KPMG

Considerations for the boardroom

2nd edition

May 2022

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Contents (Cont.)

Some other topics to consider

Watch for the future

Executive summary

We're delighted to share our second edition of "Considerations for the boardroom", a toolkit of the hottest boardroom topics for the asset management and alternative investment industries. We believe this guide will boost the quality of your boardroom discussions.

Alongside a brisk overview of the leading boardroom topics, we've also included questions to help you uncover the fund's status regarding these crucial matters.

We will regularly update this toolkit to capture the evolving regulatory agenda and our market insights.

We wish you a pleasant and insightful read.

KPMG

The LFR reform — what's at stake?

CSSF Circulars 21/788, 21/789 and 21/790

On 22 December 2021, the Commission de Surveillance du Secteur Financier (CSSF) published three new circulars that will together implement the "Long-form reform".

Summary of the requirements

IFM separate report — Circular 21/789
Applicable from year end (YE) 31 December 2021

- Chapter 15 management companies
- Authorized alternative investment fund managers (AIFMs)
- Internally managed alternative investment funds (FIAAG)
- Investment companies that have not designated a management
- company (SIAG)
- Luxembourg branches of investment fund managers (IFMs) (chapter 17)
- Foreign branches of Luxembourg IFMs

IFM to fill out self-assessment questionnaire (SAQ) — 18/698 compliance	YE + 4 months 31 December 2021 + 6 months
Approved statutory auditors (réviseurs d'entreprises agréés — REA) to perform work on certain questions and provide comments in the IFM separate report	YE + 7 months 31 December 2021 + 9 months

eDesk

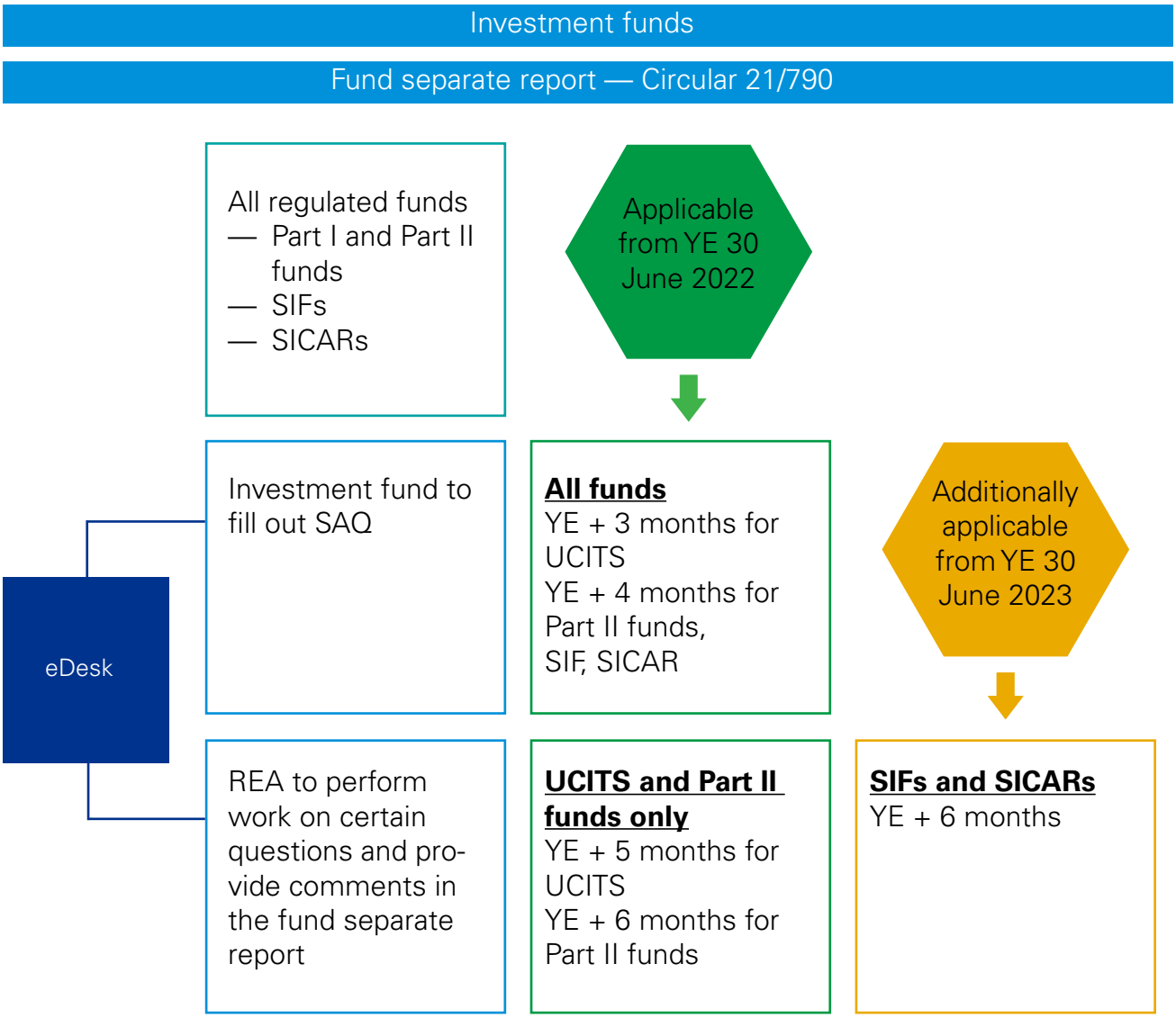
AML/CFT external report — Circular 21/788
Applicable from YE 31 December 2021

- Chapter 15 management companies
- Chapter 16 management companies
- AIFMs — authorized and registered
- SIAG and FIAAG
- Non-AIF, specialized investment funds (SIFs) and
- Investment companies in risk capital (SICARs)

eDesk

IFM to fill out SAQ — current AML annual survey	15 April
REA to perform work on certain questions, including sample testing and provide comments in the AML/CFT external report	YE + 6 months 31 December 2021 + 9 months

Summary of the requirements



Questions that may be raised

01 Are the long-form requirements clear for both the management company (ManCo) and the funds?

02 Have we obtained and reviewed the questionnaires to determine the required information, impacted departments and the data needs?

03 Have we assessed the necessary requirements to complete the self-assessment questionnaire on time (eDesk access, data collection, time and personnel availability, etc.)?

