SPECIAL NEWSLETTER ON THE NEW LAW ON UNDERTAKINGS FOR COLLECTIVE INVESTMENT

WITH A FOCUS ON NON-UCITS RELATED CHANGES

December 2010

The new law on undertakings for collective investment (the "**New Law**"), which has emerged from the bill of law Nr 6170 deposited with Luxembourg Parliament on 6 August 2010 (the "**Bill**"), has been adopted by the Luxembourg Parliament on 16 December 2010 and will be published in the *Mémorial* shortly. The New Law is to repeal the current amended Luxembourg Law of 20 December 2002 regarding undertakings for collective investments (the "**2002 Law**"). It aims mainly at implementing the EU Directive 2009/65/CE of 13 July 2009 on UCITS (so-called UCITS IV), but it also introduces a number of other changes to the current Luxembourg investment fund legislation which concern both UCITS and UCIs (non-UCITS). The purpose of this **Newsletter** is to describe these other changes and to that effect comprises a summary of those changes followed by an explanatory discussion. We have also prepared an **English translation of the New Law** alongside the French original thereof.

The New Law, as regards its structure, is largely inspired by the 2002 Law and, in the same manner as the latter, deals in Part I with UCITS complying with EU Directive 2009/65/CE and in Part II with other UCIs.

The five main blocks constituting UCITS IV have been reflected as follows:

- the provisions on the simplified notification procedure appear in Chapters 6 and 7 in Part I;
- the provisions on merger of UCITS appear in Chapter 8 in Part I;
- the provisions on master-feeder structures appear in Chapter 9 in Part I;
- the provisions on the passport and additional MIFID-inspired obligations of the management company appear in Chapter 15 in Part IV;

- the provisions regarding the key investor information document (the "**KIID**") appear in Section C, Chapter 21 in Part V.

As the provisions relating specifically to the implementation of the aforementioned UCITS IV features have been discussed in some detail in our previous Newsletters, we will focus hereafter on (I) the coming into effect of the New Law and its transitional provisions and (II) other (non-UCITS IV-related) changes which the New Law will introduce for UCITS, UCIs and their management companies.

I. Coming into effect and transitional provisions

Chapters 25 and 26 in Part V of the New Law comprise transitional and amending provisions which imply the following consequences as regards the coming into force of the different provisions of the New Law:

- existing UCITS have the choice to remain subject to the 2002 Law or to submit themselves to the New Law as from 1 January 2011. They will automatically become subject to the New Law from 1 July 2011 (without prejudice to the simplified prospectus grandfathering provisions until 1 July 2012 if they have not submitted themselves to the New Law before 1 July 2011);

- UCITS newly created between 1 January 2011 and 1 July 2011 have the choice to submit themselves from the outset to the New Law or to submit themselves to the 2002 Law in which case they will automatically become subject to the New Law from 1 July 2011 (without prejudice, in the latter case, to the simplified prospectus grandfathering provisions until 1 July 2012);

- existing UCIs will automatically become subject to the New Law as from 1 January 2011 (without prejudice to certain grandfathering provisions on delegation of functions until 1 July 2012);

- for existing and newly created UCITS management companies the same rules apply, as regards submission to the 2002 Law or the New Law, as is the case for existing and newly created UCITS respectively;

- existing and newly created non-UCITS management companies are subject to the New Law as from 1 January 2011 (without prejudice to certain grandfathering provisions on delegation of functions until 1 July 2012);

- all fiscal provisions introduced by the New Law become effective as from 1 January 2011;

- the majority of other (non-UCITS IV related) changes (see II. below) come also into force as from 1 January 2011.

II. OTHER (NON-UCITS IV-RELATED) CHANGES WHICH THE NEW LAW WILL INTRODUCE FOR UCITS, UCIS AND THEIR MANAGEMENT COMPANIES

For easier reading, we will first provide a summary of the changes and then discuss some of these in more or less detail.

A. Summary

General

1. A sub-fund of a UCITS or UCI with multiple compartments may invest in one or more other sub-funds of the same UCITS or UCI.

Corporate

2. For corporate UCITS or UCIs, the annual report no longer needs to be sent to shareholders with the convening notice to the annual general meeting of shareholders.

3. The board of directors of a corporate UCITS or UCI can decide to fix a record date 5 days prior to the shareholder meeting by reference to which attendance rights and quorum and majority requirements for shareholder meetings are measured.

