

CROSS SUB-FUNDS INVESTMENT
A NEW WEAPON IN THE ARMOURY OF LUXEMBOURG INVESTMENT FUND LAW

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From early in 2011, a Luxembourg investment vehicle should be allowed to implement cross sub-fund investments, meaning that any of its sub-funds will be able to acquire and hold shares or units issued by another sub-fund within the same investment vehicle. This new feature will offer new pooling opportunities likely to enhance management and operational efficiencies as well as the possibility of setting up *fund of funds* structures within a single legal entity. This paper analyses the conditions and restrictions currently provided for in the draft legislation intended to implement this new feature.

1. *Introduction and concept* – “Cross sub-funds investment” envisages that any sub-fund created within an undertaking for collective investment in the widest sense of the term (“UCI”) with multiple compartments (whether, in Luxembourg, it is a UCITS¹, a Part II UCI², a SIF³ or even a SICAR⁴) may invest in one or more other sub-funds of the same UCI. This would allow a single legal structure within which cross sub-funds investment takes place to subscribe for, acquire and hold its own shares or units. This feature has been permitted for a few years in certain EU countries (such as Ireland), but not, as yet, in Luxembourg.

2. *Current regime* – In view of the conditions and limited circumstances under which the current Luxembourg law on commercial companies authorises a company to

¹ UCI in transferable securities qualifying under either the amended EU directive 85/611/EEC of 20 December 1995 or the EU Directive 2009/65/CE of 13 July 2009 on UCITS.

² UCI governed by either Part II of the Current Law (as defined in paragraph 3) or Part II of the New Law (as defined in paragraph 3).

³ UCI governed by the amended Luxembourg Law of 13 February 2007 relating to specialised investment funds.

⁴ UCI governed by the amended Luxembourg Law of 15 June 2004 relating to the investment company in risk capital (or *société d'investissement en capital à risque*).

subscribe for, acquire and hold its own shares, the CSSF⁵ has consistently taken the position that a sub-fund of a corporate UCI cannot invest in shares issued by an other sub-fund of the same UCI and has consequently refused the implementation of cross sub-funds investment⁶. To ensure a level playing field amongst the different legal forms which UCIs may adopt, the CSSF has taken the position that a common fund or *fonds commun de placement* (“FCP”) should also be prevented from undertaking cross sub-funds investments.

3. *The New Law on UCIs* – Commencing early in 2011, implementation of the new law on undertakings for collective investment (the “**New Law**”) which will emerge from the bill of law Nr 6170⁷ deposited with Luxembourg Parliament on 6 August 2010 (the “**Bill**”) and which is to repeal the current amended Luxembourg Law of 20 December 2002 regarding undertakings for collective investments (the “**Current Law**”), these legal obstacles should be removed and UCIs falling within the scope of the forthcoming New Law should be authorised to undertake cross sub-funds investment, albeit subject to certain conditions and restrictions. It is also expected that SIFs and SICARs should soon, on amendment of the relevant laws governing them, benefit from a similar, yet presumably more flexible, regime.

4. *Introducing the cross sub-funds investment feature* –The New Law, aiming primarily at transposing the so-called UCITS IV Directive⁸ into Luxembourg law, will also introduce a number of other changes to existing Luxembourg investment fund legislation which will affect both UCITS and Part II UCIs. Cross sub-funds investment may arguably be considered the most important and probably the most eagerly awaited change. The purpose of this paper is to describe the conditions and restrictions currently contemplated by the provision introducing this new feature in the Luxembourg legal landscape, namely by Article 181 (8) of the Bill (a free English translation of which may be found at the end of this paper).

⁵ The Luxembourg *Commission de Surveillance du Secteur Financier*.

⁶ Cross subfund investment situations inherited from a foreign UCI which has been redomiciled in Luxembourg has however been accepted by the CSSF.

⁷ The initial Bill deposited on 6 August 2010 has subsequently been slightly amended in the course of the legislative process and all references to specific Articles of the Bill correspond to this revised version of the Bill which is expected to become law, in this form, before the end of 2010. You may access an English translation of this document on our firm's website at www.ehp.lu.

