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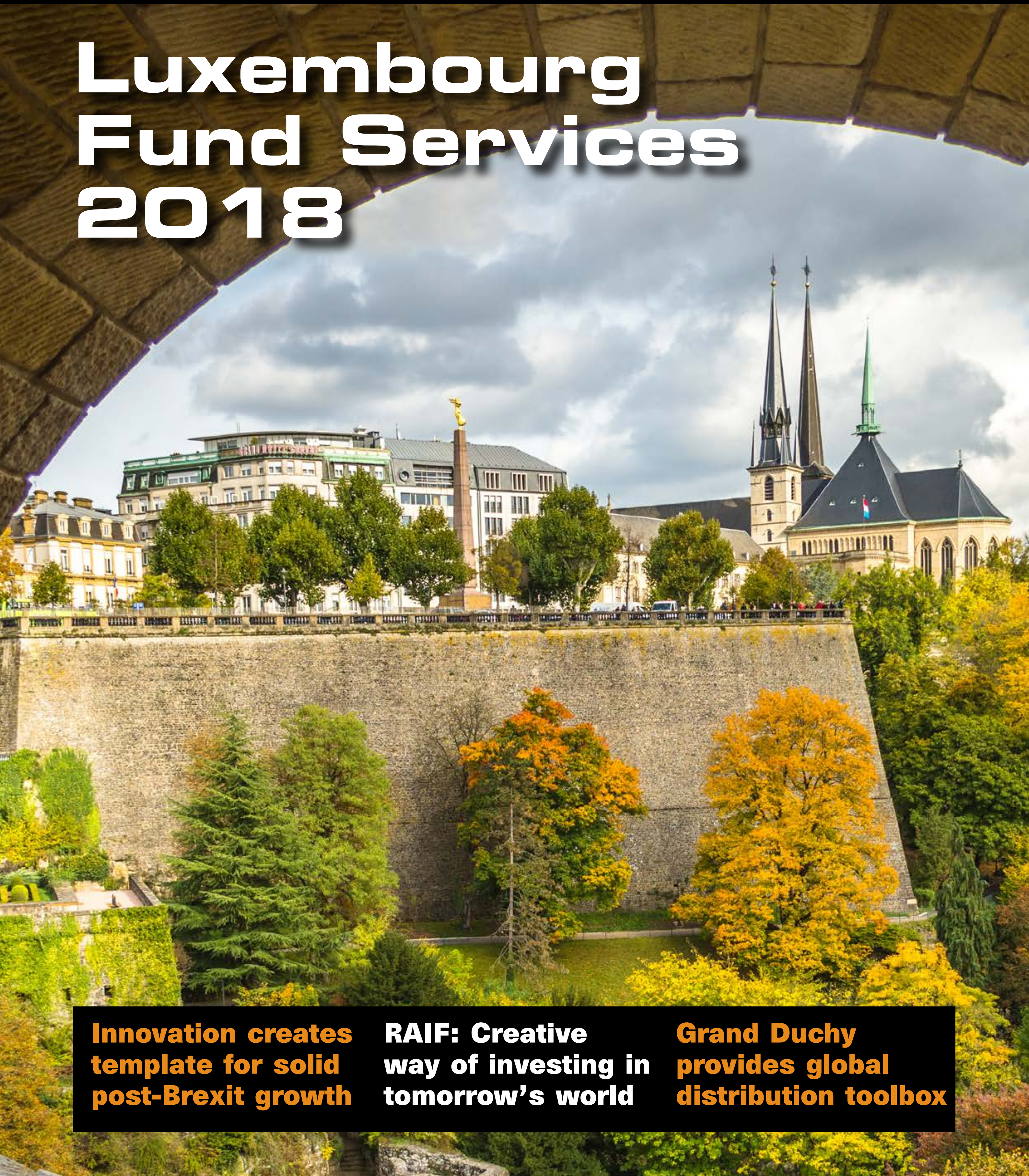
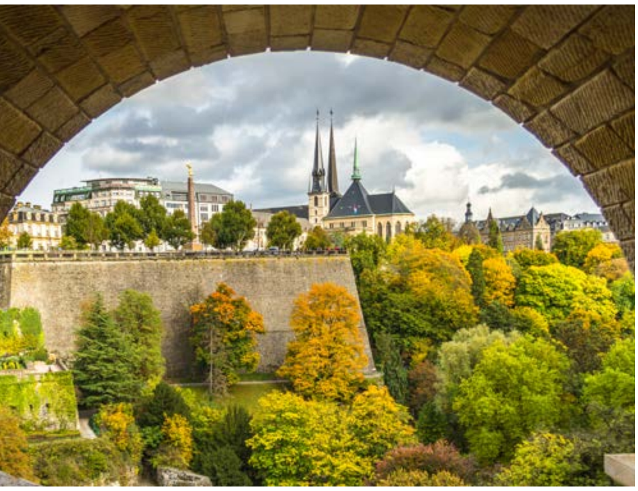


Innovation creates template for solid post-Brexit growth

RAIF: Creative way of investing in tomorrow's world

Grand Duchy provides global distribution toolbox



In this issue...

