Cross-border questions

OUR EXPERT PANEL DISCUSSES THE AML REQUIREMENTS OF UCITS FUNDS, THE IMPACT OF THE COVID-19 PANDEMIC ON THE INDUSTRY, BREXIT AND THE GROWTH OF PRIVATE EQUITY.

PANEL

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Funds Europe – Lloyd's, the insurer, has moved to end investment in Ucits funds by its member firms owing to strenuous anti-money laundering (AML) requirements. What's the panel's reaction to this?

Camille Thommes, Alfi – Ucits are well-regulated products which put strong emphasis on investor protection, both for fund houses and intermediaries on behalf of the fund. Over the years, the Financial Action Task Force and European legislators reinforced measures to combat terrorist financing and money-laundering and introduced additional requirements to properly identify clients investing in funds.

Luxembourg is operating in a cross-border environment and takes those measures extremely seriously. Our supervisory authority does the same, and it's something we as an association support. The fact that Lloyd's decided to disinvest, or recommend its members disinvest from Luxembourg and Irish Ucits, was quite surprising to us.

"WE HAVE TO ACCEPT LLOYD'S DECISION TO DISINVEST FROM UCITS. PERSONALLY I FOUND IT REGRETTABLE, AS IT WILL OFFER ITS CUSTOMERS LESS CHOICE."

Camille Thommes, Alfi

It's a commercial decision which I think we have to accept, but I personally found it a regrettable one because in the end it will certainly offer its customers less choice. Both in Ireland and Luxembourg, we have to apply the highest standards.

Anja Grenner, TMF Group – We regularly get comments about Luxembourg's AML KYC [know-your-client] requirements from clients that use TMF Group in different countries. We don't do Ucits funds, so we are talking about alternative funds – especially when clients have experience with funds in various jurisdictions before coming to Luxembourg, whether that's Jersey, Guernsey, Hong Kong or Cayman.

The requirements are more onerous in Luxembourg, and there can be discontent if the topic of Luxembourg KYC-AML differences has not been specifically addressed early on.

This is European law that we are transposing into Luxembourg law. To a certain extent, this law should be the same everywhere in the EU. These requirements are just part of doing business and I think it is actually OK.

Robert Brimeyer, Alter Domus – Given its position as a financial centre in Europe, it is the ambition and probably also the role of Luxembourg to adopt best practice in applying European law.

The general challenge that we all have is that the whole KYC process is far from being efficient. If you look at large institutional investors investing into multiple funds across multiple jurisdictions, they have to provide the same documents again and again to a broad range of service providers, everyone looking at the same documents.

As a market, we should have the ambition to address this topic. Identifying who is behind an investor is in essence a quite easy task, but it would be interesting, for example, to establish a kind of an organisation or public administration that would say, 'I have identified this investor, you have clearance, go and work with them,' rather than all of us executing the same identification process to all the investors all the time.

Fèmy Mouftaou, IQ-EQ – It is true that the AML requirements are significant. For example, the identification of the ultimate beneficial owner for every transaction can represent a heavy process for every provider. It is clear that there is potential for greater efficiency in applying the AML and compliance regulation.

Such requirements are applicable throughout the lifecycle of the entity or the investment and are crying out for automation and standardisation.

All players are looking for solutions to monitor compliance risk closely and efficiently. This is can only be achieved by the use of smarter systems such as regtech solutions and more efficient processes.

***Funds Europe* – How well has the Luxembourg funds industry coped with working from home?**

Grenner – I've been quite amazed at how quickly everybody switched to home working and how quickly work resumed as if it was being done in the office, whether via company laptops or home computers. I think it has worked for probably the majority of people quite smoothly. The objective was that the client would not notice any difference,

"THERE ARE SITUATIONS WHERE YOU NEED YOUR COLLEAGUES AROUND. WE RECRUIT A LOT OF PEOPLE, SO HOW ARE YOU GOING TO ONBOARD SOMEONE IF YOU HAVE AN EMPTY OFFICE?"

