Considerations for the boardroom

Third edition

October 2023

Content

Executive summary

We're delighted to share our third edition of "Considerations for the boardroom", a toolkit of the hottest boardroom topicsfor the asset management and alternative investment industries. We believe this guide will boost the quality of your boardroom discussions.

Alongside a brisk overview of the leading boardroom topics, we've also included questions to help you uncover the fund's status regarding these crucial matters.

We will regularly update this toolkit to capture the evolving regulatory agenda and our market insights.

We wish you a pleasant and insightful read.

KPMG

Digital Operational Resilience Act (DORA)

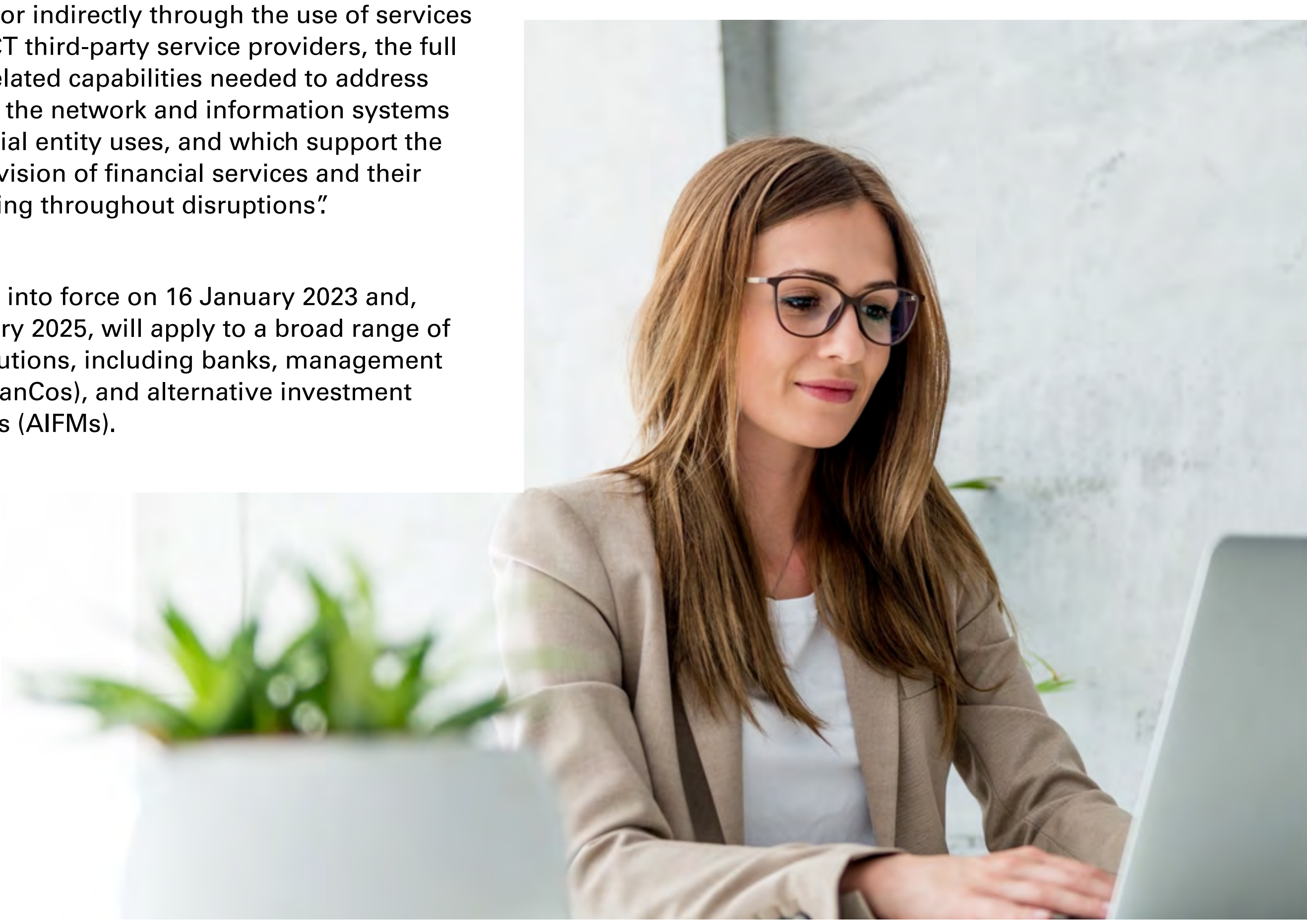
In September 2020, the European Commission proposed a new, single regulatory framework for managing digital risks arising from information and communications technology (ICT) and suppliers. The Digital Operational Resilience Act (Regulation (EU) 2022/2554), or DORA, aims to improve the financial sector's digital operational resilience.

DORA defines digital operational resilience as "the ability of a financial entity to build, assure and review its operational integrity and reliability by ensuring, either directly or indirectly through the use of services provided by ICT third-party service providers, the full range of ICT-related capabilities needed to address the security of the network and information systems which a financial entity uses, and which support the continued provision of financial services and their quality, including throughout disruptions".

DORA entered into force on 16 January 2023 and, from 17 January 2025, will apply to a broad range of financial institutions, including banks, management companies (ManCos), and alternative investment fund managers (AIFMs).

In Luxembourg, the CSSF is actively preparing the market for DORA in several ways, including:

- **Regulatory developments:** Circular CSSF 22/811 recommends entities acting as undertakings for collective investment (UCI) administrators that are not already in the scope of Circular CSSF 20/750 (e.g. ManCos and AIFMs) comply with DORA's ICT and security risk management principles by 30 June 2023.
- **Market surveys:** the CSSF sent a DORA compliance preparation survey to a selection of IFMs during Q2 2023.
- **Raising awareness:** the CSSF has already given a number of presentations on DORA, including to professional associations and in other market forums.



What is required?

DORA sets out a comprehensive framework for managing risks linked to the financial sector's growing digitalization and the dynamic cyber threat landscape. So, what do financial entities need to do to establish a robust digital operational resilience framework?

Governance and organization

- Implement an internal governance and control framework to ensure effective ICT risk management
- Ensure the management body is ultimately responsible for managing ICT risk.

Digital operational resilience testing

- Create a digital operational resilience testing program as an integral part of the ICT risk management framework
- Perform advanced testing based on threat-led penetration testing (TLPT)
- Implement requirements for testers carrying out the TLPT.

ICT risk management framework

- Identify all sources of ICT risk
- Protect ICT systems
- Detect anomalous activities
- Implement response and recovery plans and procedures.

Managing third-party risk

- Establish ICT third-party risk as an integral part of the ICT risk management framework
- Create a strategy for ICT third-party risk
- Establish a register of information
- Perform pre-contracting analyses over ICT services
- Promote standard contractual clauses

ICT-related incident management, classification, and reporting

- Implement an incident management process
- Classify ICT-related incidents and cyber threats
- Report major ICT-related incidents to authorities.

Information-sharing arrangements

- Reinforce the legal grounds for information sharing arrangements on cyber threat information and intelligence.

Questions that may be raised

01 Has the management body been informed of the entity's strategy to get DORA ready?

02 Has the entity conducted a gap analysis against the requirements of DORA?

03 What challenges does your entity anticipate facing during the implementation of DORA requirements, including sufficient understanding and mobilization at the group level?

04 Do you comprehensively understand your entity's ICT dependencies, including all ICT assets and any direct or indirect ICT third-party service providers?

05 Has a budget has been allocated for DORA compliance?

06 Has a person or team been designated to follow the evolution of future RTS / ITS / Guidelines underpinning DORA?

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EU Retail Investment Strategy:

Changing the face of fund distribution

Retail funds are sold, not bought

European retail fund distribution is dominated by intermediaries like banks and financial advisors, who act as an important conduit between asset management firms and individual investors. They identify their clients' needs, provide and explain product information, help with selecting the right solution as well as organize order flows and custody of investment funds on behalf of their customers.

Unlike the US, most European countries' investment cultures or regulatory and tax frameworks do not incentivize personal investments as a critical part of retirement provision and wealth creation. Therefore, private households tend to hoard cash and deposits even during times of low interest rates or high inflation.

It is to the financial intermediaries' credit that investment fund ownership has risen over the past 50 years. For this purpose, their services are rewarded by the product providers — the asset management firms — who embed the distribution charges within fund management fees.

Mitigating conflicts of interest

Consumer advocates have criticized this indirect remuneration model for the conflict of interest it may create for financial advisors. Instead of offering the best product to the client, intermediaries may be inclined to sell the fund with the highest embedded sales charge instead.

To mitigate the danger of bad advice, the EU introduced strict rules regarding product sales as part of its first revision of the Markets in Financial Instruments Directive (MiFID II) in 2014, including:

- A ban on inducements for discretionary portfolio management and independent advice.
- Restrictions on investment research compensation (i.e. the unbundling of trading commissions).
- Prerequisites for inducements to be permissible — alignment with investor interests, quality enhancement of services, maintenance of an inducement register, and full client disclosure.

The EU left it open to individual countries to introduce more stringent regimes in their jurisdictions. Consequently, the United Kingdom (Retail Distribution Review) and the Netherlands (Provisieverbod) completely banned inducements.

Same, same — but different

Almost a decade after MiFID II's publication, the face of Europe's fund distribution has not really changed for the better for retail investors.

1. Intermediaries have prevailed as the dominant sales channel, with inducements still widely used.
2. Independent financial advice (directly charging clients) is mostly a niche service offering.
3. Distributors' product shelves are more restrictive (return to guided or even closed architecture).
4. Cost disclosures have not led to a significant change in client behavior or a fee reduction.
5. Direct sales (e.g. robo advisors) have seen some successes, but starting from a very low base.