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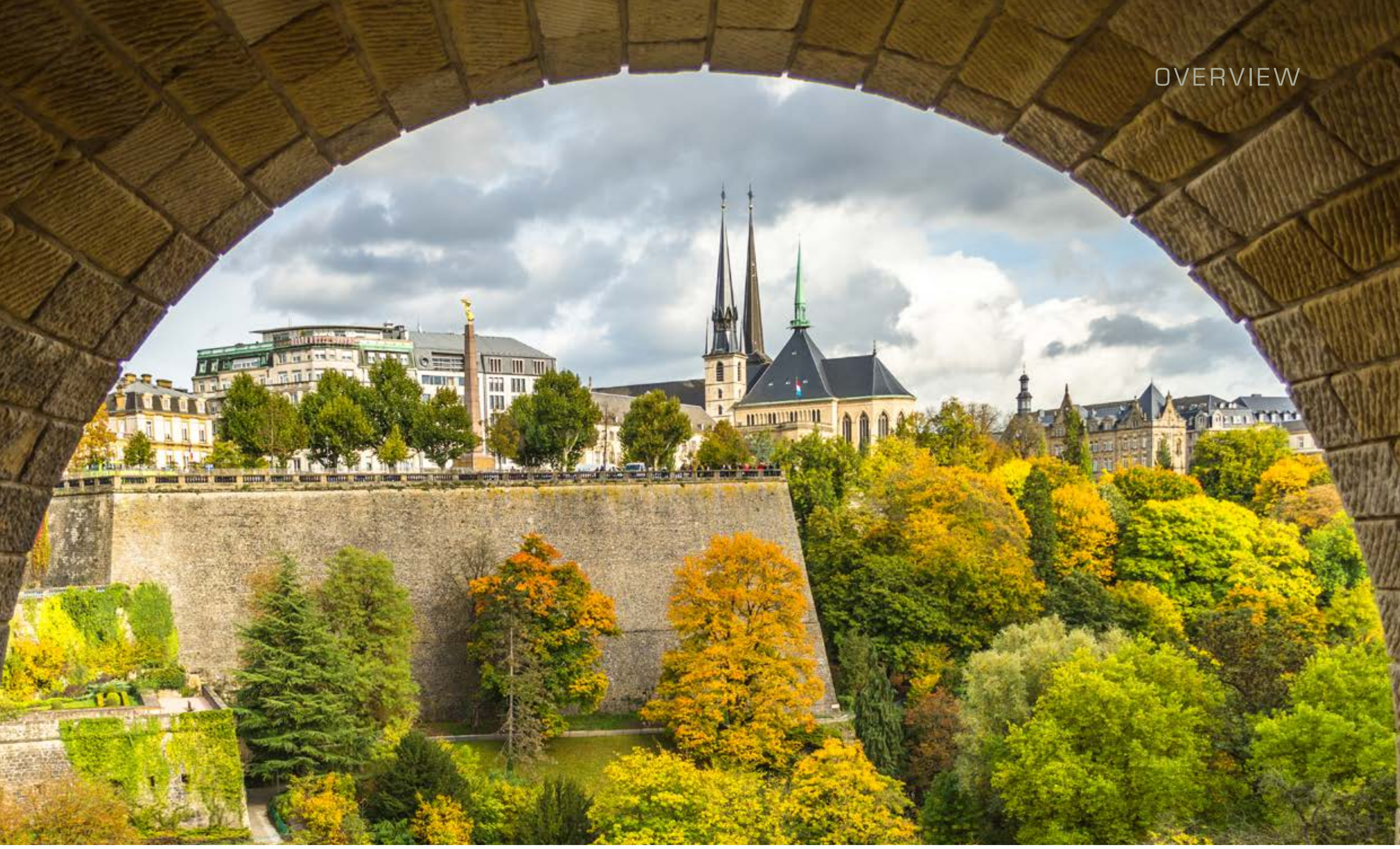


Luxembourg deepens its alternative fund roots

By James Williams

Luxembourg's funds industry enjoyed a good period of growth last year, a period during which assets under management grew, on average by 15 per cent, asset flows grew by 5 per cent, profits grew by 10 per cent, while margins were broadly maintained somewhere close to 37 per cent.

As of August 2018, total fund AUM in Luxembourg stood at EUR4.27 trillion, up 7.15 per cent year-on-year. Interestingly, US fund sponsors account for the largest market share, equivalent to 20 per cent of total AUM, followed by Great Britain (17.6 per cent), Germany (14. 4 per cent) and Switzerland (13.7 per cent).

On the back of this upward trajectory, the next 12 months will be interesting as the EU prepares for life without the UK. Then there are global macro pressures to consider, specifically what impact the US/China trade war could have on global economic markets, and the impact that a rising rate regime in the US could have on global equity markets.

These are all known unknowns at this stage. One cannot speculate as to how the cards may fall. But at this point in time, Luxembourg stands in a strong position, where recent product and regulatory updates have helped to make it even more attractive to global fund sponsors wishing to do business under the AIFM Directive, and garner new European institutional capital.

Arne Bolch is Partner at GSK Stockmann's Luxembourg office. In his view, Brexit is unlikely to make a lot of UK fund managers relocate to Luxembourg: "However, I have a feeling there will be more substance, with more middle- and back-office functions moving to Luxembourg but you will not necessarily see the fund or portfolio management function moving here.

"I would expect that there will be some

formal arrangement that will not lead to the UK becoming a third country without taking into account the significance of London for the EU and vice versa, and that something along the lines of the current set-up will remain; maybe an EEA-like arrangement, but it's hard to know for sure where the discussions are heading. I am hopeful there will be some form of rapprochement."

