



Association Luxembourgeoise
des Compliance Officers
du Secteur Financier

Newsletter

N°14

JUNE 2008

Editorial



Dear friends and members of ALCO,

ALCO communication managers do their best to publish our Newsletters at a steady rhythm. Accordingly, we are very pleased to be sending you this new edition before the summer holidays.

We have often discussed in which language the Newsletter should be published. You will notice, and this is the case for this edition, that we publish our articles indifferently in the language in which we receive them, in English or in French, in a first edition.

In the future, we will systematically publish a second edition entirely in English.

A priori, we have not planned to translate into French articles which we receive in English.

In this edition, we propose:

- An article by Karine Vilret-Huot which deals with laundering offences which more specifically threaten the insurance sector. The risks are most certainly higher and more

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varied than the sole statistics of declarations to the State prosecution office would have us believe.

This article coincides perfectly with the publication of the new circular from the Insurance Commission on professional obligations for this sector relating to the fight against laundering.

- An article by Stefano Pierantozzi from the Citibank, who reviews progress and the tentative steps of the regulations on “short” positions in UCITS. This very specialised article shows that progress achieved leaves many questions still open. What is the actual challenge for the Compliance activity! A fascinating subject which will most certainly have a sequel...
- Lastly, the Dialogue Group provides answers to questions that members are asking themselves. I sincerely hope that this dialogue will continue. Do not hesitate to send your questions to the ALCO secretariat (secretariat@alco.lu) on all compliance subjects.

We shall meet again very soon for a Plenary Meeting which will review our workgroups’ activities, and we will also be able to hear Benoît Sauvage from ABBL on the prospects of the current financial crisis.

You are all welcome on **June 17 at 5:30 p.m.** in the Auditorium of the Fortis Bank Luxembourg that we sincerely thank for welcoming the ALCO once again.

I look forward to seeing you shortly.

Jean-Marie Legendre
Chairman

Doctrine

Money laundering offences and typologies in the insurance sector

Introduction

1. The general money laundering offence which sets forth legal bases for preventive measures relating to the detection, seizure and confiscation of criminal proceeds provided by the Luxembourg Criminal Code, today constitutes one of the most important repressive sections of anti-criminal policy. The comprehensive body of legislation will once again be reinforced via the transposition law of the third European Directive¹.

The said repressive section has grown and accelerated under pressure from the international community, the Council of Europe Convention of November 8, 1990, and

¹ 1/ Draft law n° 5811 entailing transposition of directive 2005/60/EC of the European Parliament and the Council on October 26, 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, entailing transposition of directive 2005/70/EC of the European Parliament and the Council of August 1, 2006 entailing implementation measures for directive 2005/60/EC of the European Parliament and Council with respect to the definition of "politically exposed persons" and the technical conditions for the application of simplified obligations of vigilance with respect to the clientele, and exemption on the grounds that the financial activity is only undertaken on an occasional basis or on a very limited scale – 2/ Draft law n° 5756 relating to the fight against laundering and terrorism financing – 3/ The Council of State recently filed, on April 22, 2008, a critical opinion on these two draft laws.

European Union directives. Accordingly, the Luxembourg legislator imposed on financial organisations, then on certain individual or legal entities exposed to major risks, and finally on law and accounting professionals, active cooperation with the detection and warning mechanism, under penalty of sanctions.

2. Based on the American model, this cooperation is mainly expressed through obligations of vigilance for persons' identification, special study of operations and their recordings and preservation, and communication of the corresponding documents. This mandatory cooperation may result in a declaration of suspicion concerning a certain number of specified or specifiable criminal offences or activities. This declaration must be sent to the Financial Intelligence Unit which has been set up for the purpose of collecting and processing the information it receives. In compensation for this cooperation, the informant who acts in accordance with legal instructions benefits from immunity, except in the event of fraudulent collaboration.

3. For several years now, the number of unlawful activities or supposedly unlawful holdings has been on the increase. The criminal definition of money laundering offence has a very extensive scope, therefore the updated list of offences which lie within its scope of application goes beyond drug trafficking and now includes organised criminal activities, fraud against European Community interests, corruption and terrorist financing².

