



Association Luxembourgeoise
des Compliance Officers
du Secteur Financier

News Bulletin

NO. 11

JUNE 2007

Editorial



Dear friends, members of the ALCO,

We have a lot of chance! The subjects which concern Compliance of the financial sector are every day more numerous, more diversified and more complex. European directives, national legislative evolutions, continuous deepening of the most classic subjects, the domains of preference of the Compliance function are not ready to dry up. The already impressive list of questions approached on our bulletin since its launching four years ago shows it. With around thirty articles such a variety of subjects appeared that it seemed necessary to us to organize a little our "library".

Thus, on the web site of the ALCO (www.alco.lu), you will find from this summer a directory of all the articles appeared since the creation of the bulletin. To facilitate the research, a classification is going to be established by subject and by author.

It is the occasion for me to thank all of those who contributed to the bulletin of the ALCO with quality articles we are happy to find in every new number. It is also the occasion to launch naturally once again an appeal to all our members for an active participation in our future bulletins.

Send to us ideas of articles, or better, send to us articles!

News Bulletin

This number will not explode with regard to the precedents. Three articles are proposed there, on three different subjects:

- Great classic - the bank secrecy – coming back with the insurances one, their limits and the always open question of the law and order;
- A new Luxembourg legislation for a new financial envelope. Will SIF provide the ideal framework awaited for the hedge funds? We could hope it, but has it not been equipped with limits unsuited to such an objective? ;
- The MiFID Directive and many questions it raises for the multinational groups.

MIFID always, ALCO, ALJB and IRE have the privilege to receive next July 3 the General Secretary of the CESR who will announce recent recommendations of the European Regulators Committee. Our regulator - the CSSF - will also intervene and the conference will continue with a round-table conference in which will take part the representatives of three organizing associations.

Come numerous:

03 July 2007 from 17:00
“Chambre de Commerce”

Once again, I am pleased to finish this leading article saying

See you soon.

Jean-Marie Legendre
President

Legislative news

International news

Implementation of MIFID into French law through "ordonnance" n° 2007-544 of 12 April 2007 in relation to financial market instruments – JORF: French Official Gazette - 13 April 2007. Enforced on 1 November 2007.

European news

-Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions

- Directive 2007/14/EC of 8 March 2007, laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market,

Luxembourg news

- Law of 16 March 2006 relating to international accounting rules for credit institutions which overrules the modified law of 17 June 1992 related to credit institution accounts and implementation:

- European Parliament and Council Directive 2001/65/EC of 27 September 2001 which modify Directives 78/660/EEC, 83/349/EEC and 83/635 EEC on valuation rules applicable to annual and consolidated accounts of certain type of companies as well as of banks and other financial institutions;

- Articles 5 and 9 of regulation EC n°1606/2002 of European Parliament and Council of 19 July 2002 laying down international accounting rules

- Parliament and Council Directive 2003/51 EC of 18 June 2003 which modify Directives 78/660 EEC, 83/349/EEC, 86/635 EEC and 91/674 EEC of Council on annual and consolidated accounts of certain type of companies, banks and other financial institutions, insurance companies
- Memorial nr 55 of 28 March 2006 page 1146.

- Law of 11 May 2007 regarding "d'une société de gestion de patrimoine familial («SPF»)" – Memorial nr 75 of 14 May 2007 page 1608.

- Ministerial regulation of 2 April 2007 approving the Luxembourg Stock Exchange internal rules and regulation, Memorial nr 58 of 18 April 2007 page 1182;

- Law of 23 March 2007 overruling the modified law of 10 August 1915 in relation to commercial companies; 2. law of 19 December 2002 on company and trade register along with accounting and annual company accounts and modifying other legal provisions; 3. law of 25 August 2006 in relation to the European company, the public limited company with directory and board of trustees and the sole trader limited company – Memorial nr 46 of 30 March 2007 page 816;

- Law of 23 March 2007 laying down modification of articles 271, 273(a) and 276 of the modified law of 10 August 1915 on commercial companies – Memorial nr 46 of 30 March 2007 page 826;

- Bill 5711 brought in on 16 March 2007 transposing Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

Karine Vilret-Huot

Opinions

Limits of bank and insurance secrecy

In our last bulletin, Sophie Rase evoked the reasons for lifting bank secrecy in paying agent companies.

The solutions for banking institutions and insurance companies differ in some ways. It seems of interest to clarify those differences.

I – BANKING AND INSURANCE SECRECY

A review of the principles underlying the bank secrecy regime will be our starting point.

A/ LEGAL TEXT

1. Bank secrecy¹ was established by article 41 of the 5 April 1993 law, which stipulates that:

1) Board members, members of executive and supervisory bodies, managers, employees, and other persons at the service of credit institutions, other financial sector professionals, regulatory bodies, central counterparties, clearing houses, and foreign operators of systems accredited in Luxembourg covered in part I of the abovementioned law, are required to keep secret information entrusted

¹ By virtue of his profession, a banker holds confidential information on clients and third parties. He is not only bound by a duty of discretion subject to civil penalties but is also bound by professional secrecy subject to penal sanctions. While requiring bankers to maintain secrecy, the law confers on them the right to refuse any disclosure or investigation request whether made by private individuals or public authorities. Lux courts/Trib. Lux. 24 April 1991, P. 28, 173.

to them in the framework of their professional activities. Disclosure of such information is punishable by penalties stipulated in Penal Code article 458.

2) The secrecy obligation ceases when disclosure of information is authorised or imposed by or based on legislative provisions, even predating the abovementioned law.

...

(6) Subject to applicable rules on penal matters, the information concerned in paragraph (1), once disclosed, may only be used for purposes for which the law permitted its disclosure.