Luxembourg – A nexus for global distribution

When structuring a large private equity fund, it is likely going to contain international investors (the US, Europe, Asia) and is, in effect, a commercial deal between all interested parties to draw down the money.

Different investors have different preferences. Whereas sovereign wealth funds will want the most efficient funds possible and are prepared to have no tax leakage, European insurance groups who are subject to Solvency II will want to invest in EU regulated fund structures. This is because investor regulation in the EU embeds financial advantage in investing through European fund structures so European investors are steered to allocate to European funds.

These international nuances can work to Luxembourg's advantage by virtue of it being the hub of the European funds industry and a nexus for global funds distribution.

Rather than solely structuring an offshore vehicle, PE/RE fund management groups are instructing lawyers to establish multiple parallel vehicles across multiple jurisdictions.

"For us as a group, we consider Luxembourg to be one of our key hubs," states Sean Murray, Managing Director, Alternative Assets (EMEA) at SANNE – a leading provider of alternative asset and corporate administration services with more than EUR235 billion in AuA.

"We see massive opportunities in PE/RE in Luxembourg given the large amounts of dry powder. We see everything from mid-market PE fund managers all the way up to multi-billion dollar PE managers using Luxembourg to launch fund products. Luxembourg will, I think, remain the jurisdiction of choice for international fund managers who are looking to deploy capital into Europe and beyond. It's a tried and tested jurisdiction. It has a strong regulatory environment. It has a stable and favourable economic environment, and I think managers and investors alike are looking for that stability. All the key legal and advisory firms are located here and that acts as an enabler for Luxembourg to remain at the forefront."

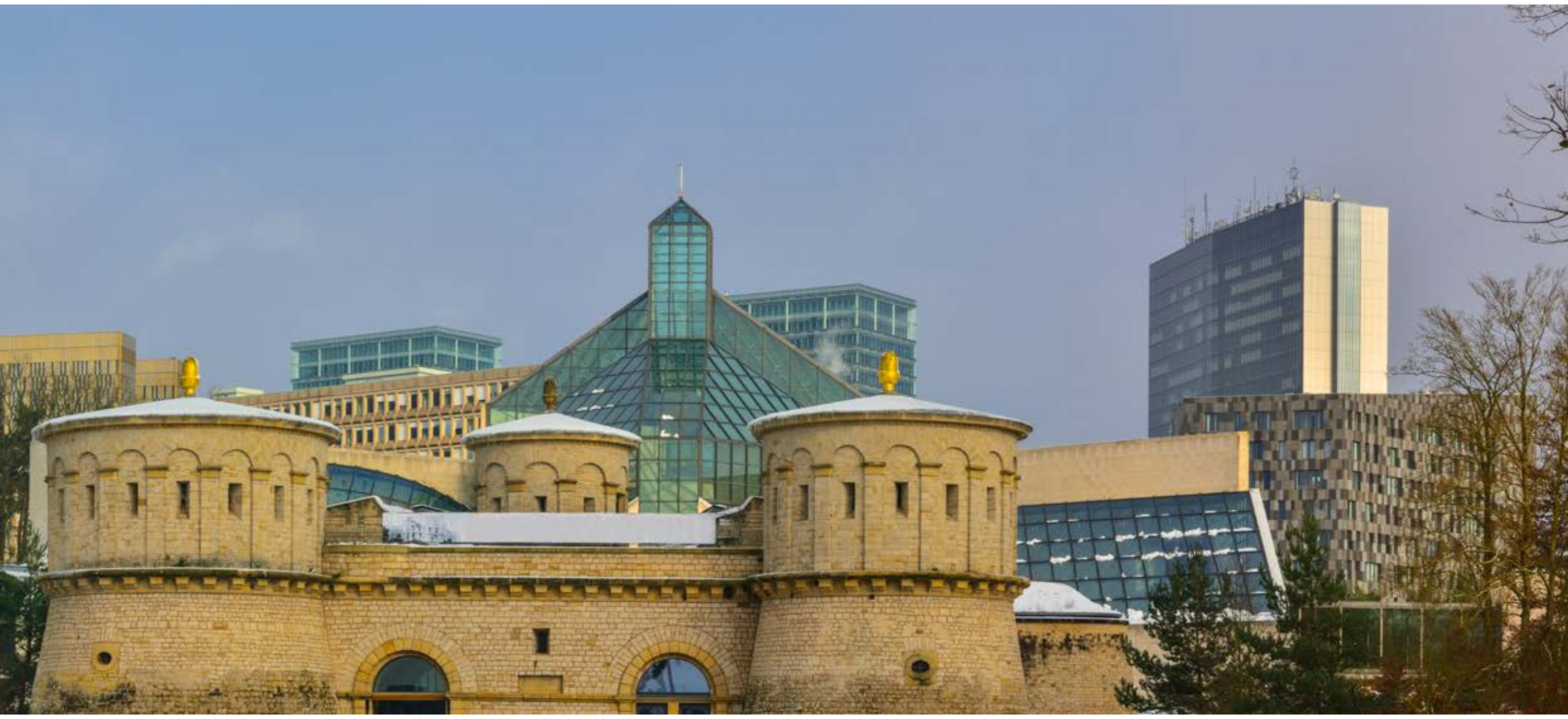
Crestbridge, has a long history of dealing with real estate and private equity funds, having worked with them from its Jersey office since 1998 and Luxembourg since 2010.