Moreover, evidence suggests that fund distribution in countries with a stricter regulatory regime has suffered. While post-MiFID II, average quarterly fund sales in Europe have more than quadrupled, the UK experienced an “advisory gap” and lost more than 70% of their respective volume. Investment fund ownership in eurozone private households rose by 93%, with inducement-friendly countries like Germany (+126%) and Spain (+228) enjoying above-average growth, while the Netherlands managed a mere 76% rise.

EU Retail Investment Strategy

In May 2023, the European Commission published its proposal to further improve investor protection and boost private clients’ investments as part of its Capital Markets Union work agenda.

The EU Retail Investment Strategy is a bundle of new measures amending key EU legislation such as MiFID II, the Insurance Distribution Directive (IDD), the Undertakings for the Collective Investment in Transferable Securities (UCITS) Directive, the Alternative Investment Fund Managers Directive (AIFMD), the Packaged Retail and Insurance-Based Investment Products (PRIIPs) Regulation, and Solvency II.

The key takeaways can be summarized as follows:

01 Inducement ban, except for financial advice

02 New value for money regime to prevent undue costs

03 Update of marketing rules and product disclosures

Unintended consequences

What was originally announced as a well-balanced compromise raises several significant questions and challenges for the seasoned fund distribution practitioner.

- The criticism against product payments is rooted in the potential conflict of interest when giving financial advice — the only investment service that is now excluded from the inducement ban.
- In practice, it is difficult to impossible to distinguish advised and non-advised fund transactions, which will either create significant operational costs or inadvertently lead to a complete ban.
- Intermediaries provide important services to fund companies as stipulated in distribution agreements, for which new pricing models and invoicing processes will be required.
- Important ecosystem actors, such as fund platforms, are financially dependent on taking a haircut of the inducement cash flows — these firms will need to revisit their business models.
- The value for money regime favors scale over diversity with unknown consequences — unthinkable in other industries such as airlines, consumer products or car manufacturers.
- Given the differences in national market practices and the diversity of the fund universe, a uniform European price benchmarking may only provide limited insights at a significant extra burden.
- Retail clients prefer simplicity over complexity, putting regulated funds at a competitive disadvantage compared to easily accessible crypto investments or direct trading platforms.

As a next step, the European Commission will enter into trilogue discussions with the European Parliament and the Council, and the outcome of this political process is still open. The entire fund sector is well advised to thoroughly prepare and educate the political stakeholders on any unintended consequences of the current draft legislation. It may be the last and final chance to avoid irrecoverable harm to both the financial industry and retail investors equally.

The EU Commission's Retail Investment Strategy at a glance

01 Investor interaction

Simpler product disclosures

- Risk warnings to alert investors about potential high losses with certain products
- Revised disclosures on cost and charges (including third-party payments) ex-ante as well as in annual client statements

Fair marketing

- Compulsory marketing communication policy
- Strengthened marketing compliance incl. alignment with product distribution strategy
- Tighter marketing communication rules from identification, reporting to archiving

Eased professional status

- Wealth limit reduced from EUR500,000 to EUR250,000; additional criterion on investor education
- Legal entities can qualify as professional clients on request when criteria are met

02 Investment service quality

Broadened inducement ban

- Ban of inducements for advice-free services (i.e. order transmission/execution)
- New "best client interest" test for financial advice, replacing quality enhancement rules

Better advisor qualification

- Higher requirements for financial advisor trainings and certifications

Suitability and appropriateness 2.0

- New client information on purpose of suitability and appropriateness tests
- Additional focus on ability to absorb losses as well as around portfolio diversification
- Standardized warnings if lack of client data
- Simplified independent advice for non-complex, well diversified, low cost products

03 Value for money

Prevention of undue costs

- New "pricing process" for PRIIPs distributors and manufacturers
- Price benchmarking by European Securities and Markets Authority (ESMA) to prevent "undue costs"
- Cost reporting obligations to ESMA

04 Supervisory action

Supervisory efficiency

- Crackdown against misleading marketing practices, in particular digital communication
- Improvement of cross-border collaboration incl. reporting of international activities

Financial literacy

- Member States shall promote measures to improve financial literacy of retails clients

Questions that may be raised

01 How will the proposed EU Retail Investment Strategy impact the fund sector and its various stakeholders?

02 How will the proposal change the company's business and operating model?

03 Are there any gaps in the organization, processes or IT that will need to be closed, and what is the required lead time to do so?

04 Which mitigating strategies are available to preempt the suggested measures' potentially negative consequences?

05 What actions should the asset management community take now to avoid any unintended consequences in a competitive environment?

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AML/CTF — Fighting financial crime remains high on the government and regulator agenda

In April 2023, the European parliament approved its negotiating mandates for proposals reforming the EU's policies on AML and CFT.

As a reminder, the new AML/CTF package includes:

- The AML Regulation, a single rulebook legislation that aims to reduce differences between EU member States. Compared to a directive, this regulation will directly apply to member states when entering into force and does not require transposition.
- The Anti-Money-Laundering Authority (AMLA) regulation to introduce an AML competent authority at the EU level. While the AMLA's location is still unknown as of the date of this report, Luxembourg has confirmed its interest as a welcoming country. The AMLA aims to further enhance coordination with financial intelligence units (FIUs), and establish direct supervision of 40 selected obliged entities in the EU with the highest residual risk.
- Additional provisions for the sixth AML Directive (AMLD6), including a 15% ultimate beneficial owner (UBO) identification threshold instead of 25%, a 5% UBO identification threshold for the extractive industry and any company with a higher money laundering/terrorism financing (ML/TF) risk level, and the obligation to identify the ownership of goods worth more than EUR200,000 in free zones.

The first meeting to kickstart negotiations already took place at the beginning of May 2023, so stay tuned

Focus on the complexity of your operating model

Organizations face these common challenges when designing an adequate AML/CTF risk response:

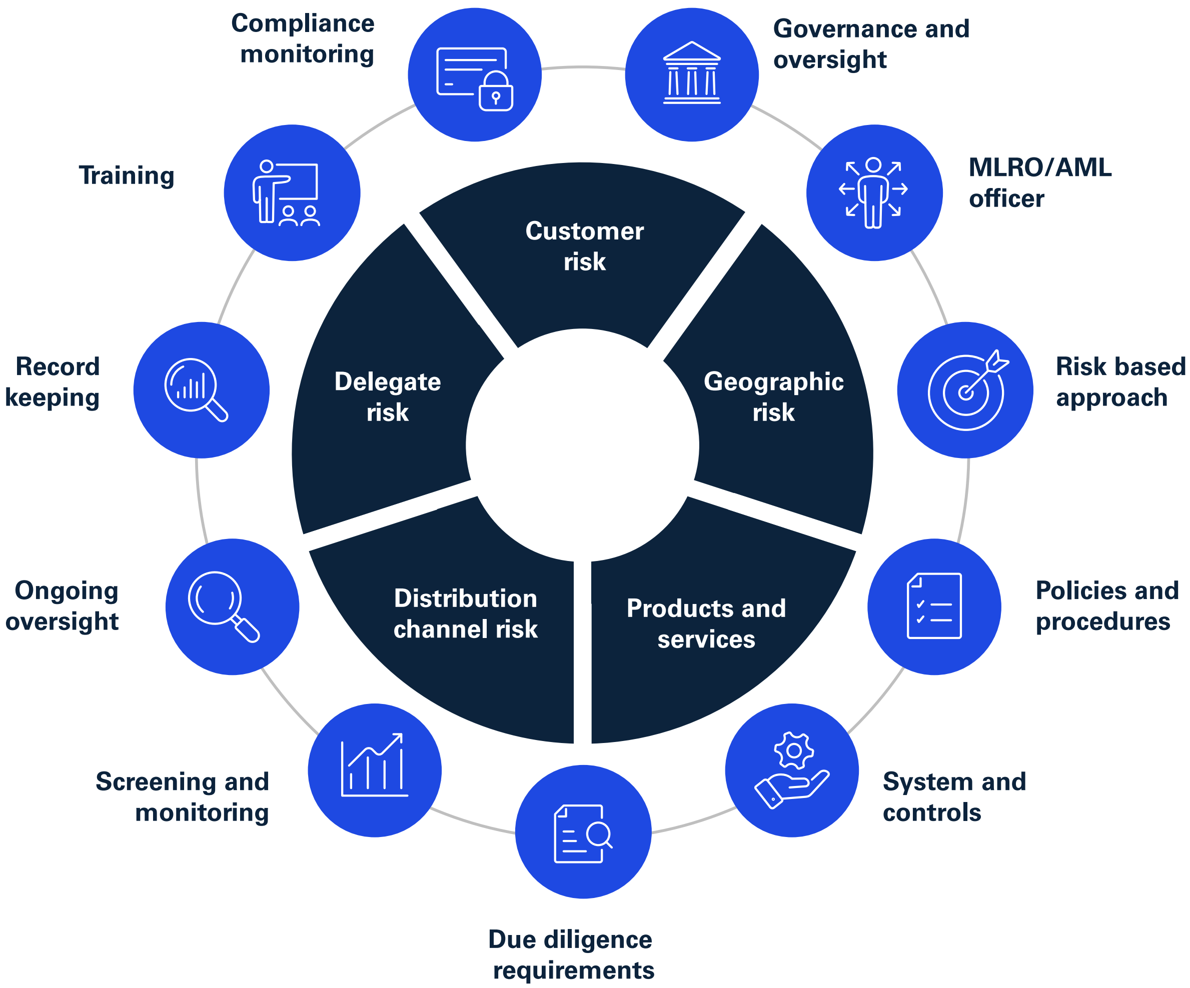
The diversity of distribution channels requires organizations to maintain a detailed understanding of roles and responsibilities across the value chain, to guarantee transparency and access to underlying information upon request. Inherent risk exposures can only be assessed by using reliable data on countries of origin, investor type, etc.

