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

This contribution is a summary if a more detailed Memorandum on the same subject published by Jacques Elvinger, Marc Elvinger and Frédérique Lifrange, all partners at the Luxembourg law firm Elvinger, Hoss & Prussen, and which can be downloaded from the Legal Topics section of the firm's website www.ehp.lu

Everyone agrees 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 in their activities become more profitable, 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.

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.

On this basis 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.

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

Those vehicles may take the form of (i) an undertaking for collective investment that may be marketed to the public with a European passport for distribution ("UCITS"), (ii) an undertaking for collective investment that may be marketed to the public without a European passport ("UCI"), (iii) a specialised investment fund ("SIF") and, (iv) an investment company in risk capital ("SICAR"), the two last being reserved for "well-informed investors".

The choice of the most appropriate structure requires an analysis of the specific needs of the promoter/initiator and particularly 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 below described vehicles have been "tested" in the context of microfinance projects.

• UCITS may only invest in listed securities and certain other liquid assets, must comply with specific diversification and concentration limits and must be open-ended for redemptions, meaning that investors. UCITS benefit from a so-called European "passport" allowing them easily to market their securities to the public throughout the European Economic Area.

Due to the significant constraints as regards eligible assets (excluding unlisted securities and loans), investment diversification rules and liquidity features (requiring bi-monthly redemption rights for investors), it is not very frequent for microfinance funds to be set up as UCITS.

• UCIs may invest in any type of assets, comprising unlisted securities and loans or may grant guarantees for investment purposes and must operate under the principle of risk-spreading. UCIs, unlike UCITS, do not benefit from a European "passport" and can therefore in practice generally be sold outside of Luxembourg only on a private placement basis in accordance with the local private placement rules.

In light of the general characteristics of microfinance investment funds, the UCI legislation is an appropriate legal framework. Especially if the vehicle is to be marketed to retail investors, a UCI would have to be opted for.

• SIFs have significant flexibility with respect to the assets in which they may invest and the investment strategies they may pursue. SIFs are subject to less stringent diversification rules than UCIs and may be of the open-ended or closed-ended type. SIFs are reserved for well-informed investors meaning, institutional investors, professional investors and investors investing a minimum of 125,000 euro. Like UCIs, SIFs do not benefit from a European passport.

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 UCIs 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 investment managers and entrepreneurs 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 UCITS and UCIs.

• SICARs are investment companies whose object is to invest their assets in securities representing risk capital, including any type of contribution of assets, be it in the form of capital, debt or other financing. A SICAR is not required to operate under the principle of risk-spreading. As for a SIF, the securities issued by a SICAR are reserved to well-informed investors. In a similar manner to UCIs and SIFs, a SICAR can generally only be sold in other jurisdictions under applicable private placement rules.

The SICAR is an appropriate vehicle only if the proposed investments meet the definition of risk capital. It may be the most appropriate choice if the proposed investments are of such a nature that it is important for double tax avoidance treaties to be applicable of if it is considered to. The SICAR may also constitute the appropriate investment vehicle if it invests in or providing funds to a single or limited number of MFIs.

The Luxembourg financial community is actively integrating its microfinance-related activities into its overall communication and diversification policy. In this respect, the creation of a label for microfinance investment funds by LuxFlag and the recent exemption of microfinance investment funds from the capital duty generally applicable to investment funds was particularly welcomed.

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