ELVINGER, HOSS & PRUSSEN
AVOCATS À LA COUR

NEWSLETTER
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1. Implementation in Luxembourg of:

EC Directive 2007/16/EC of 18 March 2007 implementing the UCITS Directive as regards the clarification of certain definitions;

CESR guidelines of March 2007 concerning eligible assets for investments by UCITS; and

CESR guidelines of July 2007 concerning eligible assets for investment by UCITS – clarification of hedge fund indices as financial indices

The EU Directive 2007/16/CE of 18 March 2007 implementing the UCITS Directive as regards the clarification of certain definitions and CESR guidelines of March 2007 concerning eligible assets for investments by UCITS (the "Directive 2007/16") has been implemented in Luxembourg by a Grand-Ducal Regulation dated 8 February 2008 relating to certain definitions of the amended law dated 20 December 2002 relating to undertakings for collective investment (the "Grand-Ducal Regulation"). The provisions of the Grand-Ducal Regulation mirror precisely the provisions of the Directive 2007/16.

On 19th February 2008, the CSSF issued a Circular 08/339 (the "Circular") referring to the Grand-Ducal Regulation and clarifying that the provisions of the Grand-Ducal Regulation must be read in conjunction with the *CESR guidelines concerning eligible assets for investment by UCITS* as well as the *CESR guidelines concerning eligible assets for investment by UCITS – the classification of hedge fund indices as financial indices*, such two documents being attached to the Circular. The Circular does not add any specific rules or interpretations to the one given by CESR guidelines.

The Circular provides that the UCITS shall take into account these guidelines when assessing whether a specific financial instrument can be considered as an eligible asset for investment within the meaning of the relevant provisions of the amended Law of 20 December 2002, as further specified in the Grand-Ducal Regulation.

The Circular confirms that the guidelines issued by CESR are applicable as from the entry into force of the Grand-Ducal Regulation of 8 February 2008, such date being the 25th February 2008.

The Circular further specifies that UCITS already set up at the time of the implementation of the guidelines issued by CESR benefit from an extension until 23 July 2008 at the latest to comply with the guidelines.

It is important to note that the CSSF already fully applied the provisions of the Directive and the related CESR advices and that therefore no significant changes should normally occur in practice.

On the other hand there is obviously an ongoing evolution in the CSSF's practice in circumstances where there is further need of interpretation of the provisions of the Grand-Ducal Regulation and the CESR guidelines. Typical subjects of this kind have been the appreciation of the circumstances in which a security embeds a derivative, the specific approval by the CSSF of certain eligible indexes, such as commodity futures indexes and hedge funds indices, permitted investments within the 10% *trash ratio* (such as the possibility to include regulated open-ended hedge funds, funds of hedge funds, real estate funds, private equity funds and commodity funds), the eligibility of cash settled credit default swaps on loans, and similar issues which arise on an ongoing basis in the structuring of innovative UCITS.

You will find an English translation of the Grand-Ducal Regulation and the CSSF Circular 08/339 on our website.

2. Regulated markets

After a period of uncertainty as to the precise meaning of the terminology used in article 41(1) of the law of 20th December 2002 (the "2002 Law") in the context of MIFID, the CSSF has now clarified the following:

1. *Regulated markets* in the sense of article 41 (1) a) of the 2002 Law are to be considered as regulated markets in the meaning of directive 2004/39/EC (MiFID) which are specifically referenced on the relevant list held and updated by the European Commission.

2. *Other markets in a Member State of the European Union, regulated, operating regularly, recognized and open to the public* within the meaning of article 41 (1) b) of the 2002 Law implementing article 19 1. b) of directive 85/611/EEC as amended, are to be considered as the markets eligible in accordance with the above referenced provision of said directive in application of the local regulations applicable to such market.

As confirmed also in the CSSF annual report 2007, the CSSF considers that the EURO MTF operating with the Luxembourg Stock Exchange is to be considered as a market targeted by article 41 (1) b) of the 2002 Law.