² For a precise definition of the money laundering offence, read Articles 506-1 to 506-7 of the Criminal Code.

4. The Grand Duchy is turning towards regulations that will completely change current practices and the understanding of money laundering offences, which will now come under a general approach per threshold. The State Council rightfully remarked that *“in practice this results in grafting money laundering offences on almost all primary offences, insofar as any proceeds generated by an offence which is punished by a prison sentence equal to or in excess of at least six months, is now included. Although it should be remembered that this is the wilful tendency which may be understood in directive 2005/60/EC (“3rd money laundering directive”), the State Council must also remember the reserves set forth in its opinions of March 30, 2004 (parl. doc. N° 51655) and March 17, 1998 (parl. doc. N° 42946) in the face of a generalisation of money laundering offences. The said reserves concern both the risk of systematic implosion of control mechanisms when suspicion becomes a principle and that good faith must be proved, and above all, the fact that the projected approach may result in inverting the burden of proof.”*³

The Council of State also adds that *“In addition, the Council of State once again draws attention firstly, to the considerable difficulties of practical implementation which unregulated professions in particular will encounter and secondly, to the worrying tendency of making economic proponents officers of the law, which is all the more true insofar as the basis of concerned offences is more extensive.”*

This position will probably not go unheeded as it is of capital importance both for our legal system and also for economic market proponents.

³ Parliamentary works 5756/4 and 5811/4 of April 22, 2008, pages 2 and 3.

5. The insurance sector is certainly not spared by money launderers' increasing interest, in the same way as for the financial sector.

The insurance sector is potentially vulnerable to money laundering due to its size, the availability and varied nature of its products, and the actual structure of its activities. With respect to the last point, it should be pointed out that in certain countries, insurance is above all a transnational activity and that in most cases, insurance products are distributed via brokers or other intermediaries who do not necessarily belong to the company, or who are not under its control or supervision.

The cooperation obligations imposed on the insurance sector are obviously very different from secrecy standards or non-interference practices which have been rooted in the professional insurance world for many years.

Firstly, the professionals concerned by these regulations must be identified (1). Secondly, it is of interest to briefly list the operations which in practice come within the scope of money laundering offences (2), to review their perpetrators' specificity (3), to finally list the typologies of money laundering offences found at national and international levels (4).

1. The insurance professionals concerned by anti-money laundering legislation

The law on the fight against money laundering and terrorism financing concerns insurance companies which are either accredited or authorised to do business in Luxembourg.

There is nothing new in the application of anti-money laundering measures for insurance brokers as the amended law of December 6, 1991 on the insurance sector already addressed these professionals⁴.

The third European Directive relating to money laundering extends the scope of the concerned professionals, by henceforth listing “*life insurance intermediaries*” and no longer brokers alone.

The formers’ subsidiaries and branches are also concerned, whether located in Luxembourg or abroad, insofar as they are not submitted to equivalent professional obligations applicable where they are established.

2. Money laundering offence

In substance, money laundering generally consists in three stages which may overlap according to the size of assets to be laundered and the more or less sophisticated methods used by the launderers.

a. Investment

This is the first stage which consists in the penetration of collected illicit cash into licit circuits. This immersion, occasionally called “pre-money laundering”, can either be undertaken directly with banking establishments, as deposits which are often spread out, the purchase of anonymous bonds or foreign currencies, or by transfers from international locations. It also occurs by introducing cash into gaming establishments such as casinos and circles which are controlled or used by criminals, or even into activity sectors which necessarily handle large amounts of cash such as

“laundrettes”, bars, restaurants, hotels, jewellery and precious metal trades or the second-hand market.

b. Conversion

Also known as “*stacking*”, “*dispersion*” or “*washing*”, conversion consists in making the trace of “dirty” money’s origin disappear by circulating this through numerous and complicated financial operations and by blurring the operators’ real identity. Sometimes this is simply a sale of physical assets, followed by multiple uses and re-uses. But, on a large scale, money launderers multiply conversions, especially international ones, by telegraphic, or even better, electronic fund transfers (such as via the SWIFT network, a worldwide telecommunications company for inter-bank financial transactions), which make the identification of their authors practically impossible due to their abundance. They will also methodically use one or several so-called interposition companies and offshore financial centres by taking advantage of regulatory leniency, banking confidentiality and professional secrecy, to conceal the identity of persons’ concerned.

