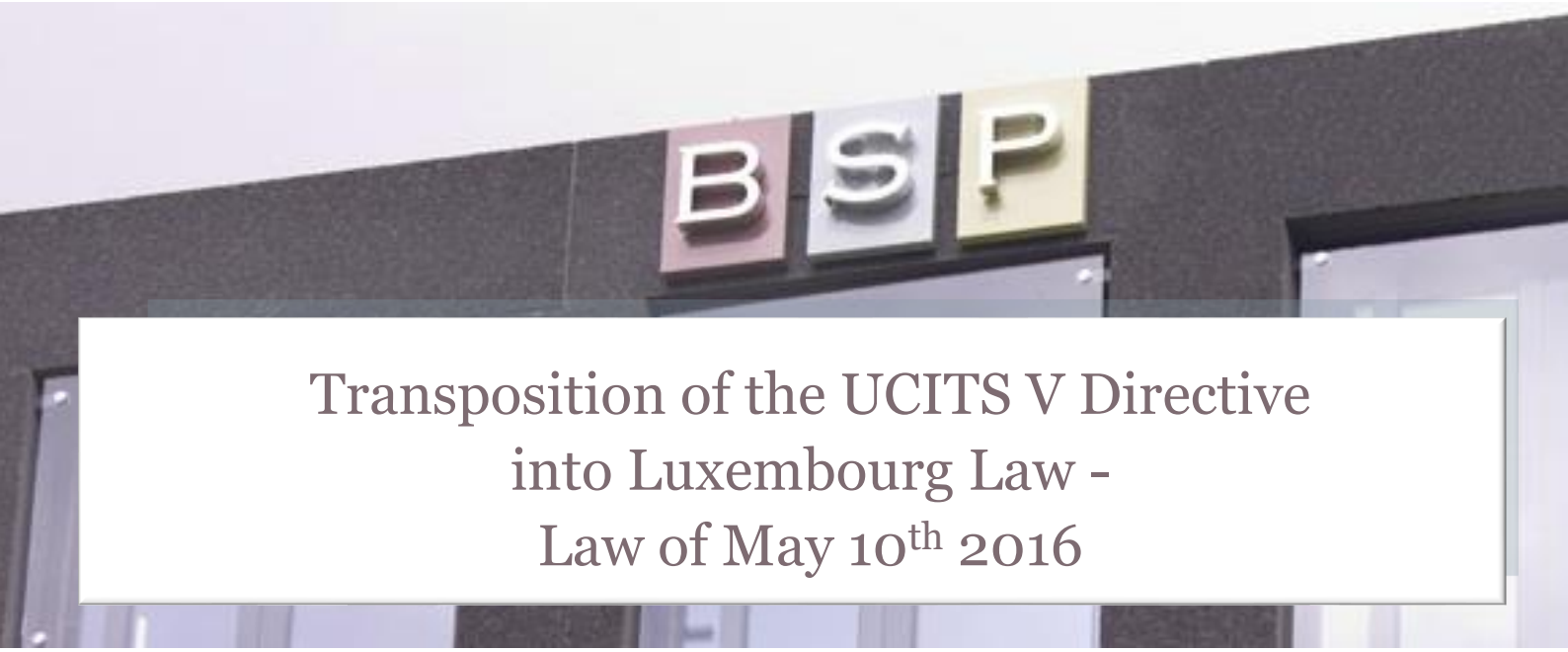

Transposition of the UCITS V Directive into Luxembourg Law - Law of May 10th 2016

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On May 10th 2016, the Luxembourg parliament approved the law transposing into Luxembourg law Directive 2014/91/EU ("UCITS V Directive") on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ("UCITS") as regards depositary functions, remuneration policies and sanctions ("2016 Law").

The 2016 Law aims at increasing investor protection and it aligns the rules regarding the depositary, remuneration policies and sanctions with the rules set out in Directive 2011/61/EU of the European Parliament and of the Council of June 8th 2011 on alternative investment fund managers ("AIFMD").

The 2016 Law entered into force on June 1st 2016 and it amends the current Law of December 17th 2010 ("2010 Law") on Undertakings for Collective Investment as regards depositary functions, remuneration policies and sanctions as well as the law of July 12th 2013 on alternative investment fund managers ("AIFM Law").

