Investment management

Equilibrium in the operating models of Luxembourg management companies

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Asset management has changed considerably over the past years and is progressively recovering since the financial and economic crisis that severely impacted the global economy back in 2008.

The wait-out position defensively adopted by investors since the very beginning of the crisis caused, among other consequences, a decrease in tax revenues in all jurisdictions. Consequently, supranational institutions, governments and regulators had no choice but to respond with strong measures aimed at reinstalling a higher level of confidence that the market needed to get capital flows circulating again.

Historical background and context

Investor protection has always been a priority for legislators, regulators and investors, since confidence is, in essence, a key driver in the investment management industry. And Luxembourg did not miss this opportunity.

Since the very first UCITS Directive, dating back to the late 80s, the UCITS regulatory framework has set the gold standard in terms of investor protection by defining types of eligible assets, investment diversification requirements, risk management, monitoring and supervision of delegates, asset protection and transparency requirements in relation to investors.

This regulatory framework also paved the way for cross-border distribution of UCITS funds throughout the European Union.

While UCITS Directives set the standards, they needed to be transposed into national laws and allow the Member States some degree of flexibility in designing these. Luxembourg seized this opportunity at a very early stage and, thanks to this foresight, nowadays, Luxembourg has the most advanced and versatile set of laws governing regulated investment funds.

Figure 1: Funds, sub-funds and net assets

End of period	TOTAL			OF WHICH		
	Number of funds[1]	Number of fund units[4]	Net Assets (€ millions)	Number of umbrella funds[2]	Number of sub-funds[3]	Net assets of umbrella funds (€ millions)
2005	2,060	8 497	1,525,208	1,298	7,735	1,341,411
2006	2,238	9 473	1,844,850	1,387	8,622	1,639,559
2007	2,868	11 115	2,059,395	1,688	9,935	1,812,442
2008	3,371	12 325	1,559,653	2,019	10,973	1,349,898
2009	3,463	12 232	1,840,993	2,108	10,877	1,628,125
2010	3,667	12 937	2,198,994	2,302	11,572	1,979,524
2011	3,845	13 294	2,096,512	2,427	11,876	1,881,506
2012	3,841	13 420	2,383,826	2,462	12,041	2,155,437
2013	3,902	13 685	2,615,363	2,529	12,312	2,384,349
2014	3,905	13 849	3,094,987	2,538	12,482	2,845,114
Jan 2015	3,885	13,864	3,277,013	2,521	12,500	3,017,822
Feb 2015	3,893	13,902	3,403,866	2,524	12,533	3,138,666
Mar 2015	3,888	13,910	3,524,793	2,523	12,545	3,250,443

(4)=(1) - (2) + (3)