The delegation model may lead to a significant number of business counterparties to oversee. Therefore, organizations must define the reporting content, its frequency, and the applicable escalation procedures when required.

Luxembourg vehicles' investment strategies, especially those in the alternative assets landscape, must assess the AML/CTF inherent risk exposures derived from these assets. All involved parties have a role to play. "Which one and when" remain key questions on the agenda. Binding agreements between investment managers, ManCos, investment funds and depositary banks should specify roles and responsibilities and contain a detailed operating model.

Based on our recent interactions with the CSSF and market participants, organizations must ensure that the bridge between the ML/TF risk appetite defined by the board and the risk assessment's final outcome is appropriately documented.

The board should also obtain assurance that the underlying methodology for assessing the inherent and residual risks is robust, well-documented, and applied consistently year on year.



Questions that may be raised

01 Is the ML/TF risk appetite well defined, transposed by the authorized management, and communicated to all staff involved? Has it also been communicated to our delegates, for example our transfer agent?

02 Is an analysis of the ML/TF risk linked to the business activities performed on an annual basis? Does it consider as well the risk posed by our investments (assets)?

03 Are the outcomes of the ML/TF risk assessment aligned with the ML/TF risk appetite?

04 Does the current methodology provide a quick overview of the assessment outcomes, in terms of inherent and residual risks?

05 Do we receive regular key performance indicators (KPIs) and/or key risk indicators (KRIs) that provide a proper overview and understanding of the risks?

06 Are we properly involved in ML/TF matters through reports, discussions and reviews, as well as in the decision-making process for situations, relationships or transactions that present a higher risk?

07 How robust is the oversight performed on distributors, delegates, and service providers?

08 Have we obtained sufficient assurance from the portfolio manager/investment manager that asset due diligence procedures are adequate and in line with AML/ CTF requirements?

09 Is our AML training program correctly tailored to the specificities of the collective investment scheme sector?

10 Have we already received a request from the CSSF regarding an AML/CTF on-site inspection? Are we prepared for such an inspection?

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Sustainable finance — Reporting challenges continue

The sustainable finance journey goes beyond regulatory requirements

Here are the main environmental, social and governance (ESG) and sustainability challenges that market players are still facing, and the questions to tackle them:

Put my ESG strategy into motion

How can I define an ESG strategy and put it into practice?

Adapt my operating model to address ESG opportunities

How should I update my operating model to ensure regulatory compliance and create value from ESG?

Reporting according to final Regulatory Technical Standards (RTS)

How should I address the reporting requirements of the final RTS?

Developing an ESG strategy

ESG is a long-term trend that's here to stay. It requires a fund-level, future-proof product strategy that:

- Ensures a better long- term risk management approach, including sustainability risk
- Offers a diversified portfolio with environmental and social contributions
- Meets a new generation of investor expectations

To develop a successful ESG strategy, market players must define their ambitions, assess their current capabilities, and set out an action plan.

Defining your ESG data model for SFDR readiness

From 1 January 2023, the Sustainable Finance Disclosure Regulation (SFDR) requires financial market participants to report additional information in their pre-contractual documents, websites and periodic reports. These new reporting obligations are changing the ESG data paradigm by standardizing the indicators that qualify an investment product as sustainable. Financial market participants must also have the technical capabilities to gather the necessary data and produce the reports, ranging from European ESG Templates (EET) to SFDR periodic reports.

To meet these reporting obligations, financial market participants must:

- Assess the impact on ESG data along their operation's value chain
- Identify the ESG data needs based on their assets under management
- Qualify ESG data from investment decisions to reporting requirements
- Train and educate employees to address these ESG data needs
- Adapt the IT systems to integrate the ESG data model
- Assess current ESG due diligence process for integrating SFDR obligations
- Update risk management processes, compliance checks and internal audits to ensure data accuracy and reliability
- Convert the RTS templates into business requirements
- Adapt their technology or seek external parties to provide support with producing reports.

Reporting according to final RTS requirements

Both the SFDR and the EU Taxonomy Regulation require market players to disclose ESG information through their prospectuses, annual reports and websites. The final RTS provides further details of this required information and its prescribed format through mandatory templates. These reporting requirements entered into force on 1 January 2023.

	SFDR product periodic disclosure	SFDR entity's "principal adverse impacts" disclosure
Content	• Fund's ESG performance • Alignment with EU Taxonomy Regulation	• Entity's ESG impact
Process	• Recurring report to be included in the annual report • Ongoing monitoring is optional	• Recurring report to be disclosed on the client's website (annually) • Quarterly monitoring is required
Scope	• SFDR Article 8 funds • SFDR Article 9 funds	• All direct and indirect investments at the entity level
Deadline	• Any annual report published after 1 July 2022 must comply with SFDR Level 1 requirements • SFDR Level 2 (RTS) entered into force on 1 January 2023	• 30 June 2023 for the 2022 reference period (1 January 2022 to 31 December 2022)

	European ESG Template ("EET")	"Taxe d'abonnement" reduction
Content	• ESG data for all investment products to be produced at the share class level	• Eligibility/alignment with EU Taxonomy Regulation
Process	• EET template used to exchange ESG data from asset managers to banks and insurers to produce ESG reports for their own products (mandate or life insurance)	• EU Taxonomy data monitoring is required to claim this reduction
Scope	• All investment products (Articles 6, 8 and 9)	• SFDR Article 8 funds • SFDR Article 9 funds • Potential analysis for Article 6 funds
Deadline	• EET light version applied starting 1 June 2022 • EET complete version applied starting 1 January 2023	• From a regulatory perspective, claims can currently be made; however, the data available is limited • Communication to the Registration Duties, Estates and VAT Authority (AED) should be done within 3 months after the financial year end

Questions that may be raised

01 As board members, what is our collective level of understanding of sustainable finance to engage in credible discussions?

02 Have we received any investor or regulator feedback on the information published on our website, and in our prospectuses and periodic report? If yes, what action was taken?

03 Have we identified our ESG ambitions? Should existing products be adapted, and are there opportunities for new products?

04 What are the fund's main sustainability risks? Is the fund's sustainability risk monitoring robust enough to keep tabs on these risks?

05 Have we identified the disclosure information that was required as of January 2023? Are there any difficulties foreseen? Were we able to produce all related information?

06 How are we addressing any additional information requests from the CSSF? Are we prepared for any potential ESG site inspections?

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Sustainable finance disclosures

ESG — Don't forget the disclosure requirement!

Who is impacted and when?

- Articles 8, 9, 10 and 11 of the SFDR impose disclosure requirements for financial market participants — including management companies and AIFMs, whether authorized or registered — that offer financial products referred to in Article 8(1) or Article 9(1), (2) or (3). These obligations apply to any fund, whether self-managed or managed by a chapter 15 ManCo or AIFM.
- As these requirements applied from 1 January 2022, it's implied that periodic reports published since then should already contain the relevant disclosures. In addition, from 1 January 2023, prospectuses, websites and periodic reports needed to comply with further reporting obligations and dedicated templates.

What needs to be disclosed?

The disclosure requirements are contained in Articles 8, 9, 10 and 11 of SFDR and have been subsequently complemented by the EU Taxonomy's provisions in its Articles 5, 6 and 7. A Level 2 delegated regulation shares further details on the disclosures and templates to ensure consistency amongst market players.

The content and extent of the disclosures depend on:

- The fund's classification (under Articles 6, 8 and 9)
- The characteristics it promotes (social and environmental) for Article 8 funds
- Its sustainable objective (social and environmental) for Article 9 funds.

CSSF communications

The CSSF has issued several communications relating to SFDR in 2023, including a two-phased dedicated data collection exercise. On 1 February 2023, the first phase was launched for IFMs regarding organizational arrangements via a dedicated questionnaire with a submission deadline of 2 March 2023. The second phase focuses on products, collecting information related to precontractual disclosure.

IFMs were initially required to collect this information on a best-effort basis by 15 June 2023, which was extended to 31 October 2023.

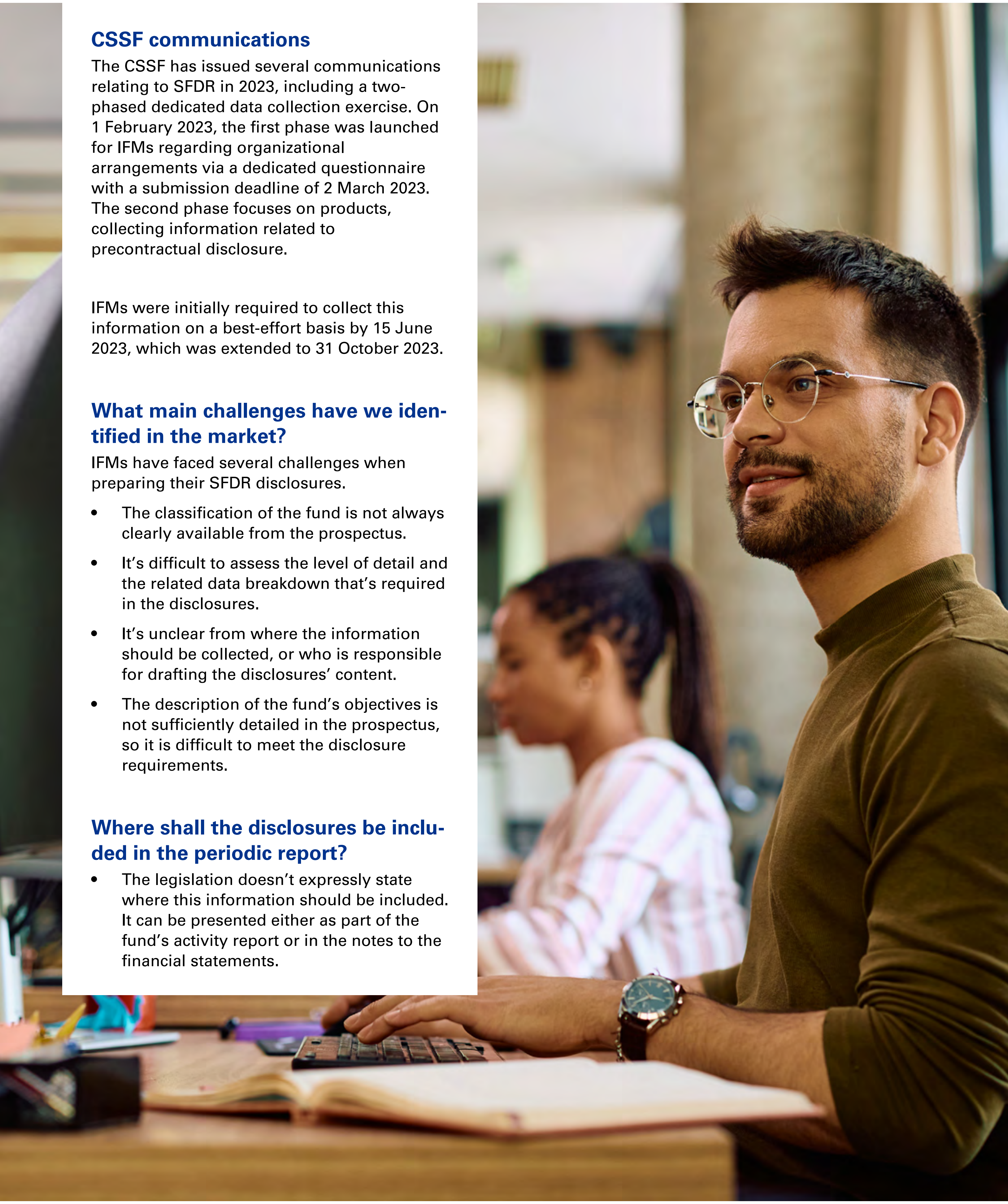
What main challenges have we identified in the market?