The 2016 Law follows the previous publication of CSSF Circular 14/587 of July 11th 2014 which already requested existing UCITS funds to align by March 18th 2016 their depositary regime to the one under AIFMD, in view of the upcoming transposition of the UCITS V Directive.

AMENDMENT OF THE 2010 LAW

The 2016 Law transposes faithfully the text of the UCITS V Directive into the 2010 Law thus respecting the spirit of the original text. The amendments aim at determining the roles and liabilities of the UCITS depositaries, introducing general remuneration principles that apply to UCITS management companies/self-managed investment companies and defining the administrative sanctions that may be applied by the Luxembourg financial supervisory authority, the *Commission de Surveillance du Secteur* Financier ("CSSF").

1. DEPOSITARIES

The 2016 Law amends the 2010 Law by defining the entities eligible to assume the role of depositary, their tasks, the possible delegation arrangements and the depositaries' liability.

1.1. ELIGIBILITY AND APPOINTMENT

Management companies or investment companies (i.e. self-managed UCITS) shall designate a single depositary, in order to ensure that (i) the depositary has an overview of all assets of the UCITS and (ii) both fund managers and investors have a single point of reference, in the event of problems occurring concerning the safekeeping of assets or the performance of its oversight functions.

Such appointment shall be evidenced by a written contract.

The 2016 Law further confirms that the sole entities that can act as depositaries for UCITS are credit institutions authorized under the Law of April 5th 1993 on the financial sector, as amended, so as to ensure a high level of protection for retail investors.

1.2. OBLIGATIONS OF THE DEPOSITARY

1.2.1. Oversight and cash monitoring duties

The Law introduces a list of the depositary's oversight duties that will now be applicable equally to depositaries of all UCITS (whether constituted under a contractual or corporate form).

The 2016 Law provides that the depositary shall have the following oversight duties:

- ensure that the sale, issue, repurchase, redemption and cancellation of units/shares of the UCITS are carried out in accordance with the 2010 Law and the management regulations or articles of incorporation (as applicable);
- ensure that the value of the units/shares is calculated in accordance with the 2010 Law and the management regulations or articles of incorporation (as applicable);
- carry out the instructions of the UCITS or of the management company acting on behalf of the UCITS, unless they conflict with the 2010 Law and the management regulations or articles of incorporation (as applicable);
- ensure that in transactions involving the assets of the UCITS any consideration shall be remitted to the UCITS within the usual time limits; and

- ensure that the income of the UCITS is applied in accordance with the 2010 Law and the management regulations or articles of incorporation (as applicable).

Moreover, the depositary is entrusted with an obligation of proper monitoring of cash flows of the UCITS. In particular for the cash-flow monitoring it shall:

- ensure the proper monitoring of all cash flows of the UCITS;
- ensure that all payments made by or on behalf of investors upon the subscription of units/shares of the UCITS have been received and all cash is booked in the accounts of a credit institution, central bank or third country bank, opened in the name of the UCITS, or its management company or depositary on behalf of the UCITS; and
- ensure that the principle of segregation of the UCITS's money from the depositary's own cash is being complied with.

The above oversight and monitoring duties cannot be delegated to a third party.

1.2.2. Safekeeping of assets ("*la garde des actifs*")

The 2016 Law introduces a distinction of assets that shall be entrusted to the depositary, based on their nature.

For financial instruments that may be held in custody, the depositary is obliged to hold them and ensure their registration in financial instruments accounts.

For other assets, such as derivative contracts, the depositary is obliged to verify the ownership and maintain up-to-date records of those assets for which it is satisfied that the UCITS or the management company acting on behalf of the UCITS holds the ownership. The verification of the ownership shall be based on information and documentation provided by the UCITS or the management company and, where available, on external evidence.

Finally, an exhaustive inventory of all assets of the UCITS shall be provided by the depositary to the management company or the UCITS on a regular basis.

The above provisions change the notion of the safekeeping of assets in place as it currently includes **only** the supervision of assets, i.e. the depositary is only obliged to be aware where the assets are held and how they are invested ("*garde-surveillance").*

The 2016 Law provides a differentiated approach regarding the notion of **safekeeping** of assets, including the notion of **supervision** for assets not eligible to be held in custody ("*garde-surveillance"*), as well as the notion of **custody** for assets eligible for registration in financial instruments accounts ("*garde-conservation*").

