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Advantages and expertise of - and opportunities for - the Luxembourg Financial Sector in the creation and registration of microfinance investment funds

Executive Summary

1. It is unanimously admitted, nowadays, that microfinance constitutes a powerful tool to achieve poverty alleviation and economic and social progress, above all in developing countries.

As microfinance institutions based in developing countries mature and conduct their activities in a profitable manner, they are in need of supplementary financial resources, part of which are bound to originate from the financial sector of developed economies.

Microfinance investment funds play an increasing role in channelling such supplementary financial resources to microfinance institutions.

2. Generally speaking, Luxembourg offers an adequate legal, regulatory and fiscal framework for the incorporation of microfinance investment funds. The flexibility of the available legal vehicles, combined with a recognised regulatory framework and a favourable tax environment have shaped the Luxembourg financial sector's attractiveness. It further appears that service providers present in Luxembourg offer the skills which are necessary in order to be able to respond to the somewhat specific needs of microfinance investment funds. Actually, the Luxembourg financial sector has already attracted a proportionally significant number of microfinance investment funds and a number of further projects are about to be launched.

3. Certain impeding – and potentially deterrent – factors do exist, however, and these need to be addressed when it comes to defining initiatives aimed at rendering the Luxembourg financial centre even more attractive for this type of activity:

- Both because microfinance investment funds are generally of a limited size and because their profit margins remain modest, they are very cost sensitive, a factor which can handicap a financial centre with a developed regulatory framework generating, by definition, supplementary costs in setting up and running a fund.

- Because microfinance investment funds are not normally in a position to qualify as UCITS and, as such, to benefit from a European passport, their distribution in foreign jurisdictions is subject to restrictions. Therefore, an incorporation in the main country of distribution may be preferred.

- For funds with a geographical focus, it may be attractive to choose a place of incorporation which is located in the same region, in particular where a good regional network of double tax avoidance treaties already exists.

4. It seems, however, that in most cases, these potentially deterrent factors are outweighed by the advantages which the Luxembourg financial centre is offering to those who wish to set up a microfinance investment fund:

- *Without mentioning its overall reputation and the professionalism of its service providers with regard to investment funds, in general, the Luxembourg financial centre currently benefits from the fact that a proportionally significant number of investment vehicles dedicated to microfinance have made their way to Luxembourg, having successfully passed the "test" of the Luxembourg regulator ("CSSF") which, at the same time, has approved the investment managers specialised in microfinance.*

- *The broad range of investment vehicles provided for by the legal and regulatory framework, combined with the great flexibility offered by a number of these vehicles, notably when it comes to the definition of an investment policy, allow the Luxembourg financial centre to meet the rather specific needs of microfinance investment funds.*

- *The major flexibility offered by the "SIF" and the "SICAR" vehicles, such as the experience of Luxembourg service providers on certain matters which may be decisive for microfinance investment funds, provides considerable comparative advantages to the Luxembourg financial centre.*

- *Further, and without prejudice to the above mentioned constraints regarding distribution, the fact that the Luxembourg financial centre provides for a recognised regulatory framework opens the door to the registration, and thus the distribution, of Luxembourg incorporated microfinance investment funds in other jurisdictions.*

5. A number of measures, some of which are fiscal in nature while others aim at promoting the visibility of the sector, could further enhance the vocation of the Luxembourg financial sector to host microfinance investment funds.

On the other hand, there is a need for the Luxembourg financial community to integrate its microfinance-related activities into its overall communication and diversification policy. In this respect, the creation of a label for microfinance investment funds and the exemption of microfinance undertakings for collective investment from the subscription tax (taxe d'abonnement) were particularly welcomed.

Note

This memorandum is based on a study prepared by Mr Jacques Elvinger and Mr Marc Elvinger within the framework of the "Luxembourg Round Table on Microfinance" at the request of ATTF, with the support of the Luxembourg Ministry of Finance[1].

This study was presented during the Luxembourg microfinance week: Capital Markets – European Dialogue – Rural Finance, which was held from 17-19 October 2005 in Luxembourg.

As defined by ATTF, the aims of this study consisted in the examination of the following issues:

- *What are the main reasons for which certain existing microfinance investment funds have or have not been incorporated in Luxembourg?*

- *What can the Luxembourg financial centre offer to an entity wishing to incorporate a microfinance investment fund? What are the advantages and skills of which Luxembourg can currently avail itself with regard to this market segment?*

- *Which orientations can and should be taken, both publicly and privately, in view of positioning the Luxembourg financial sector on the market segment of microfinance investment funds?*

This memorandum is based on the same structure as the study mentioned above.

Sections 6. to 10. (previously sections 7. to 11.) have been updated. Only sections 1. to 5. (previously sections 1. and 3. to 6.) have been left unchanged. Although the latter have not been updated, the findings remain substantially relevant to date. *What is important to mention, however, is that in recent times increasing concerns have been raised with regard to making sure that microfinance achieves its social and development goals. Thus, in order to maintain the confidence of those who are ready to invest in microfinance because of the double bottom line promised, it will be important, in the future, to enhance the efforts made to measure the social performance of microfinance institutions (and of microfinance investment vehicles, such as investment funds) so as to enable investors to channel their investments towards those within these institutions which are able to show the best record in this respect.*

[1] This study may be found on www.ehp.lu (Legal topics, Investment funds and other investment vehicles).

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1. Some words about microfinance

1.1. What microfinance is about

It is obviously impossible to, in the context of this memorandum, enter into the details of microfinance.

In summary, microfinance originates in the finding that while a vast majority of the world's poor are deprived from any access to financial services, the fact to facilitate these persons' access to such services and in particular to microcredit, enables them to launch or further develop an economic activity and to thereby increase their revenue, their social situation and the educational level of their children.

Not only does microfinance enable its beneficiaries to improve their living conditions; it further allows them to become independent and to play their role as economic actors. It thereby enables people to regain dignity. Furthermore, at present, the majority of beneficiaries of microcredits are women and microfinance has shown to constitute a major tool in promoting women's rights.

While the present volume of microcredits has been evaluated at some 15 billion US dollars, the need for microcredits has been evaluated at no less than 100 billion US dollars[2]; some observers of the sector even put forward substantially higher figures.

While microfinance can promote altogether services, trade, production of manufactured goods and agriculture, it appears that the latter currently attracts the by far lesser part of microcredit, even though the vast majority of the world's poor make their living in agriculture. Agriculture thus represents a considerable growth potential for microfinance.[3]

While initially targeted mainly towards credit activities, microfinance can embrace, and indeed more and more embraces, other financial services such as savings, remittances and insurance.

1.2. Institutional aspects

At first sight, microfinance and investment funds would seem to be very far from each other. And indeed, microfinance institutions ("**MFIs**") constitute an indispensable link between those two extremes. It is the MFIs which, in the field, grant microcredits and, possibly, render other financial service to their clients, the "micro-entrepreneurs".

While initially MFIs were mainly of an NGO-type with no commercial orientation, more and more of them achieve or aim at achieving profitability and adopt legal structures reflecting this evolution. This does not, by itself, mean that they depart from their original objectives, i.e. poverty alleviation and promotion of economical and social independence. It goes without saying, however, that

[2] Etude Brugger Duggal, "Micro Finance Investment Funds: Looking ahead", KfW Symposium November 2004.

[3] Although, for a number of reasons (geographical remoteness of the beneficiaries; lower profit margins than in the trade sector; credit needs over longer periods combined with irregular cash flow) microfinance directed towards agricultural activities appears to be more difficult to be made profitable than microfinance directed towards trade activities in particular.

sticking to such objectives needs to be monitored on a permanent basis.

As MFIs get more professional and profit-oriented, and as their business grows, they are in need of attracting supplementary funding. This is where investment funds can play their role in providing such supplementary funding to MFIs.

In her presentation at the recent international Paris Conference "*Broadening the access to microfinance. challenge and actors*", Mrs Maria Novak stated that "*The current portfolio of MFIs the world over is estimated at 15 billion dollars and the growth of microfinance at 15 to 30% a year, creating a demand for credit resources of about 2,5 to 5 billion dollars and 300 to 400 million dollars in additional equity capital a year".*

While part of these resources are and need to be local resources – more and more MFIs have turned towards collecting savings – another part is bound to come from abroad. This is where microfinance investment funds have an important role to play.

1.3. Limitations on microfinance

The enthusiasm about microfinance and its obvious merits must not lead to believe that microfinance alone will eradicate poverty and underdevelopment. In particular, microfinance does not dispose of the need for investing in education, health and infrastructure in developing countries. Similarly, microfinance does not dispose of the requirements of good governance, nor does it by itself resolve issues such as the terms of trade in North-South commerce. This is to say that while governments should promote microfinance where they can, microfinance will not dispense them from tackling other issues on their agenda.

Reminding that microfinance alone will not resolve the problems of poverty and social exclusion is by no means intended to minimise its merits and potential. Those merits and potential appear to be enormous and call for a reinforcement of microfinance-related mechanisms and institutions. Here, microfinance investment funds have an important role to play.