IFMs have faced several challenges when preparing their SFDR disclosures.

- The classification of the fund is not always clearly available from the prospectus.
- It's difficult to assess the level of detail and the related data breakdown that's required in the disclosures.
- It's unclear from where the information should be collected, or who is responsible for drafting the disclosures' content.
- The description of the fund's objectives is not sufficiently detailed in the prospectus, so it is difficult to meet the disclosure requirements.

Where shall the disclosures be included in the periodic report?

- The legislation doesn't expressly state where this information should be included. It can be presented either as part of the fund's activity report or in the notes to the financial statements.



Questions that may be raised

01 Have we identified the information required for disclosures published from January 2023 onwards? Are there any expected difficulties?

02 Have discussions been engaged with the investment manager to ensure that they will provide the necessary information and data to prepare the disclosure, or will they prepare the disclosure themselves?

03 Are the responsibilities for preparing and validating the disclosures clearly set out?

04 Is there a project plan to ensure the various steps are in place, from collecting the information to preparing the reports?

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From anti-money laundering to anti-tax crime laundering: Can you manage your tax risk?

When the scope of AML widens to tax crime, compliance officers need to hit the tax books. And when the financial regulator also comes into play, the topic is a must for the boardroom.

Today's tax landscape is driven by heightening tax obligations, with a shift towards increasing tax transparency and enhancing tax conformity for financial services and professionals supervised by the CSSF. As a result, Luxembourg underwent a significant tax reform in 2017, which created — amongst others — new tax-related criminal offenses.

As such, the fight against tax crime is imperative for both the traditional financial industry and the alternative investments sector, not least due to the financial regulator's rising expectations.

One example is CSSF Circular 20/744, which introduced nine tax indicators to identify potential tax crimes in July 2020, on top of the 21 tax indicators already presented in Circular 17/650.

In its thematic review, the CSSF emphasized that these nine tax indicators must be implemented by all professionals from the asset management sector directly supervised by the CSSF.

To mitigate their exposure to these potential tax risks, professionals must adapt their tax compliance policies and AML frameworks by integrating these indicators into their risk assessment processes.

The nine indicators: At a glance

01	**Complex investment structuring**
02	**Tax base erosion**
03	**Investment transactions** Lack of AEOI/CRS/FATCA procedures
04	**Investment transactions** Lack of economic rationale
05	**Investment transactions** Frequent transactions resulting in losses
06	**Efficient portfolio management techniques**
07	**SICAR**
08	**Subscription tax**
09	**Investor tax reporting**

CSSF audits

After Circular 20/744 was published, the CSSF included these new indicators in the scope of its 2021 audits and began sending specific observations in December 2021 requesting dedicated procedures on the Circular.

Going forward, the circulars and their implementation will be a key consideration of the CSSF.

What are the risks of non-compliance?

- If you don't include the Circular's nine tax indicators in your internal procedures, you could be considered non-compliant with your AML obligations.
- In case of a breach, the CSSF could impose (public) administrative sanctions, ranging from a warning or an administrative fine up to withdrawing or suspending your registration or authorization.
- In a worst-case scenario, you could be considered a money laundering accomplice, resulting in criminal fines and up to 5 years of imprisonment.

Questions that may be raised

01 Are we directly supervised by the CSSF?

02 Have we performed an impact assessment of Circular 20/744 on our business?

03 If yes, have all the assessment's issues been addressed by implementing the necessary mitigating measures?

04 Have we properly implemented the Circular's requirements in our procedures and policies?

05 How robust is our oversight of third-party delegates, funds, and service providers?

06 Has the portfolio/investment manager provided sufficient assurance that its asset due diligence procedures are adequate and in line with the Circular?

07 Has the CSSF already requested an AML/CFT on-site inspection? Are we prepared for such an inspection?

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FATCA and CRS

Background

All Luxembourg financial institutions (including investment funds and ManCos) must comply with the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS).

The FATCA and CRS law of 18 June 2020 hasn't just heightened the already heavy burden of compliance — it's also reinforced the Luxembourg tax authorities' powers to carry out audits within a 10-year time limit.

Given the increased risk of falling under the tax authorities' spotlight, now more than ever, financial institutions must make sure that appropriate policies, controls, procedures and IT systems are in place to meet their reporting and due diligence obligations.

Luxembourg reporting financial institutions (FIs) should also maintain a so-called "Register of Actions", which describes the FI's actions to comply with FATCA and CRS and the roles and responsibilities within the organization.

If a Luxembourg CRS or FATCA audit uncovers non-compliance with due diligence procedures, the maximum penalty of EUR250,000 may apply. And, if the audit finds reportable accounts that are unreported or under-reported, an additional maximum penalty of 0.5% of the non-reported amount could apply.

What will these audits look like?

- As suggested by the OECD, jurisdictions like Luxembourg have several options available when designing and implementing a compliance review procedure. One logical starting point is to review the financial institution's internal control framework regarding its compliance with CRS and FATCA. The Luxembourg tax authorities have already started conducting these audits.
- Another approach is to review a sample of accounts, or combine both methodologies in a multi-phase compliance review using the risk-based approach.

Questions that may be raised

01 Was the FATCA and CRS entity classification of the investment funds under management reviewed?

02 Are there adequate FATCA and CRS procedures in place at the fund or ManCo level?

03 Have internal audits been carried out to ensure the procedures and processes are adequately followed?

04 Do we have training in place to educate all personnel on their FATCA and CRS responsibilities?

05 Is our FATCA/CRS reporting solution efficient and adequate?

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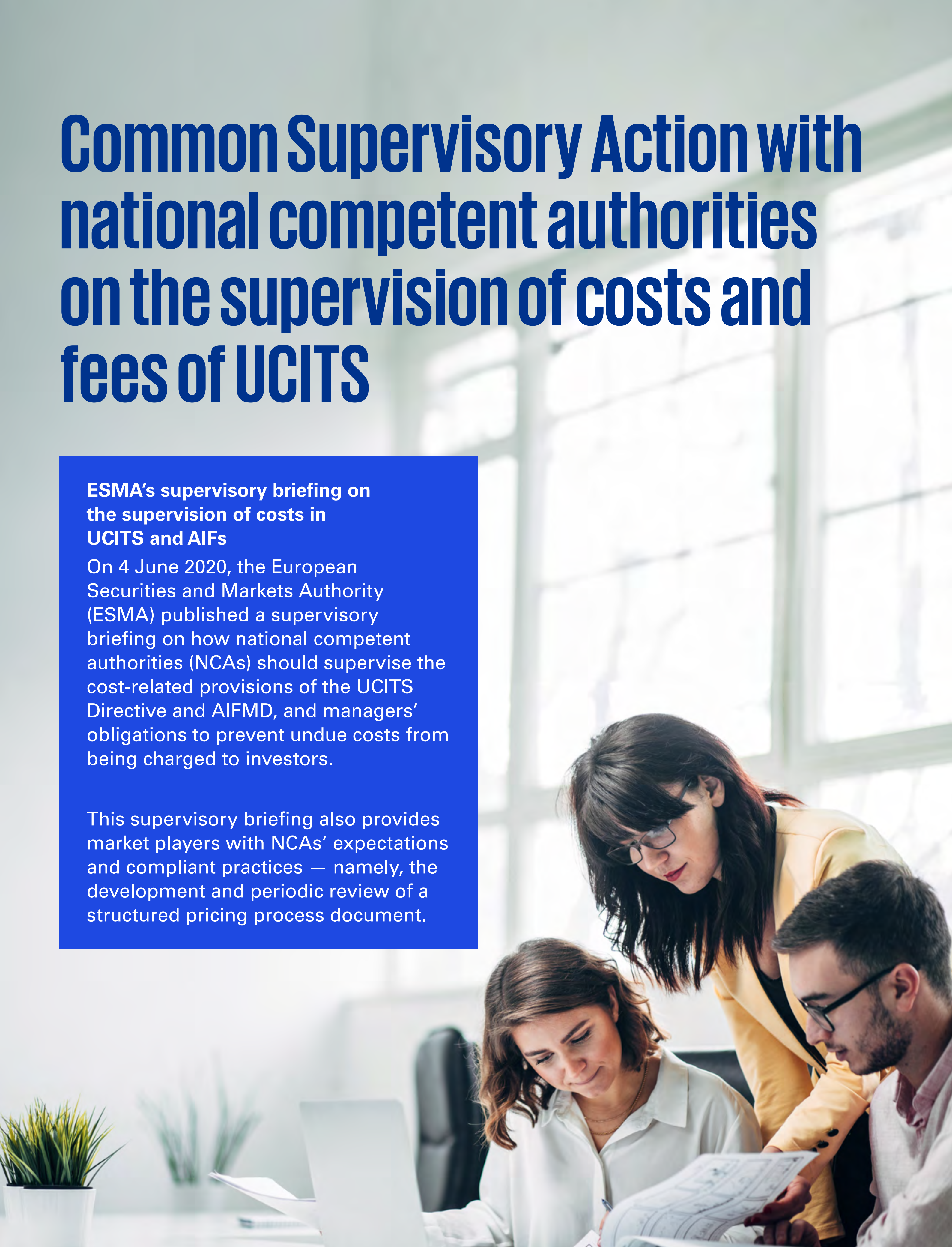