"What we've been able to offer our clients is an ability to combine expertise in understanding the asset class, we are able to ask the right questions, with our expertise in understanding Luxembourg's regulatory market," says Daniela Klasen-Martin, Managing Director and Country Head, Crestbridge Luxembourg.

"We see a lot of global managers coming to Luxembourg for distribution. We see opportunities by combining different jurisdictions, whilst some still want to stay outside of the EU if they do not need to access EU investors. Luxembourg is for sure very strong for those managers seeking global distribution for their funds."

Product flexibility

Luxembourg has made strides over the last six or seven years to create a funds environment that is equally as appealing to PE/RE and VC fund managers who want less regulated fund structures, for speed to market purposes, as it is to traditional asset managers for regulated funds; be they SIFs or UCITS.



There never used to be proper regulation for alternative funds. It was more for retail-orientated UCITS fund products, which have existed since 1988. For those who were investing in offshore PE/RE funds, there was nothing similar until a few years ago when the special limited partnership (SCSp or *société en commandite spéciale*), a vehicle without legal personality modelled on the English law limited partnership, was introduced, following the AIFMD.

These are flexible vehicles free from corporate law overrides, of maintaining limited liability for investors and of generally avoiding any tax leakage at the fund level.

"Replicating an Anglo-Saxon concept in a civil law jurisdiction might seem a little odd at first, but where the SCSp can be advantageous is that managers can benefit from Luxembourg's fund management and administration infrastructure. Service providers here are very familiar with managing or administering SCA and SCS structures, and many would already have been supporting Cayman or Delaware LPs, for example," commented Pierre de Backer, Principal in the Investment Funds and Corporate practices at Deynecourt, a Luxembourg law firm, in last year's Luxembourg Fund Services report.

This is starting to reap benefits with the likes of Carlyle Group and Oaktree Capital Management choosing to run funds out of Luxembourg. Since 2013, more than 1,400 special limited partnerships have been established, most of which are unregulated.

The Luxembourg limited partnership has a number of advantages over the English limited partnership. Although the SCSp does not have its own legal personality or capacity, all contributions, acquisitions and dispositions of assets are made in the name of the SCSp and not the in the general partner's name nor any of the limited partners.

That is quite practical as it means one does not have to disclose the identity of investors in order to register an asset.

"Suddenly, regulation has allowed things like the SCSp and the Reserved AIF to be created. In the past, we had products where the regulator had to give its approval before they could be marketed to investors (the SIF, SICAR). That meant having to respond to a lot of questions from the regulator and it took longer to get the product to market.

"Time really is of the essence because you want to get your product to market as early as possible. The RAIF is a product where an entity such as Fuchs Asset Management, which is a Luxembourg-registered AIFM, can provide the requisite oversight to the RAIF. We as the AIFM are regulated, not the product," explains Timothe Fuchs, CEO of Fuchs Asset Management.

At GSK, Bolch confirms that many of the new fund requests the firm currently receives are for the RAIF. "Real estate funds and private debt funds seem to be very much in demand right now, not to mention private equity," he says.

The RAIF in his view is good solution for experienced fund sponsors, wanting to continue the perks of the SIF. Experienced fund managers know what they are looking for, whereas a first-time fund manager may see more value in relying on the added value of CSSF supervision.

"Sometimes it may be better for first-time fund managers to stick to SIFs, which as regulated funds require a disciplined approach to filing with the regulator," suggests Bolch. "The RAIF is a good option for more experienced and larger fund providers who have experience in the market.

"You can more easily attract continental European investors now with an unregulated SCS or SCSp or a RAIF, as opposed to an English LP structure, at least for now, given that no one knows where the UK is going as of 29th March 2019."

Francois Pfister is a partner in the funds group at Ogier (Luxembourg). He says that 90 per cent of the work Ogier does is for special limited partnerships, whether they are RAIFs or other fund structures, and helping clients outside of Europe to set up parallel fund structures in Europe alongside their offshore funds, based on their existing documentation.

"If a US manager has a Cayman or Delaware fund and now wants to attract EU investors, we would take the Cayman partnership as a template and set up an SCSp under Luxembourg law, which would to all intents and purposes look just like a Cayman fund," says Pfister.

"I would estimate that half of the funds we've set up over the last 12 months as RAIFs have been private debt funds, and mostly with US fund managers. We are also working presently on real estate funds, and a couple of substantial private equity funds.

"The strategy is important for the manager but when it comes to structuring the vehicle, Luxembourg has a very complete toolkit. You can always improve your arsenal, of course, but today I think we are very well

"Luxembourg has a very complete toolkit. You can always improve your arsenal, of course, but today I think we are very well equipped. Our role is to provide a structure that fits most of the strategies for most of the investors."

Francois Pfister, Ogier

equipped. Our role is to provide a structure that fits most of the strategies for most of the investors and I think that's what is driving Luxembourg's legislative actions."

Substance builds among AIFM community

According to PwC's latest ManCo report, "Observatory for Management Companies 2018 Barometer", Luxembourg is now home to 228 licensed AIFMs overseeing EUR94 billion in AUM. The number of Super ManCos, which act as the investment manager to both UCITS funds and AIFs, stands at 124, overseeing EUR2.6 trillion in AUM. Lux-domiciled AIFMs employ 760 professionals and this is likely to continue to grow over the coming 12 months as UK managers get their Brexit plans firmed up.

