Institut Luxembourgeois
des Administrateurs

Luxembourg Fund Governance Survey 2016

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Foreword

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On behalf of PwC and the Institut Luxembourgeois des Administrateurs (ILA), we are pleased to introduce this year's Luxembourg Fund Governance Survey.

In this, our eighth edition, we benefit from the insights of more than 120 investment fund groups, across both retail and alternative markets, making this the broadest representative assessment of fund governance in Luxembourg to date. This record number of participants evidences the increasing focus on governance matters across market participants.

Our industry continues to face significant intensification of regulatory oversight and scrutiny, and with the AIFM Directive now fully implemented, we observe a convergence towards the same levels of investor protection, transparency and reporting requirements within UCITS and AIF markets.

Fund governance continues to be a priority for the Luxembourg fund industry. However, governance comprises much more than observance of the law. As this year's survey demonstrates, good governance is not simply a compliance exercise but is reliant on sound decision-making and the exercise of good judgment in all areas of responsibility.

As one of the world's leading international investment fund centers, Luxembourg has been at the forefront of embracing sound fund governance practice. In addition to early adoption of regulation, Luxembourg is active in providing practical guidance as evidenced by the numerous publications from ILA and ALFI. This survey demonstrates a consolidation of good governance practices observed in our previous edition.

Our aim, in preparing this survey, is to provide boards with insights as to current best practices and to further strengthen the overall governance framework surrounding the investment fund industry in Luxembourg.

In conclusion, we would like to thank all the respondents who have participated in this survey, the members of the ILA Fund Committee who devoted a significant amount of time and effort to design the survey and analyse its results, as well as my colleagues from PwC Luxembourg's Market Research Centre who provided their support.

We hope you find the contents valuable.

Nathalie Dogniez,
ILA Fund Committee Chairman
PwC Luxembourg Partner and European Asset Management Regulatory Leader

Michael Delano,
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Introduction

About the 2016 Survey

This year's Luxembourg Fund Governance Survey reflects the results of a survey undertaken jointly by PwC and ILA between July to September 2016.

The current edition is the eighth in our series and it is our broadest and most comprehensive survey to date. The number of participants is 50 percent higher than our last survey, in 2014, highlighting the greater focus placed on governance in the fund industry.

This bigger sample rendered comparisons with our 2014 survey difficult. However we believe it also means we achieved a more representative picture of the industry as our sample includes recently formed AIFMs[1], as well as a larger number of middle sized management companies and investment funds (with Assets under Management in the EUR 10-50 billion range), and promoters with a more diverse geographic reach (US, UK, mainland Europe and Asia). Consequently, we better capture how governance is approached and implemented in Luxembourg.

Highlights and key trends from the 2016 survey include:

- Demise of the self-managed SICAV: only one respondent fell under this category this year, as opposed to eight in our last survey.
- New Super-ManCos and AIFMs have been formed: these new management companies have been set under current AIFM regulations and usually under best-in-class latest governance practices.
- Greater emphasis is being placed on diversity at the board level, in particular in the areas of business experience and skills, gender, and independence. We note that UCITS V[2] will also have an impact on some board compositions, however it was too early to capture its impact in this year's survey.
- Increased attention is being paid to corporate governance, with more industry stakeholders participating in the survey this year.
- Digitalisation as a part of business strategy, and cybersecurity as a risk management issue, are increasingly on the watch list of boards. These are likely to have a greater impact on the behaviour and conduct of fund managers and investors going forward.

General market information

Luxembourg is Europe's largest fund centre, second only to the US, with more than EUR 3.6 trillion AUM, and is recognised worldwide for its leading position in the UCITS fund industry. It is the largest cross-border investment funds distribution centre in Europe, with Luxembourg funds offered in more than 70 countries.

[1] Alternative Investment Fund Managers

[2] Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions

Luxembourg's position as a funds domicile began almost three decades ago with its early adoption and vigorous embrace of the UCITS framework, which has contributed to the creation of a pan-European and international distribution hub; today, Luxembourg accounts for 67% of worldwide authorisations for cross-border fund distribution. This preeminent position has resulted in a robust ecosystem of service providers that support complex internationally invested and distributed funds.

Traditionally, Luxembourg's success has been powered by its ability to serve as a platform for retail funds to be distributed throughout Europe and the world. Luxembourg's UCITS investment funds have a dominant share in both the retail and the institutional marketplace in Europe, and are the vehicle of choice in many parts of Asia, Latin America and the Middle East. Moreover, it continues to increase its international reach, signing agreements with overseas jurisdictions. In 2016, the Association of the Luxembourg Fund Industry (ALFI) successfully negotiated an agreement with Australian authorities, which will enable Australia's institutional investors, including superannuation funds, to gain easier access to Luxembourg UCITS.

Luxembourg is also a leading centre for alternative asset classes such as hedge funds, private equity, real estate, private debt/loans and infrastructure, among others. About EUR 569 billion of assets in Luxembourg funds are managed by alternative fund managers.

Luxembourg maintains a strong focus on custody, fund accounting and transfer agent functions, helping to make it an attractive platform for investment funds distributed locally and globally. Governance requirements introduced in recent regulations, together with new tools, have broadened the expertise of local service providers and management companies in areas such as global distribution, risk management and compliance.

Luxembourg's specialisation in complex and sophisticated administrative tasks throughout the asset management process gives it a competitive advantage. The fund centre's leading position continues to be reinforced as new regulations affecting retail and alternative funds come into force in Europe and are swiftly implemented in Luxembourg law and practice. In December 2015 the European Long-Term Investment Fund (ELTIF) entered into force at European level, while in July 2016 the Luxembourg government introduced a new vehicle for alternative investments called the Reserved Alternative Investment Fund (RAIF). These will continue to broaden the range of vehicles available to international promoters looking to market their funds to a variety of institutional, sophisticated and retail investors. Our survey does not yet capture governance practice within those funds, however we hope to include them in our next survey.

Our sample

Our 2016 survey consists of information gleaned from 124 respondents who answered the survey on behalf of boards of management companies or funds, and represents a 50% increase over the 2014 survey, which had 82 participants. The respondents, who serve in the capacity of board members, chairmen of the board, conducting officers or company secretaries, all have first-hand knowledge of the governance practices at their management companies and funds.

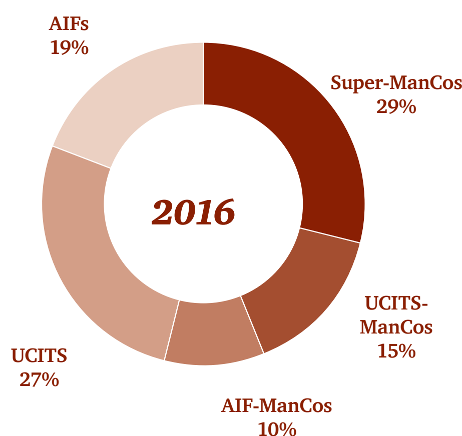
The survey population is representative of investment fund promoters drawn from 20 different nations of origin (as opposed to 15 nations in 2014) and three continents, North America, Europe and Asia.

Our survey once again encapsulates a majority of the UCITS industry, representing more than half of the assets under management in UCITS funds domiciled in Luxembourg. It also captures more than 25% of the assets of Luxembourg-domiciled AIFs[3], an increase from 20% captured in 2014.

Respondents fell into five separate categories (as was the case in 2014):

- Super-ManCos[4] (large management companies overseeing both UCITS and AIFs);
- UCITS-ManCos[5] (management companies overseeing mainstream UCITS funds only);
- AIF-ManCos[6] (management companies overseeing AIFs only; usually these are smaller but more recent entities);
- UCITS[7];
- AIFs[8].

Figure 1: Sample composition, by respondent type



In the report, we use the term "management companies" to refer to Super-ManCos, UCITS-ManCos and AIF-ManCos on a combined basis and we use the term "funds" to refer to UCITS and AIFs combined as well.

This year's survey covers a variety of alternative asset classes - including real estate, hedge fund, private equity, private debt/loans and infrastructure - in addition to covering the traditional UCITS classes - equity, fixed income, money market, and balanced funds.

Roughly a quarter (26%) of the funds in the sample have appointed a cross-border management company (i.e. a management company managing funds established in another country), and more than two-fifths (43%) of Super-ManCos operate as cross-border management companies (see Figure 2a and Figure 2b.)

Figure 2a: Are you a cross-border management company?

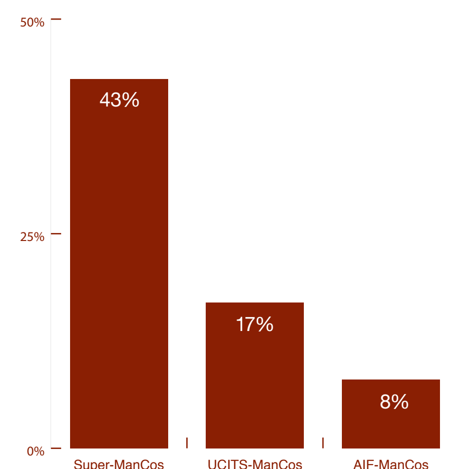
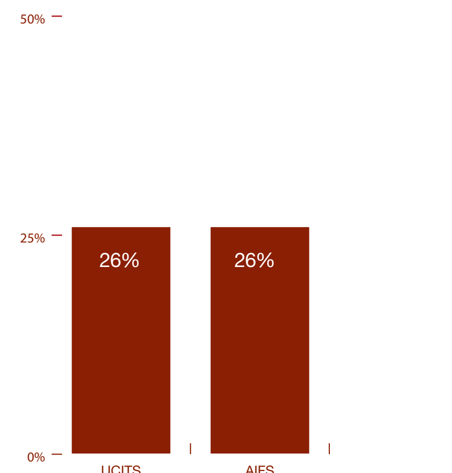


Figure 2b: Have you appointed a cross-border management company?



