

New CSSF FAQ on collective investments and the protection of investors

News - 05/08/2020

The Financial Sector Supervisory Authority (the **CSSF**) has published a list of frequently asked questions (**FAQ**) on the application of the CSSF Circular 02/77 concerning the protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to undertakings for collective investment.

This FAQ was issued on 7 July and applies to Undertakings for Collective Investment in Transferrable Securities (**UCITS**) and Undertakings for Collective Investment (**UCI**) subject to the part II of the 2010 Law^[1]. It clarifies several situations linked to investment breaches, potential correction methods and tolerance thresholds.

This briefing summarises the key points detailed in the Circular.

| General application

1. Remedying active non-compliance by a UCITS of the cumulative investment restriction^[2] (holding of transferable securities and money market instruments with a single issuing body exceeding 5/40% of total asset value)

In terms of securities to be sold to remediate the breach, the CSSF specifies that they do not need to be the same as those which caused the breach. It is the responsibility of the UCITS to identify the acceptable ones, while respecting the rules outlined in the FAQ. The financial impact calculation may be carried out with a reference to the security that caused the breach (if not specified otherwise in the IFM policy, this method should be used by default), the security sold to remedy the breach, or by comparing the performance of the reference of the portfolio to the average performance of the securities that generated the breach.

2. Active investment breaches corrected via market evolution or new subscriptions

Even though an investment breach may be corrected independently of the sales of the

excess positions, an impact calculation must be performed and the unrealised loss generated during the period while the fund was in breach must be compensated to the fund.

3. Active “intraday” investment breaches

Investment breaches that occur and are corrected on the same trade date, between two official NAVs have to be reported to the CSSF and potential losses resulting from such a breach compensated.

4. Examples of active investment breaches of the 20% deposit limit^[3]

The FAQ provides for examples of portfolio transactions of a UCITS which do not cover capital activity (subscriptions and redemptions) due to a settlement date mismatch, and which exceed the 20% deposit limit. These will be considered active should the mismatch date be predictable/avoidable and therefore within the fund's control.

5. Interest rate comparison

Financial impact calculations may not be performed using methods which compare interest rates borne by the UCITS to those of equivalent deposits made with other credit institutions.

6. Situations in which a UCI^[4] should provide a “Remedial Action Plan” or a “Notification” to the CSSF

- No notification required:
 - Passive investment breaches. Monitoring and timely remediation by the IFM needs to be in place.
- Notifications and remedial plans to be sent for:
 - material NAV calculation errors where no subscriptions and redemptions occurred during the error period and no related compensations are to be paid to the fund or to the investors
 - active investment breaches resulting in a gain for the fund, and
 - active investment breaches whose compensation amount for the fund exceeds EUR 25,000 and no compensations are to be paid to investors in the fund.

7. Using the de minimis amount for compensating the investors of a UCI who are financially impacted in the context of a material NAV error calculation

No prior approval is required, however such usage must be specified in the IFM's policy and an ex post substantiated justification may be required.

8. Applicability of the Circular to specific situations

The CSSF highlighted that the Circular also applies to active non-compliance with diversification and other rules applicable to the collateral laid down by ESMA^[5].

Specialised investment funds (SIFs) have the possibility to opt for the application of the Circular or set their own specific internal rules (in case the latter are not set, the Circular will apply).

9. Treatment of the notification by the CSSF

The closure of the procedure will not be notified to the fund and the CSSF may demand additional information or require further actions to remedy the breach.

Selection of the correction method

1. Applicable organisational requirements

IFMs need to set up robust policies and procedures governing the treatment of NAV calculation errors and investment breaches, comprising of governance process, oversight, definitions of breaches, thresholds, impact calculations and the correction timeline.

Certain SIFs should also implement such policies, while internally managed UCIs subject to Part II of the 2010 Law are recommended to do so.

2. Economic method for determining the financial impact an active investment breach caused to a UCI

Using this method to calculate the compensation is permitted if there is an adequate justification for it, and if the following principles are respected:

- alignment with the investment policy
- consistent application for active breaches of the same nature
- no prejudice for investors
- there is adequate documentation in the internal policy.

If this method is not foreseen in the investment policy, the CSSF requires the accounting method to be used.

To determine the compensation amount, the performance of a non-eligible asset may be compared to the performance of a reference which is representative of the investment policy, and not to a corresponding eligible asset having the same characteristics.

The ultimate responsibility for the choice of method lies on the board of directors of the IFM, and the UCI, if applicable. It may be determined for sub-funds individually, at the level of the whole entity.

Using both methods within the same entity is possible and the compensation amounts may be calculated using the accounting method for certain breaches, and the economic method for others, if stated in the internal policy of the IFM.

A change of policy is permitted if justified and approved by the board of directors for managing future investment breaches but cannot apply retrospectively to handle a specific investment breach that has already occurred.

Tolerance thresholds

1. Errors in fees and costs

Tolerance thresholds provided in the Circular do not apply to errors in the calculation of fees and costs borne by the UCI that led to payments higher than those laid down in the prospectus. Overcharging would need to be reimbursed to the UCI in all cases.

NAV will have to be recalculated only where the reimbursed amounts exceed the materiality threshold applicable in accordance with the Circular.

2. Notifications

If the tolerance threshold applied to the fund in case of NAV calculation errors is lower than that stated in the Circular (or not applied at all), such errors have to be notified to the CSSF.

3. Applicable thresholds

The applicable materiality thresholds for funds of funds, index trackers and feeder funds should be defined by making a reference to the investment policy stated in the prospectus. A simple consideration of investments as equity and a subsequent application of the 1% threshold of the Circular applicable to equity is not permitted.

Finally, the FAQ provides useful decision schemas for NAV calculation errors, investment breaches and the application of the economic and accounting method.

[1] The Law of 17 December 2010 relating to undertakings for collective investment, as amended

[2] Article 43 (2) of the 2010 Law

[3] Article 43(1) of the 2010 Law

[4] Define UCI in the introduction

[5] Point 43 of Guidelines on ETFs and other UCITS issues, implemented by the Circular CSSF 14/592

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