"With respect to our AIFM services, we see a lot of mid-market managers choosing to use the delegated model," comments Murray. "For non-EU managers wanting to come to Europe, if they come to someone like us who has all of the services in place under AIFMD, they see it as an easier step to take. They know they can use a third party AIFM and it allows them to open up their distribution strategy to Europe. It's less restrictive in that sense and they only have to deal with one counterparty who takes care of everything for them.

"However, there is a strict level of segregation in place between the fund administrator, the depositary and the AIFM. It's easier than dealing with three different counterparties in my view."

James Burke is Head of Apex Europe,

Apex Fund Services (Ireland). He notes that UK fund managers have had to ramp up their contingency planning in response to Brexit and as a result the volume of applications that the CSSF has received has significantly increased over the last few months "as firms seek to finalise their Brexit plans and put them into action – both managers who have decided to totally Brexit-proof their businesses by setting up EU hubs as well as those entering into discussions with third party ManCos in earnest".

He is of the opinion that Luxembourg will continue to grow as the jurisdiction of choice for third party ManCos in Europe.

"Those who establish their own AIFM tend to retain the risk management and portfolio management functions in-house, but we would help with all the transfer agency and fund accounting services, AML services on investors, as well as give them a depositary solution. The central administrative function and other non-core requirements such as tax and regulatory reporting services are increasingly outsourced by managers who set up their own AIFMs," comments Burke.

There will need to be a cooperation agreement between the UK and the EU in order for the portfolio management function to be delegated back to the UK manager in a post-Brexit environment because UK fund managers will, in six months time, be classified as third country managers.

The delegation model is already in use now. An EU AIFM can delegate the portfolio management function back to non-EU fund managers, such as those in the US and Asia Pacific and it appears to be working well enough.

"We envisage that a similar arrangement should be possible for UK managers wishing to use an EU-based AIFM," continues Burke. "Brexit is placing more focus on that delegation model but that is the proposition and from an Apex perspective it means we can offer clients that one-stop-shop solution at the local Luxembourg level, across the value chain."

Sonja Maria Hilkhuijsen, Global Head of Compliance and Data Protection at Apex Fund Services, confirms that a number of UK managers are opting to have their own substance and relocating to Luxembourg.

"They aren't waiting for the Brexit

outcome. Particularly UK AIFMs, they are anticipating and scenario planning to ensure they are able to meet EU regulations and secure their distribution channels in EU. Waiting for the final Brexit outcome would put their entire marketing strategy at risk."

"These larger managers are recruiting local professionals in Luxembourg in order to demonstrate local governance and substance to the CSSF, particularly in light of the latest CSSF Circular 18/698 which is fundamental for regulatory approval," says Hilkhuijsen.

The rules under AIFMD say that if you invest more than 85 per cent of an EU feeder fund into a non-EU offshore fund you will lose the passport rights. As such, fund sponsors must set up a parallel onshore fund that runs alongside the offshore fund, if they wish to avail of the funds passport. Some people in the marketplace still aren't aware of this.

"The very largest PE/RE fund managers will likely have both offshore funds as well as European funds. I think the perception is starting to change in terms of managers thinking about Luxembourg to establish funds as opposed to just thinking about offshore jurisdictions such as the Cayman Islands," opines Joelle Hauser, Partner, Clifford Chance (Luxembourg) and head of its Investment Funds Division.

Hilkhuijsen points out that one of the attractions to UK managers appointing third party AIFMs in Luxembourg is that there are no linguistic concerns, as one might encounter when choosing Frankfurt, for example, or Paris. "Luxembourg is very multi-cultural, English is spoken among professionals throughout its funds industry, and it is well connected, making it easy to travel to a number of different European cities. It is Europe's financial hub," she says.

One point to stress for those managers who are thinking of setting up their own AIFM is that there is much closer scrutiny by the CSSF in terms of substance. This should be viewed as a positive, according to Fuchs, and should not be feared.

"The Luxembourg Government, the CSSF and professional associations have always been proactive to develop new regulation. In other jurisdictions, when regulation is introduced it generates fear but Luxembourg is different. Regulation should not be feared if you establish the right sort of partnership," says Fuchs.

Luxembourg will continue to develop as an attractive place to do business. However, it has become more complicated today than it used to be in the past. The 18/698 Circular has replaced Circular 12/546, which imposes a certain level of organisation on a management company.

This is likely to make the third party AIFM an even more attractive option, moving forward. There will always be people with new ideas who will need such a solution because for them it will be too difficult to establish a dedicated, regulated management company of their own.

"The trend of having ManCos operated by a handful of people will probably disappear. They will need to be a lot more organised under Circular 18/698. It is an opportunity for us as a large and well organised AIFM to tailor make solutions for our clients," adds Fuchs.