[3] Alternative Investment Funds
[4] Regulated under both regimes described in 5 and 6 below
[5] Regulated under Chapter 15 of the Law of 17 December 2010
[6] Regulated under Chapter 16 of the Law of 17 December 2010 or under Chapter 2 of the Law of 12 July 2013 transposing the AIF Directive into Luxembourg law
[7] Undertakings for Collective Investment in Transferable Securities; those funds regulated under the Law of 17 December 2010 transposing Directive 2009/65/EC relating to Undertakings for collective investment in transferable securities (UCITS)
[8] Alternative Investment Funds; those funds that are not covered by European Directive 2009/65/EC

Breakdown of survey areas

The survey is divided into seven sections, allowing us to go into greater depth in key areas of board governance, which are of growing importance to funds in Luxembourg and throughout the world:

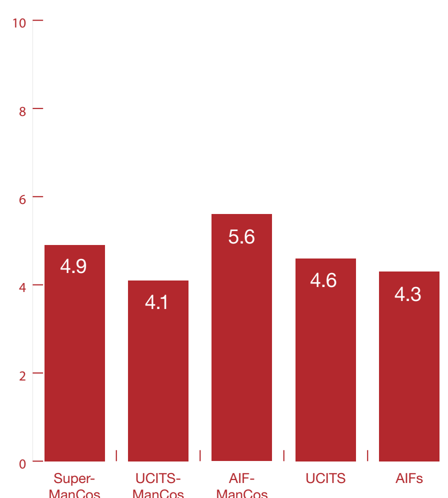
- *Board composition* focuses on the profile of board members, dealing with such matters as independence, expertise, tenure, age, gender and place of residence, as well as appointment procedures.
- *Board organisation* presents the survey data on the more practical aspects of board sessions, such as location, attendance, duration of meetings, agenda, use of circular resolutions, invitation of non-board members, existence of committees, and remuneration of board members.
- *Roles and responsibilities of the board* focuses on key issues in the internal processes of the board, such as management style, performance evaluation, relationship with the conducting officers, ensuring quality and efficiency of service providers, hiring new board members, and providing continuing education to board members.
- *Conflicts of interest and legal liabilities* tackles the management of conflicts of interest and mitigation of directors' liabilities.
- *Code of conduct* is an area of critical importance to investors, and is central to governance. The section examines the adoption of the ALFI code of conduct and board compliance with their adopted framework of principles and best-practice recommendations.
- *Board oversight* studies the various ways boards exercise their responsibilities with regards to investment management, expenses, risk management and distribution.
- *Looking forward* takes into account the implications of the recent regulations and the areas that will require most attention from the board over the next two years.

Board Composition

Appropriate board composition is a critical first step towards good governance. As a best practice, the composition of the board should be balanced, not only in such areas as age and gender, but also in terms of expertise, tenure and geography.

Board membership increasingly is a role that calls for a commitment of significant time and energy. Directors must bring a focus and not be distracted by other, competing responsibilities. In choosing a member, it is important therefore that the board take into consideration a director's serving on multiple boards and having competing commitments.

Figure 3: How many board members does the board have including the chairman?



Board size

While no one size fits all, it is important that boards be big enough to allow for a range of perspectives and also be able to manage the various required board processes. At the same time, boards should never be so large as to hinder open discussion among its members, especially in the absence of formal committees.

On average, Luxembourg fund and management company boards have four to six members, including the chairman, a range that is consistent with past surveys. The AIF-ManCo boards tend to have more members (the largest board has 12 directors and is active in the real estate world). The legal minimum in Luxembourg is three board members.

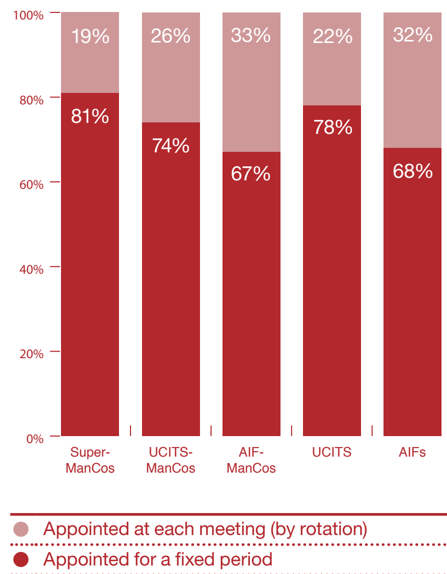
Chairman appointment

The appointment of a board chair is increasingly seen as a key step in establishing the tone at the top. The board chair provides leadership to the board and establishes the tone and approach for the entire board. He or she harnesses the energies and talents of the other board members. While in the past, funds and management companies often rotated the chair role among all the members of the board and hence approached it in terms of simply chairing the board meetings, funds and management companies are increasingly abandoning that approach and are more often appointing a permanent board chair.

A permanent chair is a way to ensure real leadership of the board and is seen as an essential component of good governance. The chair ideally should be someone who brings energy and leadership to the board as a whole – not only chairing meetings, but also being the main point of board contact and coordination outside of the regularly scheduled meetings. He or she is involved in formulating the goals of the board, efficiently and proactively managing meetings, setting the meeting agendas, steering discussions and making certain that the conclusions are reached in a timely and transparent manner, as well as ensure follow-up between meetings.

We found that an overwhelming majority of Super-ManCos, UCITS-ManCos and UCITS now appoint a permanent chair, as opposed to rotating the role. That is not quite the case among alternative funds, where about one-third still adhere to the rotational approach. In future we expect practice to converge towards appointing a permanent chair in line with best governance practices.

Figure 4: Is the chairman's position appointed for a fixed period or appointed at each meeting?



Appointed at each meeting (by rotation)

Appointed for a fixed period

Independent non-executive directors

Investors and regulators alike are paying more attention to board composition – and especially to the practice of retaining independent/non-executive directors as a sign of good governance. Although a majority of the directors continue to be employed by the fund promoters, a definite trend in the direction of independent directors is emerging.

That said, we find a greater ratio of independent/non-executive board members at the fund level (that is, within UCITS and AIFs) than at management company level. This most likely is reflective of a reluctance on the part of the headquarters/promoter to add independent directors to the boards of their "inside" corporate entities.

We expect the number of independent board members to continue to increase, in line with the spirit of the ALFI code of conduct and certain regulatory requirements.

Figure 5: Proportion of chairmen with the following employment status

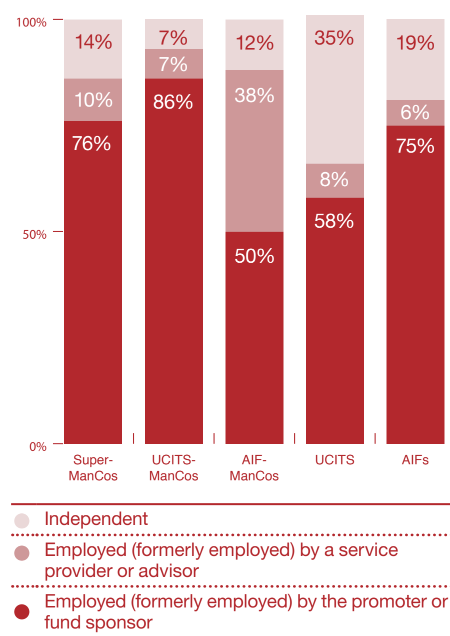
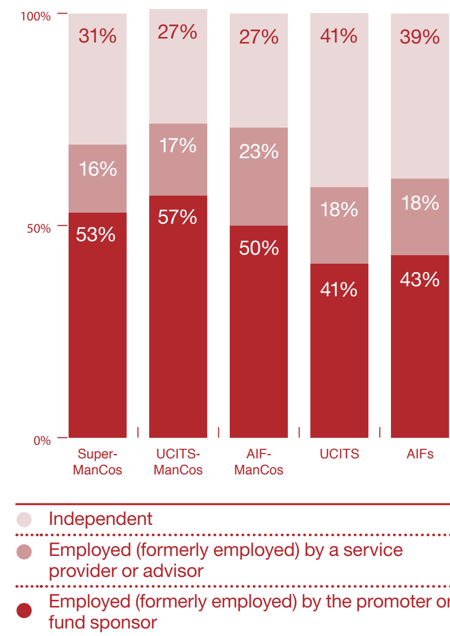


Figure 6: Proportion of board members with the following employment status



Note: this year, we have considered only those chairmen appointed for a fixed period in order to analyse the chairman's employment status. Chairmen appointed by rotation at the time of the survey completion are integrated within figure 6.

Collective expertise of the board

It is important that board members, in addition to being of high professional standing and ethical standards, have experience and expertise suited to their role so that as a unit they fulfill their responsibilities to the investors. That is one reason why boards should be balanced: to allow the group to make informed and considered decisions in the areas in which their responsibility falls.

We find that board members collectively tend to possess a depth and range of experience in such areas as investment management, distribution, risk management, compliance, legal, fund administration, custodian, product and fund governance.

Within AIF funds, it is noteworthy that the proportion of chairmen with investment management expertise is very high (80%), reflecting the fact that most chairmen of AIFs are fund promoter representatives with specialised investment management focus. However the overall ratio of respondents with finance/accounting skills is relatively low. Given the additional responsibilities attached to the board under the EU Audit Reform, this is an area where we expect boards to collectively gain additional expertise in the future.

Looking forward, we also expect boards to seek adequate expertise in new emerging areas of risk, such as digitalisation and cybersecurity. Some promoters in Luxembourg are already thinking about attracting those requisite skills and background as they look towards selecting new board members.

Figure 7: What are the main areas of expertise of the chairman and the board members?