3. *Other markets of a State which is not part of the European Union, which are regulated, operating regularly, recognized and open to the public*, referred to in article 41 (1) c) of the 2002 Law, are to be considered as the markets of a non-member State of the European Union which comply with the conditions of the definition (i.e. being regulated, operating regularly, recognized and open to the public), such as detailed in chapter F, point III 1. of the circular IML 91/75.

In this context the explanations given in the CSSF annual report 1999 are still relevant.

The CSSF will not express an opinion of the qualification of a certain market vis-à-vis the above-mentioned criteria and it is accordingly not necessary to provide to the CSSF ex ante explanations in order to justify the choice of market as operated. However, the persons conducting the business of the UCITS must be in a position to justify ex post the choice made if such a request was addressed to them.

3. Relevance of "cooperation" of the CSSF with other supervisory authorities in the context of UCITS

Certain provisions of the 2002 Law require an assessment to be made whether there is "co-operation" between the CSSF and the supervisory authorities in non-EU member countries. Such assessment must be made for the purpose of

(i) article 85(1)d) of the 2002 Law which provides that the delegation of investment management functions can only be made to an investment manager if cooperation between the CSSF and the supervisory authority in the relevant investment manager's country is ensured;

(ii) article 41(1)e), first indent of the 2002 Law, which requires that the UCITS can only invest in other UCIs which are authorised under laws which provide that they are subject to equivalent supervision and that

cooperation between the CSSF and the local supervisory authority is sufficiently ensured.

ad. (i): Appointment of investment managers

a) The CSSF had initially taken the view that, outside of the EU, only the jurisdictions in respect of which the CSSF has concluded a formal Memorandum of Understanding ("MoU") were acceptable.

b) Subsequently the CSSF took the view that all OECD member countries should also be acceptable, even if no formal MoU had been concluded.

c) Most recently, the CSSF has taken the view that, in principle, all countries where the relevant supervisory authority is a signatory to the *IOSCO Multilateral Memorandum of Understanding concerning consultation and co-operation and the exchange of information*[1] (the "IOSCO MoU") are acceptable.

ad. (ii): Investments in other UCIs

a) In this context, the CSSF has for some time taken the view that only those supervisory authorities with whom the CSSF has concluded a formal MoU are acceptable.

b) The CSSF has recently confirmed that they now take the same view as indicated in (i) c) above, i.e. that there is cooperation between the CSSF and those supervisory authorities that are a party to the IOSCO MoU. However they reserve the right to review their position as regards a limited number of countries / authorities that are a party to the IOSCO MoU.

[1] www.iosco.org

c) It is however to be noted that the cooperation in itself is not sufficient as article 41(1)e) requires in addition, that the relevant UCI is "subject to equivalent supervision".

4. Sub-delegation of investment management functions in the context of UCITS

On the basis of the provisions of Article 85 of the 2002 Law, a management company or a self-managed SICAV may delegate investment management functions only to an investment manager that is authorised or registered for the purpose of asset management and is subject to prudential supervision in its country. In addition, cooperation between the CSSF and the supervisory authority of that country must be ensured.

To ensure compliance with this requirement, appropriate supporting documentation relating to the status and the financial situation of the relevant investment manager has to be submitted to the CSSF which, on this basis, grants its approval for the proposed delegation.

The same procedure was required in the case where an investment manager (approved by the CSSF on the basis of the aforesaid procedure) was delegating its investment management functions to a sub-manager, thus resulting in a similar formal approval of such sub-manager by the CSSF.

The CSSF has now taken the view that this approval process of a sub-manager is no longer required if the investment manager is based in an EU member country and therefore subject to the provisions of the MIFID Directive. Indeed, the CSSF takes the view that this kind of sub-delegation falls

within the scope of the local legislation applicable to the investment manager as a result of the implementation of the MIFID Directive in its home country. If this does not prejudice the other requirements of article 85, namely that the CSSF must be informed in an appropriate manner about the delegation and sub-delegation and that the CSSF might suggest that the delegation and sub-delegation be properly disclosed in the prospectus of the UCITS.