⁸ EU Directive 2009/65/CE of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

5. *Basic restrictions* – As regards the investment limits for cross sub-fund investments, the basic principle is that, for UCITS, the standard UCITS investment rules and limitations apply. Some of these are listed below. The following assumes that **A**, **B**, **C**, etc. are sub-funds belonging to the same corporate or FCP UCITS.

- (i) As per Article 46 (1) of the Bill, Sub-fund **A** can invest no more than 20% of its net assets in each of the sub-funds **B**, **C**, etc.
- (ii) Sub-fund **A** can acquire all the shares or units of each of sub-funds **B**, **C**, etc. provided those shares or units represent no more than 25% of the aggregate number of shares or units issued by the UCITS as a whole.
- (iii) Subject to complying with the limitation set forth under (i) and (ii) above, Sub-fund **A** can invest 100% of its net assets in other sub-funds **B**, **C**, etc. (in this case, at least five of them).
- (iv) According to Article 41 (1)e) last indent and Article 181 (8) of the Bill, aiming at preventing “cascade investments”, Sub-fund **A** cannot invest in sub-fund **B** if sub-fund **B** is permitted to invest more than 10% of its net assets in UCITS and other UCIs.

6. *Additional restrictions and requirements* – In its present form, the Bill imposes some additional restrictions and requirements. Most of these additional restrictions and requirements are not applicable in the case of investments by a sub-fund of a given UCITS in a sub-fund of another UCITS, even if these two UCITS are under common management.

- (a) Article 181(8), 1st indent of the Bill prohibits “circle investments”. In other words, sub-fund **A** may only invest in sub-fund **B** if sub-fund **B** does not invest in sub-fund **A**.
- (b) Article 181 (8), 5th indent of the Bill prohibits the duplication of management fees or “double dipping” as it is sometimes referred to. In this respect cross sub-fund investments are treated differently from investments in sub-funds of separate UCITS where, according to Article 46 (3), 2nd par. of the Bill, double charging of management fees is not prohibited but where there is a compulsory disclosure in the prospectus of the maximum proportion of management fees charged. In our opinion, this is open to challenge not only as a matter of principle, but also because there are cases where duplication of management fees is justified. This is the case for a *fund of funds* structure where additional management fees at the level of the

investing sub-fund remunerate the fund selection and allocation services. According to Article 181(8), 5th indent of the Bill, double charging of subscription and redemption fees likewise is not permitted, but this prohibition applies in any event under the UCITS rules applicable to investments in separate UCITS under common management pursuant to Article 46 (3), 1st par. of the Bill.

- (c) According to Article 181(8), 2nd indent of the Bill, voting rights relating to the acquired sub-fund shares are suspended. According to the commentaries attached to the Bill, acquired sub-fund shares are not accounted for when calculating quorums and, as the case may be, majorities.
- (d) According to Article 181(8), 3rd indent of the Bill, the net asset value of the acquired sub-fund shares or units is not considered for the purpose of the requirement that the capital of a UCITS or a UCI may not become less than the minimum required capital (i.e. currently 1,250,000 euro).
- (e) The CSSF currently takes the view that the power to make cross sub-fund investments must be specifically provided for in the articles of incorporation or the management regulations of the UCITS or the UCI. As a result, any UCITS or UCI that wishes to take advantage of this opportunity will first have to amend its articles of incorporation or management regulations. The CSSF accepts that articles of incorporation or management regulations can be amended to that effect now, in anticipation of the coming into force of the New Law. Possibly, the CSSF might request existing sub-funds who intend to invest across sub-funds to give their investors one month's prior notice during which redemption could be made free of charge.
- (f) There are a number of provisions in the Bill (UCITS and non-UCITS-related) which make it impossible for a UCITS sub-fund to become a feeder sub-fund (as per Chapter 9 of the Bill) of another sub-fund of the same UCITS. This prohibition might prove unfortunate in the future if industry practice were to find this type of intra-fund master/feeder structure useful or necessary. This is all the more regrettable if we consider that, in our opinion, there are arguments for the relevant provisions to be amended to allow intra-fund master/feeder structures, without infringing upon the relevant UCITS IV master/feeder provisions.