	Chairman					*Board members*				
	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
Investment management	41%	50%	38%	36%	80%	18%	17%	18%	22%	16%
Distribution	28%	14%	12%	32%	33%	16%	16%	12%	14%	15%
Risk management	3%	14%	12%	16%	40%	19%	22%	16%	18%	16%
Compliance	10%	14%	12%	20%	7%	13%	16%	16%	10%	17%
Legal	3%	21%	-	32%	13%	14%	16%	16%	15%	12%
Fund administration/Operations	34%	57%	12%	36%	27%	17%	17%	20%	21%	20%
Custodian	17%	21%	12%	8%	7%	10%	10%	12%	7%	7%
Finance/Accounting	10%	21%	38%	20%	13%	19%	17%	20%	11%	16%
CEO/Managing director	59%	21%	62%	20%	40%	13%	17%	10%	10%	6%
Fund governance/Professional director	21%	14%	12%	36%	-	12%	21%	14%	19%	16%
Other	3%	-	12%	4%	-	3%	2%	8%	2%	2%

Multiple choice question. A maximum of three areas of expertise could be selected for each board member. The “Other” category was opened to suggestions and includes “Product innovation/management”, “Sales”, “Audit”, “Fund trading”, “Banking/bank relationship” and “Microfinance”.

Appointment procedures

The majority of boards do not have a set of formal written procedures for appointing new board members that seek to achieve a diverse blend of experience and skills; nor do the majority have formal guidelines on members' roles and responsibilities. Indeed, most of the funds surveyed have no plans of introducing a formal process. The process of selecting a board member is nevertheless an important undertaking and calls for a professional approach.

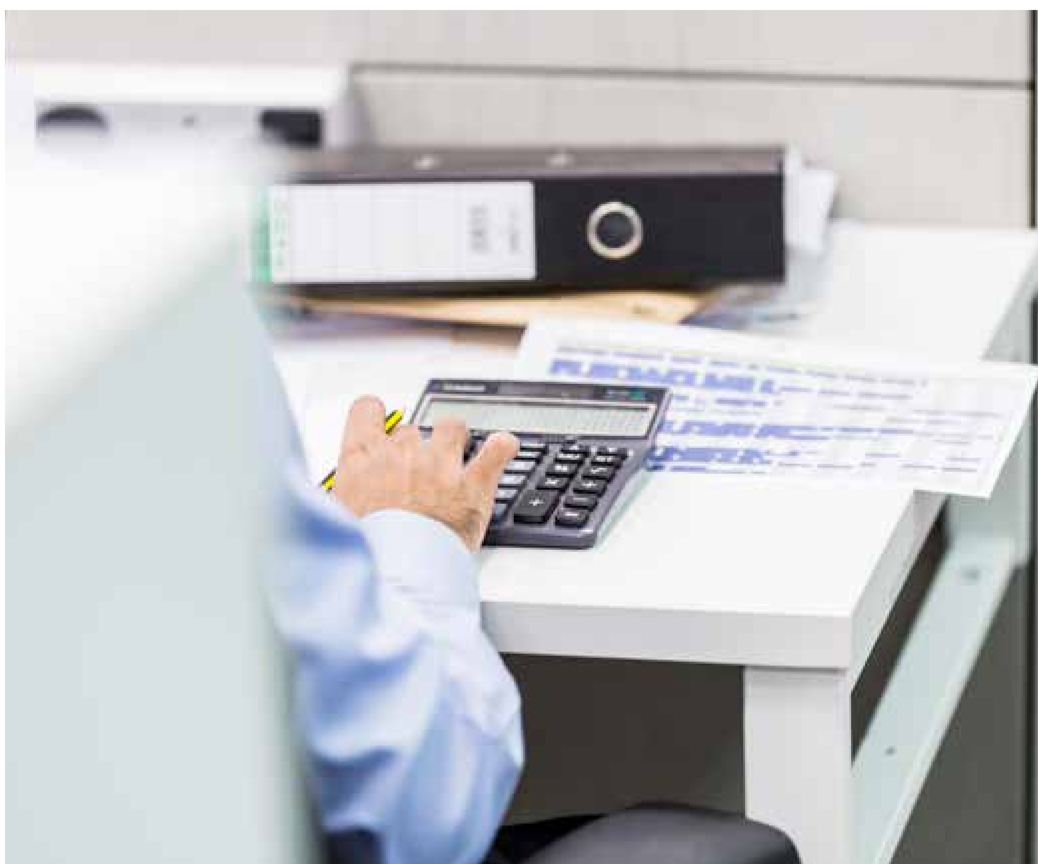
That said, such formal procedures often exist at the level of the promoter/head office. And the ALFI code of conduct recommends boards to think about good governance practice when appointing new members so as to ensure board diversity in such areas as specialised skills, geographical location, gender and other areas.

However, we find noteworthy the growing trend for independent directors to have written terms of appointment. In our 2010 survey only 32% of UCITS boards had written terms of appointment for independent directors. In the 2016 survey, that number more than doubled: 72% of UCITS boards have them. A large majority of boards have processes in place that allow directors to gain an understanding of the promoter group, management company, and the funds managed. This educational process takes place at various stages (prior to appointment, upon appointment and throughout their term).

Directors serving both at management company level and fund level

In order to minimise the potential for conflicts of interests, the regulator now requires that a majority of directors not be on both the board of the management company and the board of the fund.

This is designed to ensure minimal overlap of board members – and better governance. However, there are still a number of legacy boards in Luxembourg where an overlap exists. The survey shows that the number of directors who sit at both levels is on the decline: in the previous survey, there were an average 4.7 Super-ManCo directors sitting at both levels; this year, that number was cut practically in half, to 2.4.



Board diversity

Our survey finds that the average age of board members in Luxembourg is 50, both within management companies and funds, which is not significantly changed from 2014.

Chairmen of management companies have an average tenure of a little more than 7 years, while the chairmen of funds have tenures of about 5 years. Board members at management companies have shorter tenures, ranging from 5.5 to 6.5 years, while board members of funds have an average tenure of 5 years, respectively.

Tenure figures have decreased since our 2014 survey, but we believe this is due in part to the launch of new entities having brought down the average tenure length. There is no reason to think that this is the result of an effort to implement term limits for chairmen or directors. Indeed, most boards (more than 80%) do not have a term limit for directors. And those funds that do have term limits almost always use the length of service as opposed to age.

Regulators are pushing for greater board diversity and the inclusion of more independent directors to achieve good governance. The European Union has issued recommendations on the role of independent/non-executive directors, stating that after 12 years sitting on the board, the independent director should no longer be considered independent. However, these are only recommendations, and there is no definition of independent directors in the Luxembourg mutual fund regulation or in the ALFI code of conduct (except the UCITS V requirements to appoint independent board members when both the management company and the custodian belong to the same group).

Increasing representation of women on boards has also been the goal of corporations everywhere, but progress, while being made, has been slow. We find 14% of board members are female in this survey, a slight increase from 2014.

To put this figure in perspective, the European Commission's database on women and men in key-decision making positions indicates that 23% of board members of publicly listed companies are female within EU-28, versus 13% in Luxembourg. In 2012, the Commission proposed a new Directive brought forward by Vice-President Viviane Reding which would set an objective of a 40% presence of women among non-executive directors on the boards of publicly listed companies. This proposal is still under discussion.

Clearly, much work remains to be done in terms of board diversity. Various regulations in Luxembourg and Europe, as well as institutional investors' initiatives, are seeking to improve governance on boards and are increasingly asking for more information on board diversity.

Publicly available information on directors

Fund investors are increasingly interested in transparency in all aspects of governance, including information about a fund's directors. Luxembourg-based funds tend to take a minimalist approach regarding information concerning directors: most often the information includes the name and job title. With AIF board directors, there is often a short bio being published, in line with practice in the US and UK. We would expect to see a greater emphasis on transparency and information in the future: specifically, funds should go into greater detail on the skills and expertise brought by each director, especially given the emphasis on board composition and diversity.

Figure 8: Information on directors provided in publicly available fund documentation (prospectus, annual report, etc.)

Information provided	UCITS	AIFs
Name	100%	100%
Age	-	4%
Job title	82%	87%
Address	55%	52%
Short biography/ Background	42%	65%
Skills brought to the board	15%	13%

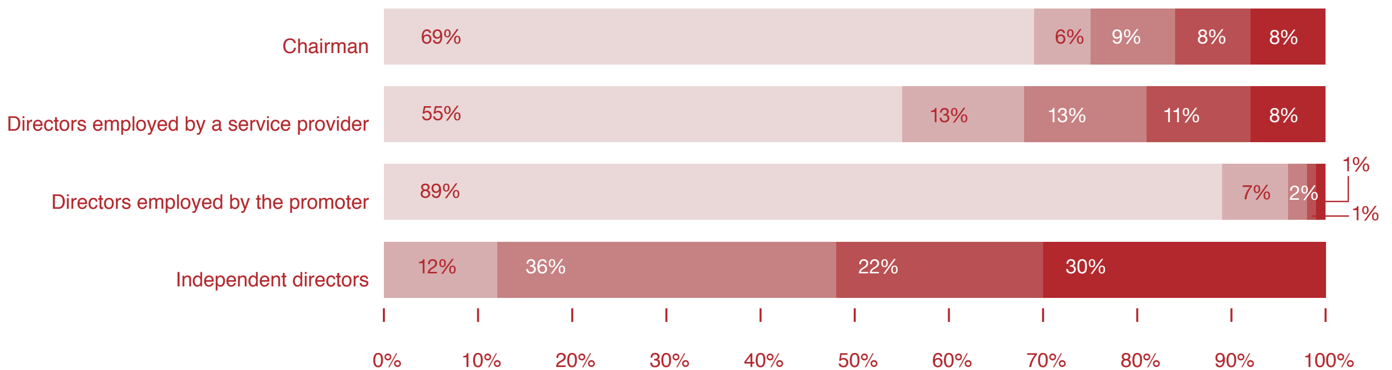
Structure of remuneration and disclosure

Our 2016 survey is in line with the one conducted in 2014. We find that, in most cases, directors employed by the promoter or service provider, and board chairmen, do not receive additional compensation for serving on the board, as their remuneration is already included in their salary.