Secrecy is taken very broadly and extends to all information entrusted to professionals in the framework of their profession. A banker not only has an obligation to clients to protect information concerning them of which he has knowledge, but he also remains held to professional secrecy should the contractual relationships with such clients be terminated, and even has such an obligation to individuals encountered in the framework of private relationships

2. The principle of the 6 December 1991 law, article 111-1, on the insurance sector parallels the bank secrecy law exactly.

1. Board members, members of executive and supervisory bodies, managers and other employees of insurance companies, and their agents as well as insurance brokers, sub-brokers, and other insurance broker employees are required to maintain the secrecy of confidential information entrusted to them in the framework of their professional activity. Disclosure of such information is punishable by penalties stipulated in Penal Code article 458.

News Bulletin

The reasons for lifting the secrecy obligation are not, however, strictly identical with the second paragraph stipulating that:

The secrecy obligation ceases when disclosure of information is authorised or imposed by or based on legislative provisions, even predating the abovementioned law or is necessary in executing in good faith commitments resulting from insurance contracts or to prevent or curb insurance fraud.

....

Both bank and insurance secrecy can be lifted by effect of the law.

Unlike bank secrecy, however, insurance secrecy can be lifted where necessary in meeting in good faith commitments resulting from insurance contracts or to prevent insurance fraud. Can such additional justifications for lifting secrecy undermine the strength of the secret? As much as fraud prevention is subject to supervision in the insurance industry, the lifting of secrecy in meeting commitments in good faith may not be as exacting.

The two secrecy regimes, although similar in the way their principles are formulated, are thus not identical as regards the reasons for lifting the secrecy obligation.

Does bank secrecy appear more absolute than insurance secrecy?

3. Moreover, the Penal Code, article 458, punishes violations of secrets entrusted to professionals:

“. . . all other persons that disclose secrets in their custody by virtue of their status or profession, apart from cases where they are called to testify in a court of law or before a parliamentary commission of investigation or otherwise compelled by law to lift their secrecy obligation, will be subject to imprisonment for eight days to six

months and a fine of 20,000 to 200,000 francs.”

The list of professionals concerned by that article of law is not exhaustive just as bankers were subject to an obligation of secrecy long before the 5 April 1993 Bank Law sanctioned that obligation. It was also customary for an insurer — necessarily the confidant of his clients — to avoid disclosure of information provided to him in the course of his professional activities. When the 18 December 1993 law sanctioned insurance secrecy, legislators did not fail to point out that that obligation was inspired by bank and medical secrecy, and even the secrecy obligation of lawyers.

B/ DISCUSSION OF THE PUBLIC ORDER CHARACTER OF BANK SECRECY

1. Based on current legislation, it is uncertain whether bank secrecy is entirely consistent with the public order.

Based on parliament's work on the bank law² as well as the financial sector supervisory commission's position, which tend to confirm the public interest character of bank secrecy in view of the establishment of a legal secrecy obligation subject to penal sanctions under Penal Code article 458, the legislator has duly established the public interest character of the secrecy obligation with any exceptions to that status the exclusive province of the law.

The legislator has not, however, written a legal text into either the bank law or the insurance law that alone could qualify the secrecy obligation as a rule of law and order.

Although the violation written into the Penal Code has law-and-order status, the provisions of bank law article 41 or insurance law article 111-1 do not necessarily make bank secrecy a rule of law and order.

² Parliamentary work #3600 of 3/4/1992, article 4, page 8.

News Bulletin

Those articles, although certainly complementary, cannot be analysed in the same manner.

2. Lacking explicit legal provisions, several factors argue in favour of the law and order character of bank secrecy.

If we consider one definition of law and order, formulated by Dean Gérard Cornu, it constitutes “a mandatory norm from which individuals may not deviate in either their behaviour or their agreements.”³

Henri Capitant expressed agreement on the meaning of law and order in these terms: what are known as “rights of public interest are precisely those that by law cannot be abandoned”⁴;

There are few legal provisions on law and order. Civil Code article 1133 stipulates respect for law and order as essential to the validity of agreements. Article 1134, in establishing that agreements represent the law for those making them, takes care to stipulate that such agreements must be legally formed, and article 1133 does not allow them to be considered as such if they are contrary to the public interest.

The idea that the public interest is the antithesis of contractual freedom emerges from those texts. That freedom permits contracting parties to freely determine the content of their commitments to an extent consistent with the public interest. Public interest responds to the necessary priority of general community interests over private interests thereby safeguarding our fundamental principles. The public interest derives from the spirit of laws enacted to safeguard legal provisions intended to protect private interests. Law and order constitutes a set of measures legislated to protect the will of those making commitments.

³ VOCABULAIRE JURIDIQUE (Legal Vocabulary) Gérard Cornu -

⁴ Capitant memorandum: D. 1922, 2, 153

3. Penal Code article 458 literally stipulates only three instances when a professional’s secrecy obligation can be lifted:

- when he is called to testify in a court of law⁵
- when he appears before a parliamentary investigating committee
- when the law compels him to disclose confidential information.

The secrecy obligation can thus only be lifted by an article of law or in compelling circumstances. A client’s abandonment of his right to secrecy cannot be justified by an article of law or compelling circumstances. Only the client’s express intent can do that.⁶

4. Luxembourg jurisprudence includes very few rulings on the nature of bank secrecy, tilting initially toward the private character of secrecy as reflected in the following decision:

“By virtue of his profession, a banker possesses confidential information on clients and third parties. Not only does he have a duty to exercise discretion imposed by civil law, but he is also bound by a professional secrecy obligation sanctioned by Penal Code article 458.”