c. Integration

All known as “*rinsing*”, this final stage of the operation is the use of amounts concerned in lawful investments; the criminals’ aim being to circulate the said amounts as “*clean*” money and which, more often than not, is taxable. Generally speaking, for petty criminals’ proceeds, integration takes place directly, via false invoices with insufficient supplies or due to gaming establishments’ participation in the form of official winnings. But to absorb the proceeds of serious crime, much more elaborated processes are employed, such as real estate transactions through shell

⁴ Article 111-2 of the law of December 6, 1991 on the insurance sector.

companies, drawing up false import-export invoices, or subsidiaries' reimbursement of fictitious loans granted by their parent company, etc.

3. The dangerous nature of these proponents

When such operations are performed and insofar as we wish to make the required distinctions between the different criminal types, according to variables resulting from diversified personalities and situations, we find that money launderers' motives are numerous and open to modification.

Criminal analysis reveals that by their very existence, money launderers provoke and favour the accomplishment of criminal enterprise by specific actions. The launderers are less noticeably aggressive but, however, show more cunning and organisation both over time and spatially for the purpose of accomplishing the various money laundering operations. This is an occasional or usual activity.

a. The occasional criminal

Many money launderers who have been uncovered to date by the police and convicted by the courts do not appear as hardened and habitual criminals, but on the contrary, as professionals "beyond any suspicion" such as lawyers, notaries, bankers who act occasionally either due to being intimidated, or who are simply unwise or negligent. In many cases they pretended that such was the case whereas they should have presumed that the "laundered" assets or income constituted illegal proceeds.

b. The habitual criminal

The most dangerous of all money launderers are most certainly habitual criminals who

use the facilities provided by the exercise of certain professional activities which involve international financial relationships. At ease in sensitive professions or business worlds, they have perfect command of the most modern technologies and resources, in particular planetary communications, while profiting from legal loopholes for the purpose of concealing the illegal origin of the assets in question.

4. Money laundering typologies recorded at national and international levels⁵

The typologies of money laundering cases can be found at both national and international levels and are grouped into the following categories:

When simple transactions prove to be suspicious

- In October 2001, a country's financial intelligence unit transmitted approximately 10 files to legal authorities concerning money laundering activities connected to terrorism. As a rule, these are simple operations (currency exchange operations for private individuals, international fund transfers) which reveal connections with other countries. Some clients have criminal records, in particular in the field of drug and arms trafficking, and are connected to foreign terrorist groups.

One of the files submitted to the financial intelligence unit is particularly interesting. The client holds a current account and a savings account with the financial institution which drew up the declaration of

⁵ Source: GAFI and CRF reports

suspicion. Furthermore, he had bought transferable securities and contracted a single premium life insurance policy in the same financial institution. He undertook various transfers from his current account to beneficiaries in various countries. The bank became suspicious because a name similar to the client's appeared on a consolidated list of persons and/or entities included in the United Nations Security Council on Afghanistan (S/RES/1333(2000) and regulation 1354/2001 of the European Commission). Suspicion increased as the client had performed gradual withdrawals from his accounts in the said bank since the end of April 2001. He successively emptied his savings account, sold his transferable securities before their expiry date, bought back his life insurance policy and then transferred the balance of his funds to his European country of residence. He undertook his last operation at the end of August 2001, i.e. approximately two weeks before the terrorist attacks on the United States. The bank has never heard from this client again...

Single premium policy

- Single premium insurance policies continue to become ever more popular with money launderers; they prefer these policies. Money launderers contract these products and then buy them back, more or less rapidly, at a lower price; the balance can then be used by the launderer as a “disinfected” cheque issued by an insurance company.

- Single premium insurance policies also have another advantage as a means to launder capital; in actual fact these policies can easily be used as collateral⁶ to obtain loans from financial institutions.
- Life insurance has also been connected several times to fraudulent bankruptcy. Thus, a bankrupt person used an account held by a member of his family to collect and withdraw money via a cheque addressed to a lawyer. The lawyer subsequently gave a certain amount of money in return, in the form of a cheque, to a family member whilst the rest was injected into a single premium life insurance policy contracted by the bankrupt person. The life insurance policy was immediately terminated and the buy-back value was paid into the account of the family member.