04 Are the processes in place to collect the necessary data to complete the self-assessment questionnaires?

05 Is a project plan and schedule in place?

06 Should we organize a review of our compliance with the key aspects of Circular 18/698 to identify any potential gaps, define remediation plans if necessary, and provide valuable information to senior management or investors?

By Gabrielle Jaminon, Head of Regulatory Centre of Excellence Asset Management.
E-mail: gabrielle.jaminon@kpmg.lu

Sustainable finance – being ready for 2023

The sustainable finance journey goes beyond regulatory requirements

Here are the main environmental, social and governance (ESG) and sustainability challenges that market players are still facing, and the questions to tackle them:

Put my ESG strategy into motion

How can I define an ESG strategy and put it into practice?

Adapt my operating model to address ESG opportunities

How should I update my operating model to ensure regulatory compliance and create value from ESG?

Reporting according to final draft Regulatory Technical Standards (RTS)

How should I address the reporting requirements of the final draft of the RTS?

Developing an ESG strategy

ESG is a long-term trend that's here to stay. It requires a fund-level, future-proof product strategy that:

- Ensures a better long-term risk management approach, including sustainability risk
- Offers a diversified portfolio with environmental and social contributions
- Meets a new generation of investor expectations

To develop a successful ESG strategy, market players must define their ambitions, assess their current capabilities, and set out an action plan.

Defining your ESG data model for SFDR readiness

From 1 January 2023, the SFDR requires financial market participants to report additional information in their pre-contractual documents, websites and periodic reports. These new reporting obligations are changing the ESG data paradigm by standardizing the indicators that qualify an investment product as sustainable. Financial market participants must also have the technical capabilities to gather the necessary data and produce the reports, ranging from European ESG Templates (EET) to SFDR periodic reports.

To ready themselves for these reporting obligations, financial market participants are currently:

— assessing the impact on ESG data along their operation's value chain

— identifying the ESG data needs based on their assets under management

— qualifying ESG data from investment decisions to reporting requirements

— training and educating employees to address these ESG data needs

— adapting the IT systems to integrate the ESG data model

— assessing current ESG due diligence process for integrating regulations

— updating risk management processes, compliance checks and internal audits to ensure data accuracy and reliability

— converting the RTS templates into business requirements

— adapting the technology or seeking external parties to provide support with producing reports.

Reporting according to final draft RTS requirements

Both the SFDR and the EU Taxonomy Regulation require market players to disclose ESG information through their prospectuses, annual reports and websites. The final draft RTS provides further details of this required information and its prescribed format through mandatory templates. These reporting requirements entered into force on 1 January 2022.

	SFDR product periodic disclosure	SFDR entity's "principal adverse impacts" disclosure
Content	— Fund's ESG performance — Alignment with EU Taxonomy — Recurring report to be included in the annual report — Ongoing monitoring is optional	— Entity's ESG impact — Recurring report to be disclosed on the client's website (annually) — Quarterly monitoring is required
Scope	— SFDR Article 8 funds — SFDR Article 9 funds	— All direct and indirect investments at entity level
Deadline	— Any annual report published after 1 July 2022 must comply with SFDR Level 1 requirements — SFDR Level 2 (RTS) enters into force on 1 January 2023	— 30 June 2023 for the 2022 reference period (1 January 2022 to 31 December 2022)

	EET	"Taxe d'abonnement" reduction
Content	— ESG data for all investment product to be produced at share class level — Template used to exchange ESG data from asset managers to banks and insurers to produce ESG reports for their own products (mandate or life insurance)	— Eligibility/alignment with EU taxonomy — EU taxonomy data monitoring is required to claim this reduction
Scope	— All investment product (article 6, 8 and 9)	— SFDR Article 8 funds — SFDR Article 9 funds — Potential analysis for Article 6 funds
Deadline	— EET light version applicable starting the 1st of June 2022 — EET complete applicable starting the 1st of January 2023	— From a regulatory perspective, claims can currently be made; however, the data available is limited

Questions that may be raised

01 As board members, what is our collective level of understanding of sustainable finance to engage in credible discussions?

02 Have we received any investor or regulator feedback on the information published on our website and in our prospectuses on 10 March 2021? If yes, what action was taken?

03 Have we identified our ESG ambitions? Should existing products be adapted, and are there opportunities for new products?

04 What are the fund's main sustainability risks? Is the fund's sustainability risk monitoring robust enough to keep tabs on these risks?

05 Have we identified the disclosure information required as of January 2023? Are there any difficulties foreseen?

06 Is there a project plan to ensure we meet the January 2023 reporting deadline, from collecting the information to preparing the reports?

By Julie Castiaux, Associate Partner, Sustainable Finance.
E-mail: julie.castiaux@kpmg.lu

Sustainable finance disclosures

ESG — don't forget the disclosure requirement!

Who is impacted and when?

Articles 8, 9,10 and 11 of the Sustainable Finance Disclosure regulation (SFDR) imposes disclosure requirements for financial market participants — including management companies and AIFMs, whether authorized or registered — that offer financial products referred to in Article 8(1) or Article 9(1), (2) or (3). These obligations apply to any fund, whether it is self-managed or the fund is managed by a chapter 15 management company or an AIFM.

As these requirements applied from 1 January 2022, it's implied that periodic reports published since the beginning of the year should already contain the relevant disclosures. In addition, by 1 January 2023, prospectuses, websites and periodic reports will need to comply with further reporting obligations and dedicated templates.

What needs to be disclosed?

The disclosure requirements are contained in Articles 8, 9, 10 and 11 of SFDR and have been subsequently complemented by the EU Taxonomy's provisions in its Articles 5, 6 and 7. A Level 2 delegated regulation will share further details on the disclosures and templates to ensure consistency amongst market players.

The content and extent of the disclosures depend on:

— the fund's classification (under Articles 6, 8 and 9)

— the characteristics it promotes (social and environmental) for Article 8 funds

— its sustainable objective (social and environmental) for Article 9 funds

CSSF communication

In a communication on 6 December 2021, the CSSF encouraged financial market players to already use the periodic product information templates of the future Level 2 delegated regulation even though those will become applicable at a later stage. The different sections of these templates should be completed on a best effort basis until their final implementation.

What main challenges have we identified in the market?

Investment fund managers have faced several challenges when preparing their SFDR disclosures.

— The classification of the fund is not always clearly available from the prospectus.