2. The context: a sector with substantial growth potential in the medium term

2.1. While microcredit in particular and microfinance in general should not be viewed as a solution for all poverty-related problems[4], the merits of microcredit in reducing poverty and promoting social and economical development are currently undisputed. This is also the reason why the UN declared 2005 as the "International Year of Microfinance".

2.2. Those who analyse the sector forecast that it will experience substantial growth over the next years.

On the one hand, the need for microcredit is unanimously viewed as being very important in

[4] See above 1.3.

volume.[5]

On the other hand, more and more MFIs succeed in conducting their activities in a profitable manner. As a result thereof, they gain the capacity to address the market in order to obtain the financial resources needed in order to expand their activities.

2.3. The emergence and consolidation of sufficiently mature MFIs constitute a prerequisite for the development of microfinance investment funds because it is (only) in such sufficiently mature MFIs that microfinance investment funds can invest their assets.

There is however an interaction here: less commercially oriented investment funds accept to provide MFIs with financial means and technical assistance enabling them to achieve the level of professionalism and profitability which is required in order for them to be in a position to address the ordinary capital market, and thus also more commercially oriented investment funds.[6]

2.4. Considering the foregoing, it is normal that while microfinance as such and MFIs have already experienced substantial growth, the microfinance investment fund sector remains relatively modest for the time being. This is so even more if one focuses on funds pursuing a predominantly commercial aim, i.e. funds which aim at procuring – apart from a social benefit – an attractive financial return to their investors.[7]

The market segment appears to be even narrower – at the time being – if one focuses on structures which are open to the public and which thus address the investment community at large and private persons in particular.[8]

Even though this is likely to change in the medium term, as the maturation process of a larger number of MFIs goes on, it furthermore seems that the identification of investment opportunities by microfinance investment funds often requires significant time. Launching a microfinance investment fund thus often requires a period of time during which the fund actually remains poorly invested in microfinance.

2.5. It appears that in general microfinance investment funds are of low size, often a size below the one commonly considered to be commercially critical, i.e. between 20 and 30 million euro[9]. As for all funds of modest volume, this results in specific needs and constraints with regard to costs in particular.

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5 See above 1.1.

6 In his study "Microfinance Investment Funds", conducted for the Luxembourg NGO ADA and the German development Bank KfW and published in February 2005, Patrick Goodman classifies microfinance investment funds into three categories depending on their objectives, thereby distinguishing between "Commercial Microfinance Investment Funds", "Commercially oriented Microfinance Investment Funds" and "Microfinance Development Funds" (study, p.20). We shall revert in section 4 herebelow to this categorisation.

7 In his study, Goodman identified 43 funds in existence or about to be incorporated, including some 20 non commercial structures which he classifies among the "Microfinance Development Funds" and which are normally incorporated in the form of a foundation, a not-for-profit association or a co-operative structure.

8 In his study, Goodman identifies a little bit less than 10 structures which are open for investment coming from private persons (which does not mean that all of them may, legally speaking, be distributed to the public).

9 It however appears that some commercial microfinance investment funds have, in recent times, experienced sustained growth as a result of which they substantially exceed these volumes. In particular, the Dexia Microcredit Debt Fund has now reached a volume of some 80 million euro, whereas the responsAbility Global Micro Finance Fund has achieved a volume of some 40 million euro.

2.6. It follows from all the above elements that the microfinance investment funds sector offers considerable growth perspectives, albeit these are middle term perspectives rather than short term perspectives.

Luxembourg has an obvious interest in positioning itself on this developing market segment even though, at this stage, the profits arising therefrom for the Luxembourg financial centre will remain modest. Strategy-wise this by the way fits with the ambition of the Luxembourg fund industry not to focus exclusively on UCITS funds.

An active involvement with the sector will also have a positive impact on the financial centre's image, showing its dedication to sustainable development-related issues. It is an undisputed fact that there is increasing client demand for socially responsible investment products. Being able to satisfy such demand constitutes, and will constitute more and more, a competitive advantage for professionals of the financial sector wishing to meet the whole range of needs and demands of their clients.

3. Development oriented and commercially oriented microfinance investment funds: distinctive and common features

3.1. Three types and generations of microfinance investment funds

In his study on "Microfinance Investment Funds", Goodman notes that just as has been the case for MFIs, "*the first financial structures put in place in order to extend loans to MFIs were established by private donors and development agencies, again with a development objective in mind*" (p. 8). Goodman classifies vehicles of this type as "Microfinance Development Funds", and out of some forty "funds" he identified in 2004, not less than twenty belonged to this category with most – but not all – of them being set up in the form of not-for-profit-type structures.

In a second phase, vehicles have been put in place which, although initiated by development oriented entities (development banks and institutions; private foundations; NGOs …), had among their objectives to provide a fair financial return to those funding them. Goodman classifies this type of funds as "Commercially Oriented Investment Funds". In order to be (legally) in a position to channel a return on investment to their founders, these entities opt for commercial-type vehicles similar to those generally used for investment funds.

The third generation of funds identified by Goodman has been inaugurated in 1998, with the launch of the Dexia Micro-Credit Fund. These funds will be set up by actors coming from the "financial world" (banks, investment managers…) rather than by actors coming from the "development world". The objective of those setting up such funds is to enable their investor clients to participate in a project which is of interest not only for its financial return but also for its social return ("double bottom line"). In order to be in a position to be distributed among third party investors, these funds – which Goodman classifies as "Commercial Investment Funds" – will opt for legal vehicles enabling them to approach a larger range of investors.

3.2. Common requirements in terms of sustainability and quality

Whereas the differences between these three types of funds are undeniable (to an extent such that, for example, there will be hardly any reason for a "fund" of the first generation to turn towards Luxembourg as place of incorporation), the contrast with regard to their respective aims must not be exaggerated.

- As the sector becomes more and more professional, there seems to be unanimity about the fact that in order for microfinance to develop to an extent such that it can have a significant impact in terms of development and poverty alleviation, its sustainability in terms of profitability needs to be achieved at all levels in the chain (activities benefiting from microcredits; MFIs; funding structures of MFIs).

- On the other hand, microfinance investment funds (just as MFIs) will loose their credibility towards investors if they loose sight of the very preoccupation which has caused their emergence, i.e. combating poverty and promoting social and economic progress.

Any temptation to maximise profitability at the expense of quality at the level of the investments made will cause harm to the sector overall, in the medium and long run[10]. The Luxembourg financial community should thus, as far as possible, make sure that it participates only in projects which achieve a high standard in terms of quality[11].

4. The opportunity is not just about servicing microfinance investment funds

It has already been noted that while there is a substantial growth perspective for microfinance investment funds, the sector, for the time being, remains relatively modest in size (see above 2.4 and 2.5). We shall furthermore note, in section 8.2 herebelow, that in terms of profitability this segment of the fund industry may be less attractive for the service providers than the average.

However, it would be an error to, when appraising the opportunities which the sector offers to the Luxembourg financial community, ignore the links which the microfinance investment fund sector entertains with other activities which are of interest for Luxembourg.

On the one hand, microfinance investment funds must be viewed as forming part of the wider category of socially responsible investment funds. On the other hand, services to the microfinance

[10] In her address to the previously mentioned Paris Conference, Mrs Maria Novak seemed to express some concern in this respect: "*Today, we find ourselves in a rather strange situation. On the one hand, there is emphasis on the fight against poverty and the social impact of microfinance, the choice tool for reaching the Millennium Development Goals; on the other hand, there is the call for a strict business approach and a leading role for banks. At a time when businesses are signing on to (...) socially responsible investments, microfinance seems to be turning its back to its roots and speaks only of profits and market share. It would be unfortunate to separate the two sides of the coin – the social and the financial - because it is precisely in the marrying of the social and the financial that microfinance innovates. The actions of all actors need to be supported. It is only through the cross-fertilisation of the different experiences that microfinance can move forward*".

[11] As to this, it is interesting to note that after credit rating, social rating of MFIs is currently emerging (see, in particular, Micro-Credit Ratings International Ltd (M-CRIL)).

sector are not limited to services to microfinance investment funds, as illustrated in particular by securitisation transactions.

4.1. Microfinance investment funds and socially responsible investment funds

While microfinance investment funds currently represent only a very small part of the fund industry, the figures speak a different language when one turns to socially responsible investment funds in general. Even leaving apart banks which offer no but this type of funds to their clients, it appears that for certain traditional banks, the segment of socially responsible funds currently represents a considerable part of their business.[12]

Now, it is reasonable to consider that for any credit institution aiming at being significantly present on the market segment of socially responsible investment funds, the capacity to offer investment opportunities in microfinance investment funds is of importance.

4.2. Microfinance offers further opportunities to the financial centre: the example of securitisation

Securitisation transactions will play an increasing role in the financing of MFIs13 and Luxembourg should be in a position to offer its services for such transactions.[14]

The interaction with the sector of microfinance investment funds is obvious here, considering that the securitisation of loans granted to MFIs facilitates the investment by microfinance investment funds. And depending on the characteristics of the securities issued in such securitisation transactions, the problem arising from the rather illiquid character of investments in microfinance might, in the medium term, become less stringent.