Contracting a policy via intermediaries

One of the issues in the insurance sector is the distribution method of insurance products. A large percentage of the said distribution is undertaken through intermediaries.

- Insurance brokers are often the only professionals who have personal and direct contact with contracting clients and, in some countries the insurance company, rather than brokers, are under obligation of reporting any suspicious activity. It is true to say that this could not happen in Luxembourg as the delegation

⁶ For a detailed study of all possible guarantees for a life insurance policy, read: “Assurance-vie: Instrument de crédit - Les garanties sur police d'assurance-vie au Grand-Duché de Luxembourg” by Karine Vilret-Huot – Larcier publications 2006.

faculty is only possible for national professionals and foreign professionals who are in the same activity sector and are submitted to an equivalent identification obligation.

- However, if the information transmitted by the broker is inexact or out of date, the insurance company will not be able to undertake compliance controls.
- Money launderers are on the lookout for brokers who do not know the required procedures, or who do not comply therewith, or again who simply forget to record or declare information relating to possible cases of money laundering.
- The companies' attention must be drawn to cases where:
 - Identification is evidenced by the intermediary using documents which local companies cannot verify, and
 - They rely on the intermediary to undertake the identification and vigilance measures, and
 - Payments are performed by the intermediaries to local companies,
 - After a few months, the companies receive notification from subscribers specifying that circumstances have changed, that they must terminate their insurance policy, and that they request early reimbursement by cheque.
- A few years ago, a drug trafficker contracted a life insurance policy for

a total of 80 000 USD. The policy had been contracted via the agent of a major life insurance company with a bank cheque. The investigation evidenced that the client had informed that the funds used to contract the policy were drug trafficking proceeds and that, aware of this information, the agent had pocketed a very high commission.

Premiums

- Insurance companies must pay very careful attention when premiums are paid in cash upon subscription, and if the subscriber changes his/her mind during the legal withdrawal period.
- Another case which should arouse suspicion is when a single premium policy is purchased in cash or using a cashier's cheque and where the amount is obviously too high in view of the subscriber's profession or declared income.
- Contracting an insurance policy for an important amount with premium payments from an offshore financial centre is also obviously suspicious.
- The same applies to policy subscription which provides for the periodical payment of premiums which are too high as compared to the subscriber's apparent level of income.
- For example, a couple had contracted a life insurance in their name with periodical premium payments. If either spouse died, the surviving spouse would become the insurance beneficiary. The holder of the bank account, which paid the premiums,

turned out to be a foreign company in which the couple held office as directors, but was not their own bank account. However, the life insurance policy had been privately contracted by the spouses and not by the company. The investigation revealed that the stratagem was intended to conceal the illicit origin of the funds which were generated by organised tax evasion, for which the couple was well known.

Change of beneficiary

- During the insurance policy performance period, companies should worry when the contractually specified beneficiary is substituted by a person who has no evident connection with the subscriber.
- The insurance company should also ask questions and obtain coherent answers if the beneficiary often changes.

Policy termination or early buy-back

- With respect to termination, suspicions should increase when a client has no concern for important taxes or other penalties that must be paid in the event of early buy-back.
- Attention should be given to applications for reimbursement of capitalisation bonds presented by persons other than the subscriber. This is especially the case when the person who applies for reimbursement and the subscriber do not appear to be connected to each other. Lastly, companies should carefully examine cases where bonds initially contracted by an individual

in one country are bought-back by a company located in a different country.