— It's difficult to assess the level of detail and the related data breakdown that's required in the disclosures.

— It's unclear from where the information should be collected, or who is responsible for drafting the disclosures' content.

— The description of the fund's objectives is not sufficiently detailed in the prospectus so that it is difficult to meet the disclosure requirements.

Where shall the disclosures be included in the periodic report?

The legislation doesn't expressly state where this information should be included. It can be presented either as part of the fund's activity report or in the notes to the financial statements.

Questions that may be raised

01 Have we identified the information required for disclosures published from January 2022 onwards? Are there any expected difficulties?

02 Have discussions been engaged with the investment manager to ensure that they will provide the necessary information and data to prepare the disclosure or will prepare the disclosure themselves?

03 Are the responsibilities for preparing and validating the disclosures clearly set out?

04 Is there a project plan to ensure the various steps are in place, from collecting the information to preparing the reports?

By Julie Castiaux, Associate Partner, Sustainable Finance. E-mail: julie.castiaux@kpmg.lu

Gabrielle Jaminon, Head of Regulatory Centre of Excellence Asset Management
E-mail: olivier.schneider@kpmg.lu

Navigating transfer pricing in the world of asset management

Background

Historically, transfer pricing for asset management was largely limited to analyzing and pricing transactions between the fund's ManCo and its overseas subsidiaries/affiliates that provide services to the ManCo, like distribution, portfolio management, or investment management.

While intercompany arrangements regarding ManCos are still a key concern, there are three evolving trends:

01

The rising controversy risk on:

— **related-party financing transactions,** especially at the fund level, where shareholder loans/financing can arise due to structuring asset acquisition (debt quantum, interest rate, interbank offered rate [IBOR] transition, etc.)

— **substance,** especially when high-value functions are split over different locations and/or in branches

— **transfer pricing documentation,** a key element in transfer pricing audits to defend the Manco's filing position.

02

Changing business models with a direct impact on transfer prices:

— new value chains where technology plays a larger role and the growing digitalization of capital raising and distribution

— innovative investment management

— tools that enhance the investor experience

— reimagined back and middle offices (changing cost base and allocation keys).

Background

Historically, transfer pricing for asset management was largely limited to analyzing and pricing transactions between the fund's ManCo and its overseas subsidiaries/affiliates that provide services to the ManCo, like distribution, portfolio management, or investment management.

While intercompany arrangements regarding ManCos are still a key concern, there are three evolving trends:

03

The regulatory intersection

— The Alternative Investment Fund Managers Directive (AIFMD) reform discussions have suggested that transfer pricing is a good indicator of regulatory "substance" in the EU.

— For US groups, the Securities and Exchange Commission (SEC) has long focused on cost and fee allocations, especially in the alternative investment space. Examples include management and monitoring fees, and charges to portfolio companies. Similarly, the EU's second Markets in Financial Instruments Directive (MiFID II) seeks to identify and attribute fees to specific functions. Investors have also taken notice.

— Asset management regulations are concerned with the seniority and expertise of key personnel that is dedicated and present in key jurisdictions.

— One of the nine tax indicators in the CSSF's Circular 20/744 refers to tax base erosion derived from cross-border transfers of financial flows (e.g. management fees, service fees, marketing commissions, etc.) and (intangible) assets. This triggers questions regarding compliance with Luxembourg transfer pricing rules.

What are the risks?

If transfer prices applied on intercompany transactions don't reflect arm's length prices or haven't evolved in line with the group's business model and the latest transfer pricing trends, Luxembourg or foreign tax authorities are highly likely to impose transfer pricing adjustments and even penalties. These adjustments usually lead to double taxation that can reach very material amounts.

Questions that may be raised

01 Does the group have a transfer pricing policy that our ManCo effectively applies?

02 Are all intercompany transactions supported by legal arrangements?

03 Are intercompany prices regularly benchmarked in transfer pricing documentation according to Luxembourg regulations and OECD Guidelines?

04 What transfer pricing methods have we used (commonly cost plus or fee/profit split), and have we recently reviewed whether they are aligned with the group entities' current business model and functional profile?

05 Do we have supporting documentation for headquarters allocations and, more globally, cost allocation within the group?

06 Have we considered technology's role in the value chain and its transfer pricing consequences (allocation of costs, royalties, profit share, etc.)?

07 Have we revisited any related party financing considering the 2020 OECD Guidelines on financial transactions and/or the IBOR transition?

08 Do we have branches where profit allocations are not documented?

09 Have we ensured our transfer pricing model aligns with the regulatory framework?

By Sophie Boulanger, Partner, Tax – Transfer Pricing.
E-mail: sophie.boulanger@kpmg.lu

From anti-money laundering to anti-tax crime laundering: can you manage your tax risks?

When the scope of AML widens to tax crime, compliance officers need to hit the tax books. And when the financial regulator also comes into play, the topic is a must for the boardroom.

Over the past few years, the international tax landscape has shifted towards increasing tax transparency and enhancing tax conformity across many industries and professions. As a result, Luxembourg underwent a significant tax reform in 2017, which created — amongst others — new tax-related criminal offenses.

As such, the fight against tax crime has grown more relevant for both the traditional financial industry and the alternative investments sector.

In this context, and in response to the Luxembourg fund industry's concerns, the CSSF issued Circular 20/744 that introduced nine tax indicators to identify potential tax crimes, on top of the 21 tax indicators already presented in Circular 17/650.

The CSSF Circular 20/744 is applied to all professionals from the asset management sector that the CSSF directly supervises. By systematically tackling potential tax risks, they aim to enhance the existing tax governance frameworks and strengthen the Luxembourg fund industry's robustness and stability.

To mitigate their exposure to these potential tax risks, professionals must adapt their tax compliance policies and AML frameworks by integrating these nine indicators into their risk assessment processes.

The nine indicators: at a glance

01 **Complex investment structuring**

02 **Tax base erosion**

03 **Investment transactions** lack of AEOI/CRS/FATCA reporting

04 **Investment transactions** lack of economic rationale

05 **Investment transactions** frequent transactions resulting in losses

06 **Efficient portfolio management techniques**

07 **SICAR**

08 **Subscription tax**

09 **Investor tax reporting**

CSSF audits

After Circular 20/744 was published in July 2020, the CSSF included these new indicators in the scope of its 2021 audits and began sending specific observations in December 2021 requesting dedicated procedures on the Circular.