There is thus a positive interaction between the development of the microfinance investment fund sector and securitisation deals. And it is a fact that the Luxembourg financial sector can service both these activities.

5. The needs in a nutshell: a great amount of flexibility in an environment with recognised supervision and favourable tax treatment

5.1. A great need for flexibility, in particular with regard to investment policies

[12] From information communicated by Dexia in particular, it appears that more than 10% of the assets under management of Dexia are said to be invested in accordance with socially responsible criteria.

[13] Blue Orchard, an investment manager specialised in microfinance, has participated in launching an 87 million dollar securitisation deal with underlying loans to 14 MFIs (most of them located in Latin America). While this transaction has been launched in the United States, similar transactions shall no doubt, in the future, be launched from other countries. Another micro-finance related securitisation transaction is already, at present, about to be launched out of Luxembourg.

[14] As to the legislation enacted in Luxembourg with regard to securitisation transactions, see also our memo *Summary of the Law of 22 March 2004 on securitisation*, on www.ehp.lu; (Legal topics; Corporate, banking, finance, securities and financial markets).

5.1.1. In order to cope with the various needs of MFIs, microfinance investment funds need – subject to the policy which they pursue in terms of risks to be assumed – to be in a position to invest into equity, debt and possibly guarantees.

At present, funds which are primarily development oriented will typically invest into equity, while funds which are primarily commercially oriented will rather invest into debt. But both types of investments can also be made in parallel and in variable proportions.

There is further the need for the possibility to invest into other investment funds, including local funds.

5.1.2. At present, investment instruments issued by MFIs are hardly ever listed on a stock exchange or a regular market. Any fund intending primarily to invest into microfinance will thus have to be in a position to invest into assets which are not easily tradable and have an investment portfolio with limited liquidity, subject to adapted valuation mechanisms.

In particular, the possibility for investors to exit the fund must be framed in accordance with the fund's limited liquidity.

While the investment into debt instruments may allow for an increased liquidity thanks to an adequate diversification of the portfolio in terms of the number of loans granted and their respective due dates, investment into equity will normally result in high illiquidity such as that which is typically encountered in private equity vehicles where investors often have to accept that they will not be in a position to exit the vehicle throughout its life.

5.1.3. Microfinance investment funds wishing to be in a position to invest into foreign, possibly local currencies, will need to be able to hedge the currency risks resulting therefrom. It however appears that currently microfinance investment funds investing into debt instruments tend to extend loans in dollar and euro only, thus leaving it to the borrower to protect himself against corresponding currency risks.

5.1.4. One way of encouraging private institutional investors and, possibly, private individuals, to invest into microfinance, notwithstanding the increased risks commonly associated with this type of investment, consists in structuring funds with various risk tranches where certain investors – such as the promoters or managers of the vehicle as well as development institutions or other actors having a longer track record in investing into microfinance – accept a subordinated position in the fund, thereby reducing accordingly the risks incurred by other investors. Logically, these different risk profiles should be reflected at the level of the expected returns on investment.

Concerning investment risks, it by the way seems that the microfinance sector would be well advised to develop on enhanced communication and information policy: indeed, while microfinance is often – and somewhat instinctively – perceived as presenting a rather high risk profile, the reality seems not to support such perception. To the extent, further, that the microfinance sector appears to be largely decorrelated from the evolution of the formal banking sector and the overall formal economy, microfinance offers investors the opportunity to diversify their investment risks. Microfinance is, therefore, increasingly referred to as a "new asset class".

5.1.5. One should also mention a double evolution which microfinance investment funds need to take into consideration when defining their investment policy:

One the one hand, certain MFIs enlarge the scope of their activities beyond microcredit (collection of savings; remittances; insurance …) and increase the average size of their credits, servicing also small and medium enterprises. These MFIs are thereby led to conduct their activity under a regular banking (or similar) licence.

On the other hand, certain traditional banks downscale their activities and enter the microfinance sector, either directly or through dedicated subsidiaries.

In both cases, microfinance investment funds are, at some point in time, confronted with the question to which extent they want to continue or start investing into this type of mixed institutions: which is the amount above which credit does no more qualify as microcredit; which is the admissible mix of activities? These are questions which need to be addressed when defining an investment policy[15].

5.1.6. Also, it must be noted that depending on the geographical area in which an MFI conducts its activity, the borders of microfinance are shifting. Whereas in certain developing countries of the third world, a credit of less than hundred dollars may be the general rule in microfinance, things may be quite different in such or such Eastern country where microfinance is also developing.

5.2. A need for a well supervised environment

As to this, the position and needs of microfinance investment funds are not really different from those of other investment funds.

The necessity to incorporate in a jurisdiction providing for adequate supervision and investors protection is particularly obvious for investment funds which aim at addressing a large range of investors, if not the public at large: the need to benefit from the investors' confidence and to be legally in a position to distribute the fund on a sufficiently broad basis, are factors which cannot be ignored.

However, it appears that even where such factors are of lesser importance – in particular where the investors are at the same time the initiators of a fund which does not aim at addressing the public – there is an increasing inclination to opt for a jurisdiction with recognised regulatory supervision.

For example, while a "pioneer" fund such as *Pro Fund* – with a small number of investors most of which were development institutions – was incorporated in Panama, similar funds do currently hesitate to incorporate in offshore financial centres. Increasing expectations with regard to good governance standards with which such investors need to comply are certainly part of this evolution.

[15] See, as to this, the criteria proposed in the study of M. Damien von Stauffenberg ("Quality label for microfinance investment funds") for the identification of eligible MFIs.

It remains that for funds to which factors like regulatory supervision and investors' protection are not essential, other factors, such as the speed of setting up a fund, high flexibility and low costs remain very attractive. Certain financial centres which, without being straight forward offshore centres, offer a legal and fiscal environment imposing little constraints on fund initiators, may be viewed as very attractive. One may note that *Africap*, a fund recently incorporated on the model of *Pro Fund*, and with to a large extent the same investors, has chosen Mauritius as place of incorporation.

5.3. A favourable tax environment

Here again, microfinance investment funds present little specificity compared to investment funds in general.

The tax aspect is multidimensional: taxation of the fund *per se*; taxation of the fund's revenues in the countries in which the fund is invested; investors' taxation; taxation of services rendered to funds (VAT in particular). In some of these respects, the existence of a good network of double tax avoidance treaties may form a necessary component of a tax environment attractive for investment funds.

While there may be further causes explaining this, it is quite significant that two microfinance investment funds addressing the public at large are based in the Netherlands, a country which has put into place a tax incentive scheme benefiting private individuals investing into socially responsible investment funds and, among these, microfinance investment funds.

6. The legal, regulatory and fiscal framework offered by Luxembourg

6.1. General overview

Luxembourg today offers a broad range of investment vehicles that may be used by a promoter/initiator wishing to set up a vehicle investing in microfinance.

This memorandum deals exclusively with investment vehicles subject to the supervision of the Commission for the Supervision of the Financial Sector (*Commission de Surveillance du Secteur Financier* or "**CSSF**") and which shall hereafter be collectively referred to as "**Regulated Investment Vehicles**").

Those vehicles may take the form of traditional undertakings for collective investment that may be marketed to retail investors ("**Public UCIs**"), an investment company in risk capital ("**SICAR**") and a specialised investment vehicle ("**SIF**"), the last two being reserved for "well-informed investors".[16]

[16] Although falling outside the scope of this memorandum, it is worth mentioning that besides the above Regulated Investment Vehicles, the financing of microfinance activities may also be realised through other Luxembourg platforms, such as an ordinary, non-regulated company (so-called "SOPARFI"), a securitisation vehicle or a foundation.

All these vehicles have specific features. For instance, not all of them are appropriate for all types of investors. Although they are all subject to the supervision of the CSSF, some are subject to a somewhat lighter prudential regime. And some of these vehicles are subject to certain restrictions in terms of investment rules. Also the tax regime applicable to each of them may vary.

The choice of the most appropriate structure requires an analysis of the specific needs of the promoter/initiator and notably the type of investors that the promoter/initiator is targeting, the jurisdictions in which these investors are located, the kind of investments which the contemplated structure will make and which vehicle would be the most tax-efficient.

All of the above-mentioned vehicles have been "tested" in the context of microfinance projects.

These vehicles are subject to various Luxembourg specialised laws which govern the setting up and operation of investment vehicles of different types. These laws also refer to the legal forms which any such investment vehicles can adopt, referring in the case of a corporate form generally to the Luxembourg Law of 10 August 1915 regarding commercial companies. It is not possible in this memorandum to discuss in detail the numerous possible structures which result from a combination of the different types of funds and legal forms available. This memorandum will therefore be limited to a general description but will concentrate on those aspects which may be of particular relevance in the structuring of funds investing in microfinance.