- In a certain number of cases, the insurance policy is maintained for a few years before being terminated and reimbursed to a third party's benefit. The reimbursement cheque is then processed by a local financial institution which asks no questions, as the cheque is issued by another local institution of honourable reputation.
- We can quote the example of a person who paid 1 million euros in cash to a life insurance company in order to contract two single premium policies which were terminated early and therefore generated a 40% loss of the investment collected beyond the concerned jurisdiction. This was entirely performed for the purpose of preventing creditors from endeavouring to recover their money in the scope of fraudulent bankruptcy of the said person's company.
- Money laundering may also concern small amounts. Mr. P. invested £25 000 in bonds (life insurance type of investment). The money came from a house sale, which was confirmed in writing by a lawyer. The money came directly from Mr. P's account. The bonds were withdrawn by Mr. P's sister who held a proxy for Mr. P's affairs because he was in prison. During the withdrawal period, the bonds were terminated. Mr. P's sister asserted that her brother was not happy with the selected bonds. It proved to be an attempt to convert money which had

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been obtained in a fraudulent manner.

Secondary market

Another method which is becoming widespread consists in purchasing life insurance policies on the secondary market, in particular via the policy transfer mechanism.

- Criminal organisations can buy these policies at a lower price from beneficiaries who are in great need of liquidities. Duties owed in the event of decease or expiry are then paid either to the purchaser in the event of survival upon expiry, or the beneficiary in the case of decease; the money is collected via a cheque issued by an insurance company.

A specific case: 29 million USD

- In country X, customs officers launched an investigation which revealed that a drug trafficking organisation had used the insurance sector to launder proceeds from its activities. The investigations undertaken by several countries' operational authorities evidenced that traffickers laundered funds through the intermediary of the insurance company Z, located in an offshore territory.

The insurance company Z offered investment products which were similar to mutual investment funds; the rate of return was indexed on major international stock exchange indexes. Subscribers invested a maximum amount of money in the insurance policy, then either

deposited or withdrew further amounts in order to cover early withdrawal penalties, similar to current account operating. Funds were then re-released in the form of transfers or cheques issued by the insurance company, and were therefore apparently "clean".

The investigation evidenced that over 29 million USD had been laundered using this method. Furthermore, due to combined efforts by country Y (drugs' country of origin) and country Z customs officers, several wanted notices and warrants of arrest were executed for persons who had taken part in money laundering activities through the intermediary of the insurance company Z.

Conclusion

It is established that in view of the significant volume of insurance financial activities, this sector only counts a relatively low number of declarations of suspicious operations. This observation appears as proved at an international level and is also confirmed at a national level, in spite of the fact that the insurance sector has already been under the obligation of declaring suspicious operations for a certain number of years. It is true to say that the number of declarations does not necessarily correspond to the sectors' relative size as compared to the financial sector as a whole.

The question must then be asked as to whether the relatively low number of declarations of suspicious operations indicates that, at the end of the day, the insurance sector is little used by launderers or whether money laundering operations simply escape detection....

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The size of the insurance sector and the money laundering possibilities that it offers are certainly too extensive for it to be ignored by launderers. Cases recorded over many years evidence that the insurance sector is far from spared. Lastly, experience acquired in other branches of the financial sector shows that financial system sectors where anti-laundering procedures are not implemented in a coherent manner are those which carry the highest risk of being exploited for money laundering purposes.

Karine Vilret-Huot

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AGEFI Publication Luxembourg May 2008

Doctrine

Physical short selling under UCITS: is it time to reconsider, and which may be the challenges for the Compliance function?

Following amendments introduced in 2001 to the UCITS Directive⁷ (generally referred to as UCITS III⁸) and the expanded scope for the usage of derivatives, the divide between harmonised retail funds and hedge funds has become smaller and smaller.

In particular, after the publication of the European Commission's Recommendation of 27 April 2004 on the use of financial derivative instruments for UCITS⁹ (the "EC Recommendation"), the investment fund industry has realised the possibility of including synthetic short positions in a UCITS' portfolio.

In recent months we have witnessed how these opportunities have been exploited to create so-called 130/30 UCITS that are, de facto, a replication of hedge funds' long-short strategies.

Using derivatives for synthetic short selling

Article 7.3 of the EC Recommendation, "substitution with an alternative underlying cover in the case of cash-settlement", allows synthetic short selling as it states "where the financial derivative instrument is cash-settled automatically or at the UCITS

discretion, Member States should consider allowing the UCITS not to hold the specific underlying instrument as cover".

The fact that a UCITS may buy a put option on a stock without having to hold the underlying stock as a cover means that it can replicate a short selling strategy.