Going forward, the circulars and their implementation will be a key consideration of the CSSF.

What are the risks of non-compliance?

If you don't include the Circular's nine tax indicators in your internal procedures, you could be considered non-compliant with your AML obligations.

In case of a breach, the CSSF could impose (public) administrative sanctions, ranging from a warning or an administrative fine up to withdrawing or suspending your registration or authorization.

In a worst-case scenario, you could be considered a money laundering accomplice, resulting in criminal fines and up to 5 years of imprisonment.

Questions that may be raised

01 Are we directly supervised by the CSSF?

02 Have we performed an impact assessment of Circular 20/744 on our business?

03 If yes, have all the assessment's issues been addressed by implementing the necessary mitigating measures?

04 Have we properly implemented the Circular's requirements in our procedures and policies?

05 How robust is our oversight of third-party delegates, funds, and service providers?

06 Has the portfolio/investment manager provided sufficient assurance that its asset due diligence procedures are adequate and in line with the Circular?

07 Has the CSSF already requested an AML/CFT on-site inspection? Are we prepared for such an inspection?

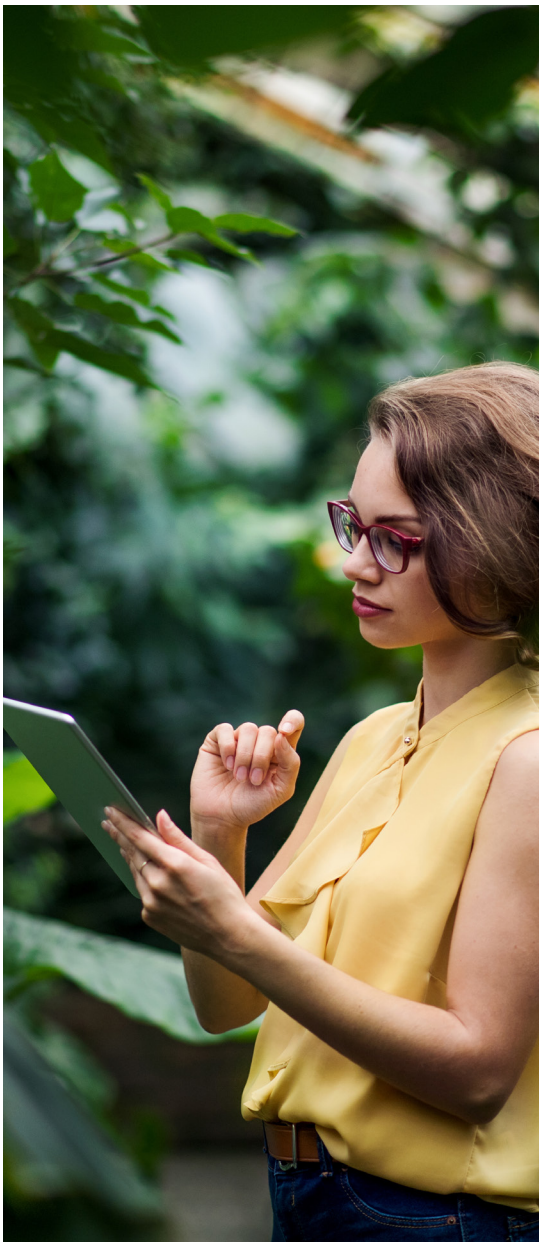
By Daniel Rech, Partner, Tax – Financial Services. E-mail: daniel.rech@kpmg.lu

Common Supervisory Action with National Competent Authorities on the supervision of costs and fees of UCITS

ESMA's supervisory briefing on the supervision of costs in UCITS and AIFs

On 4 June 2020, the European Securities and Markets Authority (ESMA) published a supervisory briefing on how national competent authorities (NCAs) should supervise the cost-related provisions of the Undertaking for Collective Investment in Transferable Securities (UCITS) Directive and AIFMD, and managers' obligations to prevent undue costs from being charged to investors.

This supervisory briefing also provides market players with NCAs' expectations and compliant practices — namely, the development and periodic review of a **structured pricing process** document.



This document must cover the following topics:

Best interest

Are costs related to a service provided in investors' best interests and necessary for the fund's investment objective, ordinary activity of the fund or to meet regulatory requirernents?

Proportionality

Are costs proportionate to market standards?

Complexity

Is there a balance between complexity of activities and costs to investors?

Sustainability

Are the fees sustainable given the fund's net returns, risk profile and investment strategy?

Equality

Do the costs ensure equal treatment of investors (except when allowed for non-retail AIFs that have relevant disclosures in place)?

Accounting

Are there no duplication of costs and are costs properly separated and accounted for?

Cap

Is a cap on fees applied and, if yes, is it clearly disclosed to investors?

Performance fees

If charging performance fees, do the performance fee model and the disclosures comply with ESMA Guidelines?

Disclosures

Are all costs clearly disclosed to investors in line with EU rules (AIFMD, UCITS, PRIIPS) and national rules (where applicable)?

Data reliability

Are the pricing process and all charged costs based on reliable data?

ESMA's common supervisory action with NCAs

In January 2021, ESMA launched a common supervisory action (CSA) to assess supervised entities' compliance with the cost-related provisions of the UCITS framework, and the obligation of not charging investors with undue costs. In their assessments, the NCAs will take ESMA's supervisory briefing on the supervision of costs into account.

The CSA will also uncover whether entities that employ efficient portfolio management techniques adhere to the UCITS framework requirements and ESMA's Guidelines on exchange-traded funds (ETFs) and other UCITS issues.

Questions that may be raised

01 Has the fund/ManCo considered the requirements of ESMA's supervisory briefing on the supervision of costs and fees in UCITS and AIFs?

02 Has the impact been assessed and what actions are required, if any?

03 Are there any unclear requirements? If yes, what steps were taken to obtain clarity?

04 Who is responsible for preparing the structured pricing document? Is all the necessary information available?

05 Were any issues noted regarding the fund's fee structure, e.g. fees that could not be justified under the ESMA briefing's criteria? If yes, what are the next steps?

06 Has the fund/ManCo already received a request from the CSSF regarding this CSA? Are we prepared?

By Alan Picone, Head of Consulting - Asset Management & Alternative Investments.
E-mail: alan.picone@kpmg.lu

Reduced subscription tax on environmentally sustainable investments

What does the law say?