In addition to the general legal, regulatory and fiscal regimes, it may be relevant to specifically mention certain flexibilities afforded by the Luxembourg legislative framework which may be of particular interest for structuring microfinance investment funds.

6.1.1. Types of Regulated Investment Vehicles

There are two main categories of Luxembourg Regulated Investment Vehicles, i.e. undertakings for collective investment ("**UCIs**") and SICARs.

SICARs mainly differ from UCIs in that they are not required to operate under the principle of risk-spreading, their object must necessarily be to invest in risk capital and they are subject to a different tax regime.

6.1.1.1. UCIs

Depending on the applicable regime, three types of UCIs may be distinguished, i.e. UCITS, Part II Funds and SIFs.

UCIs whose securities are intended to be placed with the public are governed by the Law of 17 December 2010 concerning undertakings for collective investment[17] (the "**Public UCIs Law**"). The Public UCIs Law differentiates in its Parts I and II between two types of investment funds.

[17] The Law of 17 December 2010 aims mainly at implementing Directive 2009/65/EC on UCITS (so called UCITS IV) but it also introduces a number of other changes to the current Luxembourg investment fund legislation. The Law of 17 December 2010 repeals the Law of 20 December 2002 with effect as from 1 July 2012 (except Articles 127 and 129 which were repealed with effect from 1 January 2011).

Part I of the Public UCIs Law deals with undertakings for collective investment in transferable securities ("**UCITS**") which are regulated pursuant to Directive 2009/65/EC of 13 July 2009 (the "**UCITS Directive**")[18], whereas Part II of the Public UCIs Law governs Public UCIs which are not subject to the UCITS Directive ("**Part II UCIs**" or "**Part II Funds**").

The Law of 13 February 2007 on specialised investment funds (the "**SIF Law**", together with the Public UCIs Law, the "**UCI legislation**"), provides for the opportunity to set up UCIs dedicated to one or several well-informed investors ("**specialised investment funds**").

- UCITS may only invest in transferable securities, units of other investment funds, deposits with credit institutions, financial derivative instruments and money market instruments. The transferable securities (meaning securities, bonds and similar securities or instruments) and the money market instruments need to be listed on a stock exchange or dealt in on another regulated market, except that up to 10% of the assets of the UCITS may be invested in non-listed transferable securities. Apart from being required to limit its investments to the aforesaid securities and instruments, a UCITS must comply with specific diversification and concentration limits specified in Part I of the Public UCIs Law which reflects the restrictions imposed by the UCITS Directive. For example, a UCITS may not invest more than 10% of its net assets in securities of the same issuer (diversification limit) and may not acquire more than 10% of the securities issued by a single issuer (concentration limit). A UCITS must be open-ended for redemptions, meaning that investors must have the right to request the UCITS to redeem their securities at least twice a month. UCITS benefit from a so-called European "passport" under the UCITS Directive (the "**UCITS Marketing Passport**") allowing them easily to market their securities throughout the European Economic Area (the "**EEA**") without restrictions as to the target investors (including the general public).

- Part II Funds are defined as undertakings for collective investments which invest in assets in accordance with the principle of risk-spreading. By referring to assets, Part II of the Public UCIs Law does not restrict the eligible investments and, accordingly, a Part II Fund may invest in any type of assets, comprising unlisted securities and loans or may grant guarantees for investment purposes. The Public UCIs Law requires that a Part II Fund operates under the principle of risk-spreading but does not impose any specific diversification or concentration limits. The CSSF has issued guidelines in that regard. In brief, if its investment policy so justifies, a Part II Fund may invest, even exclusively, in non-listed securities, and/or a substantial portion of its net assets in one single issuer (subject to the fulfilment of a minimum diversification) and may not be limited as to the maximum percentage of the securities of any one issuer it may acquire. Part II Funds are not subject to strict rules or restrictions as to the frequency at which securities have to be redeemed at the request of investors. Accordingly, a Part II Fund can be structured as a closed-ended investment fund where investors can exit only at the time of liquidation. Part II Funds, once authorised by the CSSF, can be publicly distributed in Luxembourg. Although they may not benefit from the UCITS Marketing Passport referred to above, Part II Funds may, under certain circumstances, benefit from a European marketing passport. Yet, the passports that

[18] The expression "UCITS" will refer in this memorandum exclusively to investment vehicles that are compliant with the UCITS Directive.

may be available for open-ended Part II Funds are restricted to professional investors and, in certain circumstances, to high net worth individuals[19]. Part II Funds not benefiting from a marketing passport can in practice generally be sold outside of Luxembourg only on a private placement basis in accordance with the local rules in the country concerned.

- Restrictions applicable to investments of a SIF are even more relaxed than those applicable to Part II Funds. SIFs are reserved to well-informed investors who are able to adequately assess the risk associated with an investment in such a vehicle. The SIF Law provides for an extended definition of well-informed investors which comprises institutional investors and professional investors but also other well-informed investors who confirm in writing that they adhere to the status of well-informed investors and either invest a minimum of 125,000 euro or benefit from an assessment made by a credit institution , an investment firm or a management company (as defined in the SIF Law) certifying their capability to appraise the contemplated investment and the risk thereof. This third category of well-informed investors means that sophisticated retail or private investors are authorised to invest in SIFs. Like Part II of the Public UCIs Law, the SIF Law allows significant flexibility with respect to the assets in which SIFs may invest. Accordingly, the regime can be opted for by vehicles investing in any type of assets and pursuing any type of investment strategies. SIFs qualify as UCIs and are thus subject to the principle of risk-spreading. The SIF Law does not provide for specific investment rules or restrictions in that regard. The CSSF has, however, issued some guidelines. In practice, the CSSF accepts that SIFs may be subject to less stringent diversification rules than Part II Funds. Besides, SIFs benefit from a particularly flexible corporate regime. SIFs may be of the open-ended or closed-ended-type. Like Part II Funds, SIFs do not benefit from the UCITS Marketing Passport but may, under certain circumstances, benefit from a European marketing passport. Yet, the passports that may be available for open-ended SIFs are restricted to professional investors and, in certain circumstances, to high net worth individuals[20].[21]

In summary, it is clear that UCITS must operate within fairly strict investment and liquidity constraints but at the same time they offer possibilities for distribution to the public all over the EEA.

In contrast, Part II Funds are very flexible in terms of eligible investments and in terms of adapting the liquidity features to the targeted investments, but benefit from less flexibility in terms of distribution to the general public on a cross border basis.

Finally, SIFs offer even greater flexibility in terms of corporate structure and investment rules and a lighter prudential regime than that applicable to Part II Funds, but they must be reserved for well-informed investors and are subject to a similar regime as Part II Funds in terms of cross-border marketing.

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19 For further details as to the passport, please refer to section 7.

20 For further details as to the available passports, please refer to section 7.

21 For more details on SIFs, see also our memorandum *Luxembourg specialised investment funds: investment funds dedicated to sophisticated investors*, on www.ehp.lu (Legal topics, Investment funds and other investment vehicles).

6.1.1.2. SICARs

The Law of 15 June 2004 (the "**SICAR Law**") relating to the investment company in risk capital (SICAR) regulates investment companies whose object is to invest their assets in securities representing risk capital, defined by the SICAR Law as "the direct or indirect contribution of assets to entities in view of their launch, their development or their listing on a stock exchange". The preparatory works of the SICAR Law clarify that this definition includes any type of contribution of assets, be it in the form of capital, debt or financing of the "mezzanine" or "bridge" type.

A SICAR is not required to operate under the principle of risk-spreading, which implies that it can invest in a limited number of target investments, or even a single such investment.

As for a SIF, the securities issued by a SICAR are reserved to well-informed investors[22].

Further, a SICAR is also subject to a somewhat "lighter" regulatory regime and benefits from a very flexible corporate regime.

In a similar manner to Part II Funds regulated by the Public UCIs Law and SIFs, a SICAR cannot benefit from the UCITS Marketing Passport but may, under certain circumstances, benefit from a European marketing passport. Yet, the passports that may be available for open-ended SICARs are restricted to professional investors and, in certain circumstances, to high net worth individuals[23].

6.1.2. Legal forms

Each of the aforesaid laws refers to the legal forms which Regulated Investment Vehicles can adopt.

Both Public UCIs and SIFs may be established under the form of either a fund of the contractual-type, *fonds commun de placement* ("**FCP**"), or a fund of the corporate-type, an investment company.

It should be noted that the UCI legislation does not limit the legal forms under which a UCI that does not qualify as a UCITS can be established, therefore other forms are in principle available for those UCIs.

A SICAR must adopt one of the corporate forms listed by the SICAR Law, i.e. a common limited partnership (*société en commandite simple* or "**SC Simple**"), a special limited partnership (*société en commandite spéciale* or "**SC Spéciale**"), a partnership limited by shares (*société en commandite par actions* or "**SCA**"), a cooperative in the form of a public limited company (*société coopérative sous forme de société anonyme* or "**ScoSA**"), a limited company (*société à responsabilité limitée* or "**SàRL**") or a public limited company (*société anonyme* or "**SA**").