4. It is no longer required that articles of incorporation, written in English, of a corporate UCITS our UCI are translated into French or German for registration purposes.

Regulatory

5. The CSSF may withdraw the authorisation of a sub-fund without withdrawing the authorisation of the other sub-funds of a multiple compartment UCITS or UCI.

6. Part II UCIs and non-UCITS management companies (Chapter 16), when they delegate functions to third parties, are subject to similar requirements as UCITS and, in particular, can delegate investment management functions only to investment managers that are authorised for investment management and that are subject to prudential supervision.

Taxation

7. Exchange Traded Funds or ETFs (whether UCITS or UCIs) are exempt from the subscription tax/*taxe d'abonnement*.

8. UCITS and UCIs, and compartments thereof, the shares or units of which are reserved to pension funds are exempt from the subscription tax/*taxe d'abonnement*.

9. UCIs and specialised investment funds ("**SIFs**"), and compartments thereof, whose main objective is the investment in microfinance institutions, as defined in a Grand Ducal Regulation of 14 July 2010, are exempt from the subscription tax/*taxe d'abonnement* (this exemption is already in force).

10. Foreign UCITS and UCIs managed by a Luxembourg management company, and whose centre of management could therefore be deemed to be in Luxembourg, are not subject to Luxembourg corporate income tax, local business tax and wealth tax and are thus not subject to taxation in Luxembourg.

11. Revenues resulting from the sale of large participations (more than 10%) held by non-residents for less than 6 months in a corporate UCITS, UCI, SIF or SICAR, are no longer subject to taxation in Luxembourg.

B. Discussion

1. <u>Cross-sub-fund investments</u>

The CSSF had until now taken the position that a sub-fund of a corporate UCITS or UCI could not invest in shares issued by an other sub-fund of the same UCITS or UCI as this would have resulted in a situation where a corporation would have invested in its own shares (all sub-funds being part of the same corporation), which is not permitted under certain provisions of the Luxembourg law on commercial companies which specify and limit the circumstances under which a company can acquire and hold its own shares. To ensure a level playing field amongst the different legal forms which UCITS and UCIs may adopt, the CSSF had taken the position that a common fund (FCP) was also prevented from undertaking cross-sub-fund investments.

The New Law allows cross-sub-fund investments, albeit subjecting them to certain conditions and restrictions.

The change has been awaited eagerly by the fund industry as it gives various new pooling opportunities which create investment management and operational efficiencies. It may indeed be used to replace complex intrapooling techniques and facilitate cash management by all sub-funds of a UCITS or UCI investing their ancillary cash in one sub-fund of the structure specially designed to that effect. It will also permit the creation, within the same UCITS structure, of sub-funds with *fund of funds* investment policies which may invest in other sub-funds of the same UCITS, whereas until now this had led fund promoters to have two separate legal entities for their traditional funds and their *fund of funds*.

As regards the investment limits for cross-sub-fund investments, the basic principle is that, for UCITS, the standard UCITS investment rules and limitations apply. The following assumes sub-funds **A**, **B**, **C**, etc. are part of the same corporate or FCP UCITS (Articles indicated between brackets are those of the New Law):

(i) sub-fund **A** can invest no more than 20% of its NAV in sub-fund **B** (Article 46(1));

(ii) sub-fund **A** can acquire all the shares of sub-fund **B** provided those shares represent no more than 25% of the aggregate number of shares issued by the UCITS as a whole (Article 48(2));

(iii) sub-fund **A** can invest 100% of its NAV in other sub-funds **B, C,** etc., subject to complying with (i) and (ii) above; and

(iv) sub-fund **A** cannot invest in sub-fund **B** if sub-fund **B** is permitted to invest more than 10% of its NAV in UCITS and other UCIs (Article 41(1)e) last indent and Article 181(8)) (aiming at preventing cascade investments).

The New Law imposes some additional restrictions/requirements (none of which applies in case of investments by sub-funds in sub-funds of another/other UCITS, even if under common management!):

(i) Circle investments are not permitted: sub-fund **A** may only invest in sub-fund **B** if sub-fund **B** does not invest in sub-fund **A** (Article 181(8), 1st indent).