As part of its 2021 Budget law, the Luxembourg government has enacted to grant a reduction of the annual subscription tax rate of UCIs (Part I and Part II funds), and compartments of UCIs, that invest in any kind of economic activities qualifying as environmentally sustainable as per the EU's Taxonomy Regulation.

The subscription rate will decrease to 0.01% and 0.04% depending on the total net assets invested in environmentally sustainable activities — i.e. any economic activity that qualifies under Article 3 of the EU Taxonomy Regulation.

To benefit from the reduced tax rate, the fund needs to calculate its percentage of investments in environmentally sustainable activities and include this percentage in its annual report or an assurance report.

The fund's auditor then issues a certificate with the percentage disclosed in the annual report/assurance report, to be filed with the immediately following quarterly subscription tax declaration. The reduced rate will be fixed for the next four quarters, and will apply the total net assets invested in environmentally sustainable activities as calculated at the end of each quarter.

The certificate of the auditor must confirm the percentage of the assets invested in activities aligned with Article 3 of the taxonomy as disclosed in the **annual report** or the **assurance report**.

Certificate from the Auditor

Agreed Upon Procedures

- Percentage of assets as disclosed in the **annual report** or in the **assurance report**
- A reference to the article 3 of the Taxonomy Regulation
- Signature of the auditor

What is the current implementation status?

To date, only very few funds have been able to file a request for the reduced subscription tax. As indicated above, the legislation requires that the fund provides a certification from an auditor of the percentage of environmentally sustainable investments. To calculate the percentage of environmentally sustainable investments, the fund must gather data from its underlying investments on their EU Taxonomy alignment.

However, the EU Taxonomy Regulation didn't require this alignment disclosure before 1 January 2022 for its first two objectives (climate change mitigation and climate change adaptation) and disclosure of the other four objectives is not required until 1 January 2023. As a result, the data is generally not yet available to determine the required percentage of environmentally sustainable investments.

Questions that may be raised

01 Has the fund/ManCo considered the potential of obtaining the reduced subscription tax on environmentally sustainable investments?

02 Is the process for obtaining this reduced tax rate clear? If not, what actions are being taken to obtain clarifications?

03 When will the fund/ManCo be in a position to benefit from the reduced tax rate?

04 Are the processes in place to obtain the necessary data to calculate the percentage of environmentally sustainable investments? If not, who is responsible for implementing these processes, and what is the implementation timeframe?

05 Who will be responsible for the quarterly determination of the percentage of environmentally sustainable investments (central administration, manager, etc.)?

06 Has an auditor been approached and/or appointed to prepare the assurance report?

By Julie Castiaux, Associate Partner, Sustainable Finance - E-mail: julie.castiaux@kpmg.lu and Olivier Schneider, Partner, Tax – Financial Services - E-mail: olivier.schneider@kpmg.lu

FATCA and CRS

Background

All Luxembourg financial institutions (including investment funds and ManCos) must comply with the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS).

The new FATCA and CRS law of 18 June 2020 hasn't just heightened the already heavy burden of compliance — it's also reinforced the Luxembourg tax authorities' powers to carry out audits within a 10-year time limit.

Given the increased risk of falling under the tax authorities' spotlight, now more than ever, financial institutions must make sure that appropriate policies, controls, procedures and IT systems are in place to meet their reporting and due diligence obligations.

If a Luxembourg CRS or FATCA audit uncovers non-compliance with due diligence procedures, the maximum penalty of EUR250,000 may apply. And, if the audit finds reportable accounts that are unreported or under-reported, an additional maximum penalty of 0.5% of the non-reported amount could apply.

What will these audits look like?

As suggested by the OECD, jurisdictions like Luxembourg have several options available when designing and implementing a compliance review procedure. One logical starting point is to review the financial institution's internal control framework regarding its compliance with CRS and FATCA. The Luxembourg tax authorities have already started conducting these audits.

Another approach is to review a **sample of accounts,** or combine both methodologies in a multi-phase compliance review using the **risk-based approach.**

Questions that may be raised

01 Was the FATCA and CRS entity classification of the investment funds under management reviewed?

02 Are there adequate FATCA and CRS procedures in place at the fund or ManCo level?

03 Have internal audits been carried out to ensure the procedures and processes are adequately followed?

04 Do we have training in place to educate all personnel on their FATCA and CRS responsibilities?

05 Who carries out FATCA/CRS reporting (transfer agent or ManCo), and is the reporting solution efficient and adequate?

By Jean Kizito, Partner, Tax – Financial Services.
E-mail: jean.kizito@kpmg.lu

Cybersecurity: the Achilles heel of digital transformation

As a strategic enterprise risk on boards' agendas, cyber threats are here to stay. This trend is driven by two main factors.

First, asset managers increasingly look to technology to boost collaboration and deliver a better client experience. While the rewards are great, the risk of cyberattacks obviously increases as the number of digital touchpoints climbs.

Second, criminals are growing in sophistication and effectiveness (e.g. ransomware extortion). Some estimates place cybercrime profits above the drug trade's.

As a result, regulatory requirements are expanding to ensure IT and cybersecurity risk management keeps up with innovation and criminal activity.

The pandemic crisis has not altered this and, as long as attackers are motivated by financial gain, this may always be the case. The most common kinds of attacks are CEO fraud, phishing, and business email compromise. With widespread homeworking, it can be more difficult to thwart these attacks — it's trickier to check the legitimacy of requests or invoices, for example, when colleagues aren't close by or as readily available.

Cyber risks can materialize across the entire asset management value chain. The industry's prevailing delegation model translates into heavy use of third parties and a complex web of providers. Client data risks are heightened when processed by multiple parties, such as third-party administrators and custodian banks.

On 1 March 2022, the CSSF published a Circular letter concerning the situation in Ukraine at that time, calling on supervised entities to exercise:

— the greatest possible vigilance regarding the risks of cyberattacks, notably denial of service attacks

— careful consideration to business continuity plans and ensure the proper functioning and recovery of backups; in particular, supervised entities should hold offline backups (not physically or logically connected to the network) of their most essential systems.

Questions that may be raised

01 As board members, what is our collective level of understanding of cyber risks to enable credible discussions?

02 Have we developed and approved a cybersecurity strategy? Given the inevitability of cyberattacks, is this strategy sufficiently balanced between defense, detection, response and recovery?