⁵ Although Luxembourg law authorises the lifting of professional secrecy for a witness testifying in Luxembourg courts, a breach of professional secrecy when testifying in foreign jurisdictions constitutes a violation of Luxembourg law.

⁶ The banker’s professional secrecy obligation does not apply to the client himself, who retains ownership of his secret. The banker benefits from no right of his own in relation to the client whose orders he must follow. Professional secrecy must not turn against the client’s interests. The banker must not stand in judgement of those interests. Should the banking relationship be terminated, the banker’s professional secrecy obligation will remain in effect. Trib. Lux. 24 April 1991, P. 28, 173.

News Bulletin

That obligation derives from considerations of both public and private interest⁷.

Above all, bank secrecy protects the private domain and personality of individuals.

Another ruling stipulated that the professional secrecy obligation of the banker does not extend to the client himself who enjoys sole control over his secret⁸.

According to a part of the doctrine bank secrecy should be included among the imperative rules, of the public interest.

Imperative rules are those intended to protect a party considered weaker compared to another party thus considered more powerful.

Professional secrecy can in no way be absolute since, from the outset, Penal Code article 458 stipulated exceptions⁹.

That current of doctrinal thinking considers that bank secrecy contributes to law and order but does not constitute law and order. The legal framework of bank secrecy would rather represent rules of public interest.

A more recent ruling by the Luxembourg Court of Appeals dated 2 April 2003¹⁰ took a position on the nature of bank secrecy: Based on Penal Code provisions stipulating that the secrecy obligation can only be lifted by the law, it constitutes a rule of law and order. The judges drew that conclusion on bank secrecy from the fact that breaches

⁷ Raymond Farhat, *Bank secrecy/le secret bancaire*, Paris, 1970, P.53 et s; Maurice Aubert, Jean-Philippe Kernén et Herbert, Schoenle, *Swiss bank secrecy/Le secret bancaire suisse*, Berne 1982, P.61

⁸ Trib. Lux. 24 April 1991, P. 28, 173.

⁹ A. Serebriakoff, "the law and order character of bank secrecy: conviction or reality?" *le caractère d'ordre public du secret bancaire: conviction ou réalité ?*, Bank and Financial Law in Luxembourg/Droit bancaire et financier au Luxembourg, volume1, p. 283.

¹⁰ Court of Appeals/*Cour d'appel* of Luxembourg 4th chamber 2 April 2003 – Court Journal/Journal des Tribunaux 2003 page 315 and thereafter.

of bank secrecy are punishable under the Penal Code and they specified that it "is in the normal course of things that information disclosed when concluding a deposit contract with a bank can be kept secret". The judges further specified that a performance obligation was incumbent on the banking institution so that in case of failure to meet that obligation, the debtor is presumed responsible without requiring that the creditor prove the existence of a fault attributable to the debtor.

In conclusion, although its law and order/public interest character is not mentioned in the law, bank secrecy nonetheless derives its constraining effect from the law. The law expressly stipulates that once information covered by professional secrecy is disclosed, it cannot be used for purposes other than those for which the law authorised disclosure. That essential provision strengthens the bank secrecy obligation. The reason for lifting it is necessarily legal and the use made of the information disclosed is limited exclusively to the scope of the purpose for which it was lifted.

Since the essential legal character of bank secrecy is similar to that of insurance secrecy, neither obligation can be considered weaker than the other. The difference relative to the additional reasons for lifting insurance secrecy is essentially attributable to the particular nature of the insurance sector and has no effect on the quality of the secrecy obligation. Insurance secrecy industry does not suffer from comparison with bank secrecy.

Such doctrinal controversies and a jurisprudence long hesitant on the public/private interest nature of bank secrecy will persist until the legislator takes a clear position and finally establishes its law and or order, public interest, or mandatory nature.

II – BANK SECRECY LIMITS IN DEALING WITH TAX AUTHORITIES

The legislator has set limits on bank secrecy and requires the lifting of the obligation in a limited number of cases. Those cases include the provision of information, consistent with prudential financial-sector supervision, at the majority shareholder's request, when required in the framework of cooperation in combating money laundering, or when required by tax authorities. The discussion below focuses on lifting bank secrecy in dealing with national tax authorities.

A/ BINDING NATURE OF THE SECRECY OBLIGATION

According to Grand Duchy regulation of 24 March 1989, article 1, tax authorities may not require that financial institutions provide information on individual clients, except in cases stipulated by the 28 January 1948 law intended to insure fair and accurate collection of transfer and inheritance taxes. That regulation also clearly affirmed the principle of the secrecy obligation's binding nature in dealings with tax authorities while specifying its scope.

Tax authorities may not request information from financial institutions on individual clients.

Even if tax authorities were aware of information concerning the bank's clients when requesting information from a banker, no valid use could be made of such information.

B/ NOT BINDING AS REGARDS INDIRECT TAXES AND VAT

Regarding indirect taxes, which come under the responsibility of the Registration and Domain Administration/*l'Administration de l'Enregistrement et des Domaines*, tax authorities have a general investigative right based on the 28 January 1948 law, article 30. But that authority is limited exclusively to information needed to determine or collect duties and taxes due

for which the abovementioned Administration is responsible.

Besides that general article, the 1948 law imposes on bankers — or more generally on all associations or companies with a main office, branch, or an operational facility of any kind and which are holders or debtors, for any purpose whatsoever, of securities, sums, or valuables belonging to an heir, legatee, grantee, or other rightful claimant pursuant to the death of a Grand Duchy inhabitant — an obligation to inform the Registration and Domain Administration regarding due collection of inheritance tax (articles 16 and 17). Those provisions (may) also apply to insurers.

