

Luxembourg Institute of Directors (ILA) Investment Funds Committee

Seminar on Specialised Investment Funds and the role of Directors: 9 October 2008 Summary of the proceedings

4.00 PM Welcome and Introduction **John Parkhouse** – Partner, PriceWaterhouseCoopers, Chairman of the ILA Investment Funds Committee

4.15 PM Panel Discussion including: **Richard Goddard**, Independent Director, The Directors Office (Chairman), **Jérôme Wigny**, Partner, Elvinger Hoss & Prussen, **Joelle Hauser**, Partner, Kremer Associés & Clifford Chance, **Michael Ferguson**, Audit Partner, Ernst & Young, **Christoph Lanz**, Head of the Private Equity & Real Estate Desk, Banque Privée Edmond de Rothschild Europe.

The proceedings commenced with a summary by John Parkhouse of the activities of the Investment Funds Committee since the previous consultation on 19 June 2008.

The panel discussion began with an overview of the panel's experience of SIFs to date. It was noted that significantly more SIFs are being launched than UCITS currently, hence the need to examine their governance more closely. In addition, it was noted that at a recent meeting of the CSSF, they had expressed a keen interest in the role of SIF directors, taking into account the less formal governance framework that often exists as compared to UCITS vehicles.

Asset classes

It was noted that a remarkable number of asset classes, including many sub-asset classes relatively or completely new to Luxembourg are being found in SIFs, eg foreign exchange, forestry, hotels, insurance policies, land and crops, music libraries, renewable energy, shipping and containers, and wine. These specialized asset classes bring with them their own issues of expertise, liquidity and valuation. One particularly creative use of SIFs which was mentioned, was as a funding vehicle, eg as an alternative to bank financing

Initiators and investors

SIFs are also appealing to new types of fund initiator and investor, including more HNWI, family offices, investment banks and boutique fund managers, many of whom may previously have used unregulated products in offshore jurisdictions. Again, this brings with it new issues in terms of the knowing your client and of qualifying investors as eligible.

Due diligence

The panel agreed that due diligence is more important than ever in assessing the risks of doing business. Issues discussed included taking references of the different parties involved; assessing the level of capital realistically likely to be raised; the indemnifying of directors in the fund's articles; appropriate D&O insurance cover; written board and operational procedures, including subscription documents covering KYC and AML risks.

Board composition

It was noted that the CSSF looks very carefully at directors' CVs before accepting them. Important criteria for selection include board balance, investment and asset class expertise, financial and operational experience, and presence in Luxembourg. The latter can also be an

important criterion from the point of view of the initiator of a fund concerned about the fiscal neutrality of the structure.

Legal forms and directors liability

The two lawyers on the panel gave an outline of the different legal and regulatory forms available. They observed that the Sàrl is a relatively common corporate form for SIFs, both for funds and for general partners of funds. They noted that the CSSF requires at least two managers, as opposed to the one manager required by the commercial law. It is important to understand the fiscal, regulatory and other reasons for the choice of regulatory and legal form. Overall, there should be no difference in board liability arising from the form chosen. It was, however, recommended that independent directors should think twice before agreeing to be a member of an investment committee, because of the potential impact on liability and insurance premia.

Closed versus open ended funds

The particular risks of closed end funds were the subject of intense discussion. It was noted that directors must ensure that dilution is avoided, for instance when investors enter at different times. The offering memorandum should be crystal clear in their rules as to the application of such mechanisms as actualization interest and equalization (eg of costs which have already been expensed), as well as the treatment of defaulting investors. Many such structures are long term, so it is important that problems do not build up, only to reveal themselves near the term of the fund.

Impact of relatively light regulation

It was agreed that “light” external regulation, compared with UCITS, paradoxically means that corporate governance, ie internal regulation, is especially important for SIFs. This point is exemplified by the fact that the private equity and real estate industries have many features of governance of listed companies, eg board committees, which are not commonly found in UCITS. It was recommended that there be written board rules, ensuring transparency of policies for valuation and risk management, as well as accounting principles (eg IFRS or LuxGAAP). The clarification of the roles of the different parties involved, ie directors, depositary, (often unregulated) investment manager/advisers, other external advisers and the external auditor was also emphasized. Examples discussed included the use of industry standards, eg from EVCA for private equity; the applicability of certain regulatory circulars which were not specifically designed for SIFs, eg on the treatment of errors and compliance breaches; and the composition of board committees.

The role of the depositary

Given the fact that assets, such as listed securities, traditionally held in custody are relatively rare in SIFs, there was a debate about the role of the depositary, particularly in the area of the verification of the existence and ownership of assets. It was suggested that some depositaries might seek to limit their verification to the assets directly held in the books, which might be shares in holding companies, rather than underlying assets. It was agreed that the duty of oversight of the depositary should go beyond this to the underlying assets, and that this is something which should ideally be agreed in the due diligence process between the directors, depositary and auditors.

The ALFI SIF Committee

Michael Ferguson summarized the activities of the ALFI group which he chairs. Issues they have been examining include the relationship between prime broker and depositary, the

applicability of CSSF circulars, best practices in financial statements and risk management, and the benchmarking of SIFs to equivalent vehicles in other jurisdictions. He appealed for input from the audience.

Commercial issues for Luxembourg

The proceedings ended with a commercial discussion of how to continue the success of SIFs in Luxembourg. Jersey and Guernsey were identified as particularly strong competitors for private equity, because of the taxation treatment of carried interest. Irish QIFs also have the advantage of not needing diversification. Other jurisdictions also seem to be quicker to market now that pre-authorisation of SIFs seems to have become the rule in Luxembourg. It was agreed that Luxembourg should be more present on the ground in London, where many decisions are made in favour of Anglo-Saxon jurisdictions.