This memorandum will be limited to describing (hereafter) only the most common legal forms.

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[22] The term "well-informed investor" has the same definition under the SICAR Law and the SIF Law.

[23] For more details on SICARs, see also our memorandum *Setting-up a Luxembourg investment company in risk capital (société d'investissement en capital à risque, "SICAR")*, on www.ehp.lu (Legal topics, Investment funds and other investment vehicles). For more details on the passport, please refer to section 7 of this memorandum.

6.1.2.1. Contractual-type vehicles

The first feature to which the UCI legislation refers is a contractual-type fund called in French *fonds commun de placement* which, in terms of structure, is somewhat similar to an English unit trust.

An FCP is not in itself a legal entity, but a co-proprietorship of assets which is managed by a management company.

Investors subscribe for units in an FCP which represent a portion of the net assets of the fund. Unitholders are only liable up to the amount contributed by them.

An FCP is not subject to Luxembourg company law, which makes this type of vehicle rather flexible.

The rights and obligation of the unitholders and their relationship with the management company are defined in the management regulations.

All decisions relating to the investments and the operation of the fund are taken by the management company on behalf of the FCP.

Unlike investors in an investment company (as explained below), investors in an FCP are entitled to vote only if and as far as the management regulations provide for such a possibility. This is usually not the case, which makes the FCP an optimal vehicle for promoters/initiators who wish to keep control over the UCI.

The FCP not being a legal entity, it may constitute an appropriate vehicle in circumstances where tax transparency is aimed at.

6.1.2.2. Corporate-type vehicles

The second possibility offered to the promoter/initiator of a Public UCI or SIF is the establishment of an investment company, i.e. a corporate-type fund.

SICARs have no choice other than to be established under a corporate form.

6.1.2.2.1. Capital structure

A Public UCI or a SIF established under a corporate form or a SICAR may be created either with variable capital[24] or with fixed capital[25].

[24] A UCI established under a corporate form with variable capital is referred to as a "SICAV".
[25] A UCI established under a corporate form with fixed capital is referred to as a "SICAF".

The capital of a company with variable capital is always equal to its net assets. It may be increased or reduced automatically as a result of new subscriptions or redemptions, with no need for formalities such as the approval of the general meeting of shareholders or the intervention of a public notary.

A company with fixed capital requires somewhat more complicated formalities to reduce or increase its share capital but by means of adequately structured capital comprising par value and premium, this company can issue further shares or redeem its own shares in a manner similar to a company with variable capital.

6.1.2.2.2. Corporate forms available

Although other corporate forms are available and sometimes used, most of the UCIs that are established under a corporate form and most SICARs adopt in practice the form of either a public limited company (*société anonyme* or "**SA**") or a partnership limited by shares (*société en commandite par actions* or "**SCA**").

In the case of an SA the board of directors, appointed from time to time by the shareholders, is in charge of the management and administration of the company, and may delegate investment management or advisory functions to local or foreign experts, and administration to local service providers.

In this structure, the shareholders are convened at least once a year for an annual general meeting to approve the accounts and to appoint or reappoint, as appropriate, the directors of the company. Besides, major decisions concerning the company such as amendments to the articles of association must be approved by the general meeting of shareholders.

An SCA has two different types of participants:

i) The "*associé-gérant commandité*", subscribing for management share(s) and who, by operation of law, is liable for any obligations that cannot be met out of the assets of the SCA. The "*associé-gérant commandité*" is responsible for the management of the SCA.

ii) The "*associés commanditaires*", subscribing for ordinary shares, whose liability is limited to the amount of their investment in the SCA.

In the aforesaid structure, the promoter/initiator or manager would usually subscribe to management share(s) through a limited liability company in order to limit its "unlimited" liability arising from holding those management shares and acting as manager. Investors would subscribe for the ordinary shares.

The "*associé-gérant commandité*" may only be removed as manager of the SCA by an appropriate amendment of the SCA's articles of association, but, unless otherwise provided for in the articles of association of the SCA, any such amendment would have to be approved by the "*associé-gérant commandité*" thus assuring that a replacement is not possible without the manager's approval.

It should be noted that a new type of investment vehicle, namely the new special limited partnership (*société en commandite spéciale*) has been introduced recently into Luxembourg law. This vehicle, which has no personality, is very similar to the Anglo-Saxon LP which has traditionally been favoured for private equity investments.

The special limited partnership is a partnership entered into, for a limited or unlimited duration, by one or more unlimited or general partners (*associés commandités*) with unlimited and joint and several liability for all the obligations of the partnership, with one or more limited partners (*associés commanditaires*) contributing only a specific amount pursuant to the provisions of the limited partnership agreement (*contrat social*).

The applicable law provides for a limited number of mandatory rules, but more importantly, it offers flexibility and freedom in the organisation of the special limited partnership[26].

6.1.2.3. Making a choice between the legal forms available

There are a number of aspects to be considered when choosing between the different legal forms available.

One consideration is the fiscal situation of the targeted investors. Indeed, depending on their nationality or place of residence, they may be in a different tax situation depending on whether they own units in a UCI or a SICAR or even whether a UCI is of the contractual-type or of the corporate-type, or is established with variable or fixed capital.

Another aspect that may be considered when choosing the legal form is the control which the promoter/initiator wishes to exercise over the investment vehicle. In the case of an FCP, in principle there are no unitholders' meetings and the unitholders cannot, as a rule, replace the management company or take control, by any other means, over the vehicle.

This is possible, at least theoretically, in the case of an investment company established under the form of an SA where the shareholders appoint the directors at general meetings and where, therefore, a majority of shareholders could take control of the investment company, replace members of the board of directors and thereby also remove or appoint investment advisers and other service providers. The risk of unfriendly takeover is reduced, however, where the vehicle is open-ended since the bidder has no assurance that the investors will remain.

Should the taking of control over the vehicle be a real concern for a promoter/initiator who wishes to set up an investment vehicle in a corporate form, it would still be possible to use the format of the SCA which was referred to previously and where the holders of management shares were definitely to keep control of the vehicle.

[26] For more details on the characteristics of the special limited partnership see our memorandum in the Legal Topics section on our website www.ehp.lu.

A third item to consider are the habits and customs of the targeted investors. In certain jurisdictions, investors are more familiar with the contractual-type fund, in other jurisdictions they are more familiar with the corporate-type fund.

As to the difference between an investment company with variable capital and an investment company with fixed capital, the usual choice would be the one with variable capital which is easier to handle from an administrative point of view. An investment company with fixed capital is used only in specific circumstances, such as Public UCIs which are closed for redemptions and where it is necessary to issue shares below the net asset value, for example if the initial shares are issued with warrants to subscribe further shares at a predetermined fixed price. Unlike a SICAF, SICAVs governed by the Public UCIs Law must indeed issue their shares at a price based on the net asset value per share, i.e. the net asset value of the SICAV divided by the number of shares outstanding. Furthermore, unlike SICAVs governed by the Public UCIs Law, a SICAF may issue partly paid-up shares, which may be of interest in certain circumstances. It should be noted that a SIF or a SICAR, whatever its form, can issue partly paid-up shares.

6.1.2.4. Umbrella and multiple class structures

Regulated Investment Vehicles may be established as a vehicle with multiple compartments, (a so-called "umbrella vehicle") provided the constitutional documents provide for such a possibility.

This structure permits the creation of compartments, within one legal entity, each having a different investment policy or other different features such as compartments with portfolios which are managed by different investment managers or compartments which are open to different types of investors.

In all of these circumstances, each compartment is linked to a specific portfolio of investments which is segregated from the portfolio of investments of the other compartments, unless the constitutional documents of the investment vehicle provide otherwise. Pursuant to this principle, although the umbrella vehicle constitutes one single legal entity, the assets and liabilities of a compartment are exclusively liable for their own debts and obligations.

Furthermore, different classes of shares may be created within a Regulated Investment Vehicle or even within the compartments of an umbrella Regulated Investment Vehicle. The creation of different classes of shares does not always require the creation of a segregated portfolio of underlying investments for each class of shares. In certain circumstances it may be more appropriate to pool the subscription proceeds of different classes of shares and to invest them in a common portfolio in accordance with a common investment policy. This is used particularly in investment vehicles where, upon the specific needs of the targeted investors, there are distribution shares and capitalisation shares. The same structure is used where investors have the choice between hedged shares and unhedged shares in which case specific hedging techniques are only used for one class of shares. Classes with other characteristics may be created such as classes with different sales charges, redemption features or currency denominations. In these structures, the underlying investments are the same for all classes of shares, but the net asset value per share of each class may become different, for instance, as a result of distribution of dividends for one class only or in case of hedging, upon the conclusion of hedging transactions on behalf of one class of

shares only. It should be noted that, unlike compartments, there is no segregation between the assets and debts of the different classes of shares.

The main interest in these various structures is their efficient combination in one single undertaking.