ESG disclosures on horizon

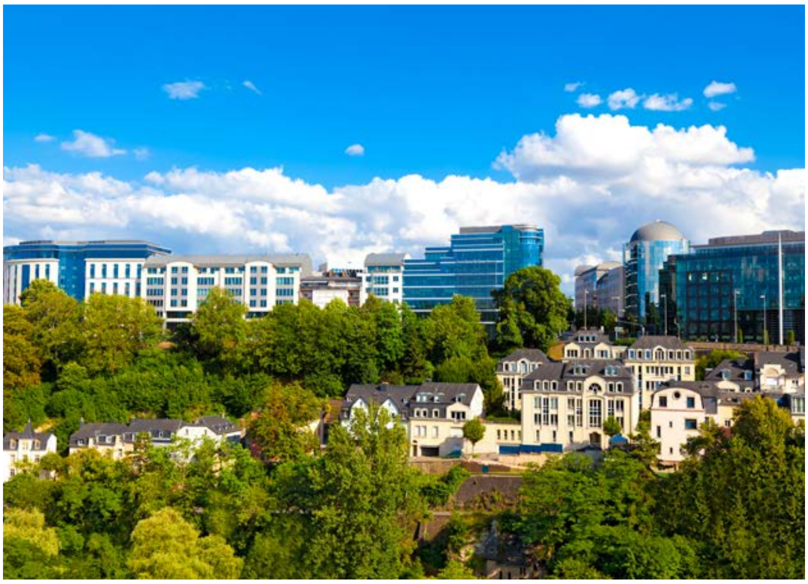
The signature of the Paris Agreement on 12 December 2015 and the adoption of the UN 2030 Agenda for Sustainable Development on 25 September 2015 marked a shift in global attitudes towards climate change and environmental degradation.

The European Commission recently wrote the fact that over 170 countries have now ratified the Paris Agreement sends a powerful signal: the necessity of transitioning to a low-carbon, resource-efficient and circular economic system can no longer be ignored.

To achieve the targets agreed in Paris, including a 40 per cent cut in greenhouse gas emissions, around EUR180 billion of additional investments a year are needed. The financial sector has a key role to play in reaching those goals, as large amounts of private capital could be mobilised towards sustainable investments says the European Commission. Capital markets, in particular, can help to reorient investments towards those sectors and activities that can contribute to the sustainability of the global economy.

The Action Plan on Financing Sustainable Growth launched by the European Commission on 8th March 2018 laid out a roadmap to deliver on this commitment.

The EU is also already providing a



massive impetus to maximise the impact of public funds to attract more private investments. In particular, the extended and reinforced European Fund for Strategic Investments (EFSI 2.0), in force since 31 December 2017, proposes a 40 per cent climate-smart investment target.

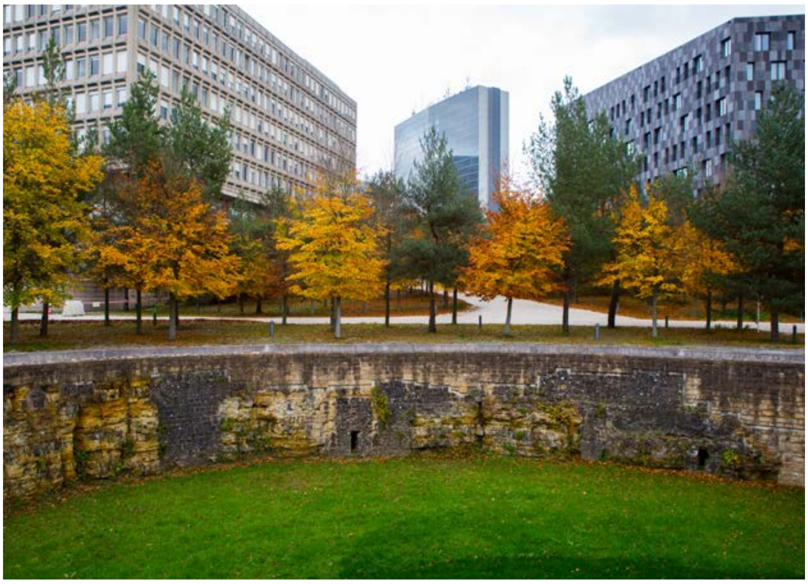
The Action Plan aims to further connect finance with the specific needs of the European and global economy for the benefit of the planet and has three objectives:

- Reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth;
- Manage financial risks stemming from climate change, natural disasters, environmental degradation and social issues; and
- Foster transparency and a long-term outlook for financial and economic activity.

Part of this strategy will be to ensure that asset managers, institutional investors, insurance distributors and investment advisors include economic, social and governance (ESG) factors in their investment decisions and advisory processes. Asset managers and institutional investors who claim to pursue sustainability objectives would have to disclose how their investments are aligned with those objectives.

This means greater transparency towards end-investors, ensuring comparability between products.

"In order to close the funding gap under the Paris Agreement, there has to be private



money invested in ESG projects. Going forward, asset managers will, in addition to pure financial criteria, also look at ESG criteria and provide disclosure reporting to investors and distributors.

"These are still draft regulations but they should be ready by Q3 2019. Looking at long-term sustainable investments is one of the new trends we have to watch," says Hauser.

It is possible that fund sponsors will start to take a more proactive stance in terms of sustainable investing, and share information on ESG policies as pertain to their investment strategies with investors, even before they ask for them. It will add more work from a reporting perspective, but asset managers increasingly understand the importance of ESG investing.

"This push (for ESG disclosures) is not only coming from institutions but also from family offices; it is a clear and recent trend. More investors have been asking for ESG disclosures in various forms," adds Kristof Meynaerts, Counsel, Clifford Chance.