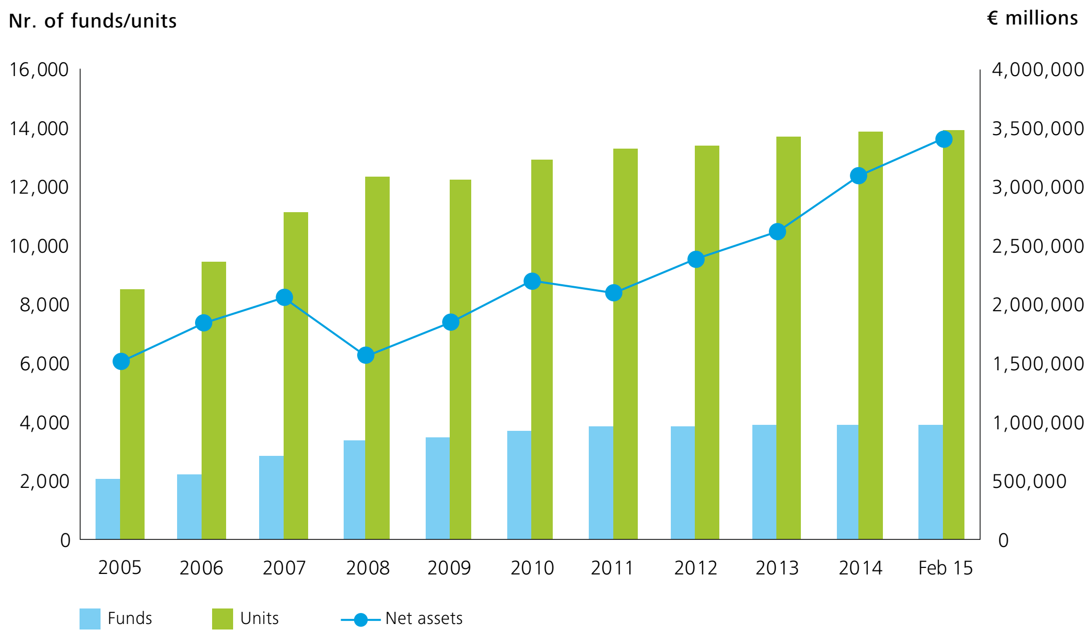
Source: CSSF

On top of this important legal framework, the Luxembourg regulator (*"Commission de Surveillance du Secteur Financier"* or *"CSSF"*) plays a key role as part of its prudential supervision prerogatives, safeguarding the quality and stability of the Luxembourg financial sector. The CSSF issues additional binding memos (Circulars) and actively supervises regulated entities, collects and analyses data and conducts on-site inspections.

As a consequence, the investment management industry (both for UCITS and AIFs) has been very successful in Luxembourg over the last decade.

While UCITS Directives set the standards, they needed to be transposed into national laws and allow the Member States some degree of flexibility in designing those

Figure 2: Evolution of the investment management industry (2005 - 2015)



Source: CSSF

Investment management – Luxembourg operating model

Luxembourg has clearly established itself as the domicile of choice for investment funds. The core element of a fund setup is the Luxembourg management company, and it is important to understand its operating model and core functions, which essentially cover:

- Investment management (the definition of the investment strategy and the day-to-day management of the fund)
- Pricing and valuation of assets
- Regulatory compliance monitoring
- Maintenance of the register of investors, distribution of income and processing of share issues and redemptions
- Distribution, sales, marketing or fund raising
- Conducting initial and ongoing due diligence on entities to which functions of the management company have been outsourced
- Ensuring risk management, permanent compliance and an internal audit function

The management company may also render some ancillary services to other group entities.

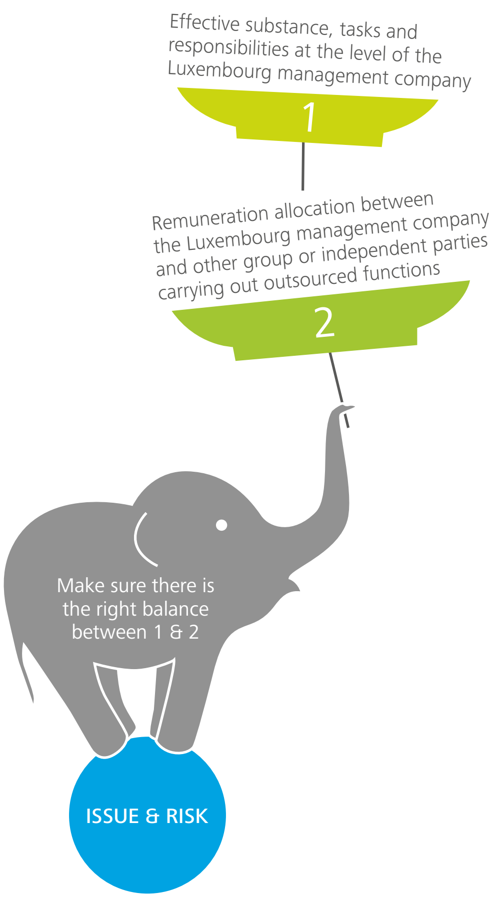
As a common feature, most Luxembourg management companies follow a semi- or fully decentralized operating model, whereby some core functions are outsourced to related entities within their group or to third parties. On the contrary, supervision and control are functions which can never be outsourced by a Luxembourg management company.

In terms of risks, the management company remains responsible and as such is exposed to liability risk even if core functions are outsourced. Accordingly, it is legally required and in the interest of the management company to supervise and perform due diligence on these outsourced functions.

In the past, a Luxembourg management company which had outsourced core functions (while keeping risk management, supervision and control at its level) was sometimes mistakenly not recognized as adding real value given its functional profile, and thus had little weight in the distribution of revenues derived from the investment management activity. However, this point of view is at odds with Luxembourg Law and regulatory prerequisites that require incremental substance and resources at the level of the management company itself, in line with the activities covered by the management company. For this reason, a Luxembourg management company must not only play its role, but also be remunerated proportionally to the functions, resources and risks it is liable for in Luxembourg.