1.2.3. Segregation of assets held in custody

The 2016 Law clarifies that, in case of insolvency of the depositary or any third party located in Luxembourg to which custody of UCITS assets has been delegated, the assets of a UCITS held in custody are unavailable for distribution or realization for the benefit of creditors of such a depositary or third party.

The insolvency of the depositary or any third party does <u>not</u> affect the ownership status of the assets held in custody.

The 2016 Law thus provides legal certainty on this matter and enforces investor protection.

1.2.4. The prohibition of the reuse of assets

Moreover, the 2016 Law prohibits the reuse of assets by the depositary itself and it permits the reuse of the UCITS assets under certain conditions. This differs from the AIFM Law which transposed into Luxembourg law Directive 2011/61/EU on alternative investment fund managers ("AIFMD"), where the reuse of assets by the depositary is permitted after prior consent of the AIF or the AIFM acting on the AIF behalf.

1.3. Delegation and Sub-delegation

Only safe-keeping duties may be delegated, whereas cash-monitoring and oversight duties cannot.

The safekeeping functions can be delegated by the depositary to third parties provided that certain conditions are met.

Indeed, the depositary may delegate these functions only for an objective reason, and not with the intention of avoiding the requirements of the 2016 Law and it will be allowed to delegate these functions only if it *has exercised all due skill, care and diligence in the selection and the appointment of any third party to whom it intends to delegate parts of its tasks.*

In addition, according to the 2016 Law, the depositary must ensure that the delegate meets at all times a range of specific requirements during the performance of tasks delegated to it. Third parties, to whom the above functions may be sub-delegated, are subject to the same requirements.

During the performance of its activities, the delegate will be subject to an on-going due diligence by the depositary and will have to comply at any time with the following requirements:

- have the structures and expertise that are adequate and proportionate to the nature and complexity of the assets received in custody;
- be subject to effective prudential regulation, including minimum capital requirements, and supervision in its jurisdiction and it shall be subject to external periodic audit to make sure that financial instruments are in its possession ;
- segregate the assets of the clients of the depositary from its own assets, and from the assets of the depositary, to ensure that clear identification of ownership is possible at any time;
- take all necessary steps to ensure that, in the event of its insolvency, the assets held in custody are not available to pay the creditors; and
- comply with the same rules applicable to the depositary notably in relation to the contract evidencing its appointment, the safekeeping duties, the reuse of assets, the independence and the conflicts of interest requirements.

1.4. Liability of the Ddepositary

The 2016 Law introduces a new regime of civil liability applicable to depositaries of UCITS. This regime applies in a uniform way to all UCITS, irrespective of their legal form (contractual or

corporate), replacing the old regime which provided different rules for UCITS depending on their legal form.

In general, the new regime of liability of the depositary of UCITS is largely based on the provisions of the AIFM Law. The main difference is that in case of delegation the depositary may not contractually discharge its liability, as it is the case for depositaries of alternative investment funds ("AIF") within the meaning of the AIFM Law.

1.4.1. The liability regime

The new regime draws a distinction between (i) the loss of financial instruments held in custody and (ii) all other losses, as certain assets cannot be held in custody.

In case of **loss of financial instruments** held in custody, the liability of the depositary remains unaffected and independent from the existence of fault. The depositary is obliged to return financial instruments of identical type or corresponding amount without undue delay. The depositary shall not be held liable if it can prove (or meet the burden of proof) that the loss has arisen as a result of an external event beyond its reasonable control. In this case, the depositary may not invoke internal situations in order to discharge its liability, such as the fraudulent behaviour of an employee. It shall also be mentioned that depositaries remain liable for the loss of **financial instruments**, even when they have delegated part or all of their safekeeping tasks, as it is the case in the current UCITS regime in force.

In case of **any other loss**, the depositary is also liable to the UCITS or the management company acting on behalf of the UCITS and to the investors of the UCITS for the loss suffered by them as a result of its negligent or intentional failure to properly fulfil its obligations, pursuant to the 2016 Law.

1.4.2. Right of investors for direct action

The former regime of civil liability only permits unitholders of UCITS constituted in the form of common funds (FCPs) to invoke directly the depositary liability and only after the management company failed to act and there was no equivalent provision for shareholders of investment companies (SICAVs).