Bolch is part of a working group with Invest Europe, the European Private Equity and Venture Capital trade association and participated in drafting a paper on ESG disclosure for the European Commission.

In essence, he thinks it is a good idea to have ESG factored in to the reporting equation but says it is not yet clear how these disclosures will be applied.

"Any fund will, amongst others, at least need to integrate sustainability risks into the respective funds' investment decision-making process, but what does that actually require from the manager or in respect of the given fund? If it's a real estate investment, what will the sustainability risk provided be? What will be the impact on the respective remuneration policy of the given AIFM?

"Transparency is good and disclosure requirements are fine, but they will need to make sense for investors and initiators alike," remarks Bolch.

Fintech developments

Luxembourg's connectivity to the rest of the world is fantastic. The reason Skype, and many others, are located there is because access to other jurisdictions is unrivalled. All the big technology companies are setting up in the Grand Duchy; Paypal, Amazon, etc.

Moreover, Luxembourg is investing heavily in infrastructure around IT, security, data lakes and so on. Indeed, in terms of Tier 4 category data centres, there are more in Luxembourg than anywhere else in the world.

While the US has Silicon Valley and London has the less glamorous sounding Silicon Roundabout, there are signs that the Grand Duchy is developing a Fintech hub of its own.

Martin Guérin, founder and owner of Nyuko, last year took over the role of CEO of Luxembourg City Incubator. Along with the Luxembourg City Incubator and Luxembourg House of Financial Technology (LHoFT), Nyuko has moved into the 4,200 square meter building Le Dôme in the Gare district of Luxembourg.

Although still early days, this announcement could be a sign that the Gare district will become Luxembourg's de facto Fintech hub.

"Luxembourg has created various incubation schemes including the House of Financial Technology and the House of Entrepreneurship. People receive proper mentorship from tech specialists, fund management companies and so on, and this helps them to scale up in a cost-effective way. Overall, I would say Luxembourg provides a hugely conducive environment for technology start-ups," says Robert Kimmels, Managing Director, Praxis Luxembourg SA.

This is important as there is always a risk, to any established funds jurisdiction, of becoming complacent.

These initiatives taken by the Luxembourg government to allow its fintech industry to grow appear to have been successful. To some, like Ogier's Pfister, this is refreshing to say the least.

"You see more start-ups using new technologies including DLT and consolidating their positions, and all sorts of reporting and compliance solutions and tools being developed.

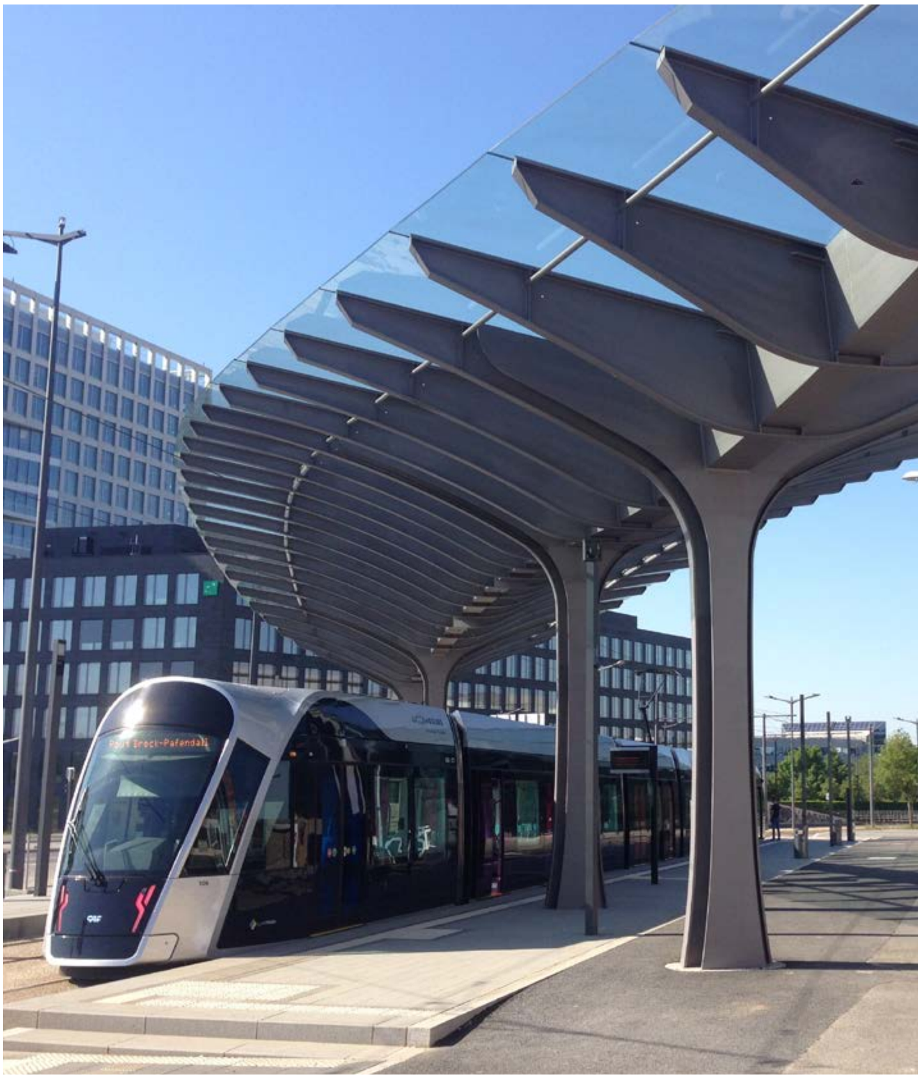
"This is helping Luxembourg's financial industry to defend its position. It was absolutely indispensible for us to move in that direction because not doing so would place us in a difficult position in the future. Smaller fintech companies are helping larger, established financial institutions operating here. Blockchain technology will be used in custody and transfer agency work and this will indirectly benefit asset managers as a result. There are now more fintech entrepreneurs operating here and that is quite a comforting thought," comments Pfister.

