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Foreword

Welcome to our Spring edition of Funds Insider, our quarterly publication focusing on hot topics across a wide range of practice areas of particular interest to our EMEA based private capital clients.

This edition covers, as usual, a variety of jurisdictions and topics, namely:

- Our global sustainability predictions for 2022
- The introduction of new UK Long-Term Asset Fund
- An overview of Islamic finance in Luxembourg
- The strengthening of foreign investment controls in France
- Proposed changes to the EU Alternative Investment Fund Managers Directive
- The Luxembourg Stock Exchange Securities Official List as alternative to share trading
- The potential impact of economic sanctions against Russia on credit default swap markets

By just about any measure, private equity enjoyed a record year in 2021 but as we begin 2022, macro-economic and political instability, volatility in international markets, higher energy costs, inflation and interest rate rises have collectively created an increased level of uncertainty for buyers, sellers and funders.

The wider ramifications of the Ukraine war have left almost nobody unaffected and we at Ashurst have continued to support our private capital clients in navigating the complex and thorny web of economic sanctions and in determining how best to protect their interests in circumstances of contract frustration.

The aftershocks of the events that have unfolded over the last couple of months will no doubt be felt in the weeks and months that follow, with a heightened level of corporate distress predicted for the rest of the year and beyond.

ESG continues to be at the top of the agenda for many of our clients, with recent events however unavoidably altering the outlook of previously unattractive industries and businesses (for example oil and gas) so it will be interesting to see how these competing agendas shape investment behaviour going forward.

We hope you enjoy reading this edition of Funds Insider and please do get in touch if you have any feedback or if there are any topics that you would like us to cover in future editions.

Funds Insider

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Our sustainability predictions for 2022

By Anna-Marie Slot

2021 was a big year for sustainability going mainstream. We discuss below some key areas to look out for in sustainability and ESG that we believe will cut across traditional industry and sector divisions in the next 12 months.

Implementing net zero/net negative and COP commitments

As E, S & G are becoming a part of board discussions and increasingly detailed in annual reporting organisations, organisations are realising how much work there is to be done. It isn't glamourous, but businesses need to turn their attention to:

- Materiality – what aspects of climate change, social licence to operate and governance are material to their businesses;
- What you know now – the real work starts with the essential role of data and technology in tracking and reporting on environmental impact in order to achieve sustainability goals. This data is critical to establishing baselines;
- Where you are going – implementing robust and effective plans and roadmaps on how to reduce carbon and other GHGs, manage supply chains and ultimately transition to more sustainable business models.

As Net Zero/Net Negative discussions become more granular and supply chain considerations from COVID-19 continue, boards and management teams would do well to start integrating a holistic approach to their short and long-term planning, particularly through the lens of a circular economy. Stakeholders need to come together across sectors and industries to establish how industry changes can deliver net zero and net negative targets.

Scaling Transition of Energy, Built Environment and Transport

Viability of transition paths away from fossil fuels towards low-carbon energy production is crucial to meeting net zero/net negative targets and with new technologies such as hydrogen and carbon capture we expect to see increasing activity and news coming out of these spaces. See here for our detailed energy predictions for 2022.

According to our 2021 Energy Transition Investment Report the most popular current power generation technology for investment is solar (photovoltaic but also solar heating), followed by hydro, and onshore and offshore wind. But change is complicated and companies reported a notable drop-off in investment into new hydro and onshore wind over the past year, including due to environmental and social licence issues. The proportion of organisations that have invested in, or decided to invest in, battery storage technology has surged from 46% to 67%. These findings likely reflect faster than expected declines in chemical battery costs, as well as the need for additional firming capacity in markets that increasingly have a high penetration of variable renewable energy sources.

But with an increase in scale and a shift from fossil fuels to established renewables such as wind and solar as well as transformative energies such as hydrogen also comes challenges, for example the "greenness" of new technologies and supply chain concerns, which organisations will need to be aware of.

The built environment is crucial to delivering a sustainable future. It is estimated that 80% of the buildings we will be using in 2050 already exist on the ground today, so retrofitting and refurbishing existing 'brown' assets into 'green' assets is vital. Join us for an overview of where we think the Built environment is heading for 2022.

Transport will be a key area of focus this year. China, Japan, Singapore, the UK, South Korea, Iceland, Denmark, Sweden, and Norway have all started taking action on limiting or banning combustion engines for cars. That change in transportation mode will bring with it changes to infrastructure and infrastructure support systems such as the introduction of charging stations as well as the rethinking of how people move around. While a number of results depend heavily on technological advancements, serious work will also need to be done to convert existing systems.

Increasing tide of regulation

ESG regulation has increased year on year and we anticipate this will continue. In the latter part of 2021 a flurry of policy announcements from around the world revealed that change is certainly afoot. Governments are being pressured to provide commitments but more importantly roadmaps to deliver on commitments. Releases such as the UK's Greening Finance roadmap are giving markets an indication of government direction on the fundamental issues. For more information about what to expect in 2022 you can view our top six predictions for the future of ESG regulation highlighting:

- ESG data and related expectations – an expansion of the regulatory perimeter and expectations
- Transition to Net Zero – a new area of regulatory focus and intervention
- ESG policies – it's time to grow up
- Oil isn't the enemy – increased promotion and regulation of stewardship
- Trust and technology – the problem and the solution to the supervision of sustainability claims
- Remuneration and corporate culture – old classics

Additionality and adaptation

Transforming our economies to be more sustainable is no easy task. It includes:

- Rapid decarbonisation of our existing industries and businesses, energy production and use, built environment and transport to name a few;
- GHG removal at scale and speed, in particular carbon but also methane, which is 25 times more potent than carbon;
- Refocusing finance and digital transformation to accelerate sustainability and support a just transition;
- Grappling with the question of adaptation, companies will need to address increasingly erratic weather and its impact on our businesses from supply chains too insurance costs.

Stakeholders across the board will have their own targets and ambitions when it comes to ESG and sustainability. We will continue to see both progress and delays from stakeholder input as tension arises as to who should be responsible for what, particularly when the benefits of turning green are shared. Increasing collaboration, whether with regard to businesses within supply chains, relationships between clients and service providers or between owners and occupiers of real estate, is going to be increasingly under the spotlight.

In conclusion, this year will not be about addressing just one aspect of sustainability. It's the opportunity for us to look at the problems and the solutions holistically. And an incredible opportunity for companies to get it right and be the leaders in their fields.

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UK Long-Term Asset Funds (LTAF)

Worth the excitement or more puff?

By Bradley Rice and Bisola Williams

In October 2021, the FCA published a **Policy Statement (PS 21/14)** containing final rules in relation to a new authorised fund regime for investing in long-term assets. This regime is the result of long-term calls for a UK fund vehicle/regime better suited to defined contribution (DC) pension schemes to enable them to invest in long-term illiquid assets, like private equity, venture capital, real estate, infrastructure and similar alternative asset classes. Despite all the reports and efforts, it still seems like we are some way from knowing whether this new regime is worth the excitement, time and energy put into it, or whether it is nothing more than puffery and another wasted opportunity for the UK funds market.

What is an LTAF?

The Long-Term Asset Fund (LTAF) is a new type of open-ended authorised fund intended to encourage investment in long-term illiquid assets.[1] The key rationale for the LTAF is to make it easier for DC pension schemes to invest in long-term illiquid assets, like private equity, venture capital, real estate, infrastructure and similar alternative asset classes. Existing regulations for authorised funds in the UK are not suitable for illiquid investments and are effectively a blocker for DC pension schemes. With trillions tied up in such schemes and the UK looking to build itself out of the pandemic, the LTAF could prove to be the key that unlocks Pandora's box, if done correctly... and in time!

The LTAF has been in the works for some time and there has been a lot of momentum behind it. It started gathering steam after the Government's 2017 review into patient capital (a term used to describe alternative investment assets intended to deliver long-term returns, e.g. infrastructure, private equity/debt)[2] and the FCA's own work in this area.[3] The establishment of an LTAF regime was one of the recommendations contained in the 2019 report of the Investment Association's UK Funds Regime Working Group.[4] The Government and other stakeholders in the finance industry consider that investment in long-term assets is vital to the success of the UK economy post-COVID-19.[5] The Chancellor of the Exchequer set out plans to introduce the LTAF in his statement to Parliament on the Financial Services Bill in November 2020. The LTAF is one of the FCA's priorities in its Business Plan 2021-22.

1 FCA Policy Statement (PS 21/14) new authorised fund regime for investing in long term assets (October 2021) (p 4)

2 https://www.fca.org.uk/publications/feedback-statements/fs20-2-patient-capital-and-authorised-funds

3 https://www.fca.org.uk/publications/feedback-statements/fs20-2-patient-capital-and-authorised-funds

4 IA UK Funds Regime Working Group Final report to HM Treasury Asset Management Taskforce (June 2019) (p 23)

5 HM Treasury: Review of the UK funds regime: A call for input (January 2021) (p 5)

The Productive Finance Working Group, set up in November 2020 to develop practical solutions to the barriers to investing in long-term illiquid assets, has been looking at creating an enabling environment for the LTAF (among other things). Its work is ongoing. In January 2021, the Government launched a call for input on the review of the UK funds regime, focusing mostly on the tax implications of the LTAF structure. It published a summary of responses to the publication in February 2022.

How can an LTAF be structured?

An LTAF is a new form of authorised fund, meaning the fund itself has to be authorised by the FCA and will be subject to the FCA's rules, in particular in Chapter 15 of the COLL (the Collective Investment Schemes Sourcebook).