Those institutions may only affect a refund, payment, or transfer after providing the list of securities, sums, or valuables concerned to the representative of the *l'Administration de l'Enregistrement et des Domaines* designated for that purpose by the director of that administration.

That legislation on inheritance tax is limited in scope exclusively to Grand Duchy of Luxembourg inhabitants. Since transfers to lineal descendants are, however, exempt from any inheritance tax under Luxembourg law (article 28), that obligation to provide information does not exist in practice except in the case of joint accounts. That obligation affects the banker in relation to joint accounts once he becomes aware, in any manner whatsoever, of the death of one of the joint account holders or the spouse of one of them. The bank will be released from its obligation to provide information upon presentation of a certificate of exemption from any inheritance tax duly established by the responsible administration¹¹.

Although bank secrecy is thus generally binding in dealing with tax collection authorities as regards direct taxes and even in case of tax fraud, that is not true, however, in relation to tax swindles

¹¹ Administration circular/*Circulaire de l'administration* #114 of 22 March 1948 -

News Bulletin

Since the 16 December 1993 legislative reform, it is necessary to distinguish between penal violations and ordinary tax violations. Only penal violations concern tax swindles. The general tax law distinguished three different types of tax violations; offences against the tax system and both intentional and unintentional tax fraud.

With the 1993 law eliminating punishment by imprisonment for unintentional fraud, aggravated tax fraud, which constitutes a tax swindle, is distinct from the other two categories by the gravity of the tax violation involved. According to the 28 January 1948 law, article 29 paragraph 1 amended by article 5 of the 22 December 1993 law, a tax swindle is involved when all four of the conditions below are met jointly:

- perpetration of a fraud
- committed by systematic use of fraudulent schemes
- involving significant amounts either in absolute terms or in relation to the annual tax due
- with the purpose of dissimulating pertinent facts from tax authorities or of persuading them that inaccurate information is factual.

Once the violation is observed, it is punishable by a prison sentence of one to five months and a fine.

With their secrecy obligation inoperative in the presence of an express legislative provision, the banker and the insurer must cooperate with the competent penal authorities.

Karine Vilret-Huot

*Avocat aux Barreaux de Paris et de
Luxembourg*

Opinions

Hedge Funds in Luxembourg under the new regime for Specialised Investment Funds: some considerations

The law of 13 February 2007 on specialised investment funds (“fonds d’investissement spécialisés”, hereinafter the “SIF law” and “SIF”, respectively) provides Luxembourg with a revamped legal and regulatory environment for alternative investments. Which are its main features, and will the new regime meet the expectations?

By when this article is published much will have been already said and written about the new SIF law in Luxembourg, and the characteristics of the new regulatory regime.

In a nutshell (and for those who may have missed some of the latest discussions), I will however identify some of its key features.

SIFs: the key features

- Investors profile: investment is restricted to “well-informed investors” only. A well-informed investor is defined as an institutional investor, a professional investor or any other investor (“*tout autre investisseur*”) meeting the following criteria:
 1. he/she has confirmed in writing to adhere to the status of “well-informed investor”;
 2. he/she invests a minimum of EUR 125,000 or
 3. has been subject of an assessment made by a credit institution, investment firm or management

company certifying his/her expertise and knowledge of the product.

- Valuation of the assets: the valuation of the assets must be based on their fair value, or anyway as determined in accordance with the management regulations.
- A depositary based in Luxembourg must be appointed, to be responsible for the safekeeping of the assets. The depositary can entrust all or some of the assets under custody to a third party, however its liability shall remain unaffected even in case of delegation. The depositary will be liable to the unitholders (through the management company) for any losses suffered by them as a result of its wrongful failure to perform its obligations, or its wrongful improper performance thereof.
- The assets of the SIF may not be less than EUR 1,250,000 - to be reached within twelve months following the SIF’s authorisation.
- A SIF can be incorporated in contractual form (*fonds commun de placement*, or “FCP”) or in corporate form (usually, a *société d’investissement à capitale variable*, or “SICAV”), however the law allows for other legal forms to be used.
- A SIF may invest into “assets” (any category thereof) in compliance with risk spreading rules and may not hold assets “passively” since the law refers to “management” of assets as opposed to a mere “holding” of.
- The management company must be based in Luxembourg.
- No promoter is required.

SIFs: risk spreading, eligible assets, custody and related issues

As I have briefly underlined above, a SIF is defined as a fund investing in “assets” in compliance with risk spreading techniques.

News Bulletin

However, no guidelines are available in terms of risk spreading rules. The law certainly states that assets must be invested according to risk spreading principles (“*selon le principe de la répartition des risques*”) however the extent and flexibility of these rules have still to be tested in practice. In particular, I underline the absence of any indication as far as leverage limits and the use of collateral are concerned.

The law does not provide additional definitions as far as the nature of the assets is concerned either. Hence, while it is forecasted that a good proportion of SIFs will consist of hedge funds or funds of hedge funds, the law allows for investments being made in any asset class – private equity/venture capital, immovable properties, fine arts, carbon emissions, wine, etc. or a combination thereof. However, investment must have a “speculative” flavour and may not be limited to the mere holding of assets.

Each category of assets requires different custody arrangements and provides for different issues for the performance of a depositary/custody function, as follows:

1. Investment into immovable properties such as buildings, land, etc (“property” or “real estate” funds) – typical issues arise for filing of purchase or leasing agreements, and look-through and tax planning requirements in the case of cross-border investments;
2. Investment into other physical assets such as fine arts, wine, etc – typical issues relate to warehouse arrangements;
3. Investment into private equity (“private equity” or “venture capital” funds) – typical issues relate to look-through requirements and the level of control exercised on target companies;
4. Investment in generic financial instruments and transferable securities (including funds of funds) – standard custody arrangements apply;
5. Other investment techniques that include short sell, and recourse to

leverage and frequent/heavy usage of derivatives (hedge funds) – typical issues relate to the need to appoint a prime broker and exercise oversight on its activities.