The question will be whether these smaller fintech players will need to comply with heavy regulations.

The CSSF needs to be careful in that respect. It will need to strike a balance that helps the fintech sector to grow without over-regulating it. "Some will be needed, obviously, but too much regulation could kill the sector. These entrepreneurs need to concentrate on their core businesses, not worry too much about complying with onerous regulations.

"I do think the CSSF is open to this. We at Ogier have been working on a few ICO projects and the CSSF has an open attitude along the lines of, 'Okay, come to us with the proposed project and we will see what is possible'. A wait and see attitude by the regulator is welcome, rather than trying to regulate against the market in advance," adds Pfister.

At Apex Group, Hilkhuijsen further explains that the government has come up with a scheme to bring Luxembourg's employees up to speed with blockchain technology. The Luxembourg Digital Skills Bridge programme supports the development of qualified employees in order to further reinforce innovation and competitiveness in a world of digitisation and automation.



There is also Lux Innovation contributing to the economic development of Luxembourg by fostering innovation, fuelling international growth and attracting foreign direct investments.

"These initiatives provide the right environment for the creation of a next generation talent hub, which should attract programmers and other technologists, and this will allow Luxembourg's companies to transpose the latest technologies through their business lines. We are looking to benefit from this to improve our data compliance and reporting capabilities," she says.

In conclusion, Aleksander Jakima, Conducting Officer at Circle Partners says: "We are committed to investing in best-in-class technologies to improve our automation capabilities. By doing so we can focus more on the relationship side of the business." ■

Disclosure requirements for sustainable investments

By Arne Bolch

The 2016 Paris agreement on climate change as well as the United Nations 2030 Agenda for Sustainable Development and its Sustainable Development Goals may until recently not have been high on the agenda of asset management professionals. This may be about to change.

In the spirit of the agreement and the UN agenda, measures taken at European level have identified (or rather stated) a need for Europe's financial system to (i) contribute to sustainable and inclusive [economic] growth as well as to (ii) strengthen financial stability by incorporating environmental, social and governance ("ESG") factors into investment-decision making.

This is now going to have a very concrete impact on the asset management industry: The proposal of a new regulation published on 24th May 2018 by the European Commission (the "EC") concerning disclosure requirements relating to sustainable investments and sustainability risks.[1]

This proposed regulation shall be, amongst others, applicable to any fund regime existing within the EU, i.e. AIFMs and their AIFs, UCITS and their management companies as well as EuVECAs and EuSEFs. In addition to existing fund disclosure requirements, such as the UCITS prospectus, the article 23 disclosures for AIF as well as KIIDs and PRIIPs, the regulation establishes another disclosure regime aiming to reinforce investor protection by tackling a perceived lack of transparency on the side of financial market participants, i.e. funds and their managers, to disclose how sustainability factors are incorporated into their respective investment decision process and ultimately endeavours to reduce investors' costs related to the evaluation of the sustainability risks.

Under the disclosure regime, qualifying financial market participants, such as the aforementioned funds and their managers, would, amongst others[2], be required to disclose to investors at a pre-contractual stage information concerning:

(a) the procedure and conditions applied for integrating sustainability risks within the investment decision-making process of the relevant fund; as well as

(b) the extent to which sustainability risks are expected to have a relevant impact on the returns of the fund; and

(c) Information of how the remuneration policies applicable to the relevant fund or manager are consistent with the integration of sustainability risks and are in line, where relevant, with the sustainable investment target of the fund in question.

These disclosures shall then be achieved by establishing written policies on the integration of sustainability risks into the investment decision-making process as well as the attribution of a sustainability profile for every financial product or fund to be published on a website referring to that fund. Further, all the information of the websites must be kept up-to-date, and where any changes occur, the explanation of the change is also required. Lastly, the relevant information concerning the offered financial products must be provided in the periodical reports, i.e. the relevant funds' annual and semi-annual report, to the extent applicable.

While of course the regulation pursue a laudable cause that certainly any asset management firm or fund will be supportive of, the regulation endeavours to link relatively general and as of yet (within the regulation) largely undefined sustainability considerations with very concrete investment returns and the remuneration of asset management professionals. It is therefore advisable for any asset management firm to monitor the development of the regulation to ensure that the sustainability considerations are going to be implemented in workable form. ■

Arne Bolch, Partner at GSK Luxembourg SA

1. Proposal for a regulation of the European Parliament and of the Council of 24 May 2018 on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341.

2. Please note that there are more detailed disclosure requirements envisaged, which are beyond the scope of this article, such as regarding funds pursuing sustainable investments and/or aiming at following an index or carbon emission reduction. Also, website disclosures are required by the regulation and marketing communications shall not defeat the purpose of the sustainability disclosures.