An LTAF can be structured as an authorised contractual scheme (which can take the form of a co-ownership scheme or a limited partnership), an investment company with variable capital (ICVC) or an authorised unit trust.[6]

6 FCA COLL 15.1.1. FCA Policy Statement (PS 21/14)

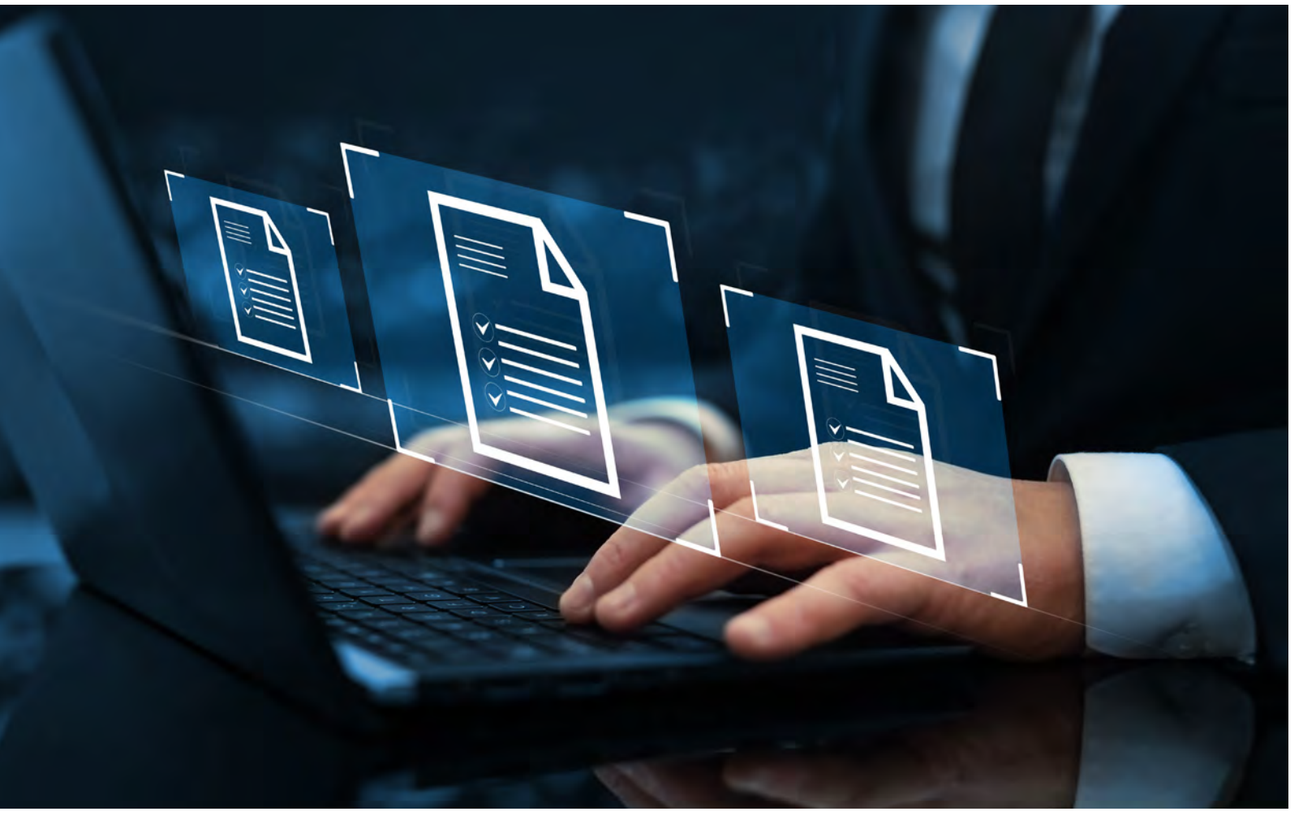
How will the LTAF be regulated?

The LTAF will be an alternative investment fund. As an authorised AIF, it will need to be managed by a full-scope AIFM with permission to "manage authorised AIFs". Many managers who currently manage private fund strategies have permission to manage only unauthorised AIFs. These managers will need to submit a variation of permission to add the authorised AIF permission to their scope of permissions. An alternative would be to appoint a service provider to act as AIFM.

As an AIF, the manager of the LTAF would be subject to the UK AIFMD[i]. The FCA's rules in Chapter 15 of the Collective Investment Schemes Sourcebook (COLL) would also apply since the LTAF is an authorised fund. COLL places even greater requirements and restrictions on the manager, in terms of governance of the fund, liquidity management, investment and borrowing powers and much more. This generally means authorised funds have much more prescriptive rules than private funds.

The fund will also need to appoint a depositary in the same way as other AIFs.

i COLL 15.2.2R FCA Policy Statement (PS 21/14)



What will the authorisation process look like?

The FCA has stated it will try to authorise (or reject) applications without undue delay, and within one to six months. Early engagement is key. The FCA also plans a review later in the year on whether one month or a longer period is appropriate, based on its experience of authorising LTAFs.[7]

A prospectus will need to be made available to prospective investors on demand. The prospectus of an LTAF will include information relating to its investment strategy, subscription and redemption terms, and charging structures. These disclosures must be set out fairly, clearly and in plain language so investors can easily understand them.[8]

Who can LTAFs be marketed to?

LTAFs are intended only for professional investors (such as defined contribution pension schemes) and for retail investors who are sophisticated investors or certified high-net-worth investors.[9]

LTAFs come under the definition of non-mainstream pooled investments (NMPIs) and, as a result, are subject to NMPI promotion rules and the restriction on promotion under COBS 4.12.3R (restrictions on the promotion of non-mainstream pooled investments).[10] FCA rules provide that a firm wishing to rely on the excluded communications exemption in COBS 4.12.4R(5) to promote units in a long-term asset fund to a retail client should note its duties under the Principles and the client's best interests rule.[11]

In January 2022, the FCA issued a consultation paper (CP 22/2) proposing the introduction of a new three-part classification of high-risk investments, namely (1) readily realisable securities; (2) restricted mass market investments; and (3) non-mass market investments (see our briefing here). As, Non-Mass Market Investments (NMMIs), NMPIs would be subject to the strictest regime. In the consultation paper, the FCA refers to the introduction of the LTAF regime and notes that, currently, LTAF can be marketed only to professional, sophisticated and high-net-worth investors but that the

7 FCA Consultation Paper (CP21/12). A new authorised fund regime for investing in long term-assets (p 19)
8 FCA Policy Statement (PS 21/14) (p 11)
9 FCA Policy Statement (PS 21/14) (p 34)
10 COLL 15.1.4G(1) FCA Policy Statement (PS 21/14)
11 COBS 4.12.13G FCA Policy Statement (PS 21/14)

> *"Many managers who currently manage private fund strategies have permission to manage only unauthorised AIFs. These managers will need to submit a variation of permission to add the authorised AIF permission to their scope of permissions."*

FCA is intending to consult on widening access to investments in LTAFs in a controlled way. Although LTAFs were largely excluded from proposals in the FCA January 2022 consultation paper, the FCA did propose to include LTAFs within proposals to introduce an evidence declaration where consumers will be required to state why they meet the relevant criteria.

FCA rules provide that when an LTAF fund is made available to retail clients, a KID will need to be prepared in accordance with the PRIIPs Regulation, in addition to the prospectus.[12]

What can LTAFs invest in?

The FCA expects the investment strategy of an LTAF to be to invest at least 50 per cent of the scheme property in assets that are illiquid and these need to be held over a longer term.[13] COLL 15 outlines investments that are permitted and these include "specified investments" (within the meaning of article 74-86 of the RAO and article 89 of the RAO), immovable assets, precious metals or commodities and collective investment schemes.[14]

Managers of LTAFs must ensure there is a prudent spread of risk, taking into account the fund's investment policy and objectives. There was a two-year investment period until this prudent spread of risk had to be achieved, but this has been removed from the final rules.

Other than the above, there is relatively little prescription around what LTAFs can and cannot invest in.

12 COLL 15.4.7 FCA Policy Statement (PS 21/14)
13 COLL 15.6.7 FCA Policy Statement (PS 21/14)
14 COLL 15.6.8 FCA Policy Statement (PS 21/14)

Can LTAFs borrow?

FCA rules provide that borrowing cannot exceed 30 per cent of the net value of the scheme property and that the authorised fund managers must take reasonable care to ensure that arrangements are in place that will enable borrowings to be closed out to ensure compliance.[15]

What are the requirements around redemptions and liquidity?

Under FCA rules, LTAFs are allowed to redeem units no more often than monthly. The FCA rules also require an LTAF to have a notice period for redemptions of at least 90 days. The FCA states that it would expect the notice periods of many LTAFs to be longer than 90 days. It states that, for a fund to be fair to all investors, redemptions should be met from the sale of a representative sample of the investment portfolio.[16] The FCA states that ensuring consistency between the length of notice investors have to give to redeem their investment and how long it will realistically take the LTAF to sell these assets is informed by findings of recent research by the Bank of England's Financial Policy Committee and the FCA and Bank of England's review into open-ended funds.[17] The FCA also states that the PFWG has been looking at how the wider ecosystem can operationally support the LTAF as a non-daily dealing fund.

What are the disclosure and reporting governance requirements?

FCA rules require independent directors on the board of the AFM of an LTAF[18] and the rules also require a senior manager within the AFM to have a prescribed responsibility to oversee that the LTAF is being managed in the best interests of investors.[19] A governing body of the AFM of an LTAF would be required to have the collective knowledge, skills and experience to be able to understand the AFM's activities, in particular the main risks involved in the activities and the assets in which the LTAF is invested.[20] The rules provide that firms which do not currently manage authorised funds would need to get additional permissions to manage an LTAF.[21]

The FCA expects managers of LTAFs to explain how their performance fees work, so that investors can assess the merits of investing in the fund.[22]

FCA rules require additional quarterly disclosures in respect of LTAFs, setting out basic information about portfolio development.

Is an LTAF different from an ELTIF?

A European Long-Term Investment Fund (ELTIF) is a type of alternative investment fund (AIF) designed for long-term investments, which can be marketed to retail and professional investors. Sounds similar, right? So what are the differences between ELTIFs and LTAFs?

The ELTIF regime was launched in 2015 and, while the policy intent and nature of permitted investments are quite similar, there are some key differences. The ELTIF is a closed-ended structure while the LTAF is not. The current ELTIF regime also appears to be more restrictive in terms of the assets that can be invested in (although, as discussed below, this is set to change).