Robert Brimeyer, Alter Domus

and – with a couple of exceptions – this has been achieved. In companies where time is recorded against client accounts, working time is traceable and trackable, and that has helped to prevent employees from disappearing into 'nirvana' for a day or so. Team managers and supervisors have also adjusted ways of working.

In practice, 35% of staff could go back to the office now. If we get something between 10% and 20%, it's because people think they can do the same work more efficiently and happily from home.

Thommes – There are certainly some critical functions where firms asked their people to have a look at it and partially work from the office, maybe on the IT side, maybe on certain risk functions. Given the fact that people have to have business continuity plans in place, they could quite reasonably and efficiently execute those.

From a market perspective, investors didn't panic or overreact. We had a drop in overall assets, but in the meantime we have seen over the last three months very positive inflows of money. Obviously, assets in the market went up as well, we had governments and central banks providing substantial monetary support, trying to mitigate some of the impacts, so overall we weathered the storm and the early stresses reasonably well.

It's true what Anja said, that maybe people have seen the benefit from working from home, so that's a top priority in many firms, to see how can we strike the right balance.

Mouftaou – In Luxembourg, we are quite lucky as we are living in a highly connected jurisdiction with a solid IT infrastructure. This has made it possible for employees to work not only from home but across country borders.

In addition, business continuity plans – which are mandatory for all regulated firms – have been activated in most cases with success.

All of these factors have made us resilient to the crisis. We have found a new balance and this is going to go on for many months yet.

Brimeyer – The first two to three months were almost painless, except for the first week where we moved everyone home.

After a while, you realise working from home is fine, but there are situations where you need your colleagues around. We continue to recruit a lot of people, so how are you going to onboard someone if you have an empty office? How do you integrate people into the teams? How do you ensure that you have efficient coaching/supervision of the juniors? These are topics that we are looking into so that we are ready for the new world where more tele-working will be happening. I think there have been challenges but not, as you would maybe have expected, early on in the crisis.

One topic that is quite an unknown for us is the tax and social security issues that non-resident employees may have (they represent more than 60% of our talents). Exceptions have been granted by governments from neighbouring countries during the crisis, but these will not last for ever. Will we therefore have the required flexibility to implement more home working? We have proven that as a market, we have the flexibility, but if governments go back to the initial rules, it might force more people back to the office than we would like. We need to be pushy on this topic so that we have sufficient flexibility to shape this.

Thommes – Work is being done internally or domestically to see how we can put a framework around this, because there are numerous topics to address. The CSSF is also looking into this. Firms are not returning with their entire teams to the office in the very near future, and beyond that, they might try to find arrangements that comply with existing regulations. If existing regulations have to be adjusted, I think there is a willingness at least to address it.

The financial industry played an important role in limiting the spread of the disease because we could quite quickly move to work from home.

Grenner – There are more far-reaching aspects that we are just tapping now. Apart from the specific Luxembourg problem with cross-border workers, you can, for the moment, hold board meetings from home. Also, before Covid, nobody wanted to fly from San Francisco to Luxembourg for one meeting, unless he or she was able to meet service providers, clients, investors, and so on in Europe. These issues will have to be discussed over the coming months.

***Funds Europe* – The UK is aiming, post-Brexit, to retain rights to sell financial services throughout the EU through the concept of 'enhanced' equivalency – where both the EU and UK would regard each other's financial regulation as achieving broadly similar outcomes. How could the current model of the delegation of fund management activities from Luxembourg to the UK be affected by this from January 2021?**

Thommes – If I look at the assets in Luxembourg funds, roughly 17% at least from the regulated space, is in funds that are held by initiators of UK-based origin. We have seen throughout Brexit firms relocating or transferring assets to Luxembourg. There is no general equivalence regime, so not even a sectoral regime, because we have roughly 39 specific equivalences foreseen in, I think, 16 pieces of legislation. The equivalences also do not all provide access to the European market, only 12 of them.

What we see in the investment fund space is already a possibility given to delegate certain functions to other jurisdictions, be it on the portfolio or management side, or on the risk management side. Only recently, the European Commission published what they called a 'readiness notice' where they reconfirmed that the delegation of certain functions to providers established in the UK may be undertaken, provided that they are in compliance with the respective directive.