Common Supervisory Action with national competent authorities on the supervision of costs and fees of UCITS

ESMA's supervisory briefing on the supervision of costs in UCITS and AIFs

On 4 June 2020, the European Securities and Markets Authority (ESMA) published a supervisory briefing on how national competent authorities (NCAs) should supervise the cost-related provisions of the UCITS Directive and AIFMD, and managers' obligations to prevent undue costs from being charged to investors.

This supervisory briefing also provides market players with NCAs' expectations and compliant practices — namely, the development and periodic review of a structured pricing process document.

This document must cover the following topics

Best interest
Are costs related to a service provided in investors' best interests and necessary for the fund's investment objective, the ordinary activity of the fund, or to meet regulatory requirements?

Complexity
Is there a balance between the complexity of activities and costs to investors?

Equality
Do the costs ensure equal treatment of investors (except when allowed for non-retail AIFs that have relevant disclosures in place)?

Cap
Is a cap on fees applied and, if yes, is it clearly disclosed to investors?

Disclosures
Are all costs clearly disclosed to investors in line with EU rules (AIFMD, UCITS, PRIIPS) and national rules (where applicable)?

Proportionality
Are costs proportionate to market standards?

Sustainability
Are the fees sustainable given the fund's net returns, risk profile and investment strategy?

Accounting
Is there no duplication of costs, and are costs properly separated and accounted for?

Performance fees
If charging performance fees, do the performance fee model and the disclosures comply with ESMA Guidelines?

Data reliability
Are the pricing process and all charged costs based on reliable data?

ESMA's common supervisory action with NCAs

In January 2021, ESMA launched a Common Supervisory Action (CSA) with NCAs on the supervision of costs and fees of UCITS across the EU and EEA. The CSA's aim was to assess, foster and enforce supervised entities' compliance with the UCITS framework's key cost-related provisions, especially the obligation of not charging investors with undue costs.

The outcome of the CSA on costs and fees showed divergent market practices in what the industry reported as "due" or "undue" costs. It evidenced that legislative clarification of the "undue costs" notion would provide more uniformity and give NCAs a stronger legal basis to take supervisory and enforcement action against relevant market participants in many cases. ESMA's Opinion on undue costs of UCITS and AIFs suggests possible clarifications of the UCITS Directive and the AIFMD's legislative provisions relating to the notion of "undue costs" to the European Commission.

The European Commission is working on policy proposals regarding the Retail Investment Strategy (RIS) to empower retail investors and enhance their participation and trust in the capital markets. ESMA welcomes the Commission's initiative and is confident that its Opinion on undue costs of UCITS and AIFs can be considered in the Commission's upcoming legislative proposals on the RIS.

Questions that may be raised

01 Has the fund/ManCo considered the requirements of ESMA's supervisory briefing on the supervision of costs and fees in UCITS and AIFs?

02 Has the impact been assessed and what actions are required, if any?

03 Are there any unclear requirements? If yes, what steps were taken to obtain clarity?

04 Who is responsible for preparing the structured pricing document? Is all the necessary information available?

05 Were any issues noted regarding the fund's fee structure, e.g. fees that could not be justified under the ESMA briefing's criteria? If yes, what are the next steps?

06 Has the fund/ManCo already received a request from the CSSF regarding this CSA? Are we prepared?

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Navigating transfer pricing in the world of asset management

Background

- Historically, transfer pricing for asset management was largely limited to analyzing and pricing transactions between the fund's ManCo and its overseas subsidiaries/affiliates that provide services to the ManCo, like distribution, portfolio management, or investment management.
- While intercompany arrangements regarding ManCos are still a key concern, there are three evolving trends:

01

The rising controversy risk on:

- Related-party financing transactions, especially at the fund level, where shareholder loans/financing can arise due to structuring asset acquisition (debt quantum, interest rate, interbank offered rate [IBOR] transition, etc.)
- Substance, especially when high-value functions are split over different locations and/or in branches
- Transfer pricing documentation, a key element in transfer pricing audits to defend the ManCo's filing position.

02

Changing business models with a direct:

- New value chains where technology plays a larger role and the growing digitalization of capital raising and distribution
- Innovative investment management
- Tools that enhance the investor experience
- Reimagined back and middle offices (changing cost base and allocation keys).

03

The regulatory intersection:

- The AIFMD reform discussions have suggested that transfer pricing is a good indicator of regulatory "substance" in the EU.
- For US groups, the Securities and Exchange Commission (SEC) has long focused on cost and fee allocations, especially in the alternative investment space. Examples include management and monitoring fees, and charges to portfolio companies. Similarly, the EU's MiFID II seeks to identify and attribute fees to specific functions. Investors have also taken notice.
- Asset management regulations are concerned with the seniority and expertise of key personnel that is dedicated and present in key jurisdictions.
- One of the nine tax indicators in the CSSF's Circular 20/744 refers to tax base erosion derived from cross- border transfers of financial flows (e.g. management fees, service fees, marketing commissions, etc.) and (intangible) assets. This triggers questions regarding compliance with Luxembourg transfer pricing rules.

What are the risks?

If transfer prices applied on intercompany transactions don't reflect arm's length prices or haven't evolved in line with the group's business model and the latest transfer pricing trends, Luxembourg or foreign tax authorities are highly likely to impose transfer pricing adjustments and even penalties. These adjustments usually lead to double taxation that can reach very material amounts.

Questions that may be raised

01 Does the group have a transfer pricing policy that our ManCo effectively applies?

02 Are all intercompany transactions supported by legal arrangements?

03 Are intercompany prices regularly benchmarked in transfer pricing documentation according to Luxembourg regulations and OECD Guidelines?

04 What transfer pricing methods have we used (commonly cost plus or fee/profit split), and have we recently reviewed whether they are aligned with the group entities' current business model and functional profile?

05 Do we have supporting documentation for headquarters allocations and, more globally, cost allocation within the group?

06 Have we considered technology's role in the value chain and its transfer pricing consequences (allocation of costs, royalties, profit share, etc.)?

07 Have we revisited any related party financing considering the 2020 OECD Guidelines on financial transactions and/or the IBOR transition?

08 Do we have branches where profit allocations are not documented?

09 Have we ensured our transfer pricing model aligns with the regulatory framework?

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Reduced subscription tax on environmentally sustainable investments

What does the law say?

- As part of its 2021 Budget law, the Luxembourg government enacted to grant a reduction of the annual subscription tax rate of UCIs (Part I and Part II funds), and compartments of UCIs, that invest in any kind of economic activities qualifying as environmentally sustainable as per the EU's Taxonomy Regulation.
- The subscription rate decreases to 0.01% and 0.04% depending on the total net assets invested in environmentally sustainable activities — i.e. any economic activity that qualifies under Article 3 of the EU Taxonomy Regulation.
- To benefit from the reduced tax rate, the fund needs to calculate its percentage of investments in environmentally sustainable activities and include this percentage in its annual report or an assurance report.
- The fund's auditor then issues a certificate with the percentage disclosed in the annual report/assurance report, to be filed with the immediately following quarterly subscription tax declaration. The reduced rate will be fixed for the next four quarters, and will apply the total net assets invested in environmentally sustainable activities as calculated at the end of each quarter.

The certificate of the auditor must confirm the percentage of the assets invested in activities aligned with Article 3 of the EU Taxonomy Regulation as disclosed in the annual report or the assurance report.

Certificate from the Auditor

- **Percentage of assets as disclosed in the annual report or in the assurance report**
- **A reference to Article 3 of the EU Taxonomy Regulation**
- **Signature of the auditor**

Agreed upon procedures

What is the current implementation status?

- To date, only very few funds have been able to file a request for the reduced subscription tax. As indicated above, the legislation requires that the fund provides a certification from an auditor of the percentage of environmentally sustainable investments. To calculate the percentage of environmentally sustainable investments, the fund must gather data from its underlying investments on their EU Taxonomy alignment.
- However, the EU Taxonomy Regulation didn't require this alignment disclosure before 1 January 2022 for its first two objectives (climate change mitigation and climate change adaptation) and disclosure of the other four objectives was not required until 1 January 2023. As a result, the data is generally not yet available to determine the required percentage of environmentally sustainable investments.

Questions that may be raised

01 Has the fund/ManCo considered the potential of obtaining the reduced subscription tax on environmentally sustainable investments?

02 Is the process for obtaining this reduced tax rate clear? If not, what actions are being taken to obtain clarifications?