The circumstances are different in the case of independent directors, who are paid specifically for acting in this role. The median compensation for an independent director is between EUR 20K and EUR 30K annually. We observe a small fringe of boards (about 12%) who pay independent board members less than EUR 10K a year – clearly an indication that the level of responsibility and expertise required to exercise the function has not been fully taken into account or considered seriously enough.

That said, in comparing the change in remuneration for respondents who participated in our survey in 2014 and 2016, we find that more funds overall are exceeding the median compensation for independent directors: in 2014 just 38% paid more than EUR 30K a year, today 50% of funds do so. This increase in median pay, we believe, is due in part to the growing responsibilities directors must meet as outlined by an ever-expanding set of regulations.

Figure 9: Total remuneration paid to individual board members, in % of all boards



- Remuneration included in salary
- Less than €10K a year
- €10-20K a year
- €20-30K a year
- More than €30K a year

We find that disclosure of remuneration remains minimal. Overall 50% of Luxembourg boards do not disclose remuneration at all, 38% disclose remuneration on an aggregate basis and only 12% disclose remuneration on an individual basis. The ALFI code of conduct recommends that "the remuneration of board members charged to the fund should be separately disclosed in the annual financial statements either individually or collectively".

Where the board member is being paid specifically for serving as a director, the structure of remuneration is fixed in about two-thirds of the cases. But in other cases, remuneration is dependent on different variables: the number of meetings and time spent (15%), the number of sub-funds and AuM (11%) and board meeting attendance (3%).

When remuneration is fixed, it is good practice to reassess it periodically. This periodic reassessment would take into account changing factors such as the number of sub-funds or the assets under management, an increase in the complexity or risk of the underlying assets, or a change in regulation or market practice. This is particularly true as institutional investors pay even closer attention to governance practices (and compensation) and ask for greater transparency into how remuneration was arrived at and the specific factors determining it.

Board organisation

Frequency of board meetings and director's attendance

Generally, boards monitor the management of the funds continuously throughout the year, with regular meetings scheduled, at a minimum, on a quarterly basis. For boards to meet their duties to investors, shareholder and other stakeholders, it is critical that board members participate actively at those meetings.

The 2016 survey reveals that, on average, boards in the UCITS world meet 6 to 7 times annually, a range that is consistent with what we reported in the 2014 survey. The range includes quarterly meetings, an annual review and other meetings that may arise as needed.

Boards in the alternative world meet on average 7 to 10 times per year – numbers that are higher than we found in our last survey. But this increase, we believe, is due to our sample having included many boards that oversee real assets investments (half of the AIF-ManCo boards and one-third of AIFs boards in our sample). Because boards overseeing investments in real-estate and private-equity typically have to approve any new investments in the fund's portfolio, more meetings must be called.

Boards meetings primarily take place in Luxembourg, with only a small number (less than one per year on average) held outside the country.

The frequency of board meetings held exclusively by phone is also very low in the UCITs world (less than one per year on average) and slightly higher in the alternative world (close to two per year on average). This is due to the fact that boards need to meet more often in the alternative world and that phone meetings may be convened at short notice.

Between 78% and 88% of board members physically attend board meetings. Those who cannot attend in person, join via video or phone (between 9% and 20%). Proxies are used only occasionally (1% to 5% of directors).

Historically, most Luxembourg funds do not publish attendance records, and this is still the case: only 5% of AIF boards publish attendance records and no UCITS funds do. We consider this is a missed opportunity, since institutional investors tend to consider attendance records very carefully. The fact that Luxembourg enjoys a regular physical attendance of board members at meetings is a positive message that should be clearly communicated to investors, institutions and other stakeholders.

Circular resolutions

Circular resolutions are a mechanism whereby fund directors can pass a resolution without having to call a meeting. They are usually used for routine, non-contentious matters. While there are no restrictions on their use, they are not intended as a substitute for important resolutions brought forward at face-to-face meetings that call for a presentation and deliberation, nor should they be used for dealing with urgent or controversial issues. It is good governance for a board to have a protocol in place for their use.

More than 80% of Luxembourg-based boards use circular resolutions from time to time to pass decisions outside of board meetings. The reasons for their use are a mix of urgent decisions and routine matters that have to be taken between board meetings. However the survey shows that in most cases circular resolutions are only used when formal discussions have taken place beforehand.

The number of circular resolutions used per year varies: from about five per year in UCITS-ManCos to about 18 a year in Super-ManCos. The reason for the greater number of circular resolutions by Super-ManCos may be due to the fact that they are overseeing many more funds. As service providers are more frequently requiring to see formal approval for formal changes to existing practice /exceptions (for example changing the authorised signature list), boards tend to use circular resolutions increasingly.

Board papers

Directors spend an average of 3.5 to 5.5 hours reviewing board papers prior to their meetings. Board papers are typically disseminated to the members from between a week to four days ahead of meetings, which is roughly in line with the 2014 survey. The papers are sent digitally, via email. Among UCITS, more than a third use a web-based application, to distribute the papers, for confidentiality issues. Boards should take into account cybersecurity when disseminating board papers – password protection should be used as highlighted by recent CSSF recommendations.

Duration and agenda of board meetings

Directors need to commit substantial time and energy to the role. Board meetings typically run two to four hours, in line with the 2014 survey. This year we inquired of respondents whether they felt that meeting time was too short, too long or sufficient. More than 80% felt the duration of their meetings was just about right; the remaining respondents found their board meetings too short, given the number of matters requiring the board's input.

Most boards have adopted the best practice of having a standard agenda in place ahead of the meeting. Standard agendas include the vast array of reports that are reviewed with varying frequencies. UCITS boards typically review about 13 to 14 reports at each meeting, while AIF world boards review six or seven reports at meetings. The difference in numbers is due in part to the fact that alternative funds are usually closed-ended funds sold to sophisticated investors and so certain documents such as the distribution report or prospectus update are of little relevance.

Nonetheless, we would like to point out a positive trend: the number of reports reviewed systematically by AIF-ManCos increased from zero in the last survey to six in 2016. This is due to the fact that the AIF-ManCo status was new in 2014 and therefore practice was still under development. The practice has developed since then and is more established on the boards of AIF management companies.

Another positive trend worth noting is that the investment manager report, investment restriction breaches report, regulatory and legal updates, and regulatory correspondence are being reviewed more systematically in 2016 than was the case in 2014.

Looking ahead, we expect cybersecurity reports and tax updates to become a growing focus of attention.

Figure 10: Review periodicity of the different items constituting the board agenda

		Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
AML/KYC report		At each meeting	At each meeting	At each meeting	At each meeting	Periodically
Audit	External audit findings report	Periodically	Periodically	Periodically	Periodically	Periodically
	Internal audit report	Periodically	Periodically	Periodically	Periodically	Periodically
Budget and other fund costs (TER)		At each meeting	Periodically	Periodically	At each meeting	Periodically
Central administration report[9]		At each meeting	At each meeting	Periodically	At each meeting	Periodically
Compliance report		At each meeting	At each meeting	At each meeting	At each meeting	At each meeting
Conducting officer report		At each meeting	At each meeting	At each meeting	At each meeting	At each meeting
Conflicts of interest		At each meeting	At each meeting	Periodically	At each meeting	At each meeting
Custody report		At each meeting	At each meeting	Periodically	At each meeting	Periodically
Cybersecurity report		Ad-hoc	Never	Never	Ad-hoc	Never
Distribution report		At each meeting	At each meeting	Ad-hoc	At each meeting	Periodically
Fair valuation report		Periodically	Periodically	Periodically	Periodically	Periodically
Financial statements of the management company	Annual	Periodically	Periodically	Periodically	-	-
	Semi-annual	Ad-hoc	Periodically	Periodically	-	-
Financial statements of the fund	Annual	Ad-hoc	Periodically	Periodically	Periodically	Periodically
	Semi-annual	Ad-hoc	Periodically	Periodically	Periodically	Periodically
Investment manager report		At each meeting	At each meeting	At each meeting	At each meeting	At each meeting
Investment restriction breaches report		At each meeting	At each meeting	At each meeting	At each meeting	At each meeting
Investor complaint report		At each meeting	At each meeting	Ad-hoc	At each meeting	At each meeting
New product approval		Ad-hoc	Ad-hoc	Ad-hoc	Periodically	Ad-hoc
Prospectus update		Ad-hoc	Periodically	Ad-hoc	Periodically	Ad-hoc
Regulatory and legal updates		At each meeting	At each meeting	Ad-hoc	At each meeting	Periodically
Regulatory correspondence (with CSSF, etc.)		At each meeting	At each meeting	Periodically	At each meeting	Periodically
Risk management report		At each meeting	At each meeting	At each meeting	At each meeting	At each meeting
Tax update		Ad-hoc	Ad-hoc	Ad-hoc	Ad-hoc	Ad-hoc

Average of respondents answers. The scale used was the following: "At each meeting", "Periodically", "Ad-hoc", and "Never".
[9] The Central administration report includes the Fund administration report and the Transfer agent report.

Invitation of non-board members

It is generally accepted that board members can perform their oversight duties more effectively when they are able to invite non-member experts to attend board meetings in person and report on important issues. Those non-members most often invited to board meetings are the conducting officers, compliance officer, risk manager, company secretary, and investment manager. We would note that UCITS boards tend to invite the largest number of non-members to attend meetings (on average nine at each meeting), while other boards invite four or five non-members to each meeting.

We note that external auditors are invited periodically. This is a typical practice of inviting the auditors to discuss the planning of audit, as well as the results of the audit conducted. The goal is to maintain an ongoing relationship between the auditors and the boards, both at the level of the management company and the fund.