Issue & risk

Consequently, it is of utmost importance to make sure there is the right balance between:



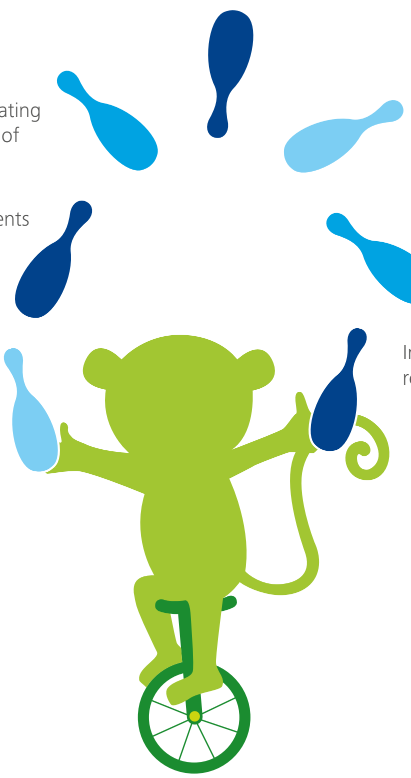
Actually, the right balance may be derived from three different categories of requirements, which are highly interactive with each other:

Regulatory requirements
Substance as well as organizational requirements impacting Luxembourg management companies are strengthened following the implementation of CSSF circular 12/546 and the AIFM directive. Further requirements are expected with forthcoming additional regulations (UCITS V, ESMA guidelines on compliance function, MiFID II).

Regulatory requirements are highly integrated with transfer pricing since the substance required within the operating model of a Luxembourg management company cannot be in breach of the transfer pricing considerations set out below.

A management company is remunerated by means of the fee received from the fund to cover all the core functions it carries out

The key regulatory requirements as of today can be summarized as follows:



Transfer pricing

Each of the activities involved in the investment management value chain within a group gives rise to transfer pricing. A management company is remunerated by means of the fee received from the fund to cover all the core functions it carries out.

In case functions are outsourced to group parties, these should be remunerated in turn by the management company on an arm's length basis as independant parties would have agreed upon in similar circumstances. Therefore, it is essential to have a clear view of the functional profile at stake, i.e. the functions, assets (to be understood as the resources used to run the business such as experience and knowledgeable staff, conducting officers for example), and risks respectively shared by the management company and these parties in proportion to their contribution to the overall value creation process.

In terms of transfer pricing documentation, article 171 (3) of the Luxembourg income tax law as amended as from 1 January 2015 clarifies that any Luxembourg taxpayer carrying out intragroup transactions must be able to deliver, upon request, the appropriate transfer pricing documentation (e.g. transfer pricing report) demonstrating that remuneration applied to related party transactions (e.g. outsourced services) are arm’s length transactions.

Tax

The tax debate around the substance required within operating models of Luxembourg management companies is twofold, since both direct tax and VAT need to be considered.

Direct tax

With respect to the relationship with other countries, in case the required substance and transfer pricing principles would not be consistently met in Luxembourg (as it would be the case if a function would not be supported by the relevant level of substance or if it would not be properly remunerated), there is a risk that foreign authorities would simply deny the existence of the Luxembourg management company and consider that:

- The investment funds are effectively managed in another jurisdiction
- The commission flows between the funds and the parties involved in their management would be fully taxed in this jurisdiction without recognizing value-added at the level of the management company

Hence, Luxembourg management companies must ensure that:

- The substance, functional profile and remuneration are correlated
- The transfer pricing documentation requirements are respected in order to be able to respond to enquiries made by Luxembourg or foreign tax authorities and avoid a direct tax adjustment in case the remuneration is not at arm’s length

Taking all efforts to reach upfront compliance with transfer pricing shall provide a valuable comfort to the management company regarding the level of taxable income.

VAT

A clear understanding of the functions and flows may also have VAT implications, such as supporting the benefit of a VAT exemption on management services rendered to the investment vehicles eligible to such a VAT exemption, thereby also helping to manage the VAT position and potential VAT costs of the management companies.

As the management companies and the funds cannot (or only to a small extent) recover any input VAT paid to their suppliers, the operating model driven by economic constraints, regulatory requirements and transfer pricing policies must also be set up and considered in light of the potential VAT implications, which need to be carefully managed.

Effectively, although the VAT Directive implemented in the 28 EU Member States stipulates that the "management of special investment funds" is VAT exempt, slight substantial differences of interpretation between Member States sometimes remain in respect of either the "VAT" meaning of "management" of funds or the definition of the eligible investment vehicles to such VAT exemptions.

It is therefore important that the various functions outsourced by the management companies to affiliated entities or any third party entities are well defined and documented to sustain the benefit of a VAT exemption when the final recipient is an investment vehicle eligible for such an exemption in the country where the fund is located.

VAT-awareness is increasingly crucial in a cross-border environment where, as mentioned above, the VAT rules can be interpreted slightly differently and where the various entities located in different EU Member States have to deal locally with their local VAT reporting requirements. Specifically, this entails completing the European sales lists for intra-community services only when the latter are taxable in the country of the recipient, or to decide to what extent the corresponding turnover impacts, positively or negatively, their own right to recover the corresponding input VAT paid to their suppliers.