Where delegation concerns portfolio management, there needs to be a cooperation in place between the supervisory authorities of both jurisdictions. One element that needs to be fixed is that the UK will be a third country or is a third country going forward. Esma will need to adopt a position on that.

Grenner – On the alternative funds side, at least for private equity, real estate and infrastructure, many asset managers in the UK have taken their measures already, for example by setting up a second AIFM here in the EU where before the AIFM was sitting in London only.

Some have relocated their AIFM to Ireland for the language convenience. We've also seen quite a few setting up a separate AIFM in Ireland or Luxembourg. The majority simply didn't want to run the risk of being negatively surprised at the end of this year.

Many of them also said, 'We have the solution all prepared, ready in our drawers and we are going to take it up and actually do it, if we think that there is going to be a hard Brexit.'

Enhanced equivalency will need to come. The UK is too important as a country not to introduce something to that end. For alternative assets in particular, the UK is absolutely key.

***Funds Europe* – What is the outlook for the private equity/real estate sector in Luxembourg? Have increasing levels of leverage in deals and the rise of covenant-light deals in recent years made the alternatives sector more vulnerable in times, like now, of market downturn?**

Brimeyer – When I look at how the last couple of years have been in private equity/real estate, and I would include private debt and infrastructure as asset classes, we've seen phenomenal growth.

As Alter Domus, we are focusing only on that activity, and we are very bullish. Luxembourg is well placed to provide a good home for these kinds of structures and service these funds.

From a macroeconomic point of view, there is a big need for these types of funds to continue operating, to provide interesting investment opportunities for pension funds, insurance companies, etc.

I would say the fundamental business model of those funds is still very valid, even more today than it was yesterday. I think the industry has shown a high level of resilience in the crisis as well.

Some funds have been a little bit under valuation stress, especially in the real estate space where it's very difficult to measure the longer-term impact that the crisis will have, but in general we are very bullish about the industry. I think we have a good story in Luxembourg.

Grenner – Shorter- and mid-term wise, I don't think that interest rates are going to go up, definitely not in the next couple of years, so the drive into alternative funds will remain valid. I share the view that more money is going to flow into alternative funds. We have only seen the tip of the iceberg on what's going to happen with regard to the real estate industry. You just have to look at Luxembourg's real estate sector, but I guess in London it would be the same. The restaurant sector is negatively affected, offices are affected, habits are changing. I heard from clients in the US that people are moving out of New York into the suburbs, again something we had about 50 years ago. I think Luxembourg will also be touched by that.

On the subject of increasing leverage in deals, we are far from the levels that we saw before 2008/09 – I am not worried about that at all for the moment: it's far from levels where there is high systemic risk, and on top of it, banks and other institutions are far better prepared than they were in 2008. I'd be more interested to see how the real estate sector is going to cope: are we going to convert offices into residential, or what's going to happen on that front? That's a far more interesting question in the short term.

Mouftaou – Real estate is going to be a challenge, as Anja has mentioned. Certainly some funds that manage residential and commercial real estate have faced cashflow issues with shops being closed in many countries, impacting their rental income.

Strategy is also a challenge. What will be the future trends of the real estate market? With the rise in teleworking likely to continue, is the trend going to be towards residential or commercial? Do we need to start thinking about the conversion of the portfolios?

In terms of private equity, I don't expect a big peak again in the number of fund managers coming to Luxembourg to set up funds, but I can see that the well-known Luxembourg fund-structuring toolbox will continue to offer many possibilities to capture new trends arising from the crisis. Also, the rise of the private debt sector, coming primarily from the US, is reaching Luxembourg and we're seeing more and more fund structures targeting the asset class.

Thommes – Definitely the alternative segment is on the rise. This has also been confirmed by studies done by Preqin on the outlook of the alternative sector up to 2023. We're certainly one of the beneficiaries of servicing those clients, be it in the private equity, real estate, infrastructure loan and debt funds where we have very strong positioning. We have seen over the years an increasing number of service providers servicing those clients with expert knowledge, so I would say the ecosystem around servicing that segment is top-notch in Luxembourg.