The direct consequence of so much flexibility on the eligible assets side is that, a comparable degree of flexibility should have been allowed as far as assets safekeeping is concerned. However, this does not seem to be the case.

As mentioned, the law requires a depositary to be appointed for the safekeeping of the assets (“*garde des actifs*”).

Historically asset safekeeping for investment funds involves three key activities:

1. Selection and monitoring a reputable and solid custodian;
2. Retaining control over assets;
3. Overseeing the assets / know where and how assets are held.

In the case of the SIF law, in consideration of the variety of eligible assets, I believe that the definition of the depositary’s responsibilities and the rules on the selection, role and responsibilities of the delegated custodian does not provide for enough flexibility.

The main question to be asked is, does or not the new SIF law rely on the framework defined under the terms of the CSSF (IML) Circular 91/75?

Chapter E, section IV of the CSSF Circular 91/75 states that as far as the oversight function of the depositary is concerned, this is complied with once the agents appointed are reputable and professionally recognised persons.

Strictu sensu, since the SIF law has been enacted well after the publication of Circular 91/75 the above provisions do not apply – also taking into account the fact that the SIF law is significantly more

News Bulletin

detailed in its contents than the law of 19th July 1991, which it has repealed.

Another question to be asked is, how should the requirements of reputability and professionalism (*“honorable et compétents”*) be interpreted for certain categories of physical assets where unregulated or uncertified parties may provide warehousing arrangements?

To restrict the area of this review, for the remainder of this article I will focus only on hedge funds.

Hedge funds definitions and characteristics

Since no official definition of “hedge funds” exist in the SIF law (or in any other Luxembourg law or regulation – even if useful guidelines and references can be found in the CSSF Circular 2002/80) I will refer to the work carried out by the International Committee of Securities Supervisor (“IOSCO”) and suggest the following:

A hedge fund is a fund having at least some of the following characteristics:

- Borrowing and leverage restrictions do not apply or are strongly relaxed in comparison with other retail fund products;
- Significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee;
- Derivatives are used, often for speculative purposes, and there is an ability to short sell securities;
- More diverse risks or complex underlying products are involved;
- Investors are typically permitted to redeem only periodically, e.g., quarterly, semi-annually or annually.

Three hedge fund features in particular require the involvement of a prime broker, and all relate to the nature of target assets: the possibility to short sell; the intense usage of derivatives; the possibility to borrow money.

In terms of short selling, the prime broker provides for the stocks to be sold on the market (typically, stock which have been lent out by “long funds” – hence some long funds managers’ concerns in entering into stock lending arrangements, because that may have a negative impact on the price of stocks lent).

In terms of derivatives investment, the prime broker provides not only for a counterpart for over-the-counter transactions, but also for technical expertise and pricing (and dedicated systems).

In terms of borrowing, apart from the necessity to borrow stock for short selling, the prime broker can provide for a counterparty to be found in case of liquidity needs.

Hence, because of the nature of the transactions carried out by a hedge fund, from a practical point of view the prime broker is the key element of a hedge fund structure – operationally by far more important than the fund administrator, the depositary and possibly the same fund manager.

Additionally, even if in some cases hedge funds deal with multiple prime brokers (this is becoming more and more frequent both in Europe and in the US), the typical set up is for a single prime broker to be appointed, often due to previous good working relationships with the fund manager.

In this respect, and in the very particular commercial and operational relationship between the fund manager and the prime broker, lie most of the issues that a depositary has to deal with when providing services to a hedge fund.

I want that prime broker

The selection of one prime broker rather than another is very often driven by the hedge fund manager's preferences.

Several considerations may play their role in determining which will be the appointed prime broker, however the fact is that the depositary has very little, if any, space for influencing this decision.

Despite this, the prime broker will be the delegated custodian of most of the assets and the depositary will be responsible for its selection and ongoing monitoring.

In consideration of the above, the depositary finds itself very often in a conflicting situation – from one side, the appetite for establishing a new or additional business relationship from the other side the need to protect the investors, but also the depositary itself and its shareholders.

Good news is that most of prime brokers belong to solid and well-regulated financial groups, and are in most if not all the cases established in highly regulated markets, such as the US or the UK.

Nonetheless, the depositary should make sure that the appointment of the prime broker is always subject to the positive outcome of a due diligence visit. This will provide the depositary comfort that the selected prime broker has all the required systems and controls to allow the depositary and the fund administrator performing their respective roles, and will give the depositary valuable insights as to how the prime broker is able to ensure that the hedge fund's assets are properly segregated.

No guidelines or templates exist to support depositaries performing a prime broker's due diligence, however the Alternative Investment Management Association ("AIMA") has produced a set of *"illustrative due diligence questionnaires for those investing in or servicing the hedge fund industry"* – which covers not only

prime brokers but also fund administrators and fund managers.

Eligible investors

Quite interestingly, there is no common playing field in Europe on the definition of professional, well-informed or adverted investors.

Each European Union member state seems to be applying different criteria, most of all as far as minimum investment thresholds are concerned – hence ongoing discussions in the industry and amongst regulators as to the opportunity to create an harmonised private placement regime.

In any country where minimum subscription thresholds have been established for investing into hedge funds, different approaches have been taken – in my experience they may range between EUR 50,000 and EUR 500,000.

Are minimum investment thresholds useful?

Considering how approaches vary from jurisdiction to jurisdiction, a question may be appropriate: is there a reasonable minimum threshold, and is setting a threshold a meaningful way of protecting non-professional investors?