In the case of 130/30 UCITS by way of example, a synthetic short position on a particular stock or on a basket of stocks is often created through an equity swap contract.

The Financial Regulator has suggested a new approach...

Physical short selling of securities has historically been considered not acceptable under UCITS. However, in October 2007, the Irish Financial Regulator ("Financial Regulator") has published groundbreaking policy changes for Collective Investment Schemes.

The Financial Regulator, in respect of 130/30 techniques (the policy change relates however to any UCITS) considers appropriate, in light of the now permitted synthetic short selling techniques, to allow UCITS entering into physical short selling transactions, providing such transactions are covered by a stock borrowing transaction.

Also, it suggests that a stock borrowing arrangement "does not constitute borrowing under Regulation 70 [...] as long as the assets used to support the stock borrow cannot be passed to the counterparty".

To better explain this requirement, Regulation 70 refers to Article 36 of the

⁷ Undertaking for Collective Investment in Transferable Securities (UCITS) Directive 85/611/EC, as amended

⁸ Amending Directives 2001/107/EC and 2001/108/EC

⁹ Recommendation COM 2004/383/EC

UCITS Directive, according to which UCITS may borrow temporarily up to 10% of their assets.

To recap, the Irish Financial Regulator has therefore considered that securities borrowed constitute adequate cover per se, that these do not fall under the generic definition of Article 36 of the UCITS Directive, and has not provided for particular guidelines in terms of quality of collateral delivered to the stock lender.

The Financial Regulator's policy change document includes also provisions in terms of risk management process and disclosures and global exposure monitoring.

...however issues remain to be clarified

Even if the Financial Regulator's proposals were adopted by other European jurisdictions, there are still several issues needing clarification, which may bring challenges to the Compliance function if called to opine on the possibility for a UCITS to enter into physical short selling transactions.

I identify some of these issues below, however this may not be an exhaustive list.

- Stating that short selling is covered via burrowing seems a tautology. It is difficult to see how physical short selling can be achieved unless borrowing from another party (which may be the market).

The real issue probably is, when the securities are borrowed which kind of collateral should be posted, how it should be monitored, which kind of guarantees are required, and which are the responsibilities of the party acting as custodian of the collateral.

- The Financial Regulator is silent on whether or not a UCITS engaged in physical short selling should be considered a sophisticated one, and

hence whether the UCITS leverage should be calculated under the commitment approach or with a Value-at-Risk (VaR) methodology.

As far as sophistication is concerned, a UCITS adopting physical short selling techniques is not, from a regulatory point of view, a sophisticated one and so is not required to adopt more complex risk management methodologies.

Also one could consider that exposure generated via physical short selling is better measured with the commitment approach in consideration of the fact that the UCITS assumes a commitment to deliver assets, – whose value can be easily determined on the basis of market prices.

However, should a UCITS also make use of complex financial derivative strategies, a VaR approach could be the preferred solution. Under all circumstances, it would be safer for any concerned UCITS to enter into preliminary discussions with the regulator and clarify the matter.

- The Financial Regulator's policy changes consider that the Committee of European Securities Regulators' (CESR) guidelines concerning eligible assets for investment by UCITS¹⁰ implicitly allow short selling when they state that UCITS are allowed "to use repurchase agreements or securities lending or security borrowing to generate leverage through the re-investment of collateral". To me is not clear how collateral can be generated through securities borrowing, unless the borrowing transaction is seen from the UCITS' counterparty's point of view. Also, CESR guidelines CESR/07-044 state that UCITS can generate

¹⁰ CESR/07-044

leverage “re-investing collateral”; in the case of physical short selling there does not seem to be a “re-investment”. These may be semantics considerations but they should be looked into.

- The same CESR guidelines state, with reference to Money Market Instruments (MMIs), that “article 42 of the UCITS Directive prohibits the short selling of MMIs by UCITS”. The Financial Regulator refers to “stocks” so further clarification and analysis will be required on this point, if any inconsistency of treatment between different categories of assets is introduced.
- The EC Recommendation provides for a definition of uncovered sale that does not refer to the absence/presence of cover, but rather to the risk to which a UCITS is exposed. Accordingly, “uncovered sales are all transactions in which the UCITS is exposed to the risk of having to buy securities at a higher price than the price at which the securities are delivered and thus making a loss and the risk of not being able to deliver the underlying financial instrument for settlement at the time of the maturity of the transaction”. In the case of a physical short sale covered via borrowing, the UCITS still risks having to buy the security at a higher price, and still risks not being able to deliver the security – not to the market but to the lender.