***Funds Europe* – The UK recently introduced an 'Assessment of Value' regime to tighten fund governance in the interests of investors. Do you anticipate similar action in the EU in general and in Luxembourg in particular? Is Luxembourg's existing fund governance regime up to scratch?**

Thommes – This question does not necessarily and exclusively relate to Ucits, but when you consider the combined effect of MiFID II and also the recent Esma supervisory work on costs in Ucits and in AIFs, I think UK investors certainly are equally protected as for the value assessment requirements.

As regards whether Luxembourg's fund governance regime is up to scratch, you wouldn't be surprised if I say,

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Anja Grenner, TMF Group

'Definitely, yes.' Not only does the Ucits directive regulate the organisation, the management and the oversight of funds, as does the Alternative Investment Fund Managers' Directive, but in addition, our regulator had issued a number of circulars in the past which provide for strict guidelines on rules of conduct applying to managers.

Grenner – You have certain retail investors also in alternative funds, which triggers another discussion of whether there should be retail investors in alternative funds at all. I know certain countries answer this with a yes, others with a no, and some take a position inbetween. For me, this regime is another step towards enhanced investor protection – one of the reasons for introducing AIFMD in the first place.

That is fine for alternative funds where retail investors are permitted to invest, but I think the new UK regime is taking this a step further, in taking away the responsibility of investors to take decisions themselves. I expect from an institutional investor that they do their due diligence, that they have the tools and systems to do so as well, to be able to assess the value of the fund they are going to invest in.

If I look at these documents in detail, I am wondering how much time people have actually invested in putting these reports together, and then there is still the question of if investors are actually going to read it. But, who at the end is paying for this? It's another burden that an asset manager has to shoulder, for a document which I doubt is going to reach all investors. First, it is the business of institutional investors to figure out in which funds they want to invest in and second, if institutional investors require more information from alternative asset managers they will ask for it, so for institutional investors I cannot see an added value in this document.

Brimeyer – We need to be careful to strike the right balance here, creating sufficient transparency to market these products to retail investors who need to have a much more straightforward way of comparing products.

Having said this, I don't believe that alternative investments is a space for many retail investors, given the liquidity mismatch between investor expectations (open-ended funds) and the assets (often highly illiquid).

Trying to fit an investor base into an asset class that fundamentally does not share the same liquidity requirements than the potential investor is creating a very big burden in terms of trying to create transparency on costs and on performance, which I believe will be very expensive to comply with.

AIFMD has already introduced quite a lot there and governance around the funds as we know it in Luxembourg is very strong.

Mouftaou – We already have the AIFM directive giving a lot of transparency, we have the GDPR rules, we have the 5AML directive, we have MiFID II, and locally we have further initiatives, regulatory pressures and follow-up, so we already have everything we need in terms of fund governance and transparency. Adding this layer doesn't give anything more, but we should think about what Luxembourg's relationship with the UK is going to be after January, because that's probably the open question for those incentives.

***Funds Europe* – With regard to Alfi's five-point priorities for the next five years (the development of cross-border savings and pension products, promoting sustainable products, extending the global reach of Ucits, broadening access to alternative investments, promoting digital innovation): which ones are most relevant to your firm?**

Brimeyer – For me, it's a very easy pick. Given that we're specialised in alternatives, I will absolutely promote any initiative linked to alternative investment. I believe Luxembourg is well positioned to continue building its influence in global markets in this area.

Then I would certainly opt for promoting digital innovation. Especially in the alternative space, where the level of maturity is not yet at the same levels as in the Ucits fund space, I think there is a big potential for more standardisation.

Mouftaou – I would probably pick 'promoting digital innovation' and 'sustainable products'. IQ-EQ has aligned its strategy to those two priorities.

That being said, even though many things are now possible (like the use of digital signatures), some players are not there yet in terms of adapting their own internal procedures and harnessing those new possibilities. I am confident, however, that the conversion of all will come very fast.