Under the ELTIF Regulation, an ELTIF must invest at least 70 per cent of its capital in "qualifying assets" (eg non-listed companies).[23] ELTIFs may not invest more than 10 per cent of ELTIF capital in any other single ELTIF, EuVECA or EuSEF. The ELTIF Regulation requires ELTIFs to run for a fixed-term period.[24] An ELTIF cannot also invest in funds of funds. The ELTIF Regulation also requires an asset manager to assess a retail investor's knowledge and experience, partially duplicating the suitability assessment under MiFID.

ELTIFs have not proven popular. As of October 2021, around 57 ELTIFs, with approximately EUR 2.4 billion in net assets under management, had been authorised to operate. These were domiciled in four jurisdictions (France, Luxembourg, Italy and Spain).[25]

The UK's Long-Term Investment Funds (Amendment) (EU Exit) Regulations 2019 amended the retained version of the ELTIF Regulation to ensure that it functions effectively after Brexit, and the Regulations came into force at the end of the transition period. The UK LTIF regime (as it's now known) broadly has the same rules as the EU ELTIF regime (minus the passport). The FCA states that only limited use was made of the specialised EU funds and no UK ELTIFs have been launched[ii].[26] Surely one for the Brexit Bonfire when HM Treasury get round to it?

In November 2021, as part of its Capital Markets Union 2021 package, the European Commission published a legislative proposal to amend the ELTIF Regulation. Many of the proposals aim to set a clearer boundary between rules aimed at ELTIFs marketed at professional investors and those aimed at retail investors. Proposals include: widening the scope of eligible assets to be invested in; relaxing current restrictions so as to enable fund-of-fund strategies and permitting ELTIFs to make use of master-feeder structures; clarification that ELTIF investment strategies can pursue a global investment mandate; increasing cash borrowing limits of ELTIFs marketed to retail investors to 50 per cent of the ELTIF threshold, and 100 per cent of the value of the capital of the ELTIF in respect of ELTIFs marketed solely to professional investors; aligning the suitability test with MiFID; lowering the threshold for eligible investment assets of ELTIFs to 60 per cent; and increasing to 20 per cent the maximum retail ELTIF exposures to instruments issued by, or loans granted to, any single qualifying portfolio undertaking.

15 COLL 15.6.17R(2) FCA Policy Statement (PS 21/14)
16 COLL 15.8.12(R) FCA Policy Statement (PS 21/14), (p 20)
17 FCA Policy Statement (PS21/14), (p 4)
18 COLL 15.7.22 (R) FCA Policy Statement (PS 21/14)
19 FCA Policy Statement (PS 21/14), (p 9)
20 FCA Policy Statement (PS 21/14), (p 10)
21 FCA Policy Statement (PS 21/14), (p 10)
22 FCA Policy Statement (PS 21/14), (p 12)
23 FCA Discussion Paper (DP 18/10) Patient Capital and Authorised Funds (December 2018) (p 18)
24 Ibid
25 Commission staff working document executive summary of the impact assessment report, November 2021

ii. Commission staff working document executive summary of the impact assessment report, November 2021
26 Ibid

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Islamic finance in the Grand Duchy of Luxembourg

An overview

By Fabien Debroise, Antonios Nezeritis and Ludmilla Bouchez-Lecuy

The Grand Duchy of Luxembourg (hereafter Luxembourg) is well known as a financial centre with a strong culture of investor protection and a multilingual and multicultural workforce. It has become the second largest fund centre in the world after the United States of America.[1]

In the past four decades, in its endeavours to cater to various types of market participants with different backgrounds, Luxembourg has undertaken several initiatives to also play a major role in Islamic finance.

In this respect, the question arises as to what exactly is to be understood by Islamic finance and Islamic-compliant financial instruments and how these can be structured.

Contrary to common belief, Islamic financial instruments are available to the general public and are not restricted to investments made only by Muslims. These instruments are considered as an alternative to conventional financial products and are increasingly regarded as a form of socially responsible and ethical investments.

Although a simplification to some extent, it is fair to say that Islamic finance mainly represents financial instruments which are structured in accordance with Shariah principles, (the sources of which are mainly the Koran and the Sunna), meeting the consensus of jurists as interpreters of Islamic law. Shariah is the body of Islamic religious law within which the public and private aspects of life are regulated for those living in a legal system based on Islamic principles.

The key principles of Islamic finance are:[2]

- Prohibition on the payment of interest (*riba*);
- Risk and profit must be shared equally between parties to a transaction;
- Speculation (*maysir*) and uncertainty (*gharar*) in transactions are strictly prohibited;
- Certain kinds of activities are prohibited (*haram*) – products deemed incompatible with Shariah law include, eg. gambling, alcoholic drinks, weapons, adult entertainment; and
- Transactions must be asset-based or asset-backed.

Luxembourg as the European Islamic Finance Hub

Luxembourg is globally known for the domiciliation of investment funds and the structuring of cross-border acquisitions. However, Luxembourg also positioned itself early to be an actor in Islamic finance, capable of attracting numerous investors from the Middle East. In this respect, Luxembourg has become the third largest Islamic fund centre in the world after Saudi Arabia and Malaysia[3] and the largest Islamic fund domicile centre in a non-Muslim country, ranked by the number of Islamic funds established in Luxembourg. According to the Association of the Luxembourg Fund Industry (ALFI), as at December 2021, Shariah-compliant funds had net assets of EUR 6,825.9 million.[4]

In this context, it is worthwhile focusing on some key figures reflecting Luxembourg's active role for more than 40 years:

1978: Luxembourg is the first western country to host an Islamic financial institution.

1983: The first Islamic insurance company is set up in Luxembourg.

2002: Luxembourg is the first Eurozone country to list a sukuk.

2008: The Luxembourg government establishes a task force in order to promote Islamic finance.

2009: Luxembourg's Central Bank is the first European central bank to become a member of the prudential standard setting body for global Islamic finance, the Islamic Financial Services Board (IFSB).[5]

2013: The Association of Luxembourg Fund Industry publishes "best practices guidelines" for the purposes of servicing Islamic funds.

2014: Luxembourg is the first Eurozone country to issue a sovereign sukuk. In order to do so,

1 Ernst & Young, Luxembourg: the gateway for Islamic finance and the Middle East, EY Luxembourg, May 2019, Ernst & Young, the Luxembourg fund series – chapter one, EY Luxembourg, 2020

2 Comprendre la Finance Islamique: Principes, Pratiques et Ethique», Dr Tarik Bengarai, 2010

3 See footnote 1

4 Alfi, Global overview Doc RR, updated on 4 February 2022 (source: CSSF)

5 See footnote 1

Luxembourg as sole shareholder set up a special purpose vehicle acting as the issuer of the instruments. The securities issued are sukuks of the *Al-ijarah* type (lease-based financing) which are backed by three administrative buildings having been purchased by the issuer from Luxembourg with the issuance proceeds of the sukuks. The rental income from the buildings constitutes the profit paid out to the holders of the sukuks. The buildings are to be transferred back to the state for a pre-agreed purchase price when the sukuks mature. The sukuks are admitted to trading on the Euro MTF market (Euro MTF) of the Luxembourg Stock Exchange (the LuxSE).

It should also be noted that, although there has not been any specific taxation framework regulating Islamic finance transactions in Luxembourg, Luxembourg tax authorities have clarified their position with respect to Islamic finance products, covering in particular the Luxembourg direct and indirect tax treatment of *murabahah* (cost plus financing, typically used for house purchase schemes) and sukuk transactions.[6]

6 Circular LG-A No. 55, Luxembourg direct tax administration, 12 January 2010

Islamic funds

In Luxembourg, Shariah-compliant investment funds are usually set up under the general Luxembourg legal framework as there is no particular legal system established for the regulation of Islamic funds[7] and Islamic finance products. Consequently, from a supervisory and regulatory perspective, there is no particular distinction between a Shariah-compliant investment fund and any other type of investment fund.

From a practical perspective this means that a large variety of Shariah-compliant vehicles are generally available to asset managers and investors given that, in theory, any Luxembourg investment vehicle can be used *de facto* to set up a Shariah-compliant fund. A Luxembourg investment fund can take either a corporate form or a contractual form. The choice of the right investment structure mainly depends on the investment policy, the investors targeted and the level of regulation desired.

Generally speaking, they can be set up as regulated or unregulated funds.

7 *Commission de Surveillance du Secteur Financier*, Guidance, Investment Funds and Islamic Finance, May 2011

Regulated funds

Regulated funds in general are subject to the prior authorisation and ongoing supervision of the Luxembourg regulator, the *Commission de Surveillance du Secteur Financier* (CSSF).

Shariah-compliant regulated funds can be set up as undertakings for collective investment in transferable securities (UCITS) or as alternative investment funds (AIFs).

UCITS must comply with part I of the law of 17 December 2010 relating to undertakings for collective investments (the 2010 UCI Law). UCITS are always open-ended funds and may invest only in certain liquid assets. They can be marketed on a pan-European cross-border basis under the UCITS passport. They offer a high level of investor protection and can be placed with all types of investors, ie retail and institutional investors.

AIFs can be used if certain terms or asset classes not available to UCITS such as real estate, private equity and venture capital, hedge funds and debt funds are to be offered to investors. AIFs must appoint an alternative investment fund manager (an AIFM), which may be based in or outside of Luxembourg. Depending on, among other things, the amount of assets under management, the Luxembourg AIFM must be authorised by or registered with the CSSF. When authorised by the CSSF, the AIFM benefits from a passport allowing it to market the fund to professional investors within the EEA.

The following regulated investment funds may be set up as AIFs:

- Undertakings for collective investment which are subject to Part II of the 2010 UCI Law (Part II UCIs) and which are flexible but heavily regulated vehicles as they may also target retail investors;
- Specialised investment funds (SIFs), which target well-informed investors and are subject to risk spreading requirements;
- Investment companies in risk capital (SICARs), which target well-informed investors and are specifically structured vehicles for venture capital that are required to invest in assets qualifying as risk capital only.