Figure 11: Invitation periodicity of non-board members to attend board meetings

	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
Investment manager	Ad-hoc	Periodically	At each meeting	At each meeting	At each meeting
Conducting officer	At each meeting	At each meeting	At each meeting	At each meeting	At each meeting
Internal auditor	Ad-hoc	Periodically	Ad-hoc	Ad-hoc	Ad-hoc
External auditor	Periodically	Periodically	Ad-hoc	Periodically	Ad-hoc
Compliance officer	At each meeting	At each meeting	At each meeting	At each meeting	Periodically
External legal advisor	Never	Ad-hoc	Ad-hoc	Ad-hoc	Ad-hoc
Internal legal advisor	Periodically	Never	At each meeting	Periodically	Ad-hoc
Risk manager	At each meeting	At each meeting	At each meeting	At each meeting	At each meeting
Fund accountant	Ad-hoc	Never	Ad-hoc	At each meeting	Ad-hoc
Company secretary	At each meeting	At each meeting	At each meeting	At each meeting	At each meeting
Transfer agent	Ad-hoc	Never	Never	At each meeting	Ad-hoc
Custodian	Ad-hoc	Never	Ad-hoc	At each meeting	Ad-hoc
Global distributor	Ad-hoc	Ad-hoc	Never	At each meeting	Ad-hoc

Average of respondents answers. The scale used was the following: “At each meeting”, “Periodically”, “Ad-hoc”, and “Never”.

Formal committees

Boards across the world increasingly are making use of smaller formal sub-committees designed to take up issues, such as risk, audit, valuation, or remuneration.

But while the use of formal committees has increased in Luxembourg, it still remains low. And although more than 70% of Super-ManCos have established at least one formal committee, the fact is that more than 65% of funds do not have any formal committee in place. This difference in practice may be due to the fact that Super-ManCos typically oversee a large number and variety of funds and therefore specialisation of the roles is a necessity. Only the risk committee and investment management committee appear to have gained much traction among the Luxembourg Super-ManCos. We expect this situation to change in the coming years, and for audit committees to become more established with the advent of the Audit Reform Directive. Furthermore, we know that some Luxembourg-based UCITS funds have already established an audit committee, despite none of our respondents having done so.

Figure 12: Formal committees established by the board

	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
None	24%	47%	50%	67%	65%
Risk committee	56%	21%	25%	-	15%
Valuation/ Price committee	53%	16%	25%	18%	15%
Investment Management committee	47%	5%	33%	9%	15%
Remuneration committee	24%	21%	17%	3%	-
Audit committee	21%	16%	25%	-	5%
Nomination committee	9%	5%	-	-	-
Governance committee	6%	5%	8%	-	-
Executive committee	18%	11%	8%	-	-

In % of respondents. Respondents could either tick "None" or enter the full list of committees established by their board. Other committees mentioned, though with low occurrence (below 5%), were the following: Compliance committee, Product committee, Swing price committee, AML committee, Anti-dilution committee, Client acceptance committee, Error committee, Distribution committee, Portfolio disclosure committee, Marketing committee, Counterparty committee, Portfolio disclosure committee, Excessive trading committee.

Roles and responsibilities of the Board

Management style and roles exercised by the board

To fulfill their responsibilities, directors must act in a way that is in the best interests of the fund and its shareholders.

Our 2016 survey finds that a majority of boards engage in active discussions on existing issues, offering high-level oversight and managing by exception. That is not the case, however, among AIFs, where about 40% of AIF-ManCos and 30% of AIFs are involved in the detailed management of all decisions impacting fund administration, fund management and distribution.

Best practice recommends that there be a formal framework outlining the roles and responsibilities of board members, as well as the board's powers. This document is often referred to as the "terms of reference" or the "board charter." Our 2016 survey reveals that more than half of Super-ManCos and UCITS-ManCos have adopted such a document. However, a majority of AIF-ManCos have yet to adopt a terms of reference.

The review of fund documentation is a major responsibility of boards. A majority of boards, both at the management company level and fund level, review the prospectus, financial statements of the fund and material fund-related agreements. A majority of UCITS boards also review the Key Investor Information Document (KIID) and communications to shareholders. However, a limited number of management company boards review marketing materials and factsheets. The practice of reviewing marketing materials and factsheets depends to which extent the distribution function has been delegated. We note that Circular 12/546 imposes responsibility on the management company for the implementation and follow-up of the marketing policy, therefore boards of management companies should ensure there are robust processes in place surrounding the review of marketing materials.

Another major responsibility of boards is to oversee the performance of service providers. In a majority of cases, the preferred method is a periodical assessment of the provider. This is accompanied, in many instances, by performing due diligence on the appointment of the service provider. Circular 12/546 requires that the management company performs initial and ongoing due diligence on the service providers which it uses even in the context where services are delegated to group companies.

However, we find in the survey that very few boards use tendering or periodical calls for a bid. Whatever the case may be, we believe this to be an area of review in the management style of boards. The only noticeable exception in Luxembourg is for external auditors, with a third of boards using calls for tender to hire the external auditor, a sign that the regulatory push from the EU Audit Reform has begun to have an impact.

Figure 13: Process(es) of choice to ensure the quality and efficiency of service providers

	All respondents		
	Due diligence on initial appointment	Periodical assessment	Periodical call for tender
Risk manager	49%	71%	2%
Fund administration	67%	77%	19%
Custodian	68%	79%	19%
Global distributor	47%	67%	2%
External auditor	56%	59%	33%
Internal auditor	32%	58%	10%
Compliance	40%	70%	1%
Transfer agent	67%	78%	18%
Investment manager/advisor	53%	77%	4%

In % of all respondents. Multiple choice question.

Involvement outside of board meetings

The role and responsibilities of board members do not stop at board meetings. We asked respondents what was their involvement outside of regular board meetings. A large majority answered that they were involved in ad-hoc meetings, due-diligence of service providers, meetings with fund managers, and signing agreements. A few are meeting with investors, especially in the UCITS world, and most often at "Investor days".

Relationship of the board with the promoter

The ALFI Code of Conduct requires boards to conduct themselves in a fair and independent manner, particularly in their relationship with the fund promoter. To assess the relationship between boards and promoters, we asked whether the board was independent from the promoter. In a majority of cases, we find that boards consider themselves as having a distinct and separate position from the promoter, even though most of the directors are executive directors. Only about 30% of boards consider themselves truly independent from the promoter. Finally, it is striking that almost 20% of fund boards consider they are an integral part of the promoter's operations, which appears to compromise board independence.

Given the recent regulatory attention on board independence, or what is referred to as "independent mindset", we expect to see a rise in the number and percentage of boards that view themselves as truly independent from the promoter in the coming years. But before this can happen we may first need to see a greater clarity around the definition of "independent boards" and "independent directors," to ensure a common understanding of those terms.

Relationship of the board with the Conducting Officers

CSSF requires that management companies appoint Conducting Officers to oversee the day-to-day management of the fund. There must be at least two Conducting Officers, and in principle, they must be Luxembourg residents or else live in a location that allows them to come to Luxembourg daily. Our survey also shows that in a majority of cases, Conducting Officers are residents of Luxembourg.

Our 2016 survey finds that many Super-ManCos and UCITS-ManCos have appointed three or more Conducting Officers due to an increase and expansion of the scope of required work and because of regulations requiring that tasks be split to avoid conflicts of interest (for example, the roles of supervising the investment management function and supervising the risk management function cannot be undertaken by the same Conducting Officer).

Most respondents find that the relationship between the board and the Conducting Officers is productive and open, with communication between the two parties taking place on a weekly basis at 50% of the management companies. A large majority of the boards at management companies rely substantially on the Conducting Officers or consider them to be an integral part of the governance process.

Conducting Officers have diverse skillsets and collectively they bring valuable additional expertise to that already present at board level. In many cases, they come from an operational background and have experience in various areas. The most common area of expertise is in risk management, with 80% of Conducting Officers having that capability. This is an important capability to bring to the table, particularly as less than 20% of board directors have experience in that area.

The next most prevalent areas of expertise for Conducting Officers are fund administration, compliance, investment management, distribution and finance/accounting. As evidenced in the survey, distribution expertise is particularly important among UCITS Conducting Officers, reflecting the shift of priority from investment management to distribution.

Management companies typically provide Conducting Officers with a document (sometimes called a "mandate letter," "terms of reference" or "operating memorandum") that defines their roles and responsibilities. A majority of management companies also provide Conducting Officers with a job description, a code of conduct and details of insurance coverage.

Board evaluation

Institutional investors and regulators have been paying greater attention in recent years to board effectiveness and performance evaluation. Institutions increasingly see board evaluations as a best practice, considering it helpful for boards to step back periodically and review their overall performance. Additionally, the ALFI Code of conduct recommends that the board "conduct a periodic review of its performance and activities."

Given the varying nature of different fund complexes, board composition and operating needs, it is impossible to specify criteria that would apply to all, but many start with written questionnaires such as the ILA toolkit and then customize as needed.

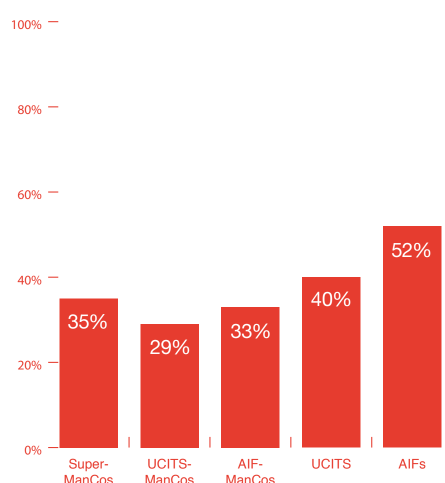
In this area, we are happy to note a jump in the number of UCITS boards who perform such an evaluation, rising from 10% in 2012 to 55% in 2016. The increase, coupled together with the significant increase in the number of respondents, seems to indicate that board evaluation is in the process of becoming mainstream within UCITS funds. In most cases, boards of UCITS funds perform a formal self-assessment on a yearly basis; very few boards (only 3%) undergo an externally facilitated review.