(ii) Duplication of management fees is not permitted (Article 181(8), 5th indent). In this respect cross-sub-fund investments are treated differently from investments in sub-funds of separate UCITS where double charging of management fees is not prohibited but the disclosure in the prospectus of the maximum proportion of management fees charged is required (Article 46(3), 2nd par.). Double charging of subscription and redemption fees is also not permitted (Article 181(8), 5th indent) but that prohibition applies anyhow under the UCITS rules to investments in separate UCITS under common management (Article 46(3), 1st par.).

(iii) The voting rights pertaining to the acquired sub-fund shares are suspended (Article 181, 3rd indent).

(iv) The net asset value of the acquired sub-fund shares is not considered for the purpose of the requirement that the capital of a UCITS or a UCI may not become less than 1,250,000 euro (Article 181, 4th indent).

(v) The CSSF currently takes the view that the possibility for cross-sub-fund investments must be specifically provided for in the articles of incorporation or the management regulations of the UCITS or the UCI. As a result, any UCITS or UCI who wants to take advantage of this opportunity will first have to amend its articles of incorporation or management regulations.

(vi) There are a number of provisions in the New Law (UCITS and non-UCITS-related) which make it impossible for a UCITS sub-fund to become a Feeder sub-fund (as per Chapter 9 of the New Law) of another sub-fund of the same UCITS.

For UCIs (non-UCITS), the restrictions set forth in (i) to (vi) in the preceding paragraph also apply. In addition, the restriction set forth under (vi) in the second preceding paragraph (prohibition of cascade investments) also applies. Whereas for UCITS this restriction was unavoidable as it is part of the UCITS rules imposed by the EU Directive, it is unfortunate that this has been included as a restriction in the provisions applicable to UCIs as there may be circumstances where these cascade investments, up to a certain level, could be justified. This could typically be the case for an umbrella UCI whose sub-funds would operate as *fund of hedge funds* each investing in a different strategy and where an additional sub-fund would be created to invest in the other sub-funds to seek exposure to multiple strategies.

Cross-sub-fund investments will be permitted from 1 January 2011 provided the articles of incorporation or management regulations of the relevant UCITS or UCI have been amended by that date.

2. <u>Annual report no longer needs to be sent to shareholders with the convening notice to the annual general meeting of shareholders</u>

The amended Law of 10 August 1915 regarding commercial companies requires in its Article 73 that the annual accounts and the auditor's report must be sent to registered shareholders at the same time as the convening notice to the annual general

meeting. The New Law derogates to that requirement and corporate UCITS and UCIs are therefore no longer required to attach the annual accounts to the convening notice to the annual general meeting of shareholders. This may result in savings of mailing costs, which may be substantial for large umbrella structures with a large number of registered shareholders. The annual accounts will still need to be sent to those shareholders who specifically request to receive a copy thereof and a specific statement to that effect has to be included in the convening notice.

3. Record date by reference to which attendance rights and quorum and majority requirements for shareholder meetings are measured

This provision in the New Law tends to facilitate the holding of shareholders' meetings of corporate UCITS and UCIs with a large number of investors where the drawing up of the attendance list on a single day on which the shareholders' meeting takes place is operationally difficult, if not impossible.

6. Delegation of functions by Part II UCIs and non-UCITS management companies

The 2002 Law does not comprise any provisions on the conditions with which Part II UCIs and non-UCITS management companies can delegate investment management, administration and distribution functions. In practice, however, the CSSF has generally required that if investment management functions are delegated to a third party, the latter should be subject to prudential supervision. In relation to this requirement the CSSF has sometimes granted derogations and a typical example in that respect is the situation where Swiss-based investment managers were authorised, although they were not subject to supervision by the Swiss supervisory authority.

Following the trend that any entity providing investment management activities should be subject to prudential supervision, the New Law now contains a specific requirement to that effect. The New Law also requires that if management functions are delegated to an investment manager established in a non-EU country, cooperation between the CSSF and the supervisory authority of that country must be ensured. In addition, mirroring here also the provisions applicable to UCITS and UCITS management companies, investment management functions may not be delegated to the depositary and the CSSF must be informed in an appropriate manner of any delegation.