The 2016 Law reverses this position, harmonizing the rights for all investors of UCITS or the management company acting on behalf of the UCITS, allowing them to sue depositaries, provided that this does not lead to a duplication of redress or to unequal treatment of the investors.

1.5. New Prospectus Disclosures

The 2016 Law also requires UCITS or the management companies acting on behalf of UCITS to amend the prospectuses of the UCITS in order to include some specific disclosures. The elements to be disclosed are listed in the 2016 Law and shall include:

- the depositary's coordinates and identity, the description of its functions and tasks and the possible conflicts of interests that might arise in its capacity as depositary;
- a description of all delegated safekeeping functions, the list of the delegates and sub-delegates (that shall be updated on an

ongoing basis) and the conflicts of interests that might arise from such a delegation, whenever applicable;
- the confirmation that the depositary will indicate that the updates to the above information will be made available to investors free of charge upon their request.

2. RULES ON REMUNERATION

One of the main purposes of the UCITS V Directive is to increase transparency regarding management companies' remuneration policies and practices by introducing disclosure requirements in relation to the remuneration in order to discourage disproportionate risk-taking.

2.1. SCOPE

The new rules apply to:

- UCITS management companies under the 2010 Law,
- self-managed UCITS; and
- all third parties which take investment decisions that affect the risk profile of the UCITS as a result of delegation, in a proportionate manner.

The similarity of these rules with the rules on remuneration provided in the AIFM Law is an advantage for management companies under "Chapter 15", having a double agreement for both UCITS and AIFs ("Super ManCos"), to establish remuneration policies.

The remuneration policies apply to those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers whose professional activities have a material impact on the risk profiles of the management company or the UCITS managed. The rules on remuneration policies cover every form of payment or incentives paid by the management company and the UCITS.

These rules introduce, among others:

- the obligation to apply remuneration policies which are compatible with sound and effective risk management,
- the respect of an appropriate balance between the fixed and variable components of the total remuneration and
- the obligation to pay at least 50% of the variable remuneration component in units of the UCITS concerned.

Fixed components are considered salaries, pensions etc. whereas the variable components consist of bonuses.

Although welcome bonuses are allowed under the condition that they are limited only to the first year of employment, severance packages (golden parachutes) are prohibited unless they reflect performances achieved over time.

A remuneration committee may be established where it is justified by the size of the management company and/or the UCITS it manages and/or by the nature, scope and complexity of its activities.

Members of the remuneration committee, if any, shall not perform any executive functions.

Remuneration of senior officers in risk management and compliance functions shall also be controlled by the remuneration committee.

The Luxembourg legislator did not make use of the possibility offered by the UCITS V Directive to place restrictions on the types of instruments or to ban certain instruments from being included in the variable remuneration of individuals concerned.

2.2. DISCLOSURE

UCITS management companies will be required to establish, maintain and approve a remuneration policy which shall be adopted by the management body of the management company. The remuneration policy shall be reviewed at least annually.

The details of the remuneration policy must either be included in the prospectus, or, in case only a summary is inserted in the prospectus, the latter shall make a reference to the website where the key elements of the remuneration policy are available and mention the possibility to obtain a copy free of charge.

The key investor information document (the "KIID") must also be updated with the link to such website and must also include a reference to the fact that a copy of the remuneration policy is available to investors free of charge upon request.

Finally, in respect to the annual report, the UCITS management company or the investment company, as applicable, shall disclose:

- The amount of remuneration paid by the management company or the investment company, as applicable, for the financial year. Such annual report shall separate, in such amount, the fixed remuneration components from the variable ones. It shall describe the number of beneficiaries and, where relevant, shall state any amount paid directly by the UCITS (in case there is a management company), including any performance fee;
- The aggregate amount of remuneration with a distinction made between employees and identified staff;
- The way the remuneration and related benefits have been calculated;
- The outcome of the periodical reviews including a description on the anomalies which took place during the financial year; and
- Any material changes to the remuneration policy adopted.

The rules on remuneration set forth in the 2016 Law are to be read together with the ESMA Guidelines on the application of the remuneration principles laid down in the UCITS V Directive published on March 31st 2016.