03 Do we receive regular management information reports?

04 Do we perform regular cybersecurity risk assessments? What are our assets? Who may attack them, why, and how?

05 Have we identified and assessed the cybersecurity risks of our delegates? Who are they and what access do they have to our data? Do we understand their respective delegation "chains"?

06 Do we have an awareness program to educate all staff on their cybersecurity responsibilities?

07 Have we documented a cyber incident response plan and ran a simulation exercise?

08 Have we considered taking out cyber insurance?

By Laurent de la Vaissière, Partner, Audit - Information Risk Management.
E-mail: laurent.delavaissiere@kpmg.lu

AML/CTF – fighting financial crime remains high on the government and regulator agenda

Following the flurry of transpositions of the fifth AML Directive into national laws and regulations in recent years, the pace of regulatory change has slowed somewhat; however, new requirements were still introduced, with further changes on the horizon.

Here are the latest changes to the Luxembourg AML/CTF legislation, which have already partly been covered in section one of this brochure as Circulars 21/788, 21/789 and 21/790 together implement the "Long-Form-Report reform"[1]:

[1]Excluding CSSF Circulars in relation to sanctions.

September 2021

Circular CSSF 21/782

Adoption of the revised guidelines, by EBA. They address:

— business-wide and individual ML/TF risk assessments

— CDD measures, including BO's

— TF risk factors

— New guidance on emerging risks.

December 2021

Circular CSSF 21/788

Implements the AML/CFT external report and specifies:

— The scope of application and exemptions

— The mandate of the REA

— The content and format of the report

— The reporting timelines and responsibilities

December 2021

Circular CSSF 21/789

Implements a self-assessment questionnaire that investment fund managers must prepare annualy, and the related separate report prepared by their REA. In that respect, further details are provided on the following:

— The scope of application

— The content, format, responsibilities, and timing of submission of the self-assessment questionnaire

— The content, format, responsibilities, and timing of submission of the separate report

December 2021

Circular CSSF 21/790

Implements a self-assessment questionnaire that funds must prepare annually, and the related separate report prepared by their REA. In that respect, Further details are provided on the following:

— The scope of application

— The content, format, responsibilities, and timing of submission of the self-assessment questionnaire

— The content, format, responsibilities, and timing of submission of the separate report

Upcoming changes

In July 2021, the European Commission presented an ambitious package of legislative proposals to strengthen the EU's AML/CFT rules. It contains four parts.

— A Regulation establishing a new EU AML/CFT Authority (AMLA).

— An AML/CTF Regulation with directly applicable rules, including to the areas of customer due diligence and beneficial ownership.

— A Sixth AML/CTF Directive (AMLD6), replacing the existing Directive 2015/849/EU (AMLD5).

— A revision of the 2015 Regulation on Transfers of Funds to trace crypto-asset transfers.

Focus on sanctions screening

The war in Ukraine has prompted international response in form of targeted and sectoral sanctions. As this landscape is quickly evolving, professionals must follow these developments closely to respond quickly and efficiently. While sanctions screening is not new, it can still present many challenges; therefore, professionals shouldn't underestimate its complexity.

Whether list management, data quality, model validation, alerts handling, or assets and accounts freezing, professionals must ensure they comply with the relevant obligations, which often extend beyond Luxembourg's or the EU's.

Questions that may be raised

01 Is the money laundering/terrorism financing (ML/TF) risk appetite well defined, transposed by the authorized management, and communicated to all staff involved? Has it also been communicated to our delegates, for example our transfer agent?

02 Is an analysis of the ML/TF risk linked to the business activities performed on an annual basis? Does it consider as well the risk posed by our investments (assets)?

03 Are the outcomes of the ML/TF risk assessment aligned with the ML/TF risk appetite?

04 Does the current methodology provide a quick overview of the assessment outcomes, in terms of inherent and residual risks?

05 Do we receive regular key performance indicators (KPIs) and/or key risk indicators (KRIs) that provide a proper overview and understanding of the risks?

06 Are we properly involved in ML/TF matters through reports, discussions and reviews, as well as in the decision-making process for situations, relationships or transactions that present a higher risk?

07 How robust is the oversight performed on distributors, delegates, and service providers?

08 Have we obtained sufficient assurance from the portfolio manager/investment manager that asset due diligence procedures are adequate and in line with AML/CTF requirements?

09 Is our AML training program correctly tailored to the specificities of the collective investment scheme sector?

10 Have we already received a request from the CSSF regarding an AML/CTF on-site inspection? Are we prepared for such an inspection?

By Anne-Sophie Minaldo, Partner, Advisory - Forensic and AML.
E-mail: anne-sophie.minaldo@kpmg.lu

Outcome of ESMA's compliance assessment with UCITS liquidity rules

On 30 January 2020, ESMA launched a CSA on UCITS liquidity risk management (LRM) to assess whether UCITS managers are meeting their liquidity management obligations. On 24 March 2021, ESMA published the results of the CSA.

Overall, the CSA showed that most UCITS managers have implemented and applied sufficiently sound LRM processes. However, for some of the participating UCITS, the CSA identified several areas of improvement.

ESMA recommends that market participants **critically review their LRM frameworks** in light of these adverse supervisory findings, which include:

— **Documentation of LRM arrangement processes and techniques** is absent or lacks granularity, including pre-investment liquidity analyses and forecasts, design phase, escalation processes, and verification of data reliability.

— LRM **procedures** do not provide for the documentation of LRM arrangements, processes and techniques, or do not cover all asset types or the use of liquidity management tools (LMTs).

— **LRM mechanisms and methodologies** are not always appropriate, forward-looking and, most often, justified and back-tested.

— Overreliance on **liquidity presumption** regarding listed securities, and monitoring based on insufficient data of past volumes, number of brokers and trading size.

— Application of **liquidity presumption** to financial instruments not admitted to or dealt in on a regulated market in violation of Article 2(1) of the UCITS Eligible Assets Directive (Commission Directive 2007/16/EC).

— When the LRM function is also performed by the **delegated** portfolio management, there can be insufficient involvement of the internal risk management function and insufficient delegation monitoring and due diligence.

— Overreliance on too few data providers, as well as a lack of robust and documented control processes based on cross-checks and back-tests to ensure **data reliability.**

— Missing, inaccurate, or unclear disclosures on liquidity risks and LMTs to investors.