6.1.3. Prudential supervision

All Regulated Investment Vehicles are subject to permanent supervision by the CSSF. The scope of this supervision may vary depending on the specific law applicable to the relevant investment vehicle.

6.1.3.1. The CSSF carries out its supervision firstly at the time of creation of the investment vehicle, then when it pursues its investment activity and finally at the time of its liquidation. When the investment vehicle is created, the CSSF has to approve all constitutive documents (including the prospectus) the choice of the directors (and depending on the type of investment vehicle investment managers), the central administration, the custodian and the auditor. During the life of the investment vehicle, any change to the constitutive documents as well as any change of director or any change of the aforementioned service providers requires prior CSSF approval. When the investment vehicle is liquidated, the CSSF has to approve the liquidator and remains competent for the supervision until the close of the liquidation.

All aforesaid persons and service providers must be approved by the CSSF on the basis of their good reputation and professional experience.

In case of non-compliance with the applicable laws and regulations, the CSSF can withdraw its authorisation for the investment vehicle concerned.

6.1.3.2. The CSSF requires that Public UCIs should be created at the initiative of a "promoter"[27] which the CSSF defines as being "the entity which has initiated or originated the creation of the investment fund, which determines the scope of its activity and which benefits from its creation". The CSSF considers that the role of the promoter is to "meet, where necessary, requests for indemnification resulting from irregularities or improper management or administration of the UCI".[28] In order to ensure that the promoter can meet these obligations, the CSSF generally requires that the promoter is a financial institution with appropriate financial resources.

SIFs and SICARs are subject to a somewhat "lighter" prudential regime than Public UCIs in that a SIF or a SICAR does not need to be set up by an institutional promoter, approved by the CSSF, with significant financial resources. Also, even though the SIF Law in principle requires that the investment manager[29] of the SIF is subject to prudential supervision, it leaves the doors open in certain circumstances for the approval of a non-regulated entity provided notably that the relevant

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[28] CSSF Activity Report 1990, p. 55 and 56.

[29] As indicated in section 7, Directive 2011/61/UE of the European Parliament and of the Council of 8 June 2011 on alternative investment fund managers (the so-called "AIFM Directive") (which has been implemented in Luxembourg by the Law of 12 July 2013 on alternative investment fund managers) regulates investment fund managers and, indirectly, the funds they manage. By virtue of the Law of 12 July 2007, investment managers of SIFs, SICARs and Part II Funds may (notably depending on the level of assets under management) thus be required to be authorised under the aforementioned Law.

entity is of sufficiently good repute and has sufficient experience in view of the type of specialised investment fund concerned. As far as SICARs are concerned, the financial standing or regulatory status of the investment manager will not need to be checked by the CSSF, subject to the requirements of the Law of 12 July 2013 on alternative investment fund managers[30]. Only the directors who formally represent a SICAR, i.e. in the case of limited partnerships, the general partner[31] and, in the case of public limited companies and private limited companies, the members of the board of directors or managers, must be approved by the CSSF.

6.1.4. Tax considerations

6.1.4.1. In Luxembourg, UCIs are not subject to any tax other than, in principle, a subscription tax (*taxe d'abonnement*) as provided for in the UCI legislation. This tax is levied quarterly on the net assets of the UCI on the last day of the relevant quarter at a rate of 0.05% or 0.01% in certain cases. There are also certain cases of exemptions.

The UCI legislation exempts Public UCIs and SIFs and individual compartments of umbrella Public UCIs and SIFs, whose main object is the investment in MFIs, from the subscription tax.

UCIs which adopt the legal form of an investment company might claim the benefit of a tax treaty on their own behalf depending on the wording and the interpretation of the relevant tax treaty. With respect to more than 35 tax treaties signed by Luxembourg, the Luxembourg tax authorities have specifically agreed with the local tax authorities that the tax treaty would be applicable to those UCIs[32]. For a certain number of other countries with which Luxembourg has also entered into a tax treaty, no such agreement has been reached.

6.1.4.2. For SICARs, the SICAR Law provides for a tax regime which is fundamentally different from the one described above in relation to the UCI legislation. The SICAR Law provides for a tax regime under which an opaque SICAR is subject to general corporate income tax and municipal business tax, but the income resulting from securities invested into private equity investments as well as income resulting from the transfer, contribution or liquidation of these investments does not constitute taxable income. As a result, if a SICAR is fully invested in a portfolio of private equity investments, it will not be subject to tax on revenues resulting from that portfolio. Being subject to corporate income tax, an opaque SICAR qualifies as Luxembourg resident entity under the tax treaty and the Luxembourg tax authorities will issue a tax-resident certificate for the SICAR. A SICAR, in the same manner as UCIs, is exempt from net wealth tax.

6.1.4.3. UCIs and SICARs benefit from favourable VAT treatment in that Article 44 §1 d) of the amended Law of 12 February 1979 concerning VAT (the "**VAT Law**") provides that the *management* of such investment vehicles is exempt from VAT. The term *management* is interpreted by the tax authorities as including not only investment management services but also administration services (as listed in Annex II of the UCITS Directive) and any other service which would be

[30] Please refer to footnote 29.
[31] In practice, the approval of the general partner is subject to the approval of its board members by the CSSF.
[32] It concerns as at the date of this memorandum the following countries: Germany, Armenia, Austria, Bahrain, China, Finland, Indonesia, Ireland, Malaysia, Malta, Monaco, Morocco, Uzbekistan, Poland, Portugal, Qatar, Romania, Republic of Korea, Singapore, Slovakia, Spain, Thailand, Trinidad and Tobago, Tunisia, Turkey, Vietnam, Azerbaijan, Denmark, United Arab Emirates, Georgia, Hong Kong, Israel, Moldavia, Mongolia, San Marino and Slovenia.

deemed specific and essential to the management of the UCI or of the SICAR. On the other hand, purely material or technical services as well as the services rendered in the framework of their control and supervisory function by custodian banks are not exempt from VAT under Article 44 §1 d) of the VAT Law and are therefore subject to VAT at the rate of 15% (standard rate) or 12% (for services rendered in the framework of its control and supervisory function by the custodian bank) as the case may be.

6.2. *Assessment: Luxembourg offers an appropriate legal and tax framework for the setting up of microfinance investment funds*

In light of the characteristics of the legal regimes and tools described above and our understanding of the specific needs of microfinance investment funds, it appears that Part II Funds created under the Public UCIs Law, SIFs and SICARs are the most appropriate investment vehicles to undertake microfinance investments and invest in MFIs. This seems to be confirmed by practice insofar as the currently existing Luxembourg microfinance investment funds are mostly Part II Funds and SIFs with also a few SICARs.

6.2.1. Part II Funds

In light of the general characteristics of microfinance investment funds, Part II of the Public UCIs Law appears to be an appropriate legal framework. Indeed, the Public UCIs Law grants broad flexibility in terms of the choice of the legal form of the investment vehicle and also affords sufficient flexibility as regards eligible investments and their limited liquidity and, at the same time, ensures protection of investors, mainly through the supervision performed by the CSSF and, last but not least, all within a favourable, substantially neutral, Luxembourg tax environment.

It should be noted that, if the vehicle is to be marketed to retail investors, a Part II Fund would have to be opted for as a SIF or a SICAR would not be an option.

6.2.2. SIF

The SIF regime has proved to be an appropriate legal framework for establishing a microfinance investment fund, if the fund is reserved for sophisticated investors. The SIF regime indeed allows for all the above-mentioned flexibilities available to Part II Funds and benefits from a more flexible corporate regime and, although subject to permanent supervision by the CSSF, from a somewhat lighter prudential regime. As a consequence, the SIF Law also allows initiators without substantial financial resources to create an investment vehicle for well-informed investors, without the sponsoring of a sizeable financial institution, in a somewhat less demanding legal and regulatory framework than that applicable to Public UCIs.

6.2.3. SICAR

The SICAR Law is an appropriate legal framework if the proposed investments qualify as "risk capital" within the meaning of the law, which should generally be the case in relation to microfinance investments.

Notwithstanding the fact that the term "risk capital" is defined broadly by the SICAR Law and the related parliamentary documents (see 6.1.1.2 above), the proposed investments must meet the definition of risk capital to avoid potentially detrimental regulatory and tax consequences. For example, the question arises whether non-securitised loans to MFIs of a certain size, remunerated by interest at a rate close to usual market rates, could be considered as "risk capital" investments within the meaning of the SICAR Law.

As with SIFs, SICARs benefit from a flexible corporate regime and a lighter prudential regime that allows the setting up of an investment vehicle by smaller institutions or entrepreneurs.

A SICAR may also be the most appropriate choice in circumstances where the investment policy and, especially, the proposed investments are of such a nature that it is important for double tax avoidance treaties to be applicable.

Finally, a SICAR is not subject to the requirement to invest in accordance with the principle of risk-spreading, as is the case for a Part II Fund or a SIF, and may therefore constitute an appropriate investment vehicle if it is considering an investment in or providing funds to a limited number of MFIs.