My personal point of view is no, for two main reasons.

The first one is that linking a person's financial situation to his/her understanding of financial products is not only limitative, but also misleading – your lovely grandmother is probably financially wealthier than your newly graduated son, but which one of the two should be allowed to invest in a speculative instrument?

The second consideration is that imposing higher thresholds does not protect an investor, it just pushes him/her to commit for a higher amount. In the case of a SIF, an investor could decide to re-mortgage his/her house at 6 per cent fixed interest rate, to

News Bulletin

realise the required EUR 125,000, thinking that a hedge fund will provide a higher return. Had the minimum investment threshold been lower, that person could have taken a less risky investment decision.

Assets valuation: is “fair pricing” a sufficient statement?

The needs to ensure that an investment fund’s assets are invested at the right price and that the investment fund’s net asset value calculation gives the best and most accurate approximation of its true value apply also in the case of hedge funds – not only to protect investors but also to ensure the integrity of the financial markets.

In March 2007, the International Organisation of Securities Commissions (“IOSCO”) published a consultation report entitled “*principles for the valuation of hedge fund portfolios*” (consultation closing date: 21 June 2007).

A review of IOSCO’s consultation report would deserve a separate article, so I will merely report here the nine principles identified by IOSCO, respectively:

1. *Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund;*
2. *The policies should identify the methodologies that will be used for valuing all of the financial instruments held or employed by the hedge fund;*
3. *The financial instruments held or employed by hedge funds should be consistently valued according to policies and procedures;*
4. *The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness;*
5. *The Governing Body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed;*

6. *The policies should seek to ensure that an appropriate level of independent review is undertaken of the individual values that are generated by the policies and procedures and, in particular, of any valuation that is influenced by the Manager;*
7. *A hedge fund’s policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an independent party;*
8. *The Governing Body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services;*
9. *The arrangements in place for the valuation of the hedge fund’s investment portfolio should be transparent to investors.*

Some of the above recommendations refer to the establishment of a solid control environment, and would be redundant or over-detailed to be included in the text of the SIF law, however they provide for a very useful reference guide.

In particular, as far as the 9th principle is concerned, I would like to underline that information disclosures should include, according to IOSCO, “*a description of the extent to which valuations have been provided by or influenced by the manager*”. The question could be also asked, if the fund manager in a position to influence valuations that are provided by the prime broker he/she may have selected.

Conclusions

The new SIF law provides Luxembourg with a modern and pragmatic legal and regulatory environment for alternative investments, however there is a risk that it fails to meet some of its expectations, and raises the two following questions:

- If the approach was to establish a regulated, reliable and somehow risk-adverse regime for alternative investments, which is the purpose of such a high minimum investment

News Bulletin

threshold, and is this threshold socially or economically justifiable?

- On the other side, if the purpose was to create an attractive regime strictly for professional and adverted investors, why imposing risk-spreading requirements (whose extent is still to be clarified) and the presence of a depositary?

The Luxembourg hedge fund market has showed a more than significant expansion in the last few months, and this is surely due to the enhanced legal framework.

However this framework brings new challenges and questions for depositaries and administrators, as well as for the internal control functions, including the Compliance function.

Stéfano Pierantozzi

Opinions

MiFID : Applicability within and outside the European Union and group's policies.

1. Do MiFID's provisions apply to investment firms established outside the European Union?

No, in principle MiFID's provisions *stricto sensu* only apply to investment firms whose registered office is located within the European Union. Non-E.U. countries are not required to implement the market in financial instruments directive. This does not mean however that these countries do not intend to do so nor that their legislations necessarily diverge significantly from MiFID's provisions.

2. Shall a European subsidiary (located e.g. in France) of an English investment firm be bound to respect MiFID as (already) implemented in the English law or within the French legislation ?

In principle, a subsidiary has to obey the law of the country in which it has established its registered office. From a purely legal point of view, no conflict of laws should occur unless the various European legislators would provide that their national law also applies to European subsidiaries of their national investment firms.

This is not just a theoretical hypothesis. One will remind that before the law of November 12th, 2004 regarding the fighting against money laundering and financing of terrorism, the regulation in Luxembourg in this respect as well as its interpretation, especially through the CSSF Circular 94/112, were planned to be also applicable to foreign subsidiaries of a Group whose mother company is based in Luxembourg. One can particularly wonder as the CSSF Circular 2000/15 - covering already a lot of aspects of the investor

protection and as such being partially the precursor of MiFID- has to be applied by the subsidiaries of a Group established in Luxembourg.

In our opinion, such extra-territoriality is neither useful nor desirable as far as MiFID is concerned.

It is not useful because MiFID's objective is precisely to reach a high level of harmonisation as far as its implementation is concerned by avoiding that the E.U. Member States re-create distortion of competition between the markets by adding new particularities (non-gold plating principle) and by maintaining more stringent provisions (the maintain of "super equivalent" national provisions is assumed to be restricted).

It is also not desirable. Notwithstanding the desired harmonisation, it does not seem realistic to think that no divergence will arise between the E.U. Member States points of view. Such divergence could even be necessary from time to time for the good functioning of the economy. The simplest solution is thus that each legislator enacts its own rule without any willingness to see it also applied abroad.

3. What about Groups' policies?

Depending on its activity, size, own environment, maturity degree,... each Group may of course have different opinions. It is clear however that, independently of the national legislations applicable to its various companies, large Groups may wish to establish common rules of interpretation or of implementation of MiFID provisions to all its subsidiaries.

This may offer advantages, especially to reinforce the way the members of the Group stick together, e.g. by harmonising IT solutions and procedures, by setting up standardised best execution of orders and conflict of interest policies. In certain areas,

this enables to create synergies and to limit the huge cost of the investment in MiFID for the financial sector.