These funds may be launched as stand-alone funds or umbrella structures consisting of multiple compartments. It is therefore possible for a Shariah-compliant compartment to be launched alongside non-Shariah-compliant compartments.

Unregulated funds

Shariah-compliant funds can also be established as the following unregulated funds:

- Reserved alternative investment funds (RAIFs), which are not subject to the supervision of a regulator but are managed by a regulated AIFM (whether based in or outside Luxembourg). The RAIF can have the features of a SIF or a SICAR; and
- Luxembourg partnerships, in the form of a common limited partnership (SCS) or special limited partnership (SCSp), which are not under the supervision of the CSSF but are managed by an AIFM if they qualify as AIFs.

These unregulated funds can be open or closed-ended. They differ in that a RAIF can be set up as an umbrella structure, which is not possible for a partnership. And while there are per se no restrictions for a partnership with respect to the eligible investors, a RAIF may only target well-informed investors.

Islamic finance in the context of the Luxembourg Securitisation Law

The existing legal framework in Luxembourg has proved both flexible and innovative enough to accommodate the demands of Islamic finance practitioners implementing various Shariah-compliant structures through the use of Luxembourg vehicles.

In particular the Luxembourg law of 22 March 2004 on securitisation (the Luxembourg Securitisation Law) has shown that it is an ideal tool to establish sukuk issuance structures due to the asset-backed character of sukuks (as further explained below). This is mainly due to the fact that under the Luxembourg Securitisation Law it is easy to set up issuance platforms using multiple compartments within the same securitisation vehicle, where each is linked to a different type or pool of assets. This means that each compartment represents a distinct part of the assets and liabilities of the securitisation vehicle. Thus a Luxembourg securitisation vehicle can in fact issue several classes of sukuks with each class being allocated its own specific compartment of the vehicle.

It is also possible and relatively common to combine, in a single transaction, elements of Luxembourg law with foreign law-governed

agreements and structuring tools since the financial instruments issued by a Luxembourg securitisation undertaking need not necessarily be governed by Luxembourg law.

Another reason for the increasing popularity of Shariah-compliant securitisation vehicles is the wide array of eligible assets which can be securitised under the Luxembourg Securitisation Law. Risks relating to the holding of assets, whether movable or immovable, tangible or intangible income, as well as risks resulting from the obligations of third parties or relating to all or part of the activities of third parties can be securitised. Consequently, Luxembourg securitisation transactions regularly securitise various classes of assets such as equity investments, real estate, commodities, receivables and other forms of business participations.

Furthermore, the fact that a Luxembourg securitisation vehicle is in principle an unregulated vehicle has also increased its popularity for Islamic finance issuance transactions. Generally speaking, Luxembourg securitisation vehicles are not subject to supervision as a regulated entity by the CSSF. Only securitisation undertakings which issue securities to the public on a regular basis (ie more than three times on an all-compartment level per financial year) must be authorised by the CSSF. However, any issuance of securities made in the context of a private placement does not qualify as a public offer as such. Another attractive feature of Luxembourg securitisation vehicles is the fact that due to a recent reform of the Luxembourg Securitisation Law such vehicles have ceased to be mere issuance vehicles and are now also allowed to enter into any form of loan agreement/structure with their investors instead of only issuing securities.

Shariah Board

It is, however, common practice that Shariah-compliant vehicles set up a Shariah Board the members of which assess the compliance of the intended investments with applicable Shariah precepts.

Sukuks

As mentioned, in Luxembourg there is no law dedicated specifically to Islamic financial products or services. However, so far several issuances of so-called sukuks have been made. A sukuk is a particular type of financial instrument, similar to a bond in western finance, which complies with Shariah principles. Sukuks mostly involve direct asset ownership while bonds are indirect interest-bearing obligations. Consequently, both sukuks and bonds provide their investors with payment streams. However, the income derived from a sukuk must not be speculative as such an approach would mean it would no longer be *halal*.

Therefore, the more traditional western types of debt instruments cannot be used as a viable investment approach, nor can they be used to raise capital. In order to bypass this issue, sukuks usually link the return and cash flows of a specific debt financing to a particular asset which is being acquired while distributing on a periodic basis the benefits generated by the acquisition of the asset to the investors, ie the asset-owners or asset-beneficiaries who do not qualify as creditors entitled to receive interest payments on their investments. In other words the holders of sukuks, in contrast to bond holders, receive a portion of the earnings (eg rental income) directly generated by the associated asset. Consequently, while a bond price is mainly determined by its credit rating, the valuation of a sukuk is based on the value of the assets backing it. This approach is a means to work around the prohibition under Shariah law on investing money in order primarily to receive interest payments. Due to this structure sukuks usually represent a viable instrument to raise financing for identifiable assets only. However, sukuks can also be structured so as to constitute part ownership in a debt (*Sukuk Murabaha*), asset (*Sukuk Al Ijara*), project (*Sukuk al Istina*), business (*Sukuk Al Musharaka*) or investment (*Sukuk al Istithmar*).

Summarising, one can therefore say that a sukuk can be considered the Islamic equivalent of a bond which does not give rise to periodic payments of interest.

Public offers of sukuks and admission to trading on stock exchanges

Furthermore, sukuks can also be offered to the public under Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (the **Prospectus Regulation**). In this respect, the CSSF classifies

sukuks as asset-backed securities to which annexes 9 and 19 of Commission Delegated Regulation (EU) 2019/980 of 14 March 2019 usually apply. Furthermore, sukuks can also be admitted to trading on a regulated market in the EEA under the aforementioned prospectus framework or in accordance with the relevant national listing framework for a multilateral trading facility.

From a Luxembourg listing perspective this means that sukuk issuers can choose between the regulated market (**Bourse du Luxembourg**) or the Euro MTF. The latter qualifies as a multilateral trading facility and therefore does not offer the possibility to passport the listing prospectus into other EEA jurisdictions for the purposes of a listing on another stock exchange.

In fact, as referred to above the LuxSE was the first European stock exchange to list an issuance of sukuks in 2002. The sukuks were issued by the state of Malaysia and were followed by other sovereign and corporate sukuk issuers from Malaysia, Saudi Arabia, the United Arab Emirates, Pakistan, Turkey, South Africa, Qatar, among other countries.

Conclusion

Over the years Luxembourg has evolved into an attractive financial centre for Islamic finance transactions due to strong government support and an innovative legal framework.

The Luxembourg legislator has not established a specific type of Islamic-compliant entity or legal structure. However, the wide array and flexibility of different fund entities can also be used to set up Islamic finance and Shariah-compliant investment structures. Furthermore, securitisation vehicles on account of their unregulated status and due to the fact that a vast range of assets can be securitised on a multiple-compartment basis, with each asset being ring-fenced and segregated from the other compartment asset pools, provide another alternative for Islamic finance structures. Finally, it is worth noting that the LuxSE has become a very attractive trading venue for Islamic finance securities such as sukuks and has a long history of such listings.

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Strengthening of foreign investment controls in France

The latest update

By Anne Reffay and Jacques Dabreteau

Implemented under the Law of 28 December 1966, the foreign investment regime in France is a tool that serves to protect the country's economic sovereignty. The scope of its application has been significantly expanded over the last 15 years and recently controls around foreign investment have been further reinforced in the context of the coronavirus crisis.

Any foreign investment made in France in sectors considered to be "sensitive" is subject to the prior authorisation of the Minister of the Economy.

The current legal framework for the control of such investments is the result of the Law of 22 May 2019 (*Loi PACTE*), which is supplemented by a decree and a ministerial order (*arrêté ministériel*) made on 31 December 2019, and which carried out a widespread reform of the scope of the controls, the applicable procedures and the associated sanctions. The recent legislation has already been subject to adjustments that are undoubtedly related to the coronavirus crisis, being: (i) the addition of biotechnologies in the list of critical technologies covered by research and development activities which fall within the scope of its control (under the ministerial order of 27 April 2020); and (ii) temporarily lowering the threshold of what constitutes control to 10% of voting rights for certain investments in French listed companies (under the decree and ministerial order of 22 July 2020 and decree of 28 December 2020).

This legislation illustrates the continuing trend to increase controls around foreign investments in France. Two recent measures have further strengthened the regime:

First, due to the persistence of the coronavirus crisis, the action taken in 2020 in response to the onset of the pandemic, which involved the reduction of the threshold of control from 25% to 10% of voting rights for non-European investments in listed companies, was extended by a decree dated 22 December 2021. It now applies until 31 December 2022.

The purpose of this measure is to control opportunistic minority investments by non-European investors in companies that may have been weakened by the coronavirus crisis.

Secondly, a ministerial order dated 10 September 2021, which came into force on 1 January 2022, provides a full list of information to be provided in support of an application for authorisation of a foreign investment in France.

The application must now include: requested information on the intellectual property owned or used by the French target; its customers in the EU; how French customer data is processed; its competitors in the EU; and even the market share held by its competitors in France. In addition, the foreign investor will now have to indicate its overall strategy in France and Europe, as well as in the relevant sectors the subject of the investment.

In practice, this information was often requested anyway (in whole or in part) by the Ministry services after the authorisation request had been submitted, giving the administration more time to provide its response. The purpose is therefore to avoid these types of requests for additional information and the corresponding extension delays.

The ministerial order of 10 September 2021 also includes two other new features:

- technologies involved in renewable energy production have been added to the list of critical technologies covered by the control; and
- it is now the investor, as long as such investor is registered in a non-EU country, who will have to prepare (and attach to its application for authorisation) the notification form to be submitted to the European Commission provided for in the European regulation of 19 March 2019, which established a framework for screening foreign direct investments in the EU (a form that is made available to Member States).