In case the investment manager is not based in an EU member country, any sub-managers must be approved by the CSSF as was previously the case.

5. Periodical information to be provided by UCITS to the CSSF with respect to the Risk Management process according to section V of CSSF Circular 07/308

The CSSF issued on 2 August 2007 a Circular 07/308 concerning the use of financial derivative instruments and the management of financial risks by UCITS (the "Circular")*.

The description of the Risk Management process which must be submitted to the CSSF has to comprise at least the information described in section V.1 to V.6 of the Circular. Under section V.1 headed "Implementation of a risk management process", the Circular requires among other things, the production of a summary list of the UCITS to which the Risk Management process is applicable.

In its 2007 Annual Report, the CSSF reiterates that at least the following information has to be provided in respect of each UCITS (or compartment, if applicable):

- name of the UCITS (including the names of the compartments of the UCITS),
- risk profile of the UCITS (sophisticated, non-sophisticated),
- global exposure calculation method (commitment, relative VaR, absolute VaR),
- maximum limit: the maximum limit has not to exceed the regulatory limit as determined in section III.1 of the Circular (100% for the commitment approach, 200% relative VaR, 20% absolute VaR).
- reference portfolio (if relative VaR limitation),
- exposure (i.e. use of the maximum limit).

Beyond the requirements set forth in the Circular, the CSSF has clarified in its 2007 Annual Report the following:

- The CSSF expects that the maximum global exposure limit set by the UCITS is in line with its given risk profile. This may imply that a UCITS making use of the VaR methodology will have to determine, because of its given risk profile, a VaR limit lower than the maximum regulatory limit. Thus the CSSF does not accept that UCITS, regardless of their risk profile, apply and report in all cases a VaR limit which corresponds to the highest permitted limit.

- The information has to be drawn up and filed with the CSSF on an annual basis, the next reference date being 31 December 2008. The CSSF reserves the right to request for the information to be drawn up and filed with them at a higher frequency.

* See EHP newsletter Septembre 2007

- The auditor of the UCITS has to verify in its annual Long Form report the implementation of the Risk Management process in accordance with the requirements of the CSSF Circular.

6. CSSF Circular 08/356 concerning rules applicable to undertakings for collective investment when they employ certain techniques and instruments relating to transferable securities and money market instruments

Luxembourg UCITS and UCIs have been actively engaging in securities lending transactions for quite some time. The conditions on which UCITS and UCIs can engage in such activities were initially described in a Circular 91/75 issued by the Commission for the Supervision of the Financial Sector in 1991.

Under UCITS III, securities lending is referred to in the Commission Directive 2007/16/EC and the corresponding CESR guidelines as a "technique relating to transferable securities" which can be used by UCITS for "efficient portfolio management".

On 4 June 2008, the CSSF issued a Circular 08/356 which describes in detail the techniques and instruments which may be used by UCITS, comprising in particular securities lending transactions.

The Circular innovates in particular as regards permitted collateral and permitted assets in which cash collateral can be reinvested. It specifies how collateral and assets acquired upon reinvestment of cash collateral must be safekept in order to avoid a counterparty risk for the UCITS in excess of the legal limits. It re-states that securities lending transactions may not impair the UCTIS' portfolio management activities, its redemption obligations and its adherence to corporate governance principles. Finally, it specifies the information which needs to be included in the prospectus and the financial reports.

You will find on our website a memorandum which describes the legal and regulatory background of the Circular and its detailed content as regards permitted securities lending transactions by UCITS and UCIs.

You will also find on our website an English translation of the Circular.

For any further information please contact us or visit our website at http://www.ehp.lu.