A L F I

Commission de Surveillance du Secteur Financier
For the attention of Mrs Simone Delcourt
110, route d'Arlon
L-2991 Luxembourg

8 April 2004

Circular 02/77 regarding the protection of investors

Dear Madam,

1.- We write to you in connection with Circular 02/77 regarding the protection of investors in the event of errors in the calculation of the net asset value and rectification of the consequences of a failure to observe the investment restrictions which are applicable to UCIs. The purpose of this letter is to submit to your Commission a specific interpretation of Part II of Circular 02/77.

<u>Contextualisation</u>

2.- Circular 2000/8 regarding the protection of investors in the event of errors in the calculation of the net asset value and rectification of the consequences of a failure to observe the investment restrictions which are applicable to UCIs introduced for Luxembourg UCIs a concept of materiality in the context of net asset value ("NAV") computation errors.

3.- The rationale underlying this rule is the acknowledgement that the NAV calculation process is not an exact science and that the result of the calculation is a best efforts approximation of the actual market value of the UCI's assets. The level of accuracy with which the NAV may be calculated depends indeed to a large extent on a series of external factors such as the volatility of the main markets to which it is exposed, timeliness of information, anticipation of events, reliability of the information sources which are used. Imprecision is therefore an inherent property of the NAV calculation process.

4.- Based on the above, it was decided that only computation errors which have a material impact on the NAV and which, expressed as a percentage of the NAV exceed a certain

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tolerance threshold, should be reported to your Commission and lead to the indemnification of the UCI and its investors.
In the other cases, *i.e.* when the additional effects of an error are confined to the accuracy bounds defined by Circular 2000/8, it was decided that there is no justification for the significant time and cost expenditure necessary for establishing all the implications of the error and the burdensome administrative procedures which must be put in place to recalculate misstated NAVs and compensate the UCI and the injured investors.

5.- On the other hand, Circular 2000/8 stated that tolerance thresholds provided for NAV computation errors may not be applied to prejudices caused to the UCI arising from non compliance with investment restrictions.

Preliminary remark

6.- As a preliminary remark, we would like to draw the attention of your Commission to the fact that further to recent developments in the Luxembourg UCIs legislative framework and an increased sophistication of the financial markets, compliance with investment restrictions is becoming far more complex than it used to be when Circular 2000/8 was adopted.

The implementation into Luxembourg law of Directive 2001/108/EC amending Directive 85/611/EEC with regard to investments of UCITS and the adoption of Circular 02/80 concerning UCIs pursuing alternative investment strategies have notably introduced some concepts the outline of which is subject to interpretation and rules the application of which will depend on external factors such as the reliability of the information sources used. An example of this is the rule pursuant to which companies which are included in the same group are regarded as a single body for determining quantitative investment limits. This issue was addressed during the drafting of the law of 20 December 2002 relating to UCIs which implements Directive 2001/108/EC. It was pointed out that the concept of "group" would probably raise difficulties in relation to its interpretation and application. It will indeed not be easy in practice for the professionals of the financial sector to identify the links existing between the different entities of the same group. The Luxembourg legislator, fully aware that such an identification process is not an exact science, stated in the preparatory acts of the law of 20 December 2002 that this requirement is an *obligation de moyens* and not an *obligation de résultat.*[1]

The same statement should apply to the duty to comply with all other investment restrictions. The difficulty concerning the identification of the different entities of the same group which was expressly highlighted by the legislator also concerns the other investment restrictions applicable to UCIs. Due to an increased sophistication of the financial markets,

[1] *Doc. Parl.* n° 5033, Exposé des Motifs, Commentaires des articles, p.56 à 57; Avis du Conseil d'Etat, p.22.

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compliance with those rules is becoming far more complicated. New products, which are characterized by a growing complexity, are continuously launched. In addition, the volatility of the markets intensifies. As an example, due to the complication of the financial products and markets, the classification of a series of securities is becoming problematic. It is debatable whether they may be considered as transferable securities which are dealt in on a sufficiently regulated market within the meaning of Directive 85/611/EEC. These developments affect the UCIs industry as a whole. UCIs governed by Part I as well as those governed by Part II of the law relating to UCIs are affected by this evolution of the financial markets.

7.- In the new legislative context and today's fast-moving financial world, it seems now difficult to describe compliance with investment restrictions as an exact science. Due to the imprecision inherent in the new rules and the complexity of new financial products, an increase in debatable breaches may be expected. Engaging for each of them, even the more insignificant ones, long and costly corrective procedures could lead to a serious cost increase for the industry. This would ultimately burden the investors as a result of increasing the costs of performing asset management. Investors would have to bear unnecessary high expense ratios compared to the benefit of an indemnification for losses resulting from every investment breach, whatever its impact on the NAV.

Besides, this might render the Luxembourg products uncompetitive for both the investors and UCIs promoters. To the best of our knowledge, none of the jurisdictions which have issued guidelines concerning investment breaches requires an indemnification for losses resulting from subscriptions or redemptions processed during the breach period in cases the impact of the breach has caused the NAV to be misstated below the materiality thresholds.