In this respect, it is worth remembering that this regulation established a framework for screening foreign direct investment in the EU. The European Commission can therefore issue an opinion for the attention of the relevant Member State in the event of a foreign investment that may be prone to adversely affect any projects or programmes of interest to the EU. While there were initially 8 types of projects listed in the 2019 EU regulation, a new regulation of 29 September 2021 has expanded this list to now cover 18 projects, notably in the areas of transport, energy, telecommunications, defence and healthcare.

Lastly, and importantly, the department of the Ministry of the Economy in charge of controlling foreign direct investment has announced in the first quarter of 2022 the publication of guidelines on the application of this regulation, which seeks to clarify the terms of the procedures for implementing control and as such responds to the needs of practitioners in this field.

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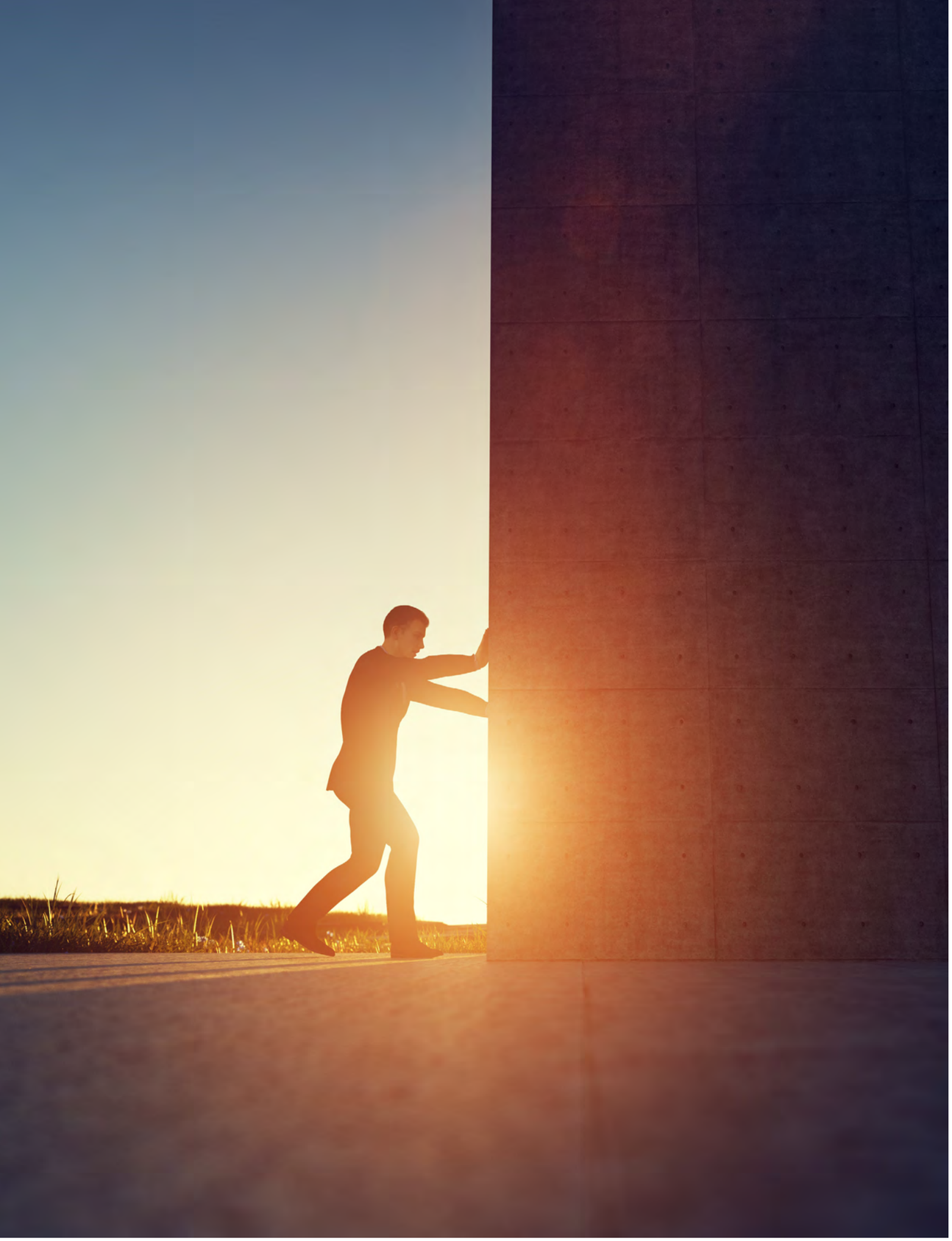

AIFMD II

Astonishingly, an Incredibly Feeble Amending Directive!

By Jake Green and Bradley Rice

Fund managers have long awaited another one of our tongue-in-cheek updates on the Alternative Investment Fund Managers Directive (AIFMD). You've probably (or hopefully) been waiting with more interest for the proposed changes to AIFMD. Well, the wait is over. And the good news is that the proposed changes are not as bad as some feared they could have been.

The key takeaways are as follows:

- Delegation and substance requirements: There will be tighter rules on delegation, but they are not as bad as they could have been... for now! There will be new substance requirements to ensure EU managers retain people with the right expertise on the ground in Europe to avoid so-called letter-box entities. There will also be new reporting requirements to ensure ESMA obtains data on the extent of delegation and this could result in changes further down the track.
- Loan Originating Funds: There is a raft of new rules and requirements for loan-originating funds.
- Liquidity management: There are new mandatory liquidity management tools to be used by open-ended funds in exceptional circumstances.
- Reporting and disclosure: Apparently we need more!
- Depositaries: Clarity that depositaries can effectively passport in Europe without formally having a passport yet; that's to come.

We take a closer look below.

Background to the proposal

On 25 November 2021, the European Commission published a proposal to amend the AIFMD, along with the Undertakings for the Collective Investment in Transferable Securities Directive and other fund-related directives and regulations. This forms part of a series of proposals published on the same day aimed at delivering several key commitments outlined in the 2020 EU Capital Markets Union Action Plan. The proposals follow an October 2020 European Commission review on the operation of the AIFMD, which has largely concluded that the AIFMD is working well. However, the European Commission and other stakeholders consider that there are areas for improvement. Some of these areas (namely delegation) were discussed in an August 2020 letter from ESMA to the European Commission. As well as delegation, the proposals seek to address issues related to AIFMD concerning the build-up and spill-over of risks to the broader financial system, such as the regime governing direct lending by AIFs and the importance of effective liquidity management tools (the European Systemic Risk Board and ESMAs recommended harmonisation of the rules on the use of liquidity management tools).

Additional services and functions AIFMs can perform

The proposals introduce additional services that an AIFM will be able to provide, including:

- Loan origination (the explanatory text to the legislative proposal states that "this means AIFs can extend loans anywhere in the Union, including cross border");
- The servicing of securitisation special purpose entities;
- Benchmark administration; and
- Credit servicing, in accordance with the 2021 EU Directive on credit purchasers and credit servicers (see our briefing).

The express reference to enabling AIFMs to lend is positive if it allows AIFMs to passport that service within the single market because it could simplify the structuring of some direct lending funds.

Stricter requirements on delegation and prescribed substance requirements

As suspected following ESMA's letter, the proposals seek to tighten up delegation to avoid a perceived risk that many AIFMs delegate substantial parts of their portfolio management function outside the EU. However, the proposals are not as bad as they could have been given ESMA's concerns.

There is a requirement that EU AIFMs have at least two full-time people in the EU with the necessary skills and expertise to oversee the retained and delegated functions. While this is a new prescribed requirement, it is common practice in many common fund jurisdictions and should not pose too many obstacles for managers. It is also in line with the UK threshold conditions and the four-eyes principle.

Applications for authorisation will need to provide more information concerning the individuals who are "effectively conducting the business" of the AIFM, including: a detailed description of their role, title and level of seniority; a description of their reporting lines and responsibilities in the AIFM and outside the AIFM; an overview of the time allocated to each responsibility; and a description of the technical and human resources that support their activities. The existing requirements concerning information and arrangements made for delegation and sub-delegation have been enhanced to include a requirement to provide a detailed description of human and technical resources to be used by the AIFM for monitoring and controlling the delegate.

Article 20(1) is to be amended to clarify that delegation arrangements apply to all functions listed in Annex I and to the ancillary services permitted under AIFMD. Language referring to "services", in addition to existing references to "functions", has been introduced in provisions found in Article 20.

The proposals provide that ESMA should receive annual notifications from competent authorities of delegation arrangements where an AIFM delegates more risk or portfolio management to third country entities than it retains. The notifications are to include: information on the AIFM and the AIF concerned; information on the delegate, specifying the delegate's domicile and whether it is a regulated entity or not; a description of the delegated portfolio management and risk management functions; a description of the retained portfolio management and risk management functions; any other information necessary to analyse the delegation arrangements; a description of the competent authorities' supervisory activities, including desk-based reviews and on-site inspections and the results of such activities; and any details on the cooperation between the competent authority of the AIFM and the supervisory authority of the delegate. ESMA is to develop technical standards concerning delegation notifications and the standard forms, templates and procedures for the transmission of the delegation notifications. We can, therefore, expect more reporting and that national competent authorities will require managers to include this information in their regular reporting requirements.

AIFMD delegation rules are to also apply to UCITS ManCos.

A depositary passport in practice but not in name

The rules requiring AIFs to appoint a depositary in the AIF's home Member State will be relaxed. This is to address concerns about so-called depositary market concentration in some markets. The European Commission has opted against introducing a depositary passport for now, owing to lack of EU-wide uniform laws in securities and insolvency; however, the proposed Directive includes a review clause concerning aspects of the AIFMD including a prospective depository passport. For now, AIFMs can procure depositary services in other Member States so we reach a similar outcome to a passport in practice.

Third country depositaries in jurisdictions which are identified as high-risk under EU money laundering laws or on the EU list of non-cooperative jurisdictions for tax purposes are not permitted.