03 When will the fund/ManCo be in a position to benefit from the reduced tax rate?

04 Are the processes in place to obtain the necessary data to calculate the percentage of environmentally sustainable investments? If not, who is responsible for implementing these processes, and what is the implementation timeframe?

05 Who will be responsible for the quarterly determination of the percentage of environmentally sustainable investments (central administration, manager, etc.)?

06 Has an auditor been approached and/or appointed to prepare the assurance report?

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Outcome of ESMA's compliance assessment with UCITS liquidity rules

On 30 January 2020, ESMA launched a CSA on UCITS liquidity risk management (LRM) to assess whether UCITS managers are meeting their liquidity management obligations. On 24 March 2021, ESMA published the results of the CSA.

Overall, the CSA showed that most UCITS managers have implemented and applied sufficiently sound LRM processes. However, for some of the participating UCITS, the CSA identified several areas of improvement.

ESMA recommends that market participants critically review their LRM frameworks in light of these adverse supervisory findings, which include:

- **Documentation of LRM arrangement processes and techniques** is absent or lacks granularity, including pre- investment liquidity analyses and forecasts, design phase, escalation processes, and verification of data reliability.
- LRM **procedures** do not provide for the documentation of LRM arrangements, processes and techniques, or do not cover all asset types or the use of liquidity management tools (LMTs).
- **LRM mechanisms and methodologies** are not always appropriate, forward-looking and, most often, justified and back-tested.
- Overreliance on **liquidity presumption** regarding listed securities, and monitoring based on insufficient data of past volumes, number of brokers and trading size.
- Application of **liquidity presumption** to financial instruments not admitted to or dealt in on a regulated market in violation of Article 2(1) of the UCITS Eligible Assets Directive (Commission Directive 2007/16/EC).
- When the LRM function is also performed by the **delegated** portfolio management, there can be insufficient involvement of the internal risk management function and insufficient delegation monitoring and due diligence.
- Overreliance on too few data providers, as well as a lack of robust and documented control processes based on cross-checks and back-tests to ensure **data reliability.**
- Missing, inaccurate, or unclear disclosures on liquidity risks and LMTs to investors.
- Insufficient **governance** in terms of frequency, granularity and clarity, or absence of reporting to senior management. Inadequate formalization of decisions relating to the UCITS' design and the LMT's setup and calibration. Also, insufficient procedures for monitoring the actual use of LMTs, documentation of cases escalated to the board or senior management and their resolution, and criteria to trigger the escalation process.
- Insufficient controls by the compliance and internal audit functions regarding LRM processes.
- No **external controls** by the depositary.

ESMA will carry out further initiatives to harmonize the way NCAs follow up on the CSA's findings.

Questions that may be raised

01 Has ESMA's feedback on liquidity management been considered and has a critical review of the LRM framework been conducted? Are there identified areas that require updating?

02 Are we properly involved in liquidity management matters through reports, discussions and reviews, and in the decision-making process for anticipated liquidity issues?

03 When did the compliance and internal audit functions last review the LRM processes? Were there any significant findings?

04 Is LRM delegated to the portfolio manager? If yes, what monitoring processes are in place?

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ESMA's guidelines on performance fees

In November 2020, ESMA published guidelines on performance fee requirements for UCITS funds and certain open-ended AIFs distributed to retail investors, except for private equity/real estate funds.

The guidelines cover the following:

- Minimum content for the performance fee methodology, such as reference indicators, crystallization frequency, reference periods, frequency of calculation, and performance fee rate.
- Required consistency between the performance fee model and the fund's investment objectives, strategy and policy — e.g. a benchmark appropriate to the fund's investment policy and strategy and adequately representing the fund's risk-reward profile.
- A crystallization period that ensures the alignment of the portfolio manager and shareholders' interest and fair treatment among investors. Should not be more than once a year, except for High-on-High (HoH) and High-Water-Mark (HWM) models.
- Payment is only allowed when the net positive performance has been accrued.
- Details on disclosures required in the prospectus (example calculations), marketing documents, and the key investor information document (KIID).

These guidelines already apply to new funds or new performance fee schemes for existing funds. However, there is a transition period for existing funds with existing schemes. For these funds, the new guidelines apply from the beginning of their performance year starting after 5 July 2021.

Therefore, organizations should now identify and plan any required changes to their existing models, to allow enough time to select a new target model and adapt the documentation and operations accordingly.

Questions that may be raised

01 Was a review conducted to ensure that the existing performance fee schemes comply with the ESMA guidelines? What changes need to be made, if any?

02 Even if the current models comply, is it perhaps the right time to review the performance strategy as a whole and compare it to market standards?

03 If changes to the model are necessary, what is the anticipated timeline? For example, to determine the target model, validate the prospectus descriptions, and implement it at the fund administration level. Will the new model be implemented in time for the new performance year?

04 Are there any funds/sub-funds where the performance fee is calculated by reference to the London inter-bank offered rate (LIBOR)? If so, how will the LIBOR transition be dealt with?

05 Does the prospectus clearly and unambiguously describe the performance fee calculation?

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ELTIFs are becoming more enticing

The European Long-Term Investment Funds (ELTIF) Regulation (EU) 2015/760, issued in 2015, had the ambitious aim of easing the access of high-net-worth individuals (HNWIs), family offices and even retail investors to the private equity market. However, eight years later, the number of ELTIF structures remain modest. When querying why the numbers are so low, the reported barriers remain the same.

1. Distributors must perform further suitability and threshold verifications in addition to those of the MiFID II Directive.
2. The investment rules are too many and too strict.
3. The 10% limit in aggregate of total investments in ELTIF for retail investors.

Aiming to remediate some of ELTIF 1.0's most critical weaknesses, the revised ELTIF (ELTIF 2.0) entered into force on 9 April 2023 and will apply from 10 January 2024. It includes several assurances for asset managers and will better support the current private equity democratization trend.

Main changes introduced by ELTIF 2.0

Simplification of distribution rules:

- As ELTIF 2.0 now refers to MiFID II's product governance and suitability provisions, all other due diligence requirements will be eradicated, including the suitability tests and the collection of information specific to ELTIF investors.
- The EUR10,000 minimum investment threshold and the 10% total wealth in investments in ELTIF limit will be removed.

More flexible investment rules:

- The minimum investment in eligible long-term assets will be reduced from 70% to 55%.
- Fund of funds investment strategies will be introduced, subject to the eligibility of the underlying funds' investment in certain assets and of master-feeder structures.
- The EUR10 million minimum investment in real assets will be abolished.
- The value of market capitalization of eligible assets quoted on a regulated market will be increased from EUR500,000,000 to EUR1,500,000,000 (at the time of the investment).
- The borrowing of cash will increase from 30% to 50% of the ELTIF net assets (and even 100% for ELTIFs distributed only to professional investors).
- Portfolio composition, diversification and concentration rules are less stringent and may be disapplied for ELTIFs that are only marketed to professional investors.
- Last but not least, open-ended structures will be allowed. Some constraints will tough limit the redemptions.
- The Luxembourg Parliament recently adopted a new law introducing a subscription tax exemption for Part II funds and SIFs authorized as ELTIFs. This law also reduces the minimum investment amount required from a well-informed investor from EUR125,000 to EUR100,000.

Questions that may be raised

01 Have we assessed the new potential of ELTIFs, based on the legislation's revision?

02 Is our retail investor base interested in a product providing access to the private equity market?

03 Do we have the necessary competencies in our fund value chain to onboard an ELTIF project?

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Leading with growing volumes

How to focus on what matters

Like any other business, investment funds face significant challenges as they grow, including scaling the business. This is because the strategic side of the company — fund raising and investing — requires a very different culture and skillset than the administrative side, which manages volume-based activities such as AML/KYC, fund accounting, and registry keeping. While managing two separate cultures and ways of working within a single company is always difficult, it is even more so in small-to-medium-sized firms like most alternative investment companies.

Because funds originate from the business' strategic side, volume-based activities are frequently seen as a distraction from "important tasks" and are rarely tackled with the same vigor applied to strategic topics. Yet, these volume-based activities are intrinsically linked to the fund's existence and are a non-negotiable part of business operations.

As the fund grows and takes on more investors, the volume of these tasks steadily increases.

Failure to adapt the business operations to this rising volume can negatively impact the overall business in multiple ways. Defining a new strategy to deal with the business' conflicting needs can be complex and quite challenging, and finding the right balance between technology and human resources can quickly become a game of hit or miss.

Most firms adopt one of three basic strategies to address the growing volumes of day-to-day operational tasks:

1. Increase the number of people dedicated to running the volume-based side of the business
2. Invest heavily in innovative technology to automate
3. Outsource to one or more specialist service providers.

Most firms eventually choose to outsource, as they struggle to achieve the economies of scale that dedicated service providers can build. However, this creates new challenges in identifying the ideal partner(s) that complement the organization's capabilities. While splitting the outsourced activities across several providers can achieve best-in-class service for each activity, this also creates additional oversight requirements that can quickly become as big of a challenge as delivering the services in-house.

In the cases of rapidly evolving and highly customized businesses, it may be more beneficial to consider outsourcing partners who can provide the fullest breadth of services, while acting as a sparring partner in defining new business models and services to take your business to the next level.