— Insufficient **governance** in terms of frequency, granularity and clarity, or absence of reporting to senior management. Inadequate formalization of decisions relating to the UCITS' design and the LMT's setup and calibration. Also, insufficient procedures for monitoring the actual use of LMTs, documentation of cases escalated to the board or senior management and their resolution, and criteria to trigger the escalation process.

— Insufficient controls by the compliance and internal audit functions regarding LRM processes.

— No **external controls** by the depositary.

ESMA will carry out further initiatives to harmonize the way NCAs follow up on the CSA's findings.

Questions that may be raised

01 Has ESMA's feedback on liquidity management been considered and has a critical review of the LRM framework been conducted? Are there identified areas that require updating?

02 Are we properly involved in liquidity management matters through reports, discussions and reviews, and in the decision-making process for anticipated liquidity issues?

03 When did the compliance and internal audit functions last review the LRM processes? Were there any significant findings?

04 Is LRM delegated to the portfolio manager? If yes, what monitoring processes are in place?

By Alan Picone, Head of Consulting - Asset Management & Alternative Investments.
E-mail: alan.picone@kpmg.lu

ESMA guidelines on performance fees

In November 2020, ESMA published guidelines on performance fee requirements for UCITS funds and certain open-ended AIFs distributed to retail investors, except for private equity/real estate funds.

The guidelines cover the following:

— Minimum content for the performance fee methodology, such as reference indicators, crystallization frequency, reference periods, frequency of calculation, and performance fee rate.

— Required consistency between the performance fee model and the fund's investment objectives, strategy and policy — e.g. a benchmark appropriate to the fund's investment policy and strategy and adequately representing the fund's risk-reward profile.

— A crystallization period that ensures the alignment of the portfolio manager and shareholders' interest and fair treatment among investors. Should not be more than once a year, except for High-on-High (HoH) and High-Water-Mark (HWM) models.

— Payment is only allowed when the net positive performance has been accrued.

— Details on disclosures required in the prospectus (example calculations), marketing documents, and the key investor information document (KIID).

These guidelines already apply to new funds or new performance fee schemes for existing funds. However, there is a transition period for existing funds with existing schemes. For these funds, the new guidelines apply from the beginning of their performance year starting after 5 July 2021.

Therefore, organizations should now identify and plan any required changes to their existing models, to allow enough time to select a new target model and adapt the documentation and operations accordingly.

Questions that may be raised

01 Was a review conducted to ensure that the existing performance fee schemes comply with the ESMA guidelines? What changes need to be made, if any?

02 Even if the current models comply, is it perhaps the right time to review the performance strategy as a whole and compare it to market standards?

03 If changes to the model are necessary, what is the anticipated timeline? For example, to determine the target model, validate the prospectus descriptions, and implement it at the fund administration level. Will the new model be implemented in time for the new performance year?

04 Are there any funds/sub-funds where the performance fee is calculated by reference to the London inter-bank offered rate (LIBOR)? If so, how will the LIBOR transition be dealt with?

05 Does the prospectus clearly and unambiguously describe the performance fee calculation?

By Alan Picone, Head of Consulting - Asset Management & Alternative Investments.
E-mail: alan.picone@kpmg.lu

Elevating the technology and data agenda

Background

Businesses are growing increasingly digital, with the pandemic accelerating this transformation. Technology offers a competitive advantage as a key factor in resilience, cost takeout and operational efficiency. Cutting-edge trends like big data, cloud and automation deliver opportunities for business transformation that boards ignore at their peril.

Turning the boardroom's focus onto technology delivers value and ensures executives target the right topics and set strategic priorities. When a board pays insufficient attention to technology and data matters, it can lead to dulled focus, missed opportunities, hindered growth and increased risks. Lacking an oversight process of digital and data activities may put a firm at risk, similarly to failing to audit its books.

Key guidelines:

— Technology isn't just an IT topic — it also concerns the board of directors.

— Leverage digital tools and platforms under a well-designed strategy.

— Address emerging technology threats with prudence.

There is no one-size-fits-all model for a firm's IT operations and digital strategy. The correct approach to digital transformation depends on a company's unique setup; its history, industry, competitive placing, financial positions, automation level, and whether appropriate resources are in place. The board's composition and awareness regarding digital and data are vital to recommend improvements and safely surf the digital wave.

Questions that may be raised

01 Do we understand technology's role in and impact on the business and its sector?

02 Has the board assessed the implications of not acting on data and technology?

03 Have we established proper governance to implement a successful digital strategy? How will we measure success or failure?

04 Do we have proper data governance and management processes to ensure good data and reporting quality?

05 Do we have a transversal view of our data to facilitate business oversight?

06 Do we make data-driven decisions and promptly respond to what is happening and why? Do we have the data and expertise to predict what is likely to happen?

07 Do we have a strategic roadmap for platforms? Do we plan for further integration to enable systems to talk to each other, adding value to the day-to-day business?

08 What is the level of our manual operations and related material costs? Are we at risk of non-compliance?

09 Do we face growth obstacles relevant to our staff turnover? Have we considered technology and automation to accelerate growth?

10 Do we have a clear view of emerging technology threats, for example, cybersecurity?

By Dimitrios Kampas, Head of Data and Analytics.
E-mail: dimitrios.kampas@kpmg.lu

Taming the data explosion

Creating order from chaos and efficiently using your information

As a services company, efficiency in everything we do is crucial to our success: lower costs, fewer opportunities for error, and a greater capacity to scale operations. Yet, as an industry, we've been slow to adopt the digital technologies that would make us more efficient. Our recent survey of Luxembourg ManCos showed that digitalization is a top priority for the coming years: 56% of respondents already have a digitalization initiative in progress, and the remaining are planning to start one soon.

The industry has gained much ground into making its core financial related activities more efficient, but this only accounts for a portion of the work we tackle. Every day, we handle thousands of individual documents, including board meeting materials, contracts, invoices, and know-your-customer (KYC) documentation. All too often, these documents are stored on a shared drive and processed through emails. While this is easy to implement, it is far from efficient. If not carefully handled, information can be hard to find, deadlines missed, and processes left incomplete because they are not properly tracked.

Physical documents add further complications to the mix. Lost, misfiled or damaged originals are an all-too-familiar story — they can be electronically scanned and processed, but important originals must also be archived, wasting valuable office space. Extracting useful information from these scanned documents is laborious and error-prone — imagine processing thousands of tax-reclaim receipts without making a mistake.