ILA Certified Director program

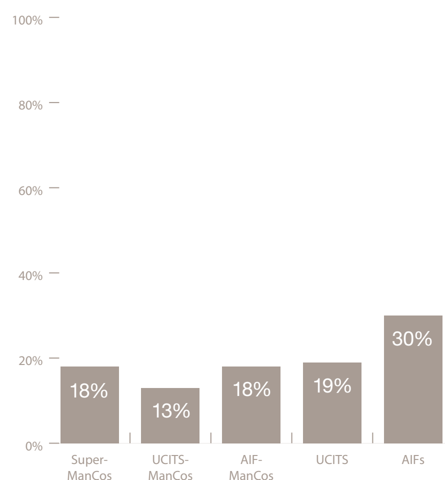
Over the past decade, ILA has sought to promote best practices in governance by offering career development programs, including a certification program. We observe in the current survey a growing number of boards with at least one director enrolled in the ILA Certified Director program. As an example of the rise, the number of UCITS boards having at least one director enrolled rose from 19% in 2014 to 40% this year, while the number of AIF boards with one director in the program jumped from 30% to 52%. Once certified, directors must maintain their continuous development, participating in programs to maintain their professional skills.

Figure 14: Proportion of boards that have at least one director enrolled in the ILA Certified Director program

2016



2014



Ongoing education

Ongoing education and orientation is no longer viewed as just a matter of good practice – it is considered essential to directors being able to keep up with developments in the industry and regulations. A majority of board members take more than three days of training on a personal basis and many of them take more than five days.

But continuing professional education provided to the board by promoters is usually very limited – often just half a day on anti-money laundering regulations (AML). This is in line with the intent of CSSF Regulation N° 12-02 which requires entities regulated by the CSSF to put in place AML training and awareness-raising programs for their personnel. Apart from AML training, promoters provide legal and regulatory updates to the board.

In practice, board members are seeking out additional training on their own. However, boards should also ensure that board members, including those based overseas, receive adequate training on various topics. Training of overseas board members is facilitated by initiatives such as the online AML training program available on the ILA website.

When examining the areas in which respondents take additional training on a personal basis, the most common areas are AML/KYC developments, risk management, legal and regulatory updates, products and tax. We also note that cybersecurity and digitalisation are new hot topics of growing interest and orientation for directors. Indeed, half of Super-ManCo board members have received training on cybersecurity or digitalisation in the past 12 months.

Figure 15: Days spent on continuing education in the last twelve months – taken on a personal basis

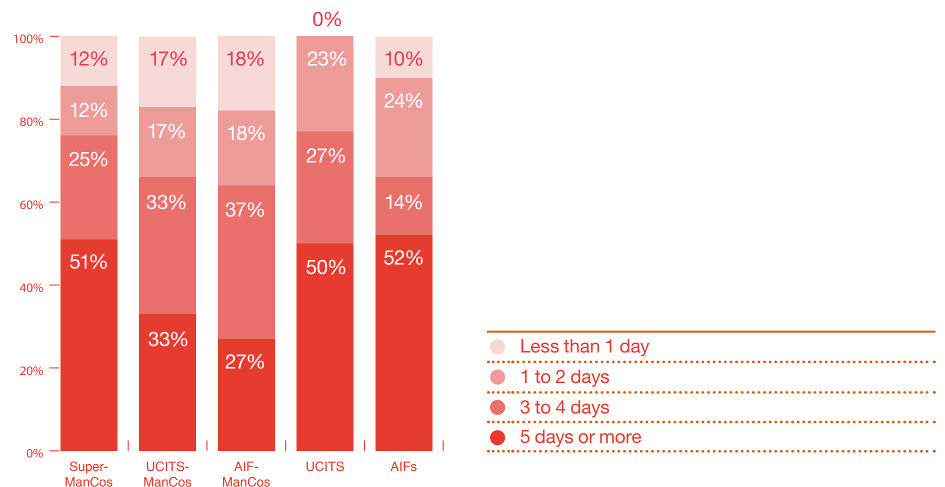
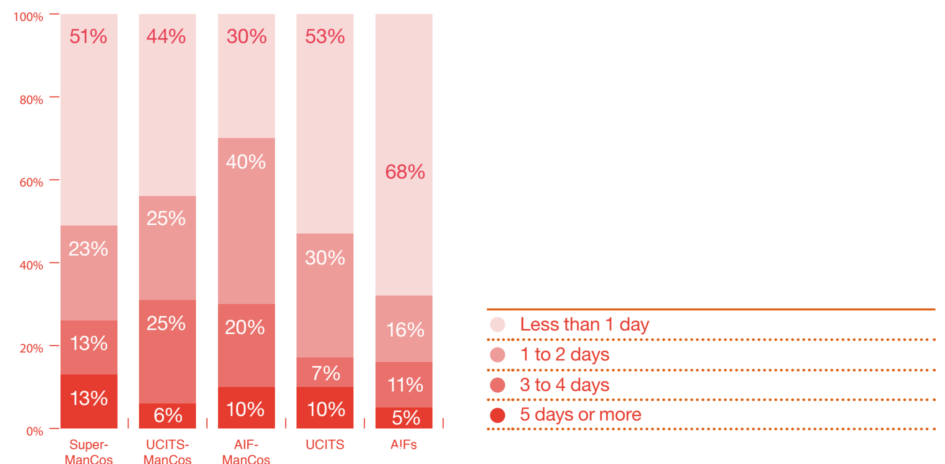


Figure 16: Days spent on continuing education in the last twelve months – provided to the board



Conflicts of interest and legal liability

Conflicts of interest

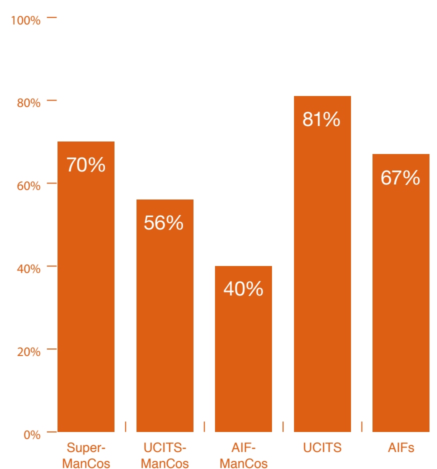
Having a policy and a process in place for identifying, mitigating, managing and disclosing potential conflicts of interest is a regulatory requirement. Independent directors often play a special role in policing conflicts of interest between the fund and its investment manager and service providers and acting as watchdogs to protect the interests of shareholders.

Conflicts of interest remain an important focus of attention for regulators. According to our survey, about 90% of boards in Luxembourg have determined how conflicts of interest are to be managed. It is a surprising result that 10% of respondents have answered that they have not yet determined what steps to take to manage them.

More than 80% of boards have an established reporting mechanism such as a register of conflicts to oversee all identified conflicts – except for AIF boards, where only 60% have such a mechanism in place. We believe the reporting mechanism is an important tool that has to be put in place by the board. It is the fundamental responsibility of directors to make certain that the shareholders' interests are safeguarded – by law and in accordance with the fund's prospectus and disclosure documents. The board cannot rely on the promoter for this critical best practice.

Most boards require that conflicts of interest be declared at each board meeting as a standard agenda item, with the notable exception of AIF-ManCo boards (see Figure 17). Best practice is to declare conflicts of interest at each meeting as a standard agenda, and to abstain from participating in votes when a conflict of interest exists.

Figure 17: Proportion of boards asking for conflicts of interest to be declared at each board meeting as a standard agenda item



Legal liability

Legal liability is an area of concern for board members, especially due to an intensification of regulatory oversight and scrutiny. In Luxembourg's highly regulated funds industry, directors are responsible for both actions and omissions. Liability may arise from a breach of various types of law or regulation – EU legislation, company law, accounting rules, CSSF circulars, insolvency regulations, employment law, civil responsibility, criminal law and environmental regulations. We would particularly highlight the increased sanctions provided under UCITS V and the EU Audit Reform, and the increased application of fines by regulators on a more systematic basis.

Liability may arise from breaches of a broad range of obligations, such as inadequate risk management, errors in accounts, incorrect valuations, not filing accounts within the statutory deadline, or improper use of corporate assets. That is why it is of paramount importance for directors to be aware of their liability.

In this year's survey, 70% of the respondents said they have taken steps to personally inform themselves about the issue of director's liability. About half those we surveyed are briefed either by an external or internal legal counsel. While the two approaches are not mutually exclusive, we would have expected a higher occurrence of briefings by legal counsel organised by the board.

Mitigation of director liability is of equal importance, irrespective of whether the director is independent or employed by the promoter. And mitigation in practice is aligned in the cases of both types of directors, with 90% of those employed by promoters receiving insurance provided by the fund or promoter, while slightly less independent directors – 80% – get their coverage from the fund or promoter. For independent directors, this is actually an increase from previous years. About half of all directors receive an indemnity from the fund or promoter, a surprisingly low number given that company articles of incorporation usually contain such an indemnity. And some 30% of independent directors have taken out additional insurance on themselves, a percentage we expect will rise as more independent directors take out coverage in addition to supplementing the insurance provided by the fund or promoter.

Investments in the funds

Directors are not legally prevented from investing in the funds they oversee. There are some who consider it best practice provided that there are adequate procedures in place to prevent conflicts of interests. Indeed, in the US, directors often invest in the fund they oversee while in Europe, however, this has not been the practice.

In the 2016 survey, we asked whether directors of Luxembourg-domiciled funds of management companies are prohibited/allowed/recommended to invest in the funds they oversee depending on promoter's guidelines. More than 90% of UCITS-ManCo respondents are allowed to invest in the funds with or without restrictions (while less than 10% are prohibited from investing).

In the AIF world, a more diverse picture emerges. Among AIF-ManCos respondents, the practice of investing in the AIF is roughly split, with 40%-plus saying they are allowed and another 40%-plus prohibited from investing in the fund. Another 10% of respondents said it is recommended they invest in the fund they oversee.

Figure 18: With regards to directors' investments in the funds they oversee, are directors...

	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
...prohibited from investing in the funds they oversee	16%	5%	45%	13%	29%
...allowed to invest in the funds, with or without restrictions (e.g. pre-trade compliance, disclosure)	84%	95%	45%	87%	67%
...recommended to invest in the funds	-	-	10%	-	4%

In % of respondents.