7. Restrictions on the distribution of microfinance investment funds

The European authorities recently published three texts impacting the distribution of non-UCITS funds in Europe.

The first one, Directive 2011/61/UE of the European Parliament and of the Council of 8 June 2011 on alternative investment fund managers (the "**AIFM Directive**"), which regulates alternative investment fund managers (and, indirectly, the funds they manage) introduces a European passport for distribution to professional investors.

In addition to the AIFM Directive, the European Parliament and the Council adopted two EU regulations, namely the Venture Capital Regulation[33] ("**EuVECA Regulation**") and the Social Entrepreneurship Regulation[34] ("**EuSEF Regulation**") introducing a passport for the marketing of investment vehicles qualifying either as European venture capital funds ("**EuVECA**") or European social entrepreneurship fund ("**EuSEF**") to EU-based eligible investors[35].

7.1. UCITS

As indicated above, UCITS benefit from a European passport for the marketing of their shares or units to the general public.

[33] Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds.

[34] Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds.

[35] Eligible investors are the professional investors as defined in the Directive 2004/39/EC on market in financial instruments (MiFID) and investors who commit to investing a minimum of EUR. 100,000 and state in writing that they are aware of the risks associated with the investment.

7.2. Non-UCITS

7.2.1. Investment vehicles falling within the full scope[36] of the AIFM Directive

7.2.1.1. Passport

The AIFM Directive introduces a passport for the marketing of alternative investment funds ("**AIF**") to professional investors in the EU. The passport will initially only be available to EU alternative investment fund managers ("**AIFM**") managing EU AIFs. The passport will only be available to non-EU AIFMs and non-EU AIFs as from July 2015.

There is no EU passport for the distribution of AIF to retail investors in the AIFM Directive, although the member states may allow AIFM to market to retail investors in their territory units or shares of AIF managed in accordance with the AIFM Directive. Luxembourg has opted to introduce this flexibility into the Law of 12 July 2013 on alternative investment fund managers.

7.2.1.2. Private placement

The AIFM Directive lays down the conditions subject to which AIFMs may market the units of AIFs to professional investors in the EU. The marketing shall only be allowed insofar as the Luxembourg AIFM complies with the AIFM Directive. The marketing occurs with a passport. Private placement rules shall therefore no longer be acceptable, save for the marketing – with a few additional AIFMD requirements – of AIFs by AIFMs that cannot benefit from the passport, such as those established outside the EU or falling below the thresholds provided for in the AIFM Directive.

The dual regime should nevertheless last until 2018, at which point the EU authorities shall decide on the possible end of national private placement regimes.

7.2.1.3. Reverse Solicitation

The marketing is defined under the AIFM Directive as a direct or indirect offering or placement, which is made on the initiative of the AIFM or on behalf of the AIFM, of units or shares of an AIF it manages or with investors domiciled or with a registered office in the European Union. Based on this definition, the solicitation made by an investor to subscribe for units in an AIF received by its AIFM should therefore fall outside the scope of the marketing and not require any notification to be made by the AIFM in order to register the AIF for commercialisation in a different member state. Burden of proof should rely with the AIFM, which would need to show positively that the communications were exclusively initiated by the investor. This may prove to be complicated where the AIF has been notified for marketing to professional investors in the relevant member state.

[36] It should be noted that the AIFM Directive allows for a series of exclusions and exemptions which we will not detail here.

7.2.2. EuVECA and EuSEF

In the case where an investment vehicle and its manager duly fulfil all the conditions provided by the EuVECA Regulation or the EuSEF Regulation, the manager of the investment vehicle will be entitled to submit a request to its competent authority in order to be registered as EuVECA manager or EuSEF manager, respectively.

Once registered, the manager will be entitled to use the European passport for the marketing of the EuVECA or the EuSEF that it manages to eligible investors[37].

7.2.3. SICARs and closed-ended SIFs and Part II Funds

SICARs and closed-ended SIFs and Part II Funds, irrespective of their qualification as AIFs or not, may in addition be subject to the provisions of the Law of 10 July 2005, as amended on prospectuses for securities (the "**Prospectus Law**") in the case where they intend to carry out a public offering or admission to trading of their shares or units.

If they are not exempted from the Prospectus Law, they might have to prepare a prospectus within the meaning of the Prospectus Law and would in counterparty benefit from the passport attached thereto. However, most SICARs and closed-ended SIFswill benefit from an exemption in that respect.

7.2.4. Other SIFs, SICARs and Part II Funds

Except if registered locally in a foreign jurisdiction, otherPart II Funds, SIFs or SICARs can be distributed outside Luxembourg only in accordance with private placement rules, which vary from jurisdiction to jurisdiction. Further, SIFs and SICARs can only be placed with well-informed investors.

8. Luxembourg service providers have the capacity to meet the needs of microfinance investment funds

8.1. The required skills are available in Luxembourg

8.1.1. The services which those setting up a microfinance fund in Luxembourg need to have available locally to be able, in particular, to comply with regulatory requirements are mainly those of the custodian, the administrative and transfer agent as well as the domiciliary[38]. Frequently, those services are provided by a single service provider or by different service providers pertaining to the same group.

[37] See footnote 35.

[38] As it is the case for the fund industry at large, investment managers will generally be located abroad, without prejudice, as the case may be, to the need for them to be acceptable to the CSSF in order for the fund to receive regulatory approval.

8.1.2. Considering the investments typically made by microfinance investment funds (loans, securities not listed on a stock exchange …), the functions of the custodian and the administrative agent require somewhat specific skills which are, however, quite similar to those required in servicing other types of Part II Funds present in Luxembourg, such as certain private equity funds and real estate funds. This is the case in particular with regard to investment valuation methods for debt and securities not listed on the stock exchange as well as with regard to legal and operational aspects specific to the acquisition of such types of assets. These skills are thus available on the spot with those service providers at least which have extensive and diversified activities in the sector of investment funds.

8.1.3. The fact that the skills required to service microfinance investment funds are not fundamentally different from those which a number of Luxembourg-based service providers have developed in servicing other types of funds, constitutes a critical advantage. Considering, indeed, the rather modest profit perspectives in servicing microfinance investment funds (see section 8.2 below), it would hardly be possible to develop such skills exclusively for that purpose.

8.2. Service providers should be in a position to offer their services on (financially) acceptable conditions.

8.2.1. Notwithstanding the fact that the microcredit sector has proved to be profitable, the profit margins which it allows to generate remain rather modest and, at any rate, below those commonly expected from activities with which microfinance is otherwise, rightly or wrongly, compared, such as private equity and, possibly, venture capital.

Furthermore, microfinance investment funds are typically rather small sized while at the same time requiring quite labour-intensive custodian and administrative agent services (compared, in particular, to UCITS investing in listed securities).

A "normal" pricing structure, i.e. a pricing structure similar to that in place for comparable funds, might thus prove to be problematic, albeit transaction-based (rather than NAV-based) is commonly practised in other sectors, such as real estate investment funds (where single transactions, however, would typically be considerably more important in volume than those entered into by microfinance investment funds).

8.2.2. As a matter of fact, the service providers' interest in servicing microfinance investment funds does not seem, at present, to be primarily profit driven.

In fact, the decision of service providers to become active in this field seems to be driven by other factors. Sometimes, there is the *ad hoc* readiness, possibly favoured by image-related considerations, to cooperate in a project perceived as being "philanthropic" and as carrying a critical social benefit. Sometimes there is a strategic decision reflecting an overall long-term policy where sustainability as such and the clients' demand for more sustainability and related investment opportunities are central. Also, the decision to service a microfinance investment fund may be determined by the fact that the fund has been set up by the very banking group to which the service provider belongs or by the fact that the initiative comes from an existing client of the service

provider.

8.2.3. The above developments should not result in a misunderstanding: servicing microfinance investment funds is viewed by those concerned in the financial community as an economic activity which has to be (and can be) sustainable from a cost/benefit perspective, even though reduced profit margins may, at least on a temporary basis, be considered to be acceptable.

At this stage, we would like to raise an issue which often remains unaddressed: the emergence of a so-called ethical financial sector – of which microfinance investment funds form an integral part – represents a serious challenge to the financial world and those who work therein. A single-dimensional approach in which the financial return (which is generally easily measurable) constitutes the only relevant criteria of efficiency and success is superseded by a multi-dimensional approach where the criteria of social return (which, on top, is much more difficult to measure) becomes of critical importance. Not only does this render the activity of those who work in the financial sector more difficult and complex, it also affects the very essence of the activity just as it confronts those who make their living in the sector with difficult issues such as this: if one part of the financial activity is said to be "ethical", what about the remaining, and by far the major part of this activity? This is probably why, among other reasons, the very concept of "ethical finance" may cause mitigated feelings among professionals of the financial sector. And this is one of the reasons why the decision to get involved in this sector is of a somewhat strategic nature, just as it is political – in the broader sense of this word.