Combining a document management system's capabilities with a powerful workflow engine can help restore order to this chaos of managing your documents. Many labor-intensive tasks can be easily automated to boost accuracy and reduce processing times. Combined with a certified dematerialization process, this can eliminate physical archives, reduce General Data Protection Regulation (GDPR) risks, and extend the digital revolution to all areas of the business.

Questions that may be raised

01 How do we ensure critical information is available and accessible to the people who need it when they need it?

02 Do we struggle to get approvals quickly, and can we rapidly adapt our approval process when key individuals aren't available?

03 Are our working files and physical archives GDPR compliant?

04 Do our teams spend a lot of time doing low-value-added repetitive activities to get the information they need?

05 Can we quickly get an up-to-date overview of our teams' open tasks, and which stages in the process are causing delays?

06 Have we ever missed a deadline for renewing or canceling a contract?

By Michael Pressel, Director, KPMG Services.
E-mail: michael.pressel@kpmg.lu

Insights from the KPMG Large-Scale ManCo Survey 2022

KPMG recently surveyed several large-scale Luxembourg Management Companies to uncover the driving forces shaping the Luxembourgish asset management market.

The following points emerged from our survey discussions:

Growth in core Mancos FTEs:

An overall growth in terms of FTEs across the Large-Scale ManCos in Luxembourg has been appreciated. In particular, our survey reveals that, ManCos have increased the number of FTEs amongst core substance functions (risk management, compliance, oversight) by 19%, compared to the previous year.

The ManCo's search for operational efficiency: the lean ManCo model

70% of ManCos consider the review and transformation of their operating model a key strategy priority. This has been motivated by the search of "lean" ManCo models, where the objective of upscaling their operational efficiency is done by seeking scalability and streamlining when reviewing their processes.

The technological adoption continues at a slow but steady pace:

The adoption of technology is a major driver in achieving scalability, specially seen on distribution oversight, where 90% of the participants already use technology for this activity. However, this increase is not appreciated in other activities, where only 30% of ManCos use tools for the oversight of delegates for functions beyond distribution.

The ESG expansion continues:

The ESG topic continues to gain strength across ManCos, where 75% of the respondents consider ESG as a cornerstone for the enterprise-wide strategy. While many ManCos expressed market struggles with data gathering and treatment, as well as, struggles to keep up with investors' demands for ESG labelled funds, the survey revealed that the fund range of Art.8 and 9 labelled funds is up to 45%.

Increasing CSSF scrutiny with changes on the regulator's interaction:

While 3 out of 4 ManCos has had an on-site inspection in the last three years, only 50% are able to claim that they feel well prepared. Moreover, there has been a change on supervisory trends, not only in the format of interactions (remote and more agile), but also, in the nature of the topics, increasing the number of thematic inspections (BMR, EPM, Branch Oversight…).

The ManCo vision of the future:

40% of ManCos indicated concerns that the increased regulatory scrutiny by the CSSF causes significant operational burdens and could damage the attractiveness of the Luxembourgish market. While concerns have raised along talent acquisition & retention, as well as a raise on operational costs, survey participants expressed a positive outlook for the market and the third-party ManCo market consolidation, as well as the rationalization of service providers, as key directions of travel.

To discover the full insights of our survey, please visit: **http://kpmginfo.lu/3kN59dN**

By Alan Picone, Head of Consulting - Asset Management & Alternative Investments.
E-mail: alan.picone@kpmg.lu

AIFMD 2

The European Commission has conducted reviews of the AIFMD's application and scope, as mandated by Article 69 of the Directive. An October 2020 report summarized the review's findings, concluding that the AIFMD's standards to ensure high levels of investor protection are mostly effective. However, the European Commission noted several areas for improvement.

On 25 November 2021, the European Commission issued a legislative proposal not only amending the AIFMD but also the UCITS Directive, believing several issues highlighted in the AIFMD review were equally relevant for UCITS. Therefore, these amendments aim to better align the requirements of both Directives.

The proposed changes for both AIFMD and UCITSD cover delegation, liquidity risk management, data reporting for market monitoring purposes, and regulatory treatment of custodians. While the changes solely for AIFMD cover activities of loan-originating investment funds and access to depositary services across borders.

As the amended Directives are in draft form, they still need to be discussed and negotiated in the European Council and the Parliament. Once the amended Directives are adopted, Member States will have 24 months to transpose them into their national legislation.

By Gabrielle Jaminon, Head of Regulatory Centre of Excellence Asset Management.
E-mail: gabrielle.jaminon@kpmg.lu

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ATAD 3 and its impact on non-executive directors

Issued on 22 December 2021, the EU's legislative proposal to fight the misuse of shell entities (known as the third Anti-Tax Avoidance Directive, or ATAD 3) is poised to become a hot topic in boardroom discussions.

Aiming to apply from 1 January 2024, the ATAD 3 proposal identifies three features, or "gateways", to filter entities at risk of lacking substance. High-risk entities — meeting all three gateways based on a self-assessment and not benefiting from a carve-out — will be required to report on their substance through their annual tax return. High-risk undertakings, with passive income earned or paid out via cross-border transactions and outsourcing their day-to-day operations and decision-making, should be subject to reporting requirements.

The ATAD3 provides for minimum substance indicators for high-risk undertakings that are in scope of the reporting requirements. One of these substance indicators is the presence of at least one qualifying director who:

— is tax resident in Luxembourg or a neighboring country

— is qualified and authorized to take decisions independently and actively

— does not perform the function of director in other non-associated enterprises.

While the EU proposal could change in the coming months during the legislative process, it's certain to be a point of attention for independent directors in Luxembourg.

By Benjamin Toussaint, Partner, Tax – Alternative Investments.
E-mail: benjamin.toussaint@kpmg.lu

KPMG contacts

If you would like to learn more about the topics covered in this toolkit, please get in touch.

Chrystelle Veeckmans
Head of Asset Management,
EMEA Region,
KPMG in Luxembourg

chrystelle.veeckmans@kpmg.lu
+352 22 51 51 - 6244
+352 621 87 - 6244

Christophe Diricks
Partner, Head of Alternative
Investments,
KPMG in Luxembourg

christophe.diricks@kpmg.lu
+352 22 51 51 - 5111
+352 621 87 - 5111

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