7. *Additional restrictions for Part II UCIs* – For UCIs (non-UCITS), the restrictions set forth in (a) to (d) and (f) in paragraph 6 above also apply. In addition, the restriction set forth under (vi) of paragraph 5 above (prohibition of cascade investments) applies. Whereas for UCITS this restriction was unavoidable as it is part of the UCITS rules

imposed by the EU Directive, it is unfortunate that this is included as a restriction in the provisions applicable to UCIs as there may be circumstances where cascade investments, up to a certain level, could be justified. This could typically be the case for an umbrella UCI whose sub-funds operate as *fund of hedge funds* each investing in a different strategy and where an additional sub-fund would be created to invest in the other sub-funds to seek exposure to multiple strategies. As for the other foregoing improvements suggested, we therefore feel that efforts should be made to exclude this restriction, with respect to UCIs, at the next opportunity when the New Law is amended. Adequate safeguards to avoid abuse could be introduced by a CSSF regulation or circular.

8. *Taxation* – Questions have been raised in relation to the applicable rate of the *taxe d'abonnement* (capital duty) at the level of the investing sub-fund or the target sub-fund. In our opinion, to the extent that the target sub-fund is not exempt of *taxe d'abonnement*, investment in this target sub-fund should be exempt from the *taxe d'abonnement* at the level of the investing sub-fund (as per Article 175 a) of the Bill), whereas the target sub-fund may, where appropriate, consider the investing fund as an institutional investor (which are eligible to have the benefit of the reduced rate of 1 bp as per Article 174 (2) c) of the Bill). From a more general perspective, it is interesting to point out that, contrary to the Current Law's language (which gives room of interpretation to conclude that an investing fund is exempted even if the Luxembourg invested fund is itself exempt of *taxe d'abonnement*), the language of the Bill is such (it only exempts units subject to the *taxe d'abonnement* provided for in Article 174 of the Bill) that the exemption of Article 175 a) of the Bill only applies if the invested fund is at least subject to a *taxe d'abonnement* of 1bp. Otherwise, if the investing fund does not fall within scope of another exemption of Article 175 of the Bill or of the reduced rate of 1 bp under Article 174 (2) of the Bill, it shall be subject to the ordinary rate of 5bp set forth under Article 174 (1) of the Bill.

9. *Entry into force* – Provided the articles of incorporation or management regulations of the relevant UCI contain the relevant provisions and the prospectus has been amended accordingly, cross sub-fund investments will be permitted from the date on which the New Law comes into effect, which is expected to be 1 January 2011.

10. *Conclusion* – The introduction of the cross sub-funds investment feature into the Luxembourg legal landscape is eagerly awaited by the fund industry as it gives various new pooling opportunities which create investment management and operational efficiencies. Indeed it may be used to replace complex intra-pooling techniques and facilitate cash management by all sub-funds of a UCI investing its ancillary cash in one sub-fund of the structure specially designed to that effect. It will also permit the

creation, within the same UCI, of sub-funds with *fund of funds* investment policies which may invest in other sub-funds of the same UCI, whereas prior to this fund promoters would have needed two separate legal entities for their traditional funds and their *fund of funds*.

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Article 181 (8) of the Bill

A sub-fund of a UCI may, subject to the conditions provided for in the management regulations or the constitutional documents as well as in the prospectus, subscribe for, acquire and/or hold securities to be issued or issued by one or more sub-funds of the same UCI without that UCI being subject to the requirements of the Law of 10 August 1915 on commercial companies, as amended, when it is constituted in corporate form, with respect to the subscription, acquisition and/or the holding by a company of its own shares, under the conditions, however, that:

- the target sub-fund does not, in turn, invest in the sub-fund invested in this target sub-fund; and
- no more than 10% of the assets that the target sub-funds whose acquisition is contemplated may be invested pursuant to their management regulations or their constitutional documents in units of other UCIs; and
- voting rights, if any, attaching to the relevant securities are suspended for as long as they are held by the sub-fund concerned and without prejudice to the appropriate processing in the accounts and the periodic reports; and
- in any event, for as long as these securities are held by the UCI, their value will not be taken into consideration for the calculation of the net assets of the UCI for the purposes of verifying the minimum threshold of the net assets imposed by this Law; and
- there is no duplication of management/subscription or repurchase fees between the fees of the sub-fund of the UCI having invested in the target sub-fund and the target sub-fund.