It is proposed that use of a central securities depositary (CSD) will be viewed as a delegation (except where the CSD is acting as an issuer CSD, i.e. a CSD providing a notary service or central maintenance service in relation to a securities issue). Under the existing regime, CSDs are not considered delegates of the depositary and the industry believes that depositaries cannot carry out oversight duties effectively without the necessary flow of information. It is also proposed that depositaries cooperate not only with their competent authorities, but also with the competent authorities of the AIF that has appointed it as a depositary and with the competent authorities of the AIFM that manages the AIF.

New rules for debt funds

There are numerous new proposals for loan-originating funds. AIFMs managing AIFs granting loans will be required to implement effective policies, procedures and processes for the granting of loans. These will need to be reviewed periodically. The proposals also restrict lending to a single borrower, when this borrower is a financial institution, so as to reduce risk to the financial system.

Under the proposals, an AIF is prohibited from lending to its AIFM or its staff, its depositary or its delegate (how that wasn't a conflict under the existing conflict rules is beyond us, but more law just in case anyone was unsure).

To address loan originations resulting in quick-fire sales of loans to the secondary market, AIFs are to be required to retain an economic interest of 5 per cent of the notional value of the loans they have granted and sold off. An AIF will be required to adopt a closed-ended structure if the notional value of its originated loans exceeds 60 per cent of its net asset value.

Mandatory liquidity management tools and requirements

The proposals provide that AIFMs managing open-ended AIFs will be able to temporarily suspend the repurchase or redemption of the AIFs' units by using one of the liquidity risk management tools set out in points 2 to 4 of Annex V, which sets out a minimum list of liquidity management tools that should be available anywhere in the EU and will be further developed via regulatory technical standards from ESMA. The tools include notice periods, redemptions fees, an anti-dilution levy and swing pricing.

Temporary suspensions will be permitted only in exceptional circumstances where it is justified and in the interests of investors. The AIFM will be expected to implement detailed policies and procedures in relation to the activation and the deactivation of selected liquidity management tools, as well as associated operational and administrative arrangements.

AIFMs will be required to notify the competent authorities about activating or deactivating a liquidity management tools.

Tweaks to the National Private Placement Regime for third-country fund marketing

The proposals update existing provisions to require that non-EU AIFMs and non-EU AIFs must not be established in jurisdictions identified as high-risk countries under the EU money laundering directive. This is an expansion of the current requirements.

The third country in which the non-EU AIF is established would need to have signed an agreement with the home Member State of the authorised AIFM and with other Member States in which the units or shares of the non-EU AIF are intended to be marketed, fully complying with the standards laid down in the OECD Model Tax Convention on Income and on Capital and ensuring an effective exchange of information in tax matters (including any multilateral tax agreements), and it must not be on the EU list of non-cooperative jurisdictions for tax purposes.

More reporting to regulators! Apparently someone does read this stuff

Under the proposals, AIFMs will be required to regularly report to their home Member State's competent authorities on all markets, instruments and exposures. This is an expansion of current Annex IV reporting, where AIFMs are required to report on the principal markets and instruments in which they trade, provide information on the main instruments in which they are trading and on the principal exposures and the most important concentrations of each AIF managed. ESMA is to develop technical standards providing revised reporting templates in this regard. Exciting times ahead!

More disclosures – no surprises

There are additional disclosures for AIFMs concerning conditions for using liquidity management tools. AIFMs are to disclose a list of fees and charges that will be applied in connection with the operation of the AIF and that will be borne by the AIFM or its affiliates. It is proposed that, on a quarterly basis, AIFMs disclose all direct and indirect fees and charges that were directly or indirectly charged or allocated to the AIF or to any of its investments, and to any parent company, subsidiary or special purpose entity established in relation to the AIF's investments by the AIFM, the staff of the AIFM or the AIFM's direct or indirect affiliates.

AIFMD III planned

The proposals provide for ESMA to regularly carry out peer reviews of supervisory practices on delegation, with a particular focus on preventing the creation of letter-box entities. The Commission is also to review the delegation regime and its implementing measures. The proposals also provide for assessing the possibility of introducing the depositary passport and the functioning of the rules for AIFMD managing loan-originating AIFs.

No mention of the AIFMD third country marketing and management passport though. All very quiet on that front and we are expecting it to remain that way given the proposals were lobbied for by the UK, and Europe conceded on the basis most third country firms would choose the UK as their member state of reference, leaving the UK FCA to deal with the supervision of such firms. With Brexit taking this off the table, there is little prospect of a third country passport coming into force any time soon.

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The Luxembourg Stock Exchange Securities Official List

An alternative solution to securities trading

By Fabien Debroise, Sacha Nesviginsky and Markus Waitschies

Stock exchanges as trading venues have grown significantly since their beginnings in the 16th century. They have provided stakeholders with a forum to invest, sell and trade securities.

While most stock exchanges have been generally geared towards trading, the Luxembourg Stock Exchange (LuxSE) introduced an alternative mechanism in 2018: the Securities Official List (SOL). The SOL enables issuers to list securities on the LuxSE's official list without admission to trading in order to provide issuers with additional visibility.

In this article, we will examine the SOL, its features and the requirements issuers must satisfy to be listed. First, the LuxSE's markets (the MIFiD-regulated market and the Euro Multilateral Trading Facility (MTF)) (the "Bourse de Luxembourg" and the "Euro MTF", respectively) will be presented to examine their key features and the distinctions between both markets (Part I). Second, the SOL will be examined to provide an overview of the listing process which issuers must abide by, with a particular focus on the documentation to be submitted and the admission requirements (Part II). Third, we will examine the Luxembourg Green Exchange (LGX), a platform geared towards sustainable securities (Part III).

Listing on the LuxSE: the Bourse de Luxembourg and Euro MTF

The LuxSE enables issuers (states, public international bodies, financial institutions and corporations) to list bonds, shares, investment funds and an array of other securities. In order to do so, issuers must follow five steps: (i) the market selection, (ii) the preparation of a prospectus, (iii) its submission, (iv) the listing and admission to trading of the securities and (v) compliance with the post-listing reporting requirements.

With regard to the first step (the market selection), the LuxSE provides issuers with two markets: (i) the Bourse de Luxembourg, a European Union-regulated market, and (ii) the Euro MTF, an exchange-regulated Luxembourg domestic market. While both regimes have certain similarities – such as the fact that (i) they are regulated, (ii) issuers need to provide certain relevant financial history[1] and (iii) language requirements[2] – there are certain distinctions which will be examined in the following section.

The Bourse de Luxembourg

Issuers who wish to list on the Bourse de Luxembourg fall under the supervision of the *Commission de Surveillance du Secteur Financier* (CSSF), Luxembourg's financial supervisory authority, should their prospectus home member state be Luxembourg. The latter reviews and approves the prospectus, which must be compliant with the EU Prospectus Regulation.[3]

Among its advantages, issuers who list on the Bourse de Luxembourg benefit from the European Union's passporting mechanism. This implies that an approved prospectus within a European Union (EU) country may be used in another market within the EU. Issuers are subject to the EU Prospectus Regulation, the Transparency Directive[4] and the International Financial Reporting Standards (IFRS), or its equivalent for non-EU issuers. Contrary to the Euro MTF, where issuers only pay the LuxSE's fees, issuers who list on the Bourse de Luxembourg will also have to pay the CSSF's prospectus approval fees.

The Euro MTF

Issuers listing on the Euro MTF are subject to the supervision of the LuxSE, which approves the relevant prospectuses. The types of securities listed in the Euro MTF include equities, funds, debt securities and structure investment products. Issuers are not subject to the application of the Prospectus Regulation and Transparency Directive. In addition, contrary to the Bourse de Luxembourg, issuers cannot benefit from the EU passport mechanism. As for financial reporting, it must be done in conformity with IFRS. However, other standards such as the Generally Accepted Accounting Principles (GAAP) are usually accepted.

1 Two years for bonds and three years for equity.
2 The relevant documentation can be drafted in English, German, French or Luxembourgish.
3 Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/ECText with EEA relevance.
4 Directive 2004/109/EC of 15 December 2004 of the European Parliament and of the Council of 15 December 2004 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, as transposed into the Luxembourgish legal framework by Law of 11 January 2008 on transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, as amended, supplemented and replaced from time to time.

The Securities Official List

In addition to the above-mentioned markets, the LuxSE offers issuers a third possibility: the SOL. It enables issuers to list securities on its official list without such securities being admitted to trading. Consequently, the official list includes financial instruments admitted to trading and listing on both (i) the Bourse de Luxembourg, and (ii) the Euro MTF, as well as the financial instruments which are recorded on the SOL,[5] without admission to trading. The SOL provides issuers who are not seeking to trade their securities with additional visibility. In addition, issuers may list on the Luxembourg Green Exchange (LGX).

1 – THE LISTING PROCESS

In order to be listed on the SOL, the LuxSE requires issuers to comply with the requirements set out in the Securities Official List's Rulebook (the Rulebook). The Rulebook provides the framework governing (i) the requirements for admission on the SOL, (ii) the ongoing obligations and (iii) the provisions regarding the withdrawal of securities from the SOL.[6] This means that securities which are both listed and admitted to trading will not be subject to the Rulebook, but have to comply with the Rules and Regulations of the LuxSE.