EXTENSION OF THE DEPOSITARY REGIME TO PART II FUNDS

Currently, under the 2010 Law undertakings for collective investment structured as Part II funds fall under the regime of the AIFMD but are subject to a dual depositary regime:

- UCIs Part II managed by authorised AIFMs shall appoint a depositary which is

compliant with the depositary rules of the AIFM Law.

- On the contrary, where the Part II AIFM is only registered, the appointed depositary must currently comply with the rules contained in the 2010 Law.

The Luxembourg legislator extends the scope of the UCITS depositary regime to UCIs subject to Part II of the 2010 Law ("Part II UCIs"). The extension of the scope of the new rules regarding the depositary to all Part II UCIs without any distinction according to their assets under management ensures equal treatment and uniform protection for all retail investors whether they are investing in UCITS or in Part II UCIs.

CSSF press release 16/10 has clarified that the new depositary regime shall be applicable as from the date of the entry into force of the 2016 Law.

ADMINISTRATIVE SANCTIONS

The 2016 Law implements a new regime of administrative sanctions applicable to UCITS and Part II UCIs, their management companies, depositaries and all other entities contributing to the activities of such funds. The 2016 Law encourages the reporting of infringements to the CSSF ("whistle-blowing") and requires that the above mentioned funds, management companies, depositaries and entities contributing to the activities of such funds have in place appropriate procedures to allow for their employees to report infringements through a specific independent and autonomous channel.

The 2016 Law sets-up a list of breaches and minimum sanctions with the aim of creating a regime of sanctions harmonised with those of other European financial authorities) and defines the rules concerning the publication of such sanctions and their transmission to the European Securities and Markets Authority ("ESMA").

AMENDMENTS TO THE AIFM LAW AND IMPACT ON AUTHORISED AIFMS

The 2016 Law further introduces some amendments to the AIFM Law which do not derive from the changes introduced by the UCITS V Directive.

Authorised alternative investment fund managers ("AIFM") shall have their annual accounting documents audited by one or several independent auditors "*réviseur d'entreprise agréé*". These provisions will therefore be identical to those currently applicable to management companies under article 104 of the 2010 Law.

The 2016 Law clarifies that those management companies authorised under the 2010 Law and which have also requested an extension to become authorised as AIFMs (i.e. Super ManCos) may request their current auditor to audit their documents.

The role of the independent auditors will also be reinforced as they will now have the obligation to inform the CSSF of any fact or decision of the AIFM that is likely to constitute a material breach of the AIFM Law if they become aware of it whilst carrying out their duties.

Finally, the 2016 Law implements the provisions of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments amending Directive 2002/92/EC and the AIFMD ("MiFID 2 Directive") thus permitting Luxembourg authorised AIFMs to offer MiFID investment services (for which they have been authorised in Luxembourg), such as individual portfolio management and investment advice, on a cross-border basis. Indeed, for the moment these activities could only be performed in the country where the AIFM was authorised**.**

TIMING

The 2016 Law entered into force on June 1st 2016 and UCITS and management companies acting on behalf of UCITS, as applicable – must immediately comply with the provisions of the 2016 Law relating to depositary and remuneration aspects.

The CSSF issued a press release 16/10 in March in order to provide some clarity on the implementation of the depositary regime and the remuneration aspects. The press release also provides some deadlines. In this press release, the CSSF clarified that it would follow the timeline set by ESMA in its document "*ESMA Guidelines on Sound Remuneration Policies under the UCITS Directive*".

Prospectus	KIIDs	Annual Report
• The remuneration information prescribed by the UCITS V Directive and the 2016 Law has to be included on the first occasion the prospectus is revised and in any case no later than March 18th 2017.	• The KIID should be updated on the first occasion the KIID is revised/replaced or at the next compulsory annual update after March 18th 2016.	• ESMA clarified that it is not necessary to include the remuneration-related information in any annual report relating to a period that ended before March 18th 2016. • For annual reports relating to periods that end on or after March 18th 2016, but before the UCITS management company has completed its first annual performance period (in which it has to comply with the provsions relating to the implementation of remuneration policies as set forth under the UCITS V Directive), the UCITS management company should include the remuneration-related information in the report on a best efforts basis and to the extent possible, explaining the basis for any omission.

For further information on the 2016 Law you may access the document at the following address:

http://www.legilux.public.lu/leg/a/archives/2016/0088/a088.pdf#page=2

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