

Requirements for substance in asset management companies.

The Luxembourg Investment Fund Professional Enhances his International Reputation

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The Luxembourg finance centre is changing quickly. The traditional role of the fund professional is being reshaped within an international environment which is constantly evolving. Today's players are reacting to new constraints brought about by financial innovation, new product offerings and increased professionalism. The regulatory authorities are enhancing this environment by demanding the highest standards from all professionals. This effort is significant and important. It is very likely that the future success of the financial centre will centre around the development of « best in class » niche specializations.

It is in this context that it is worth studying the Luxembourg approach to the UCITS III directive – a directive which targets the Luxembourg fund industry, the principal pillar of the Luxembourg financial centre.

The implementation of this Directive will extend the traditional administrative tasks undertaken for Luxembourg investment funds into the areas of investment management, risk management, compliance and corporate governance. This should in turn result in these areas becoming centres of increased excellence adding real value for the promoters of funds and, ultimately, the investors.

Provided the required effort is made, the new European approach should permit the financial centre to underscore its professionalism in investment fund administration and develop this expertise yet further. It is in this way that, in addition to the wider definition of product offerings and the creation of investment management companies, the EU Directive 2001/107/EC will open the way to the introduction of new corporate governance principles in the fund industry which will further strengthen the reputation of the industry and provide increased protection to investors.

Henceforward, for every management company registered in a member country, conducting officers must be appointed to manage the business of the management company or the fund (in the case of self-managed funds). A code of professional conduct must be established and followed. Genuine activity must be undertaken in the country of domicile of the management company or the fund.

The Luxembourg Law of December 20, 2002, supplemented by the CSSF Circular 03/108 of July 30, 2003, transposes this European Directive into national law. The Law places special emphasis on the fact that (empty) letter-box management companies ie companies without real substance, will not be acceptable.

Besides legal obligations related to financial reporting, the legislator also henceforth requires management companies to establish and implement specific programmes re *inter alia* types of activity undertaken, internal control procedures and risk

management tools. A certain number of activities can be delegated to third parties either in or outside of Luxembourg. Contractually, there must be effective supervision and ongoing monitoring of these delegated activities to the highest professional level.

The concept of « substance » and the search for excellence in the investment fund industry

In this context, the concept of « substance » refers at the same time to the appointment of two officers responsible for the daily management of the management company and the setting up of the infrastructure necessary for the two officers to fulfil their responsibilities. The current rules and regulations require therefore that two officers be appointed who are of good reputation and sufficient experience to manage the day to day business of the management company. These officers must be approved by the regulatory authorities. They may not be employees of the depositary bank or other companies offering services to the management company since this could create potential conflicts of interest. The officers must, in other words, be sufficiently independent to be able to defend the interests of the investors within the spirit and meaning of the regulations.

For this reason, it would be preferable that these officers are fully committed and have positions of authority vis a vis the management company in order to meet the spirit as well as the letter of the law. The two officers would, preferably, be members of the Board of Directors. This would enable them to decide, in their capacity as independent directors, if the investment policies pursued by the funds are compatible with Luxembourg law and with the prospectus of the funds ; if the internal control mechanisms and the risk management processes and procedures are suitable and effectively applied and audited ; if the distribution rules, including sales practices and selection of distributors, are satisfactory ; if any delegated tasks are adequately performed and in accordance with the rules and regulations and any internal requirements ; if conflicts of interest are highlighted and resolved within the spirit and letter of the rules of good corporate governance currently in force ; and if, in general, the interests of investors are safe-guarded.

The CSSF must have direct access to the officers and must be able to obtain from them any required information related to the business of the management company. One of the two officers must have a professional presence in Luxembourg . The rules require the availability in Luxembourg of adequate facilities which would allow the officers to fulfil their obligations.

We believe that, as mentioned above, and even in situations where there is a significant delegation of tasks to third parties, three types of tasks cannot be delegated. These tasks are key to any discussion of the meaning of « substance » :
1) the supervision and monitoring of risk management procedures and processes (« risk » in the widest sense of the term) ; 2) the supervision and monitoring of tasks delegated to third parties and 3) the application of good corporate governance principles.

To meet the needs of substance from this viewpoint will require a certain amount of infrastructure in Luxembourg including premises, systems and administrative staff.

This will ensure that risk, operational and financial information flows freely between the the management company , the third party service providers and the officers.

The costs of substance

It is interesting to note that while the Luxembourg legislator seeks a greater degree of transparency and efficiency in fund oversight and governance it does not impose any specific additional or significant infrastructure requirements on the management company to achieve this «substance». A number of important activities may be delegated to third parties to ensure optimal management at a reasonable cost so long as the spirit of the law in terms of efficient control of the company from its country of domicile is maintained.

Thus, the Luxembourg authorities have no objection to one or several management companies or self-managed entities having recourse to third parties to provide this substance. This third party must be able to demonstrate to the regulatory authorities that it has the technical, professional and infrastructure means to meet the requirements of the law.

A person responsible for a management company may also, for example, perform a similar role as a director / conducting officer for another company. In this case, he / she is not an employee of any one company (and will thus remain independent) but is an agent for different companies at the request of their respective Board of Directors. He / she will however ensure that each mandate will be performed in a professional manner, with adequate infrastructure and with any conflicts of interest as a result of being involved with more than one company duly highlighted. Depending on the schedule of activities undertaken by the conducting officer, it is clear that the number of mandates is limited by such constraints as the amount of time required, his/her availability or the complexity of the task. Consequently, it would be preferable that the conducting person is bound by a code of professional conduct which strictly sets out rules regarding especially availability.

With a code of professional conduct in place, such a principle is much more readily applicable since it will apply to a group of individuals exercising the same type of activities and sharing the same values in respect of good corporate governance.

It would also be preferable that these officers who together exercise basically the same profession could get together within an association which would establish norms and performance standards, provide education on good corporate governance with selected reading materials and work closely with university research centres such as the Luxembourg School of Finance. This would have the incidental benefit of enhancing the reputation of the financial centre in this specialist area.

Likewise, a company specialised in the creation of « substance » in the sense of meeting the the various infrastructure needs of the conducting officers could make its services available to several management companies. This company would offer a platform of shared services for a number of management companies with a consequent reduction in cost due to economies of scale.

In an ideal case, such a company would be subject to the regulatory authorities of the country of domiciliation. The company would ensure that each conducting officer would be able to fulfil his/her task in an independent manner and with the necessary professionalism required by the law by making available to the officers databases, analysis, reports and commentaries relative to the activities of the management companies.

Transforming a cost proposition into an opportunity for margin

There can be no doubt that any new regulation initially comes at a cost - when this new regulation is mainly one of oversight, the additional costs are unlikely to be covered by additional sales.

Even if the new UCITS III Directive and its implementation in Luxembourg will not provide an exception to this rule of additional costs, it is not so clear that, in the longer term, these new rules will not prove to be beneficial resulting in increased revenues.

The new investment opportunities presented by the Directive will certainly lead to innovation in terms of profitable new products. But beyond the new “product” aspects, the recasting of the investment management company on the theme of increased “substance” will also have a positive effect longer term on its profitability.

We are indeed convinced that if the recasting of management companies is undertaken with the care and skill described above, the oversight and governance and risk management will be more efficient, errors will be avoided and shareholders' interests will be protected. The reputation of such a company will be greatly enhanced.

Luxembourg, as the leading investment fund centre in Europe, has therefore an essential role to play in these new developments as regards investment fund management companies.