One should nevertheless not go too far in this process; the nature of activity of certain companies operating differently within a same Group and local specificities have to be taken into account. Beyond reasonable Group standards -to be considered as minimum requirements-, one should also avoid major pitfalls such as serious competitiveness problems on the local markets.

4. Could therefore a Swiss subsidiary of a European investment firm be bound to respect more stringent organisational and conduct rules defined at a Group level and imposed by its mother company¹² ?

Yes, in theory. One should probably evaluate whether the clients will be attracted by a Swiss bank which will observe these new rules intended to protect them rather than by other banks which will have not adopted these rules or, at the opposite, whether the underlying additional administrative requirements will encourage them to evade, or whether they shall remain indifferent to all of this.

Until today, the Swiss Confederation has taken no official position but do not seem to be in a hurry in order to adhere to these new European rules. Foreign banks established in Switzerland question themselves. Some Swiss Groups with several establishments in Europe have opted for the implementation of MiFID.

5. May a subsidiary from Luxembourg of a Swiss or Monacan credit institution use the services of its mother company, for example for the execution of orders, when such subsidiary has not opted for MiFID ?

Yes, but the bank in Luxembourg has to respect MiFID's provisions as they shall be

implemented into the laws of Luxembourg, and should e.o. be able to demonstrate that the execution rules applied will provide the best possible execution result to the clients on a consistent basis. If it uses the services of its mother company as intermediary/broker/Hub, it will have to ensure that such mother company observes MiFID's provisions. Indirectly, this amounts to impose MiFID on it.

6. Were the investment firms not entitled to freedom to provide their services within the European Union or to establish branches therein on basis of the authorisation obtained in their home country under the Investment Services Directive of 1993? Does MiFID introduce additional facilities or does it question the "Home country control" principle within the framework of the European passport?

This was indeed the objective of the first directive. MiFID aims at increasing the degree of harmonisation in order to provide the investors with the highest level of protection by enabling the investment firms to provide their services within the Union while observing the conditions imposed by the regulator of their home country. MiFID simplifies especially certain administrative procedures in the host country (e.g. the registration of the firm does not need to be awaited before starting its activities).

But the directive gets more into the issue of the relation between the supervisory authorities and introduces an exception to the competency of the home country regulator. Indeed, MiFID leaves to the regulator of the branch's host country to enforce the rules of conduct (integrity, transparency, suitability, appropriateness, execution of orders, conflicts of interest,...) related to the services provided by it on its territory. On the other hand, the supervision of the organisational aspects would remain under the competence of the authority of the home country.

¹² Banque et Finance, September/October 2006 :
« MiFID – Quel sera son aspect en Suisse ? »

7. Quid if the customers of such branch are investors residing outside the host country or even inside the home country of the principal investment firm?

A branch which has no own legal personality is not allowed to act under the freedom to provide services. When it exercises extra-territorial activities, the regulator of the home country is also deemed, in principle, to control that the branch respects the rules of conduct.

The Committee of European Securities Regulators (CESR) acknowledges (see consultation paper “passport under MiFID” 06-669) the complexity inherent to a double supervision. Whilst it proposes several solutions regarding the cooperation between the competent authorities, the various advices issued in response to the draft execution measures seem to be in favour of a supervision of the application of the rules of conduct being carried out by the host country only and this, whatever the place of residence of the investor.

However, this last position does not comply with the provisions of MiFID and a well-informed investor who would reside in the home country of a European investment firm while being also in relation with the branch of such investment firm established in another member State, could lawfully object to the rules of conduct of the host country regulator being applied to him¹³.

In practice, all of this could lead to conflicts of competence between regulators. MiFID recognises however delegations between supervisory authorities. It seems essential in such context that these authorities

¹³ de VAUPLANE H., «Droit des marchés financiers : le passeport européen remis en cause ? », Revue Banque, n°689, March 2007, PP. 78 to 80. This author points out that one should not mix up the question of the applicable law, which is a matter of private international law and has no direct relation with MiFID, with the formalities related to the implementation of the European passport. In this context, one could question the relevance of the “characteristic performance test” about which the authorities are invited to think.

coordinate their activities and conclude cooperation agreements. CESR carries on working in this sense, as confirmed in its last recommendations issued in May 2007 regarding the passport (Ref. CESR/07/-337).

8. To which competent authority should the branches report on their transactions? To the competent authority of the home or of the host country?

According to the recent guidelines issued in this respect by CESR in May 2007(Ref. : CESR/07-301), it is acknowledged that when the investment service is provided by the branch on its own territory, the branch must report its transactions to the authority of the host country. The other transactions executed by the branches should be reported to the home country authority.

Admitting the cumbersome nature of such double reporting, CESR acknowledges that all the transactions executed by branches may be reported to the authorities of the host country and according to their rules, if the investment firm retains this option.

9. Does MiFID apply to a branch located outside the European Union?

The rules of conduct do not apply in principle. Some organisational rules of the principal investment firm may however be applicable.

10. Should a branch in Luxembourg of an investment firm located outside the European Union respect MiFID?

Yes indeed, MiFID provisions, i.e. the rules of conduct as well as the organisational rules, are fully applicable to it.