***Funds Europe* – A legislative framework adopted by the EU last year aims to address problems that have been raised by the industry over the past three decades and which have not been solved by the Ucits and the Alternative Investment Fund Managers Directive (AIFMD) regimes. But do the new rules – which cover EuVECAs, EuSEFs and ELTIFs – go far enough?**

Thommes – We have been engaged in that specific Capital Markets Union initiative from the outset, and also tried to contribute to get rid of some barriers for cross-border distribution of products. We have been very active at multiple levels. I think in the end we welcome some of the changes that have been introduced, like harmonised pre-marketing rules for AIFs across the EU, the fact that there isn't harmonisation of the denotification procedure for both Ucits and AIFs, the removal of the requirement to have a local presence has been welcome. As always in such discussions, you would aim for more, but you have to strike a balance and you have to strike a compromise.

Overall, I think these are positive steps in the right direction, but it is clear that it's important to monitor how effectively those rules will reduce cost and the administrative burden for cross-border distribution.

Grenner – Here in Luxembourg, we have the advantage of a large range of fund structures. You can happily choose among those to find the right one for your fund, such as an unregulated SCSP for a VC fund, for example. The majority of managers in venture capital are not necessarily looking at whether an external AIFM is appointed or not. The question for Luxembourg is, do we actually need that piece of legislation? Some countries in Europe may say yes, others no, but I am not 100% convinced that Luxembourg really requires this, at least not the EuVECA.

For the EuSEFs, I don't know how many funds were launched in Luxembourg and elsewhere in the EU. I think it's a good idea as such, but with more funds adhering to ESG principles in general, the question is, 'Do we actually need something like this (EuSEFs) going forward?'

Brimeyer – We are servicing about 500 funds in Luxembourg and I believe zero EuVECA, zero EuSEF and zero ELTIF, which to me does not necessarily mean that these regimes are meaningless or that we don't need them, but I think it clearly shows that Luxembourg has a broad toolbox which allows fund initiators to achieve their goals with the other tools that we have around, and these regimes don't seem to bridge or to solve the problems that these particular types of funds might have. For me, honestly, those three topics are not really a topic today.

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Femy Mouftaou, IQ-EQ

Mouftaou – It's much more efficient and convenient to use what is existing in the jurisdiction of your choice than picking up another global European regime.

When you look at the possibilities offered by the three regimes you have listed, on paper, EuVECA should be a regime that attracts a lot of interest from the market: it offers a voluntary EU-wide marketing passport to qualifying fund managers, without the costs associated with AIFMD authorisation. Nevertheless, it is quite interesting to see that fund managers are just not choosing this fund type for their venture capital funds. It's another demonstration that jurisdiction selection is probably the first step in the fund manager's decision-making process, and after they look at the fund regimes.

***Funds Europe* – In the next 18 months, which issues will be top of the agenda for the Luxembourg funds industry?**

Thommes – For Alfi as an association, it's definitely to execute our ambition plan, which covers very broad topics.

Brimeyer – There are two big priorities. One is certainly digitalisation. The second is maybe surprising, but we have a big issue around talent and recruiting the right people to cope with the growth that we have as a financial services centre. Our success in the past has been driven by high-quality labour, but it's increasingly difficult to source the amount of people we need to service all these structures.

Grenner – Information technology is an important topic, particularly on the alternative fund side, also because the alternative fund is growing at quite a high speed. It's one of the major concerns of our clients – they expect technology to work efficiently so they can concentrate on other issues.

The major issue is indeed finding the right qualified staff. The fund structures here in Luxembourg on the alternative side are complex and very often you do not find the people here to service them. Not even within the EU do you find enough qualified staff. Because there is a large range of service providers, people also move from one to the next, which is understandable if demand for qualified staff is high. For the administrators, this is a considerable cost factor.

Mouftaou – Our priorities are digitalisation and to promote ESG, both internally and for our clients. Good, talented people want to work on tasks that add value to the company, to society, and digitalisation is offering that. **fe**