Physical short selling: yes or no?

My personal point of view is that, under normal circumstances, nothing should prevent UCITS entering into physical short selling transactions – as long as some requirements are met.

As already mentioned, Article 36 of the UCITS Directive states that a Member State

may allow a UCITS to borrow up to 10% of its assets (of its value), “provided that the borrowing is on a temporary basis”.

Additionally, Article 42 of the UCITS Directive states that a UCITS may not “carry out uncovered sales of transferable securities, money market instruments or other financial instruments”.

Therefore, the UCITS Directive does not rule out the possibility of physical short selling a transferable security. It just states that two conditions apply:

1. The marked-to-market value of the short-sold securities may not exceed 10% of the UCITS’ net asset value
2. Uncovered sales are not allowed.

It would be perfectly reasonable for a UCITS to borrow transferable securities from a third party (versus the deposit of adequate collateral), and sell them on the market – as long as the entire process happens “on a temporary basis”.

The concept of “temporary” is not defined, and has actually been defined in different ways by different regulators. One would expect that a short position would be closed anyway within a reasonable timeframe; however the definition of such timeframe remains an open issue.

As the prohibition embedded in Article 42 of the UCITS Directive relates to “uncovered” sales in general, the key issue is then to define, what should be considered as being appropriate “cover”.

As only the securities sold provide for a perfect cover, it is relevant in this respect to refer again the EC Recommendation, and in particular to the rules applicable to cover for derivative financial instruments that provide for physical delivery of the underlying financial instrument on maturity or exercise

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– this is the case that most resembles to physical short sales.

Article 7.2 of the EC recommendation, in particular, referenced “Exceptional substitution with an alternative underlying cover in the absence of cash settlement” specifies “in case where the risks of the underlying financial instrument of a derivative can be appropriately represented by another underlying financial instrument and the underlying financial instrument is highly liquid, Member States should consider allowing UCITS to hold exceptionally other liquid assets as cover provided that they can be used at any time to purchase the underlying financial instrument to be delivered and that the additional market risk which is associated with that type of transaction is adequately measured.”

The requirement for the derivative’s underlying financial instrument risk to be “adequately represented” by another liquid underlying financial instrument does not seem to imply that the cover should also provide hedging against market risk.

I do not believe there should be such an obligation, since the EC Recommendation refers to “other liquid assets as cover”. However it is fair to say that currently there are no guidelines available for reference.

So to conclude, it could be reasonable for a UCITS to enter into temporary short selling transactions, as long as cover is provided by liquid assets – and cover requirements calculated on the basis of the marked-to-market value of the shorted securities.

Conclusions

My personal opinion is that there is little doubt that physical short selling techniques will eventually be introduced in the UCITS regime, following the Irish Financial Regulator’s policy changes.

However, although the policy changes were published in October 2007, it does not seem that any UCITS adopting short selling techniques has been authorised in Ireland.

Also, no other regulators have followed this approach and the European Commission seems to have taken the stance that physical short selling is not compliant with UCITS – but no official statements have been made so far.

A number of technical and practical questions remain unanswered and it will be up to the Compliance function to support the business, but also the regulators, to ensure that any measure taken to promote, or discourage, physical short selling is technically correct, contributes to the development of the business and, most of all, considers the interests of the investors.

Stefano Pierantozzi

General interest questions and dialogue with members.

1) Must employees of banks report to their employer ALL their personal transactions in financial instruments (as the MiFID FAQ site seems to imply) or just those raising conflicts of interest?

MiFID requires that the firm identifies promptly any personal transaction entered into by a relevant person, i.e. not only the personal transactions raising a conflict of interest.