The Rulebook defines securities as including (i) shares and units including but not limited to shares or units of UCIs (Undertakings for Collective Investment), (ii) bonds or other debt securities issued by a company, (iii) bonds or debt securities issued by a state or its regional or local authorities or by an international public body, (iv) certificates representing shares/depositary receipts, and (v) all securities which LuxSE may determine as eligible to be admitted on the LuxSE SOL, as defined in section 5.3.6.1.[7]

In order to be listed on the SOL, issuers need to notably prepare an information notice which includes certain key information on the issuer, its securities and its activities.[8] In addition, Application and Know Your Client (KYC) forms need to be completed.[9] It should be noted that a submission to the SOL applies to all the securities of the same class or that are to be issued as part of the application for admission.[10]

Although the Rulebook provides the applicable framework and the relevant documentation to be submitted, it is not exhaustive. Indeed, notwithstanding the communication of all the relevant documentation, the LuxSE may request additional information or documentation which it deems necessary to protect investors and compliance with Anti-Money Laundering (AML) on a case-by-case basis and KYC obligations under the AML laws.[11] Furthermore, the LuxSE has all the necessary powers and authority to apply all AML/KYC measures and procedures which it deems necessary.[12] 'As such, it reserves the right to inform the *Cellule de Renseignement Financier* and, when necessary, the CSSF if it deems there is reasonable evidence demonstrating that the issuer is involved or is attempting to participate in acts or complicities of money laundering or terrorist financing.[13]

The documentation to be provided to the LuxSE

The SOL requires that issuers provide an information notice or any other similar document.[14] The information notice, which may be drafted in one of the official languages of Luxembourg or in English,[15] is to provide relevant information on the issuer and its securities. Issuers need to provide, inter alia, (i) their articles of association,[16] (ii) a proof of existence,[17] (iii) a written confirmation that (a) the legal position and structure of the issuer complies with the legislation and regulation under which it is incorporated and operates, (b) the legal position of the securities complies with the applicable legislation and regulations and (c) the administration of securities events and the payment of dividends and coupons shall be ensured and be paid properly and in due time,[18] (iv) if applicable, the financial statements for the last three years[19] and (v) a list of its legal representatives.[20]

5 The official list is governed by the Grand-Ducal Regulation of 13 July 2007, which implements Directive 2001/34/CE establishing the official lists.

6 Article 3.1 Rulebook
7 Article 2 Rulebook
8 Article 5.2.1.1 Rulebook

9 Article 5.1.1 Rulebook
10 Article 5.1.3 Rulebook
11 Article 5.2.2 Rulebook
12 Article 5.1.4 Rulebook
13 Article 5.1.4 Rulebook

14 Article 5.2.1.1 Rulebook
15 Article 5.2.1.1 Rulebook
16 Article 5.2.1.5 Rulebook
17 Article 5.2.1.6 Rulebook
18 Article 5.2.1.4 Rulebook
19 Article 5.2.1.5 Rulebook
20 Article 5.2.1.8 Rulebook

Admission requirements

Issuers must first demonstrate that (i) the legal position of the shares and units complies with the laws and regulations to which they are subject,[21] (ii) they respect the minimum size requirements: "[...] the capital and reserves of the company, including profit and loss, from the last financial year, must be at least EUR 1,000,000 or the equivalent value in any other currency. This condition [...] does not apply for admission onto LuxSE of a further block of shares and units of the same class as those already admitted",[22] (iii) they have published or filed their annual accounts for the three financial years prior to the admission on the LuxSE SOL, the whole in accordance with their national law.[23] This latter requirement may be derogated if determined to be in the interest of the company or the investors' and that the LuxSE deems that investors have all the necessary information to make an informed decision.

The admission requirements will depend on the type of security (shares and units, bonds, debt securities, etc). For the purposes of our article, we will focus on shares. Companies must ensure that (i) their legal position complies with the relevant laws and regulations to which they are subject,[24] (ii) the shares are freely negotiable[25] (iii) there are no applicable free float conditions[26] (iv) the shares have been issued prior to admission,[27] (v) the application concerns all shares and units of the same class already issued[28] and (vi) the shares comply with the physical form requirements.[29]

2 – THE ISSUER'S OBLIGATIONS

Among its obligations, issuers need to ensure that shareholders are treated equally.[30] Furthermore, the Rulebook provides a list of events (applicable to the securities or the issuer) which trigger a duty of communication to the LuxSE.[31] For example, in the event that the issuer proceeds with a modification of its name, it shall communicate the relevant information to the LuxSE.

21 Article 5.3.1.1 Rulebook
22 Article 5.3.1.2 Rulebook
23 Article 5.3.1.3 Rulebook
24 Article 5.1.1.5 Rulebook
25 Article 5.3.1.6 Rulebook
26 Article 5.3.1.7 Rulebook
27 Article 5.3.18 Rulebook
28 Article 5.3.1.9 Rulebook
29 Article 5.3.1.10 Rulebook
30 Article 6.1 Rulebook
31 Articles 6.2 and 6.3 Rulebook

The approval and admission process

As part of its analysis, the LuxSE will ensure that the information notice corresponds to the requirements set out in the Rulebook.[32] As such, it may deny the request in any of the following scenarios:

i. The admission will have any adverse consequences on the investors' interests;

ii. The issuer appears on one of the sanctions lists;

iii. The LuxSE deems that the admission of the securities will likely be detrimental to its reputation or the SOL's;

iv. The security is or is suspected by LuxSE to be directly or indirectly related to illegal activities or misused for such aims, or

v. The issuer is or is suspected by the LuxSE to be directly or indirectly involved in illegal activities.[33]

Notwithstanding these five elements, the LuxSE may decide to add certain conditions it deems appropriate or necessary.[34] Moreover, while reviewing the relevant documentation, the LuxSE's compliance department carries out a due diligence on the issuer whereby admission will not be granted until the process has been deemed complete and satisfactory. As such, the stock exchange reserves the right to reject any application if it concludes that (i) the results are unsatisfactory or (ii) the due diligence process cannot be completed.[35] Finally, the LuxSE reserves the right to demand additional documentation to ensure the investors are protected and/or the proper operation of the SOL and/or compliance with its obligations pursuant to the AML law.[36]

The suspension or withdrawal

The LuxSE may decide to remove a security from the SOL on the following three grounds. First, if it has reason to believe or to suspect that the normal and consistent registration for the security cannot be preserved. Second, there are facts or developments in respect of the issuer which, in its opinion, are or threaten to be detrimental to the LuxSE's or the SOL's reputation. Third, the issuer is either then or later referred to on one of the sanctions lists.[37] The decision to do so may be done on the LuxSE's own initiative.

32 Article 7.1 Rulebook
33 Article 7.2 Rulebook
34 Article 7.3 Rulebook
35 Article 7.4 Rulebook
36 Article 7.5 Rulebook
37 Article 9.1 Rulebook

The Luxembourg Green Exchange

The Luxembourg Green Exchange (LGX) was launched in 2016 as a platform geared towards sustainable securities. Its purpose is to enable issuers to raise awareness of their projects and sustainability strategies. As such, managers, issuers and investors are provided with a platform to notably obtain visibility and access to sustainable finance instruments. Over time, the LGX's activities have also included social and sustainability bonds, socially responsible investment (SRI) funds, the LGX DataHub and Sustainability-Linked Bonds, making them eligible for listing on the LGX.

In order to list on the LGX, issuers need to meet four criteria. First, they must list their financial instruments on one of the LuxSE's markets: Bourse de Luxembourg, Euro MTF or SOL. Second, on the basis of the documentation submitted, the LGX will examine whether the issuer's securities qualify as green, social, sustainable or Environmental, Social and Governance (ESG). Third, applicants will need to disclose information on the use of proceeds deriving from their securities or the investment policy and strategy of their funds, which entails the communication of mandatory documentation. Finally, they are required to undertake to commit to ongoing reporting for their securities.

The LGX includes several types of bonds. In order to determine the applicable category, the LuxSE examines whether the process derives from an instrument to finance or refinance green projects (green bonds), social projects (social bonds), a combination of green and social projects (sustainability bonds) or whether it aims to achieve predefined sustainability objectives within a set timeline (sustainability-linked bonds). In addition, it also includes Chinese domestic green bonds, which are traded on the China Interbank Bond Market or may be listed on one of the Chinese stock exchanges.

For more information or any assistance required in connection with the above, you can contact our Luxembourg Ashurst team.

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Potential impact of economic sanctions against Russia on CDS

An unprecedented and fast-evolving situation

By Julia Lu and Alexander Dmitrenko

The broad economic sanctions imposed by the US, UK, EU, Switzerland, Singapore, Japan and other countries against Russia and Russia's counter measures both have and will continue to have severe consequences on the world economy and financial markets. Not the least of such impact will be felt on the credit default swap (CDS) markets. This is an unprecedented and fast-evolving situation, with daily developments potentially changing the analysis relevant to CDS. Here we set out a summary of the relevant US sanctions and a number of questions that CDS market participants should consider.

US sanctions relevant to CDS

In April 2021, the US Office of Foreign Asset Control (OFAC) issued Executive Order 14024 (EO 14024), "Blocking Property with Respect to Specified Harmful Foreign Activities of the Government of the Russian Federation",[1] still effective today, which authorizes sanctions against persons designated by OFAC. As a result, all of the designated persons' property an interests in property that are or come within the United States or that are or come within the possession or control of any US person are blocked, and US persons are prohibited from doing business with these institutions unless authorized by OFAC.

Pursuant to OFAC's 50% Rule, all entities that are owned 50% or more by any of the designated entities are also blocked pursuant to EO 14024. In addition, FAQ 980 makes it clear that these SDN-related prohibitions apply to both US and non-US persons.

1 Executive Order 14024, available here.

OFAC has also issued several Directives under EO 14024, each with its own scope, target, and specific prohibitions. For example –

Directive 1A – "Prohibitions Related to Certain Sovereign Debt of the Russian Federation" effectively prohibits US financial institutions from participating in the primary market for Ruble- or non-Ruble-denominated bonds issued after June 14, 2021, and secondary market for such bonds issued after March 1, 2022, in each case by the Central Bank, National Wealth Fund or the Ministry of Finance of the Russian Federation.

Directive 3 – "Prohibitions Related to New Debt and Equity of Certain Russia-related Entities", prohibits "transactions in, provision of financing for, and other dealings in" new debt of longer than 14 days maturity and new equity of identified entities or their property or interest in property issued after March 26, 2022, or 30 days after the designation of the entity, if later. In FAQ 989, OFAC suggested that modifications to the terms of existing debt on or after the relevant effective date would be considered new debt for these purposes.