9. Luxembourg appears to be well positioned on the developing market of microfinance investment funds

9.1. The reasons for choosing Luxembourg as a place of incorporation of a microfinance investment fund

9.1.1. In proportion, a significant number of microfinance investment funds have opted for Luxembourg.

9.1.2. At a very general level, the reasons prompting the initiator of a microfinance investment fund to opt for Luxembourg as its place of incorporation are not really different from those applicable to investment funds, generally speaking: recognition of Luxembourg as a financial centre having extensive experience and skills in investment funds, offering recognised supervision and yet broad flexibility; large range and flexibility of available investment vehicles; attractive tax environment.

9.1.3. At a more specific level, the following comparative advantages can be identified:

9.1.3.1. The fact that a number of microfinance investment funds have already been incorporated in Luxembourg and have thus successfully overcome the "test" for the licence to be obtained from the regulator who is thus acquainted with the specific nature and needs of this type of vehicle (precedent phenomenon).

9.1.3.2. The fact that investment managers specialised in investment funds have already been approved by the CSSF upon scrutiny of their legal status, financial capacity and experience.

9.1.3.3. The great flexibility of the SIF and the SICAR regimes, combined with a particularly attractive tax regime with regard to the registration tax (exemption), VAT, the taxation of its revenues and the possibility to benefit from the application of double tax avoidance treaties.

9.1.3.4. The significant experience of certain Luxembourg service providers with regard to pooling, a technique which facilitates the management of investments and thus reduces management costs when there is the necessity, for the purpose of the distribution of the fund, to issue various classes of securities representing different risk tranches, thus enabling investors of different types and with different objectives (development objectives/commercial objectives; see section 3. above) to participate in a common project.

9.1.3.5. The long standing positioning of Luxembourg in terms of cross border distribution. Even for vehicles not benefiting from the European passport referred to above, the existence of a regulatory framework and effective supervision by the CSSF may render registration (and thus distribution to the public) possible in certain foreign jurisdictions. In this regard, Luxembourg offers an obvious advantage in comparison with jurisdictions where comparable supervision does not exist or is not recognised in the same manner by the country in which distribution is contemplated.

9.2. Potentially deterrent factors

9.2.1. For investment funds with a geographical focus, it may, for a number of reasons, be attractive to have the fund incorporated in a jurisdiction located in the same geographical area. One of these reasons can consist in the existence of a good regional network of double tax avoidance treaties.

9.2.2. The cost factor, which is in direct relation with the choice of a jurisdiction offering a more regulated environment, must not be underestimated. However, while cost is a critical factor for microfinance investment funds – both because of their modest size and because of their relatively low profit margins –their freedom to choose poorly regulated (and possibly substantially less costly) jurisdictions is becoming progressively narrower.

9.2.3. The small domestic market in Luxembourg with, as a result, the predominantly international orientation of the Luxembourg fund industry, results in a limited potential of distribution towards the general public because distribution to the general public in other jurisdictions is in principle restricted to UCITS (see section 7 above) and because at present microfinance investment funds will not, in principle, be in a position to cope with the requirements of the EU regulations governing UCITS.

10. Achievements and possible improvements

10.1. Overall assessment

It appears from the above analysis that the existing Luxembourg legislative, regulatory and tax environment is, generally speaking, adequate for the hosting of microfinance investment funds.

Without minimising certain singularities of this specific type of funds, it can be said that, generally speaking, the comparative advantages offered by Luxembourg for the incorporation of investment funds in general also operate for microfinance investment funds. Even more so since Luxembourg has introduced the SIF which, without being the only vehicle eligible for microfinance investment funds, appears, in many cases, to be particularly adapted to the specific needs of such funds.

Considering this globally positive assessment, proposals aimed at improving the existing framework are either of a punctual character, or aim to increase the Luxembourg financial centre's visibility as an adequate place for setting up microfinance investment funds.

10.2. Exemption of microfinance UCIs from the registration tax

The Law of 18 December 2009 concerning the budget of the State for 2010 amended the UCI legislation so as to exempt Public UCIs and SIFs or individual compartments of umbrella Public UCIs or SIFs, whose main objective is to invest in MFIs, from the subscription tax (*taxe d'abonnement*).

This exemption not only favours a type of funds which remains very cost sensitive but also shows the interest of the Luxembourg authorities in promoting this new market segment in Luxembourg.

10.3. Creation of a label for microfinance investment funds

In July 2006 a labelling agency called the Luxembourg Fund Labelling Agency (Luxflag[39]) was created in Luxembourg. Luxflag is an independent, non-profit making association. It grants a label to eligible microfinance investment vehicles. They may be domiciled in any jurisdictions, to the extent that they are subject to a level of national supervision equivalent to that available in the European Union countries.

The objective of Luxflag is to promote the raising of capital for microfinance by reassuring investors that microfinance investment vehicles benefiting from its label actually invest directly or indirectly in the microfinance sector.

10.4. Tax incentive scheme for private investors

The creation of a tax incentive scheme for the benefit of Luxembourg tax residents, favouring the investment in microfinance investment funds would also be highly appreciated.

It would no doubt encourage individual investors to get involved with microfinance and, to a certain

[39] More details about Luxflag may be found on www.luxflag.org

extent, help certain microfinance investment funds in overcoming the hurdle of achieving a critical size. It would also show that Luxembourg is interested in microfinance not only when it comes to servicing microfinance investment funds.

The Luxembourg experience with the so-called "loi Rau" constitutes a precedent for this type of tax incentive scheme. The government's concern that this Law was no longer compatible with EU Law in that it exclusively favoured investment in the Luxembourg economy in granting fiscal residents a tax advantage when investing into resident companies, a concern which caused the government to gradually abolish this Law, would not similarly apply to a tax incentive scheme favouring the investment in microfinance investment funds incorporated in Luxembourg.

10.5. Further develop the network of double tax avoidance treaties

While this is a task whose interest goes far beyond the specific interests of microfinance investment funds, Luxembourg should pursue its efforts to further develop its network of double tax avoidance treaties while making sure, from the start, that any such treaties newly entered into will be applicable to all types of investment funds incorporated in Luxembourg.

10.6. Available skills need to be made known to the outside world – the visibility of the sector needs to be promoted

To a very large extent, the (potential) initiators of microfinance investment funds are not acquainted with the Luxembourg financial centre. Further, within the Luxembourg fund industry, microfinance will by definition count for only a very small market share. Therefore, it is necessary to enhance the visibility of the financial sector's involvement with microfinance and for service providers active on this market segment to be easily identifiable from the outside.

If, therefore, the Luxembourg financial sector really intends to increase its involvement with microfinance, this activity needs to become an integral part of its communication strategy.

The visibility of the sector could further benefit from the issue, by the CSSF, of a circular letter related specifically to microfinance investment funds, as has been the case for hedge funds (circulaire CSSF 02/80 of 5 December 2002).

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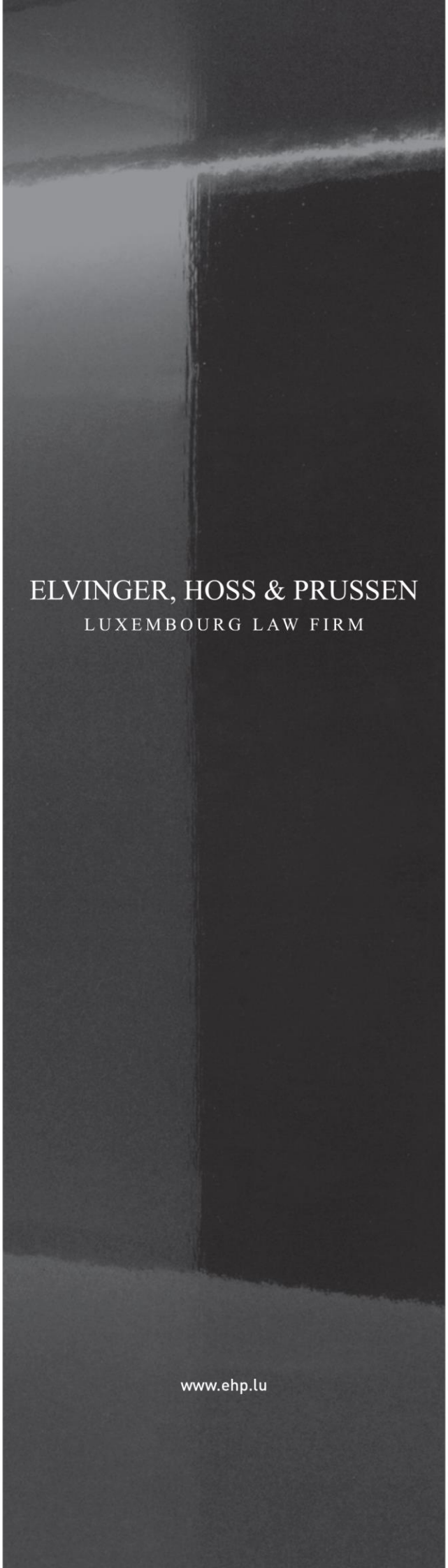

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