Marie-France de POVER
31.05.07

Association activities

VIE ASSOCIATIVE

GROUPES DE TRAVAIL ACTUELS:

A. SECTEUR TRANSVERSAL:

Groupe de travail 16

Commission permanente juridique et relations publiques / site internet

Responsable Karine VILRET-HUOT
Téléphone (+352) 26 44 14 13
kvilret@vilret-avocats.com

Responsable internet Olivier GILSON
Téléphone (+352) 49 49 30 888
olivier.gilson@eurizoncapital.lu

Groupe de travail 27

Formations IFBL

Coordinateur Jean-Noël LEQUEUE
Téléphone (+352) 62 11 94 941
jean-noel.lequeue@skynet.be

Groupe de travail 28

MiFID

Coordinateur Evelyn MCHALE
Téléphone (+352) 48 88 96 21
evelyn.mchale@hsbcib.com

Groupe de travail 29

Abus de marché

Coordinateur Cyril MATTHIEU
Téléphone (+352) 40 46 46 400
cyrilmatthieu@lu.hsbc.com

Groupe de travail 30

Domiciliation de sociétés

Coordinateur Sophie RASE
Téléphone (+352) 40 25 05 408
sophie.rase@maitlandgroup.com

ASSOCIATION ACTIVITIES

CURRENT WORKING GROUPS:

A. CROSS-SECTOR:

Working group 16

Legal and public relations / internet site

Owner Karine VILRET-HUOT
Telephone (+352) 26 44 14 13
kvilret@vilret-avocats.com

Internet Owner Olivier GILSON
Telephone (+352) 49 49 30 888
olivier.gilson@sanpaoloam.lu

Working group 27

Training IFBL

Coordinator Jean-Noël LEQUEUE
Telephone (+352) 62 11 94 941
jean-noel.lequeue@skynet.be

Working group 28

MiFID

Coordinator Evelyn MCHALE
Telephone (+352) 48 88 96 21
evelyn.mchale@hsbcib.com

Working group 29

Market abuse

Coordinator Cyril MATTHIEU
Telephone (+352) 40 46 46 400
cyrilmatthieu@lu.hsbc.com

Working group 30

Domiciliary agents

Coordinator Sophie RASE
Telephone (+352) 40 25 05 408
sophie.rase@maitlandgroup.com

B. SECTEUR BANCAIRE:

Groupe de travail 10

Contrôles de compliance

Responsable Patrick CHILLET
Téléphone (+352) 40 65 40 584
p.chillet@ing.lu

B. BANKING SECTOR:

Working group 10

Compliance controls

Owner Patrick CHILLET
Telephone (+352) 40 65 40 584
p.chillet@ing.lu

C. SECTEUR FONDS:

Groupe de travail 21

Interprétation pratique des restrictions d'investissements de fonds

Responsable Tim WINFIELD
Téléphone (+352) 34 10 23 85
tim.winfield@jpmorganfleming.com

C. FUNDS SECTOR:

Working group 21

Practical interpretation of fund investment restrictions

Owner Tim WINFIELD
Telephone (+352) 34 10 23 85
tim.winfield@jpmorganfleming.com

D. SECTEUR ASSURANCE:

Groupe de travail 13

Compliance et intermédiaires

Responsable Bruno GOSSART
Téléphone (+352) 24 18 58 51 60
b.gossart@fortis.lu

D. INSURANCE SECTOR:

Working group 13

Compliance and intermediaries

Owner Bruno GOSSART
Telephone (+352) 24 18 58 51 60
b.gossart@fortis.lu

Coordinateur groupes de travail / Working groups coordinator:

Jean-Noël LEQUEUE
Téléphone (+352) 62 11 94 941
jean-noel.lequeue@skynet.be

News Bulletin

MEMBRES ET VIE ASSOCIATIVE:

Nombre de membres (au 20/06/2007):

Banques / Banques privées	144
Fonds	76
Fonds / Banques	33
Assurances	34
Consultants / Réviseurs	25
Admin. et domiciliation de sociétés	13
Avocats	5
PSF	17
Gestion de fortune	4
Autres	11
Effectif total:	362
Membres effectifs	299
Membres d'honneur	63
Effectif total:	362

Réunions et activités:

Mensuellement	Réunions du conseil d'administration
29/03/07	Assemblée Générale annuelle – Hôtel Novotel
03/07/07	Conférence (MiFID) ALCO/ALJB/IRE
1 / 2 x par an	Réunions plénières
2 / 3 x par an	Rencontres informelles autour d'un thème

MEMBERS AND ASSOCIATION ACTIVITIES:

Number of members (as per 20/06/2007):

Banking sector	144
Funds sector	76
Funds / Banking sector	33
Insurance sector	34
Consultants / Auditors	25
Admin. and company domiciliation	13
Law firms	5
SFP	17
Asset management	4
Other	11
Total number:	362
Active members	299
Honorary members	63
Total number:	362

Meetings and activities:

Monthly	Board meetings
29/03/07	Annual General Meeting – Hotel Novotel
03/07/07	Conference (MiFID) ALCO/ALJB/IRE
1 / 2 x per year	Plenary assemblies
2 / 3 x per year	Informal meetings on a subject



Secrétariat de l'ALCO:

Laurence THILMANY-INCOURT

secretariat@alco.lu

BP 1104 L- 1011 Luxembourg

Secrétariat du Président:

Solyane LORKOVIC

Téléphone (+352) 47 67 26 12

Fax (+352) 47 67 36 12

solyane.lorkovic@ca-luxembourg.com

Secrétariat du Bulletin:

Coralie CZERWINSKI

Téléphone (+352) 26 44 14 13

Fax (+352) 26 44 15 14

cczerwinski@vilret-avocats.com

Comité de rédaction / Drafting committee:

Karine VILRET-HUOT, Marie-France DE POVER, Marie BOURLOND, Sophie PIROTTE, Claudine FRUTSAERT, Jean-Marie LEGENDRE, Leen BOM, Olivier GILSON, Philippe SCHNEIDER, Patrick SCHOTT

Visitez notre site / Visit our website:

www.alco.lu