Directive 4 – "Prohibitions Related to Transactions Involving the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation, and the Ministry of Finance of the Russian Federation", prohibits persons acting within U.S. jurisdiction from performing any transaction "involving" the Central Bank of Russia, the National Wealth Fund of the Russian Federation and with the Russian Ministry of Finance, including transfers of assets to these entities or foreign exchange transactions on their behalf. The new FAQs emphasize that Directive 4's prohibitions apply to both direct and indirect transactions involving the Central Bank of the Russia, the National Wealth Fund of the Russian Federation, or the Russian Ministry of Finance, and that US persons should be on the alert for nonroutine foreign exchange transactions that may indirectly involve the Central Bank.

OFAC has issued a number of general licenses permitting certain activities involving designated persons or their property, including General License 10A (GL 10A) which authorizes, through May 25, 2022, transactions that are ordinarily incident and necessary to the wind down of derivatives contracts entered into prior to 4 pm on February 24, 2022 that (i) include certain identified Russian entity and their 50%-owned subsidiaries as a counterparty or (ii) are linked to the debt or equity of such entity. GL 10A also permits transactions that would otherwise be prohibited under Directive 4 that are ordinarily incident and necessary to the wind down of derivatives contract, repurchase agreements or reverse repurchase agreements entered into prior to March 1, 2022, that include the Russian Central Bank, national Wealth fund or Ministry of Finance as a counterparty.

Are new CDS transactions on Russian reference entities prohibited?

In the case of CDS referencing Russian sovereign debt, while Directive 1A does not refer to "derivatives transactions", it does prohibit participation in the "secondary market" in sovereign debt issued after March 1, 2022, which likely covers derivatives. The expansive prohibition under Directive 4 may also be interpreted to cover derivatives if such instruments indirectly involve entities targeted by Directive 4 (currently - the Russian Central Bank, National Wealth Fund or Ministry of Finance).

In the case of CDS referencing Russian Corporates, the broad prohibition under Directive 3, "transactions ... or other dealings in", indicates that a CDS referencing the relevant new debt may prohibited. In order to ensure the legality of a CDS referencing old debt, it may be necessary to expressly exclude the prohibited new debt from being or becoming an Obligation or Deliverable Obligation. In the event of an old debt being modified and thus becoming new debt, it may be necessary to exclude such modified debt excluded from the CDS as well.

When will a credit event occur?

Credit Events under a Russian Sovereign CDS include the following:

- Failure to Pay – after the expiration of the relevant Grace Period, the failure to make a payment (over $1 million) when and where due, in accordance with the terms of the Obligation
- Obligation Acceleration – Obligation has become due and payable before it would otherwise have been due and payable as a result of, or on the basis of, the occurrence of a default other than a failure to pay
- Repudiation/Moratorium – both (i) an officer of the Reference Entity or a Government Authority (A) disaffirms, disclaims, repudiates or rejects or challenges the validity of, Obligations (over $10 million) or (B) declares or imposes a moratorium, standstill, roll-over

or deferral, whether de facto or de jure, with respect to an Obligation, and (ii) a failure to pay or restructuring occurring within 60 days or on the next payment date

- Restructuring – with respect to an Obligation (over $10 million), a reduction in interest, principal or premium, postponement of a payment date, a subordination or a change in the currency of payment to any currency other than CAD, JPY, CHF, GBP, EUR or USD, in each case in a form that binds all holders and occurs as a direct or indirect result from a deterioration of creditworthiness or financial condition of the Reference Entity

Credit Events under a Russian Corporate CDS include Bankruptcy of the Reference Entity, Failure to Pay and Restructuring.

The Obligation referenced in the definitions of Credit Events must be a bond or loan that satisfies certain Obligation Characteristics – including Not Domestic Currency (i.e., payable in a currency other than the Ruble), Not Domestic Law (i.e., governed by non-Russian law), and Not Domestic Issuance (i.e., not issued primarily in the Russian market). This generally means that any failure by the issuers to make payments on Ruble bonds, including as a result of a Central Bank prohibition on such payments to foreign investors as recently reported,[2] should not trigger a Credit Event under the CDS.

Foreign currency-denominated obligations, however, still may not meet the Obligation Characteristics. To the extent any bond or loan permits, by its terms, payment in currencies (such as the Ruble) other than the currency (such as US Dollars) denominating the obligation,[3] the bond or loan is not considered "payable" in a currency other than the Ruble, and therefore does not meet the Obligation Characteristic of "Not Domestic Currency".

If payment defaults occur on non-Ruble denominated, non-Russian law-governed bonds issued in foreign markets, as reported with respect to USD sovereign bonds for example,[4] then a Failure to Pay could be triggered if those bonds qualify as Obligations under the CDS and the contractual payment requirements, such as time, place and amount (including currency), are not met.

2 Russia Bans Coupon Payment to Foreigners on $29 Billion in Bonds - Bloomberg (March 1, 2022).
3 See Credit Derivatives Determinations Committee decision, available at Credit Derivatives Determinations Committee » The Russian Federation (cdsdeterminationscommittees.org).
4 Analysis: Ukraine war raises spectre of Russia's first external debt default | Reuters (March 3, 2022).

The market is also considering on another question – whether, and if so how, a Russian government decree permitting Russian entities to make debt payments in Rubles to holders from countries that have imposed sanctions on Russia regardless of the underlying obligation terms, as the Kremlin has apparently issued,[5] would affect the analysis of a Credit Event. More details will be needed regarding the decree and how it will be implemented. The answer may also partially depend on whether the bond terms permit the obligor to pay in Rubles, assuming of course that those bonds are determined to be "Not Domestic Currency".

It is therefore important to examine the terms of the debt instruments to ascertain, among other things, whether the obligor is permitted to make payments in Rubles, and the precise time and place mechanics of payments, as well as any announcement by the Russian government or the reference entity as to the Obligations.

What debt will be deliverable obligations?

The settlement of a CDS requires the delivery (in the case of physical settlement) or pricing (in the case of cash settlement) of bond or loans that the meet Deliverable Obligation Characteristics, including Not Domestic Law and Not Domestic Issuance. Deliverable Obligations must also be payable in a Specified Currency – currencies used in the G7 countries.

The Credit Derivatives Determinations Committee has determined that a non-Ruble-denominated bond which by its terms permit payment in Ruble would not satisfy this Deliverable Obligation Characteristics. With respect to bonds the terms of which do not permit alternative payment currency, if USD-denominated obligations are paid in Rubles as a result of the government decree, it may raise an issue as to whether the government decree has made the obligations "payable in Rubles", and therefore whether they still meet this Deliverable Obligation Characteristics.

Another key Deliverable Obligation Characteristics applicable to bonds is Transferable, i.e., transferable to institutional investors without any contractual, statutory or regulatory restrictions.

The Directive 1A-imposed regulatory restriction on transactions in certain debt obligations means that US financial institutions cannot participate in the secondary market in, and therefore cannot receive, Russian sovereign bonds issued after March 1, 2022. Similarly, under Directive 3, if the Reference Entity of a CDS is one of the identified Russian entities (or their 50% affiliates), or guarantees the debt of such an identified entity or affiliate, the debt issued or guaranteed by the Reference Entity, if issued or modified after March 26, 2022, may be subject to the prohibitions and a US financial institution may not transact or deal in them. These restrictions raise a serious question as to whether the new debt is Transferable and eligible to be Deliverable Obligations.

5 Russia Permits Payments to Foreign Bondholders, but Only With Rubles – Wall Street Journal (March 6, 2022).

If no instrument meets the Deliverable Obligation Characteristic for a CDS, then the CDS may be "orphaned", and the protection buyer may not receive the protection for which it is in dire need. Even if there are Deliverable Obligations, the severe dissipation of liquidity, particularly if more restrictions are imposed under sanctions, may affect the price of the Deliverable Obligations and the settlement process of a CDS.

How will CDS settlement work?

After the occurrence of a Credit Event, standard CDS transactions will be cash settled at a price obtained through an Auction. As part of the Auction, market orders (in the form of physical settlement requests) and limit orders from potential sellers and buyers of Deliverable Obligations are matched to form hypothetical physically-settled CDS trades under which Deliverable Obligations will be delivered in exchanged for payments at the final price of the Auction. The final price, in turn, will be the highest, or lowest as the case may be, price at which all market orders are filled. It is, therefore, essential that Deliverable Obligations be available for the CDS Auction, and participation in the Auction be adequate on both sides of the market.

The US sanctions have made some allowance for wind-down transactions in the otherwise prohibited transactions in debt issued by the Russian Federation or the identified Russian entities within a short window. For example, GL 10A may temporarily permit transactions in the debt of certain entities in a wind-down of derivatives transactions. However, the price at which parties are willing to buy the debt in an Auction would presumably still reflect the short duration of such permission. Indeed parties' willingness to buy these instruments at all may be severely limited as a result of the expansive sanctions.

If demand for the Deliverable Obligations is insufficient in the Auction, the final price could be determined at zero, and protection buyers could receive par payments. Conversely, if insufficient Deliverable Obligations are sold into the Auction, the final price could be 100%, eliminating a buyer's CDS protection. Protection buyers with outstanding Russian sovereign or corporate CDS would therefore presumably endeavour to acquire Deliverable Obligations for delivery into an Auction following a Credit Event, which is highly likely to occur if the sanctions continue apace. If no Auction is held or if an Auction fails to produce a final price, then the fallback settlement method would apply, and protection buyers will need to physically deliver the Deliverable Obligations in exchange for protection payments.

Conclusion

The economic sanctions continue to evolve, as is Russia's voluntary or involuntary response. What is permitted to transfer but illiquid today may be prohibited and illegal tomorrow. It is therefore critical that CDS parties continue to follow new developments in the sanctions regimes and Russia's counter-measures, while at the same time examine the terms of the debt instruments on which possible Failure to Pay, Restructuring or other Credit Events might occur to anticipate the likely scenarios and the potential fallout. A protection buyer who needs to ensure that it does not lose the protection as a result of settlement failure should consider acquiring bonds or loans that satisfy the Deliverable Obligation Characteristics in preparation for settlement.

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