Reference material:
Does outsourcing make sense for you? - KPMG Luxembourg

Questions that may be raised

01 Are you able to efficiently deliver volume-based services in-house?

02 Do you spend more time overseeing service providers than you would like?

03 Is your current sourcing mix delivering the benefits that you would like?

04 Do you have a sparring partner to help you build new business strategies?

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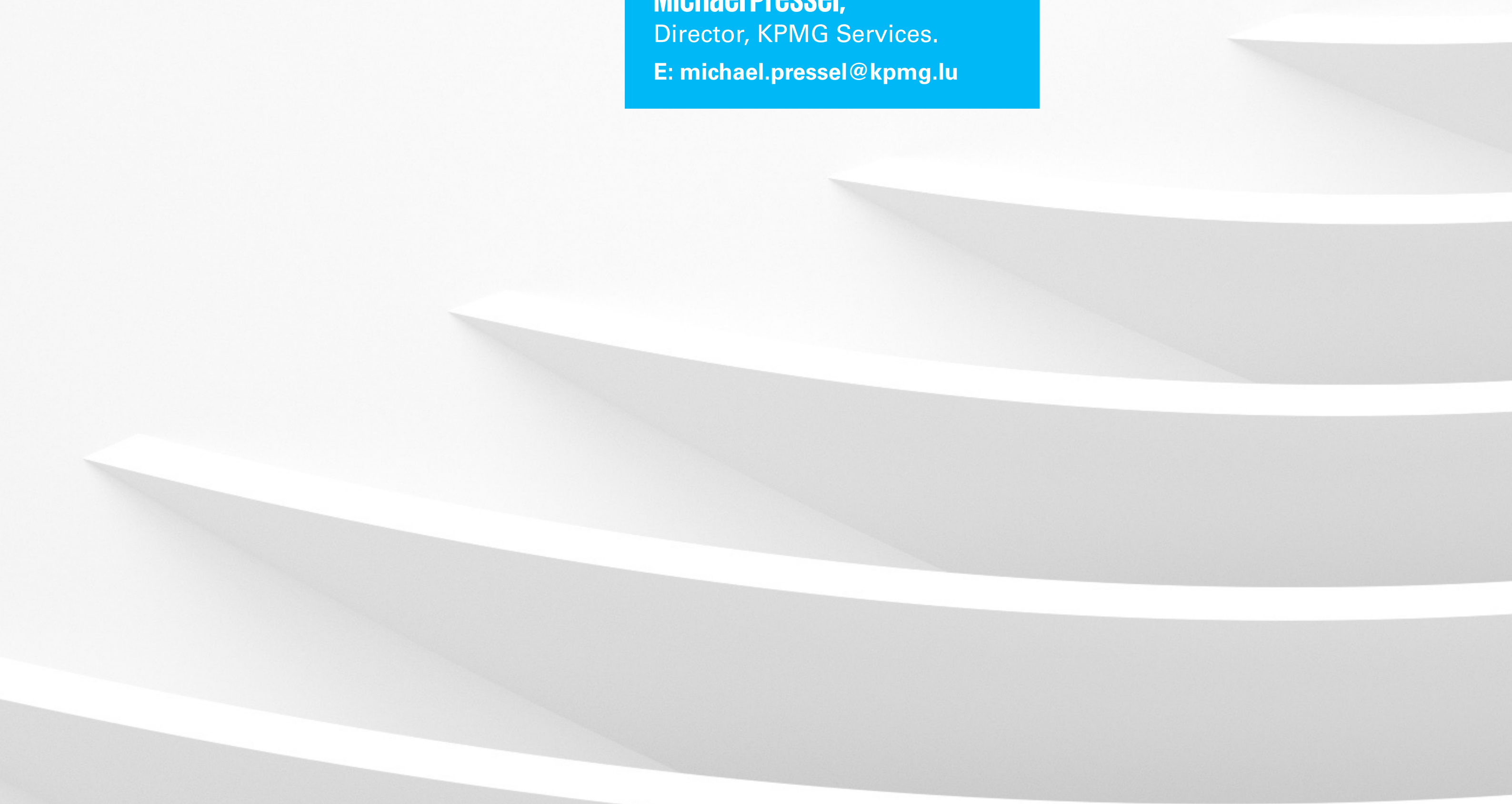
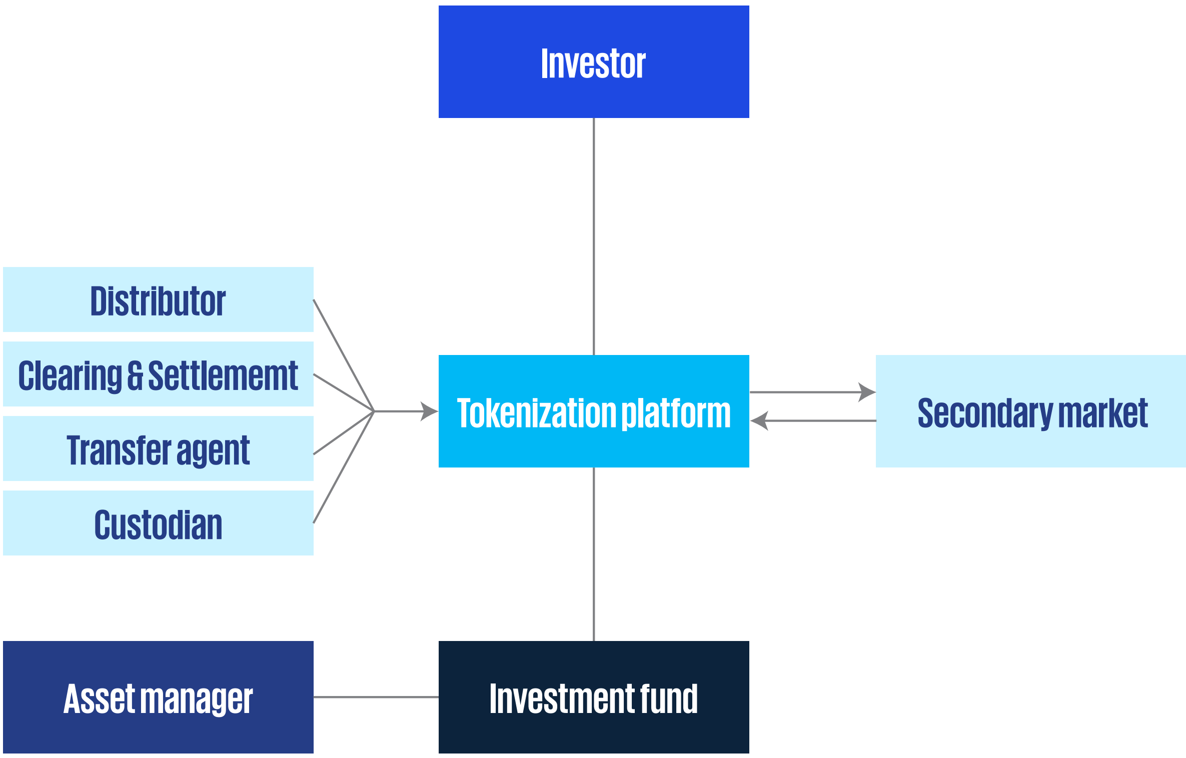


Tokenization as a value chain disruptor

The use of tokenized assets like securities and the technology behind them have the potential to create more efficient markets by optimizing the way assets and services are exchanged. The blockchain can revolutionize asset managers' entire value chain, with processes made leaner or even completely disappearing thanks to the automation of activities. This disruptive nature means asset managers must fundamentally rethink the value chain and the associated processes and business models.

While traditional investments involve multiple intermediaries, high costs and poor liquidity, tokenization tackles these challenges by:

- Allowing economies of scale with disintermediation by performing the distribution, clearing and settlement, transfer agent and custody functions.
- Increasing liquidity from an asset management and fund distribution standpoint by creating secondary markets, facilitating exit and entry strategies as a result.
- Allowing the management of larger investor pools through automation powered by smart contracts.



Questions that may be raised

01 How might blockchain technology impact my industry

02 To what extent could tokenization benefit the organization and transform the business model?

03 What level of transformation is required for the infrastructure, and what are the costs?

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Elevating the technology and data agenda

Background

Businesses are growing increasingly digital, with the pandemic catalyzing digital transformation. Technology offers a competitive advantage as a key factor in resilience, cost takeout and operational efficiency. Cutting-edge trends like big data, cloud and automation deliver opportunities for business transformation that boards ignore at their peril.

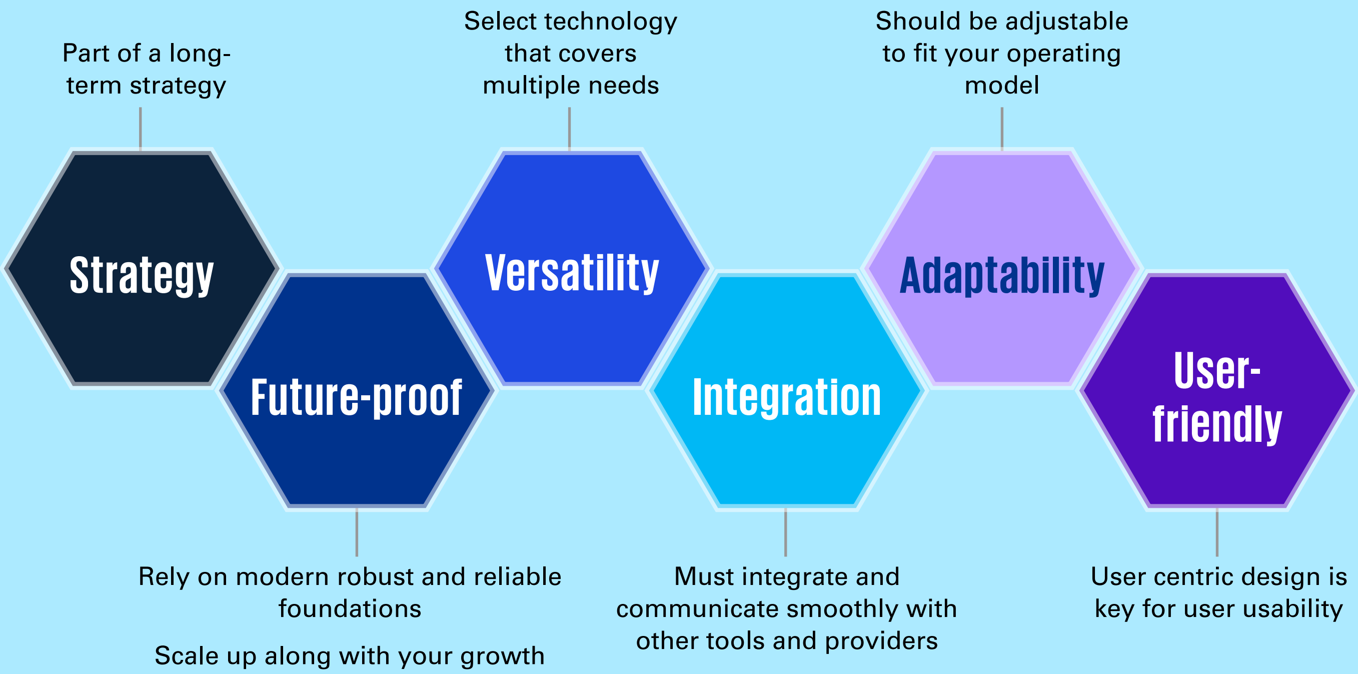
Key guidelines:

- Technology isn't just an IT topic — it also concerns the board of directors.
- Leverage digital tools and platforms under a well-designed strategy.
- Address emerging technology threats with prudence.