The purpose of MiFID is indeed not only to prevent those personal transactions which could give rise to conflict of interest but also to prevent inside or confidential information, obtained by relevant persons when exercising their professional activities, from being misused by them for personal ends and/or from being distributed in an unauthorised manner.

It is however worthy to note that:

- not all the employees of the bank (firm) must necessarily report their personal transactions but only the “relevant persons” as defined by MiFID, and including in any case its directors, managers and employees who are involved in the provision by the firm of investment services and activities;
- there are two exceptions to the personal transactions identification obligation :
 - o personal transactions effected under a discretionary portfolio management

mandate service (provided that there is no prior communication between the portfolio manager and the relevant person)

- o personal transactions in UCITS III (provided that the relevant person is not involved in the management of that undertaking).

MiFID requirements related to personal transaction have been implemented by the Règlement grand-ducal dated 13 July, 2007 regarding organisational requirements and rules of conduct in the financial sector (see Articles 11 and 12 as well as the definition of the “relevant persons”).

2) Directors of listed companies are banned from undertaking any operations on their company's securities during certain periods of time (prior to announcement of results...)

When a director of a listed company places a limit order on his/her company's securities during an authorised period and if the said order is not performed immediately, can this be executed during an unauthorised period?

Although no legal restriction exists regarding the possibility for a listed company director to issue limit orders which may extend into a prohibited period, it is advisable to monitor that the said orders cannot be subsequently modified, in particular during a prohibited period.

It is also possible that certain listed issuers impose this type of restriction on their directors as a precaution (for example: limit orders must expire the day before a prohibited period at the latest), in order to eliminate any risk of suspicion of market abuse if such an order is executed during a prohibited period and the authorities subsequently undertake an investigation.

3) For Sicar and SIF, how to identify the end economic beneficiary investors? Is a maximum holding percentage applicable? (E.g. 25% for PSF and below, do nothing).

Generally speaking, to identify economic beneficiary investors in Sicar or SIF type funds, it is advisable to apply *mutatis mutandis* the principles laid down in the ABL/ALCO/ALFI document of December 2006 entitled "Practices and recommendations aimed at reducing the risk of money laundering in the Luxembourg fund industry". Insofar as transfer agent capacity is held by a third party company, Luxembourg financial institutions could rely on the fact that said capacity is held by a regulated intermediary (often from Luxembourg, but at least in a FATF country) and is therefore subjected to equivalent requirements relating to money laundering, at the least. This last point must be appreciated by the Luxembourg financial institution. If the Luxembourg financial institution also ensures the capacity of transfer agent, rules of practice relating to the fight against laundering (See Circular CSSF 05/211) are automatically applicable.

Workgroup 33 "Replies to members' questions".

Association activities

VIE ASSOCIATIVE

ASSOCIATION ACTIVITIES

GROUPES DE TRAVAIL ACTUELS :

CURRENT WORKING GROUPS :

A. SECTEUR TRANSVERSAL:

A. CROSS-SECTOR:

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Working group 21

**Practical interpretation of fund investment
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MEMBRES ET VIE ASSOCIATIVE:		MEMBERS AND ASSOCIATION ACTIVITIES:	
Nombre de membres (au 10/06/2008):		Number of members (as per 10/06/2008):	
Banques	168	Banking sector	168
Fonds	79	Funds sector	79
Fonds / Banques	32	Funds / Banking sector	32
Assurances	43	Insurance sector	43
Consultants / Réviseurs	28	Consultants / Auditors	28
Admin. et domiciliation de sociétés	14	Admin. and company domiciliation	14
Avocats	6	Law firms	6
PSF	26	SFP	26
Gestion de fortune	4	Asset management	4
Autres	5	Other	5
Effectif total:	405	Total number:	405
Membres effectifs	342	Active members	342
Membres d'honneur	63	Honorary members	63
Effectif total:	405	Total number:	405

Réunions et activités:		Meetings and activities:	
Mensuellement	Réunions du conseil d'administration	Monthly	Board meetings
1 / 2 x par an	Réunions plénières	1 / 2 x per year	Plenary assemblies
2 / 3 x par an	Rencontres informelles autour d'un thème	2 / 3 x per year	Informal meetings on a subject



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BP 13 L- 2010 Luxembourg

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