Suggested interpretation of Circular 02/77

8.- We note that Circular 02/77 which replaces Circular 2000/8 maintains the restriction to the applicability of a materiality concept in the context of non compliance with investment restrictions.

The present letter is to be read *de lege lata* and not *de lege ferenda*. Its purpose is not to propose an amendment to Circular 02/77. We suggest an interpretation of Circular 02/77 which respects its letter and its spirit while taking into account the needs and difficulties faced by the Luxembourg industry.

9.- Further to a failure to observe investment restrictions, the UCI and the investors must be compensated for losses incurred. Indemnification due to non compliance with investment restrictions presents two aspects.

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On the one hand, the UCI must be compensated for the loss which results from selling the unauthorised investment or the excess position of this investment or, in the case of a breach of the borrowing limits, for the amount of interest payable and other costs attributable to the unauthorised portion of the borrowing.

On the other hand, the UCI and the investors must be compensated for losses resulting from subscriptions or redemptions processed during the breach period.

10.- Circular 02/77 states that tolerance thresholds provided for NAV computation errors may not be applied to prejudices caused to the UCI arising from non compliance with investment restrictions. The reading of Part II of Circular 02/77 seems to indicate that this restriction is limited to the first aspect of the indemnification process, *i.e.* the compensation of the UCI for the loss arising from selling the unauthorised investment or the excess position of this investment or the amount of costs attributable to the unauthorised portion of the borrowing.

Part II of Circular 02/77 sets out the principles applicable to this first aspect of the indemnification process. It states that non compliance with investment restrictions must be immediately corrected by selling the unauthorised investment or reducing the borrowing to the authorised limit. It indicates then that losses resulting from the sale of the unauthorised investment or the expenses linked with the unauthorised portion of the borrowing must be indemnified. In this context, Circular 02/77 finally specifies that the tolerance threshold cannot be applied to prejudices caused to the UCI resulting from non compliance with investment restrictions.

On the contrary, the second aspect of the indemnification process, *i.e.* compensation of the UCI and the investors for losses resulting from subscriptions or redemptions processed during the breach period, is not described by Part II of Circular 02/77. In this regard, Part II simply refers to Part I dealing with NAV calculation errors which must apply *mutatis mutandis*. The indemnification of the UCI and the investors for losses resulting from subscriptions and redemptions during the breach period involves a recalculation of NAVs processed during the breach period so as to determine NAVs which would have been obtained if investment restrictions had been respected. The philosophy and the rationale underlying the recognition of a concept of materiality in the context of a NAV calculation error may be transposed as such in this context. As discussed above, imprecision is an inherent property of the NAV computation process as its level of accuracy depends on a series of external factors. As long as the impact of the error remains within the margin of error inherent to the NAV calculation, the indemnification procedure involving notably a recalculation of the NAV is not cost efficient. The same reasoning applies in the context of investment breaches. If the additional effects of a failure to observe investment restrictions on the NAV are confined to the accuracy bounds defined by Circular 02/77, there is no justification for engaging in burdensome corrective actions involving significant time and

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cost expenditure. The impact of non compliance with investment restrictions on the NAV is in such a case limited to the imprecision level inherent to the NAV calculation process.

Conclusion

11.- In light of the foregoing, it may be concluded that in the event of non compliance with investment restrictions, the following principles govern the indemnification process:

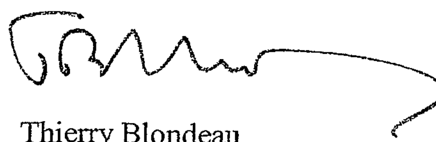
On the one hand, the UCI must always be indemnified for losses resulting from selling the unauthorised investment or the excess position of this investment or the expenses attributable to the unauthorised portion of the borrowing, whatever the impact of the breach. No tolerance threshold may be applied to these situations .

On the other hand, the UCI and the investors must be compensated for losses resulting from subscriptions and redemptions processed during the breach period pursuant to the procedure provided for NAV calculation errors which, notably, includes the application of materiality thresholds.

12.- It must be stressed that the suggested interpretation not only complies with the letter and spirit of Circular 02/77 but also meets the needs of the Luxembourg industry. As discussed above, further to the complication of the Luxembourg UCIs legislative framework and increased sophistication of the financial markets, compliance with investment restrictions may no longer be described as an exact science and an increase of debatable breaches may be expected. A restrictive interpretation of Circular 02/77 according to which any breach must lead to a burdensome rectification procedure would, in this new context, involve a significant cost increase which ultimately would in practice be borne by the investors.

13.- In addition, it should be noted that the suggested interpretation would ensure a level playing field in Luxembourg for the central administrations and the investment managers. Both of them would be submitted to the same level of requirements concerning the correct execution of their duties under Luxembourg law.

Sincerely yours,



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