Code of Conduct

Boards should strive to adhere to the highest standards of conduct in meeting their fiduciary responsibilities. Moreover regulators are increasingly placing greater importance of the code of conduct as a way of ensuring the board plays a role in the supervision of trading practices that are fair to fund investors.

In Luxembourg, an overwhelming majority of fund boards (more than 70%) have adopted a code of conduct, although the adoption rate is lower among AIF-ManCos, roughly 50%, a fact that we attribute to the relative newness of many of these management companies. Most boards have adopted the ALFI code of conduct. Those that have adopted another code (about 10% of boards) have generally adopted their promoter group's code of conduct. The advantages of having a code of conduct include: ensuring that all board members are aligned on the principles applying to the practice of the board, and providing for a check list of all the areas that should be taken into account within the board practice.

We also wanted to see whether funds are disclosing their adoption of a code of conduct, something that we believe they would want to publicise. Indeed, about 60% make such a disclosure, a figure we thought would be higher, given the positive message adopting a code of conduct sends to the market. Mostly, the disclosure is made in the financial statements or within the board's report to shareholders; only 10% of boards make this disclosure on their website.

About 70% report conducting regular checks to see how well they comply with their adopted code of conduct. The checks, which are a best practice, should be done once a year as a mapping exercise, and made a part of the board's evaluation assessment.

The ALFI Code of Conduct

The purpose of the ALFI Code of Conduct is to provide boards of directors with a framework of high-level principles and best practice recommendations for the governance of Luxembourg investment funds. The code is principles-based, rather than rules-based, relying on good judgment instead of a prescribed practice.

Respondents are very positive when asked how they perceive the ALFI Code of Conduct. Nearly all believe that the principles-based approach of the code is appropriate. One respondent said that the principles-based approach provides guidance that is sufficiently flexible to be applied to the individual circumstances of an entity. Only about 10% believe that the code should be more prescriptive.

But about half of respondents would like the code to define the term "independent directors" – a finding in line with the 2014 survey – and 80% of AIF-ManCo respondents would like to see that happen. Moreover, 60% believe the code should recommend the appointment of at least one independent director.

The ALFI code recommends that consideration be given to the inclusion of one or more members that is independent, but does not provide a definition of the term. We have noticed a tendency on the part of the market to use the terms "independent directors" and "non-executive directors" interchangeably. A "non-executive director" is not necessarily independent, as they may have other ties with the promoter, management company or fund. Therefore there may be a need for clarification to ensure a consistent understanding.

About 10% of respondents believe there are some areas for enhancement in the code. Those areas include: a description of conflicts of interests; a definition of independent directors; disclosure of meeting attendance by board members; and the presence/hiring of female board members for the purpose of diversity.

Board Oversight

Investment management oversight

An integral part of the board's role in representing shareholder interests is to provide investment management oversight: setting and monitoring the investment policy of the fund and monitoring the fund's performance.

In the survey, we asked respondents how they exercise these responsibilities. We find that 50% of the management company boards and 50% of the fund boards are involved in setting and monitoring investment policies including risk profiles. Because this is a responsibility at both the level of the management company and the fund, some boards may be relying on either the fund board or the management company board to perform these tasks.

80% of all boards monitor investment restriction breaches, more than 70% receive regular reporting from the investment manager, and 70% supervise the investment strategy and make certain the general investment policy of the fund adheres to its goals. The boards that do not perform this duty most likely rely on Conducting Officers to provide oversight.

With regards to fund performance, the survey finds that more than 80% monitor investment performance, but only 20% intervene in case of underperformance. Interestingly 12 years ago, in our 2004 survey, UCITS board directors said the most pressing issue for them was fund performance, followed by risk management and internal controls, with compliance in third place. Clearly, things have changed, and the reason for that is that boards are spending more and more time on compliance issues, devoting very little time to performance issues. But the pendulum may have swung too heavily in the direction of compliance focus. It is important that board members keep in mind they are responsible for looking out for investor interests, of which performance should be paramount.

Fund expenses oversight

It is the board's responsibility to oversee the fund's expenses to ensure the investors are not charged any undue costs. More importantly, regulators have pushed for greater fee transparency, so as to enable the end investor to make an informed decision when purchasing fund shares.

In our survey, more than half of UCITS respondents say their fund expenses are covered by a fixed TER. It is yet unclear what the impact of PRIIPs and MiFID II will be in the future as the regulation is pushing for improved transparency and investor protection.

In answer to our question of how directors exercise their responsibilities when monitoring fund expenses, most respondents said they are directly involved in monitoring fund expenses and/or review budget versus actual expenses. Within UCITS-ManCo and Super-Manco, about 10% of the respondents said their boards rely on the Conducting Officers or on members of the Expense Committee to monitor fund expenses.

Figure 19: Are the fund expenses covered by a fixed TER (Total Expense Ratio)?

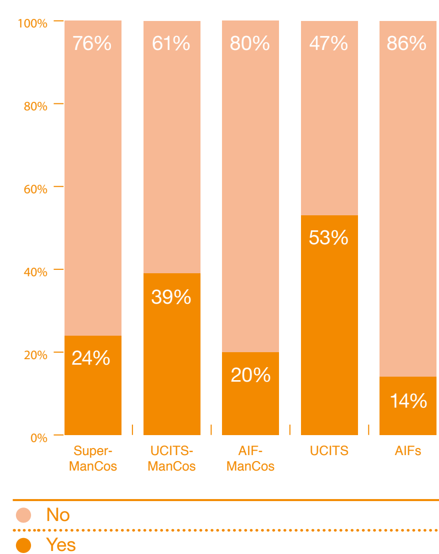


Figure 20: How does the board exercise its responsibilities when it comes to fund expenses

	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
Involved in monitoring fund expenses	62%	41%	38%	74%	44%
Reviews budget vs expenses	38%	35%	88%	42%	60%
Monitors/benchmarks expenses with competitors' comparable funds	22%	41%	25%	55%	20%
Other than the above	13%	12%	-	-	-

In % of all respondents. Multiple choice question.

Risk management oversight

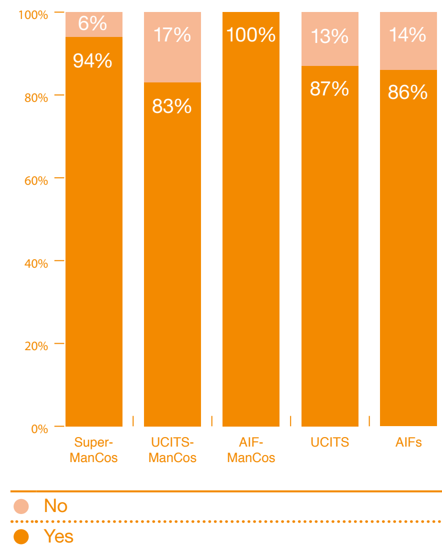
Responsibility for the core functions of risk management generally lies with the management company and cannot be delegated to specialist providers without prior approval of the CSSF. Circular 12/546 sets out in detail the prerequisites for implementing the risk management function, placing it under the ultimate responsibility of the board of directors.

More than 80% of the boards we interviewed said they review the effectiveness of the fund's risk management processes – and high number explained by the regulatory requirements. Most of those who perform a review do so on a quarterly or annual basis.

Our respondents believe their boards can adequately supervise the risk management function: 30% say that is because of the expertise and experience of all individual directors, while 70% attribute it to the board's collective understanding of risk management.

Risk, however, has multiple components and dimensions. The great majority of respondents believe they receive adequate reporting in such areas as market risk, counterparty risk, liquidity risk, valuation risk and operational risk.

Figure 21: Does the board review the effectiveness of risk management processes?



When it comes to newer and emerging risks, the picture is less clear: only 40%, for example, believe they receive adequate reporting on technology risk. As regulators begin to ask questions of directors on security risks, such as the use of laptops, bring your own devices, social media, privacy and encryption, we expect technology risk to become of paramount importance in the coming years. Boards will need to ensure they have the right level of information and that technology and information security becomes a top priority.

Distribution oversight

Global distribution is a complex activity that can either be performed in-house by the management company or the fund, or delegated to a third party. In the 2016 survey, we find that 60% of UCITS funds use a third-party global distributor, while AIF funds are more likely to perform this task in-house, with 50% signing their own agreements and 30% appointing the ManCo as global distributor. This is because UCITS funds domiciled in Luxembourg are typically distributed to retail investors in many different countries[10], each of which has specific rules and regulations that must be closely monitored by a specialised service provider. On the other hand, AIF funds are more likely to be distributed to sophisticated investors in a more limited number of countries and therefore the fund is able to handle distribution agreements by itself.

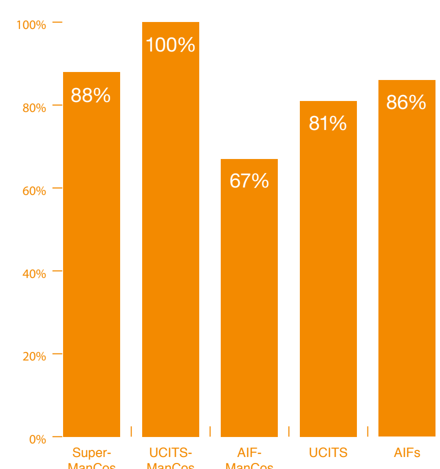
It is important to note that the board of the management company is responsible for the oversight of the distribution function. For management companies overseeing UCITS funds, CSSF Circular 12/546 stipulates that the management company is responsible for the marketing policy and distribution networks of the funds.

We observe that compared to 2014, the market in 2016 is paying more attention to distribution and KYD (Know Your Distributor) principles. The survey reveals the existence of many models for handling and monitoring distribution. Therefore, it is important that boards understand which model they are operating under and how to exercise their distribution oversight duties accordingly.