7. Exchange Traded Funds (ETFs) (whether UCITS or UCIs) are exempt from the subscription tax/*taxe d'abonnement*

The New Law does not in fact refer to the term "Exchange Traded Fund" or "ETF" but specifies that those UCITS and UCIs, as well as sub-funds thereof, (i) whose securities are listed or traded on at least one stock exchange or another regulated market operating regularly, recognised and open to the public, and (ii) whose exclusive object is to replicate the performance of one or more indices, are exempt from the tax. The New Law clarifies the term "index" by specifying that an index must represent an adequate benchmark for the market to which it refers and must be published in an appropriate manner. It further provides that additional or alternative criteria may be determined by Grand-Ducal regulation.

It is interesting to note that the New Law, when clarifying the term "index", does not refer to Article 41 (1) g) of the New Law which discusses the eligibility of "financial indices" as eligible underlying of a financial derivative instrument, or Article 44 (1) which defines the criteria for a UCITS-eligible index which does not need to be looked through for UCITS eligibility of the underlying. Whereas the latter requires that an index is sufficiently diversified, representative and appropriately published, the definition for the tax exemption only requires that the two last criteria are met, thus potentially allowing UCIs to track an index which is less diversified than that required by the UCITS requirements and still benefit from the exemption.

8. UCITS and UCIs, and compartments thereof, the shares or units of which are reserved to pension funds are exempt from the subscription tax/*taxe d'abonnement*

The exemption from the *taxe d'abonnement* of UCITS and UCIS reserved to pension funds already applies under the 2002 Law, but it is limited to situations where the relevant pension funds are part of the same group, and is thus limited to UCITS or UCIs used as group pension pooling vehicles. On the other hand, the SIF law already provides for the enlarged exemption (not requiring that the pension funds are not of the same group) and the change now contained in the New Law aims at granting UCITS and UCIs the same tax treatment as SIFs. Unfortunately it appears that, presumably as an inadvertence in the drafting of the Bill, the exemption as contained in the New Law applies only to UCITS and UCIs and sub-funds thereof, but

not to classes of shares or units reserved to pension funds. Thus, if a sub-fund should comprise a class reserved to pension funds and a second class available to other types of investors, the sub-fund as a whole, comprising also the class which would otherwise be exempted, would not be able to benefit from the exemption.

9. UCIs and specialised investment funds (SIFs), and compartments thereof, whose main objective is the investment in microfinance institutions, are exempt from the subscription tax/*taxe d'abonnement*

This exemption had already been introduced by a law of 18 December 2009, but it required a Grand-Ducal Regulation to determine the conditions and criteria for the exemption. It was only recently, on 30 July 2010, that a Grand Ducal Regulation of 14 July 2010 was published in the official gazette (Mémorial A N° 127) that determines these conditions and criteria (the "Regulation"). The Regulation foresees that UCIs and SIFs which hold the LuxFLAG Microfinance Label will be automatically exempted. UCIs and SIFs that do not hold the LuxFLAG Microfinance Label will also be able to benefit from the exemption under the condition that their investment policy stipulates that at least 50% of their assets are invested in one or more "Microfinance Institutions" (as defined in article 2 of the Regulation). Microfinance UCIs and SIFs wishing to benefit from such an exemption for 2010 must, before the end of 2010, request their registration on a list drawn up to this end by the CSSF.

10. Foreign UCITS and UCIs managed by a Luxembourg management company, and whose centre of management could therefore be deemed to be in Luxembourg, are not subject to Luxembourg corporate income tax, local business tax and wealth tax and are thus not subject to taxation in Luxembourg

This clarification was introduced in the New Law to avoid any concerns that if a Luxembourg management company were to manage foreign UCITS, as is now be permitted, the latter could become subject to tax in Luxembourg. This concern had been flagged by many as a major hurdle for cross-border activities of management companies and remains one of the main reasons why it is currently not appropriate for management companies set up in certain EU member countries where no exemption exists that is similar to that which has now been introduced in Luxembourg, to provide cross-border services to UCITS established in other EU member countries.

11. Revenues resulting from the sale of large participations (more than 10%) held by non-residents for less than 6 months in a corporate UCITS, UCI, SIF or SICAR, are no longer subject to taxation in Luxembourg

This provision was introduced that in case a non-Luxembourg Feeder UCITS disinvests from its Luxembourg Master UCITS within 6 months of its initial investment, the revenues arising therefrom would be subject to tax under current tax laws applicable in Luxembourg.

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