Turning the boardroom's focus onto technology delivers value and ensures executives target the right topics and set strategic priorities. When a board pays insufficient attention to technology and data matters, it can lead to dulled focus, missed opportunities, hindered growth and increased risks. Lacking an oversight process of digital and data activities may put a firm at risk, similar to failing to audit its books.

There is no one-size-fits-all model for a firm's IT operations and digital strategy. The correct approach to digital transformation depends on a company's unique setup; its history, industry, competitive placing, financial positions, automation level, and whether appropriate resources are in place. The board's composition and awareness regarding digital and data are vital to recommend improvements and safely surf the digital wave.

Criteria for selecting technology



Questions that may be raised

01 What is the level of our manual operations and related material costs? Are we at risk of non-compliance?

02 Do we face growth obstacles relevant to our staff turnover? Have we considered technology and automation to accelerate growth?

03 Do we understand technology's role in and impact on the business and its sector?

04 Has the board assessed the implications of not acting on data and technology?

05 Have we established proper governance to implement a successful digital strategy? How will we measure success or failure?

06 Do we have the proper criteria to select the most appropriate technology?

07 Do we have a transversal view of our data to facilitate business oversight?

08 Do we have proper data governance and management processes to ensure good data and reporting quality?

09 Do we make data-driven decisions and promptly respond to what is happening and why? Do we have the data and expertise to predict what is likely to happen?

10 Do we have a clear view of emerging technology threats, for example, cybersecurity?

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Insights from the KPMG Large-Scale ManCo & AIFM Survey 2023

In this third edition of the Large-Scale ManCo & AIFM survey, KPMG extended its scope to cover some of the largest pure-play AIFMs and took a closer look at the forces driving the ManCos and AIFM operating model evolution.

The following points emerged from our survey discussions:

Evolution of the operating model

The survey revealed that 97% of ManCos and AIFMs want to review their current operations. Of our respondents, 31% believe their operating model requires a full transformation, while 66% see a need for incremental evolution. At the core of this operating model evolution is product innovation.

Expansion towards "hub-and-spoke" group model

The majority of ManCos and AIFMs are increasing their footprints to become EMEA product and distribution hubs. This is accompanied by increased branch creation, license extensions, the appointment of Luxembourg-located executives bearing group responsibilities, and the retailization of alternative investment funds. requires a full transformation, while 66% see a need for incremental evolution. At the core of this operating model evolution is product innovation.

Growth of staff in branches

While the headcount of ManCos' Luxembourg offices was generally flat, with a 1% increase in FTE, branches' business activities have increased significantly since last year. The number of FTEs located in Luxembourg ManCos branches grew by 21% compared to last year.

The ESG paradox

While ESG is considered a key regulatory focus, most ManCos and AIFMs don't consider their framework to be sufficiently mature, with only 36% considering their framework to either mostly or fully mature. This can be explained by the different levels of endorsement and the market taking a very prudent approach around the control framework.

Increasing CSSF regulatory scrutiny

ManCos and AIFMs have recognized the need to monitor and mitigate their regulatory risk exposure by establishing several regulatory risk mitigation initiatives. Ninety-six percent have a regulatory watch solution in place and 70% meet with the regulator on a periodic basis. However, only 25% of ManCos feel fully prepared for an on-site inspection. The survey shows that 41% performed a regulatory health check and/or mock inspection over the past two years. On average, ManCos that performed a mock inspection feel almost twice as prepared for an upcoming inspection than ManCos that did not.

Product innovation at the core of the ManCo value creation

For 76% of respondents, the operating model evolution is mainly driven by the strategy to expand their existing licenses and product offering to respond to pertinent margin fee pressure and target new client segments. This is seen in the increase in alternative licenses — an 17% increase in MiFID top-up license acquisition, followed by 11% increase in private equity and 6% increase in infrastructure licenses. Additionally, 45% of ManCos are looking into offering their AIFs to retail investors and 34% into the marketing of third-party funds under the MiFID top-up.

To discover the full insights of our survey, please visit:
KPMG Large-scale ManCo & AIFM Survey 2023

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AIFMD 2

The European Commission has conducted reviews of the AIFMD's application and scope, as mandated by Article 69 of the Directive. An October 2020 report summarized the review's findings, concluding that the AIFMD's standards to ensure high levels of investor protection are mostly effective. However, the European Commission noted several areas for improvement.

On 25 November 2021, the European Commission issued a legislative proposal not only amending the AIFMD but also the UCITS Directive, believing several issues highlighted in the AIFMD review were equally relevant for UCITS. Therefore, these amendments aim to better align the requirements of both Directives.

The proposed amendments appear to be targeted enhancements rather than a widescale framework review.

The main proposed changes for both the AIFMD and UCITS Directive cover the following topics:

Authorization

- The AIFM/ManCo must have at least two full-time conducting officers resident in the EU.
- Additional information is to be provided to NCAs on the persons who conduct the business and on the human and technical resources available to fulfill the functions.

Delegation

- ESMA must be notified when the AIFM/ManCo delegates more portfolio management or risk management to third-country countries than it retains.
- Clarification that delegation arrangements also apply to ancillary services.

Data reporting for market monitoring purposes

- Review of the current AIFMD reporting and introduction of a similar reporting for UCITS.

Custodian

- Integration of central securities depositaries (CSDs) in the custody chain when they provide custody services to ensure that depositaries have access to the information needed to carry out their duties.
- Relief of ex-ante due diligence when the custodian is a CSD.

LMTs

Introduction of eight available LMTs:

1. Suspension of redemptions and subscriptions
2. Gates
3. Notice periods
4. Redemption fees
5. Swing pricing
6. Anti-dilution levy
7. Redemptions in kind
8. Side pockets.

- In addition to suspending redemptions, AIFMs/ManCos managing open-ended funds must select one other LMT from the list, taking the nature of the fund into consideration.
- Adequate policies must be in place for operating the relevant LMTs, including notifying the NCAs of their activation or deactivation without delay.

The main proposed changes for the AIFMD cover the following topics:

Depositary

- Clarification that the depositary must cooperate not only with their NCA but also with the NCA of the AIFM and the AIF.
- Possibility granted to NCAs to allow the appointment of a depositary in a different Member State than the AIF, under certain conditions.

Loan origination

- Amendment of Annex I to recognize lending as a legitimate activity of AIFMs.
- Description of the specific framework/requirements applicable to loan-originating funds.

Disclosures

- Requirements for additional disclosures on conditions for using LMTs, fees borne by the AIFM and its affiliates, and periodic reporting on all direct and indirect fees and charges that were charged to the AIF.

The amended Directives are currently following the legislative process. The European Parliament and the Council have reached their respective agreements on the text's amendments initially proposed by the Commission, while trilogues began in 2023 to reach a final compromise text, ready for final adoption.

It is currently anticipated that the texts will not apply before the end of 2024 or the beginning of 2025

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ATAD 3 and its impact on non-executive directors

Largely debated in 2023 but still not agreed on at EU level, the EU's legislative proposal to fight the misuse of shell entities (the "Unshell Directive" or the third Anti-Tax Avoidance Directive/ATAD 3) is expected to be adopted and published before the end of 2023.

Once EU Member States land on a compromise text, we expect industry players to perform gap analyses and potentially discuss changing or upgrading their business models.

Expected to apply from 1 January 2025, the ATAD 3 proposal identifies three features, or "gateways", to filter entities at risk of lacking substance.

High-risk entities — meeting all three gateways based on a self-assessment and not benefiting from a carve-out — would be required to report on their substance through their annual tax return and presumed to be shell entities if they do not meet specific substance indicators. These entities would also lose certain tax benefits under EU tax Directives or double tax treaties, potentially impacting funds' internal rate of return (IRR).

This proposal's definition of high-risk entities includes those with passive income earned or paid out via cross-border transactions that outsource their day-to-day operations and decision-making.

While Member States have not yet reached a consensus on the proposal's gateway criteria, substance indicators and various carve-out scenarios, the operating model and delegation mock-up of the concerned entities will likely be a key factor in the ATAD 3 reasoning.

Several different versions of the draft Directive that deviate from the initial text are seemingly being discussed amongst EU Member States.

Across the various discussions held around substance, one key indicator seems to be the presence of one or more qualifying directors who: are tax resident in Luxembourg or a neighboring country; are qualified and authorized to manage and take decisions independently; and do not actively perform the function of director in multiple non-associated enterprises.

A potential limitation of the number of mandates performed by directors in non-associated enterprises seems to have been previously raised during the legislative process. Therefore, this is likely to be a requirement in the final version of ATAD 3.

The final EU compromise text will clarify the future requirements and key points of attention for independent directors. We expect that this future legislation will be carefully analyzed within boardrooms.

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