Moreover, AML/KYC areas will require greater attention from the board over the next two years, as the 4th AML Directive goes into effect by June 2017 and MiFID II is implemented by January 2018. Boards will increasingly need to strengthen their capabilities in a number of areas, including reporting obligations, penalties for non-compliance, data privacy, as well regulations that are country-specific.

We asked respondents whether their fund has appointed a Money Laundering Reporting Officer (MLRO). The role of the MLRO is to inform the CSSF, on behalf of the fund, and without delay, if there is a suspicion of money laundering or terrorist financing taking place, having taken place or being attempted. The good news is that a majority of boards have appointed an MLRO. We also asked respondents if the MLRO is a board member, a compliance officer of the ManCo, fund, general distributor or transfer agent or an independent mandate. In most cases, the MLRO is a compliance officer of the management company.

Figure 22: Proportion of boards having appointed a MLRO (Money Laundering Reporting Officer)



[10] Please consult PwC's annual Global Fund Distribution Poster for data on the cross-border distribution of investment funds in the world.

By its very nature, global distribution is a complex activity due to the plethora of regulations in the countries where funds are distributed. We asked participants what are the greatest distribution risks: “Failure to comply with local jurisdiction laws” is number one, followed by “AML” – findings that are consistent with the survey in 2014. Respondents also point to “insufficient due diligence and ongoing monitoring,” suggesting that both are prerequisites for effective supervision.

Figure 23: Top 5 greatest risks regarding distribution

	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
#1	Failure to comply with local jurisdiction sales & marketing laws	Failure to comply with local jurisdiction sales & marketing laws	Failure to comply with local jurisdiction sales & marketing laws	AML	Failure to comply with local jurisdiction sales & marketing laws
#2	AML	Reputational risk	AML	Failure to comply with local jurisdiction sales & marketing laws	AML
#3	Insufficient due diligence and ongoing monitoring	Mis-selling	Insufficient due diligence and ongoing monitoring	Insufficient due diligence and ongoing monitoring	Insufficient due diligence and ongoing monitoring
#4	KYD - Know your distributors	AML	Reputational risk	KYD - Know your distributors	Mis-selling
#5	Reputational risk	KYD - Know your distributors	KYD - Know your distributors	Reputational risk	Reputational risk

Looking Forward

This final section of our survey concerns the outlook for governance practice within Luxembourg fund industry as well as the strategic implications of current and upcoming regulations.

Main attention areas in the coming 12-24 months

We asked respondents to highlight the top five areas they anticipate will require additional attention from the board over the next 12 to 24 months. The main areas cited were "law and regulation changes" and "governance and compliance." In general, we have noticed an increase in the time and energy spent by directors to monitor regulatory changes and ensure proper compliance, potentially to the detriment of other areas that are nevertheless part of their mandate to protect investors' interests – in particular ensuring proper performance/return of the fund. Boards of AIFs are particularly concerned with risks relating to "investment performance," as shown in the table below.

Figure 24: Top 5 areas requiring additional attention from the board in the coming 12-24 months

	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
#1	Law & regulation changes	Governance & Compliance	Law & regulation changes	Law & regulation changes	Law & regulation changes
#2	Governance & Compliance	Law & regulation changes	Governance & Compliance	Governance & Compliance	Governance & Compliance
#3	Risk management	Distribution	Valuation & Pricing	Distribution	Investment performance
#4	Transparency & Investor needs	Transparency & Investor needs	Liquidity management	Liquidity management	Risk management
#5	Distribution/ Market developments/ Investment performance/ Valuation pricing	Risk management	Risk management	Investment performance/ Risk management	Distribution

Strategic implications of upcoming regulations

In contrast to our 2014 survey, when a wide array of regulations had just been passed, this year's survey sees little new financial legislation or regulations. Instead, directors of funds are now faced with overseeing the implementation of the regulatory regimes and understanding the implications of regulations.

We asked respondents if their board has reviewed the implications of the new regulations, which are at different stages of discussions/implementation:

- **UCITS V:** The law that transposed the UCITS V Directive into Luxembourg law entered into force in June 2016. Among other matters, it implements a depository regime based upon – but more stringent than – the AIFMD depositary regime and creates a new sanctions regime, heightening the threat of heavier sanctions and damage to reputation. The CSSF has indicated that UCITS must update their KIIDs and prospectuses with their next update, or at the latest by 17 February 2017 (for KIIDs) and 18 March 2017 (for prospectuses). It also introduced new board composition requirements when both the management company and custodian are part of the same group. Last but not least, it requires implementation of the whistleblowing procedures. We note that overall, respondents have a good understanding of the regulation and were reviewing the operational implications.

Figure 25: Has the board reviewed the implications of the following regulations?

	Super-ManCos	UCITS-ManCos	AIF-ManCos	UCITS	AIFs
UCITS V	Yes, operationally	Yes, operationally	-	Yes, operationally	-
MiFID II	Yes, strategically	Yes, strategically	Yes, strategically	Yes, strategically	-
PRIIPs (Packaged Retail and Insurance-based Investment Products)	Yes, operationally or strategically	No	No	Yes, operationally or strategically	No
CRS (Common Reporting Standard)	Yes, operationally	Yes, operationally	Yes, operationally	Yes, operationally	Yes, operationally
SFTR (Securities Finance Transaction Regulation)	Yes, operationally or strategically	No	No	Yes, operationally or strategically	No
CMU (Capital Markets Union)	No	No	No	No	No
Solvency II	Yes, operationally or strategically	Yes, operationally or strategically	Yes, operationally or strategically	Yes, operationally or strategically	No

- **MiFID II** (Markets in Financial Instruments Directive II): This far-reaching directive will apply as from January 2018. One of MiFID II's stated goals is to reinforce investor protections by increasing fee transparency, improving information to clients and better protecting client assets. It will have direct consequences on the way investment products are created and distributed. That is why a majority of boards have looked at the regulation from a strategic vantage point to see how MIFID II could impact their business. In the coming months, we expect boards to move on to making an operational assessment of the regulation and deciding how to adapt their practice of governance to MiFID II.
- **PRIIPs** (Packaged Retail and Insurance-based Investment Products): The PRIIPs Regulation aims to improve the quality of information provided to consumers by introducing a standardised factsheet, known as a Key Information Document (KID), that presents the key features of an investment product in a simple and accessible way. Thanks to KID, EU consumers will, for the first time, be able to easily compare the potential risks and rewards of investment products, funds and investment-linked insurance policies. PRIIPs covers not only collective investment schemes but also other packaged investment products offered by banks and insurance companies. This piece of EU legislation, however, has been postponed. It is now expected that the revised PRIIPs framework should be in place during the first half of 2017 and become applicable as of 1 January 2018. Because of the postponement, a substantial number of Super-ManCos and UCITS funds have not yet looked at the regulation's implications. We advise UCITS-ManCos to undertake a strategic and (if necessary) operational assessment of PRIIPs as soon as possible.
- **CRS** (Common Reporting Standards): The CRS regulation, generally known as the Global FATCA, was initiated by the OECD, and is aimed at preventing tax evasion and encouraging a global automatic exchange of information between participating jurisdictions. In practice, it requires financial institutions to report financial accounts held, directly or indirectly, by account holders that are tax residents in a CRS jurisdiction. The CRS regulation was implemented at European Union level through the Directive on Administrative Cooperation (Directive 2014/107/UE), known as "DAC 2", and has been in effect since 1 January 2016. This is why a majority of our survey respondents said that they have already reviewed the legislation from an operational point of view.

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- **SFTR** (Securities Financing Transaction Regulation): SFTR requires managers of UCITS and AIFs to make detailed disclosures to their investors of the use they make of securities financing transactions (SFTs) and total return swaps, both in their periodical reports and through pre-contract disclosures. As from January 2017, all UCITS-ManCos and AIF managers must include detailed information regarding the use of SFTs and TRS in their investor reports and offering documents to ensure that investors are aware of the risks associated with SFT usage. We found, when we interviewed our survey respondents in the summer of 2016, only about half of Super-ManCos and UCITS had reviewed the implications of the legislation, and one-third of UCITS-ManCos. We believe that proportion has since increased.
- **CMU** (Capital Markets Union): The European Commission launched its CMU Action Plan on 30 September 2015, a plan intended to help build a true single market for capital across the 28 EU Member States. In theory, CMU presents significant opportunities to banks, asset managers and insurers, as well as offering improved access to capital for smaller and medium-sized companies. In practice, a majority of our respondents haven't yet looked at the implications of the proposed changes, perhaps because the Commission is still at the early stage of implementing this action plan.
- **Solvency II**: The Solvency II Directive creates a harmonised prudential framework for insurance firms in the EU. It became fully applicable to European insurers and reinsurers on 1 January 2016. Asset managers are indirectly impacted, as insurers are an important distribution channel for UCITS funds. In addition, Solvency II increases the data and governance demands on insurers, requiring them to review and possibly rethink their investment strategies. A majority of respondents to the survey have reviewed at least the strategic implications of Solvency II – but 40% of the UCITS-ManCo boards and UCITS boards have yet to begin their review (figures not shown on the table). We would encourage them to do so.

Conclusion

Our 2016 survey sample is bigger and more robust, both in numbers and in diversity, offering an objective representation of governance practice within the Luxembourg investment fund industry. The increased number in respondents evidences the heightened focus on governance from market participants. The extended sample makes comparison with previous surveys more challenging. We can nevertheless conclude that the survey results show a consolidation in good governance practices in Luxembourg, meeting the needs and expectations of both regulators and investors.

We note in the survey a high degree of awareness from market players who are responsive to regulatory pressures and the growing needs of investors for greater transparency. Good practices are being observed in all areas of the survey – board composition, role, organisation, policies, education and oversight function.

We expect the trend towards best in class governance practices to continue to increase in 2017, not only due to new regulations (such as UCITS V and Audit Reform for instance) introducing heavy sanctions in case of poor governance, but also because governance will remain an area of focus for investors and regulators alike.

Notes

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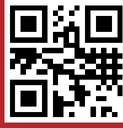
www.pwc.lu 

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