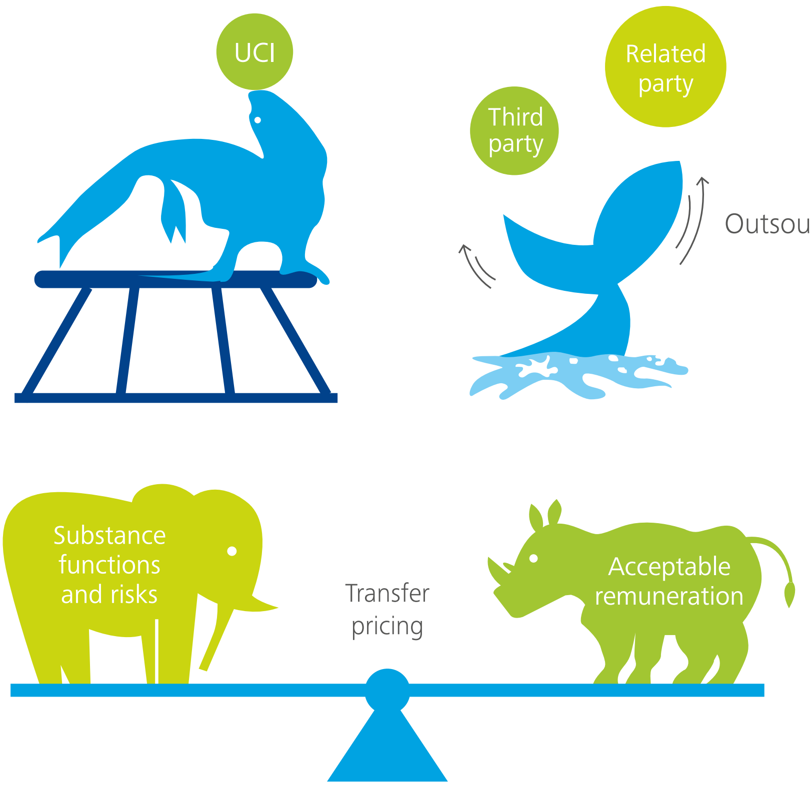
Even in the case where the affiliated entities would have to deal with VAT taxable services such as pure technical functions like IT support functions, it is recommended to identify these services and their corresponding considerations in advance, to plan the respective VAT liability in each entity that could impact a budget, a margin or any expense ratio.

Based on the above, any change within the functions justified for regulatory or transfer pricing reasons could imply VAT consequences that would have to be anticipated in advance or at the same time, in any case before the implementation of any new operating model within the management company structure.

Ask yourself the right questions:

Regulatory requirements	Transfer pricing	Tax
• What will be the key impacts of the incompatibility regime on the organizational structure? • How to ensure that Human Resources meet the new qualification requirements? • How to review the delegation and sub-delegation models with regards to reporting, due diligence and supervision? • How to address stringent requirements on the sharing of resources at the management company level (experience, knowledge, availability, etc.)? • What are the proportionality conditions on derogations to substance requirements? • How to anticipate the sanction regime under UCITS V and strengthen your control framework and oversight?	• Are there intragroup transactions in your structure that will raise transfer pricing issues? • Is the remuneration applied at arm's length? • What risks is your institution facing if it is non-compliant with transfer pricing rules or documentation? • Is your (existing) group transfer pricing policy compliant with the Luxembourg law? • How to ensure that the current distribution model remuneration is sustainable tax-wise and compliant with transfer pricing regulations applicable in Luxembourg and abroad?	• Are you ready today to address and proactively respond to a request from tax authorities on transfer pricing? • Are relevant service agreements drafted appropriately so as to support the benefit of a VAT exemption when justified? • Is the current fee structuring appropriately anticipated on the VAT side?

Figure 3: ManCo operating model, keep the balance right



Conclusion

Regulatory requirements as well as transfer pricing rules are requiring taxpayers to align the level of their remuneration with the substance within their operating model.

Substance and transfer pricing have thus become a top priority for jurisdictions since they help ascertain tax positions of both administration and taxpayers locally (and indirectly on a cross-border scale) based on a fair and acceptable allocation of revenues on an intragroup basis.

We truly believe that actively anticipating the regulatory, transfer pricing and tax challenges within each specific operating model today will give a clear and positive message to the market and to investors, by reinforcing Luxembourg's reputation as a stable place for growth within the investment management industry.

After all, this is a matter of equilibrium!