



*Commission de Surveillance  
du Secteur Financier*

# ML/TF SUB-SECTOR RISK ASSESSMENT

COLLECTIVE INVESTMENTS

January 2020

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## FOREWORD

Luxembourg is a dynamic economy with one of the leading financial centers in the world. At the heart of Europe with a highly-skilled and multinational workforce, our financial sector serves a diverse range of clients and investors both at home and abroad. The Collective Investment Sector is a significant contributor to the economic growth of Luxembourg. In terms of Assets under Management, Luxembourg ranks first in Europe and second worldwide in this particular industry.



The growth of the financial sector has increased Luxembourg's potential exposure to the threat of money laundering and terrorism financing (ML/TF). With the whole financial services sector being exposed, the Collective Investment Sector is particularly at risk. This has been highlighted in the 2018 National Risk Assessment (NRA), confirming similar findings by the Financial Action Taskforce and the European Commission's Supra-National Risk Assessment.

Luxembourg and the CSSF are strongly committed to combat ML/TF. We have implemented a series of reforms to further strengthen our regime for fighting against ML and TF (AML/CFT), and our efforts continue so that the risks arising from and within our jurisdiction are effectively managed and mitigated. The 2018 NRA has been critical to this process and the Collective Investment Sub-Sector Risk Assessment is complementary to, and an extension of the National Risk Assessment. It is one of several dedicated sector and sub-sector specific risk assessments that the CSSF is completing on areas identified as high risk.

This inaugural Collective Investment Sub-Sector Risk Assessment is a major step forward in the AML/CFT efforts of both the CSSF and the private sector. The exercise has further strengthened our comprehensive and shared understanding of the inherent risks faced by the Collective Investment Sector, the strengths of the current AML/CFT regime, and areas where mitigating measures should be developed further. It has been a joint and coordinated effort, led by the CSSF and with input from stakeholders across the Collective Investment and public sector.

The Collective Investment Sector was identified as an inherently high risk sector by the NRA. This document highlights several ML/TF threats and vulnerabilities that are particularly important for that specific industry in Luxembourg.

This risk assessment is a valuable tool for all stakeholders to better understand the ML/TF risks associated with the Collective Investment Sector and the measures necessary to mitigate them. Supervised entities should use this risk assessment to strengthen their understanding of ML/TF threats and vulnerabilities and to contribute towards the development of proportionate and effective controls. To this end, the assessment details observed best practices, common findings from supervision, and targeted recommendations which the private sector should adopt. The CSSF will monitor the entities' adherence to these recommendations as part of our supervisory activities.

I would like to thank all of those who have participated in this exercise for their valuable contribution, in particular the members of the Expert Working Group on AML in the Collective Investment Sector. I expect everyone in the sector to continue strengthening their AML/CFT efforts so as to ensure that the AML/CFT framework is and remains effective and that Luxembourg remains a place where the Collective Investment Sector can thrive.

Marco Zwick, Director, CSSF

## PURPOSE AND SCOPE OF THE DOCUMENT

The CSSF applies a risk-based approach to AML/CFT supervision. A central component of this approach is the production of thematic risk assessments for ML/TF vulnerabilities.

A NRA was published in December 2018 with a view to identify, understand and assess ML/TF risks and support the definition of the national AML/CFT strategy. It identified the investment sector, and collective investments in particular, as inherently high risk. The quality of the implemented mitigating measures allowed to reduce the residual risk to Medium. Consequently, the CSSF has chosen to drill down on the risk assessment for this sector.

Table 1 summarises the results from the NRA for the investment sector, highlighting the assessment regarding collective investments.

Table 1: Overview of Luxembourg NRA – sub-sector risks

Sector	Inherent risk	Residual risk	Sub-sectors	Inherent risk
Investment sector	High	Medium	Wealth managers ( <i>gérants de fortune</i> )	High
			Brokers and broker-dealers (non-banks)	High
			Traders/market-makers	Medium
			<b>Collective investments</b>	<b>High</b>
			Regulated securitization vehicles	High
			Pension funds	Low

The CSSF conducts entity-level risk assessments on supervised entities to increase its understanding of the inherent risk, mitigating measures and resulting residual risk of each supervised entity and to instruct entity-level supervisory plans.

This risk assessment focuses on the collective investments sub-sector, as an extension of the NRA. It aims to elaborate supervisory actions and identify specific sub-sectors, products and activities which present a higher risk of ML/TF. In doing so, it serves as a link between the sector-level and entity-level assessments.

The scope of this assessment encompasses all Luxembourg *regulated* undertakings for *collective* investments. **It focuses on Investment Fund Managers (IFM), considering their specific AML/CFT roles and responsibilities** in the sector and also covers other market participants such as service providers (for instance registrar and transfer agents).

**Important note:** While this assessment does not directly cover unregulated investments vehicles, pension funds, and securitization vehicles, these vehicles might find the information contained in this assessment helpful to reflect upon and strengthen their AML/CFT framework.

The present document is aimed for public distribution and constitutes a short version of a more substantive CSSF internal risk assessment.

This document fulfils multiple objectives, in particular:

- Serve as a resource for the Industry when performing their own ML/TF risk assessments;
- Promote the understanding of ML/TF risks and AML/CFT obligations in the Industry;
- Support public-private interaction;
- Reflect the CSSF's own understanding of particular ML/TF risks in the sub-sector;
- Further improve the CSSF supervisory activities and sub-sector specific supervision strategy, where relevant; and
- Serve as an input for CSSF risk assessments.

# 1. INTRODUCTION

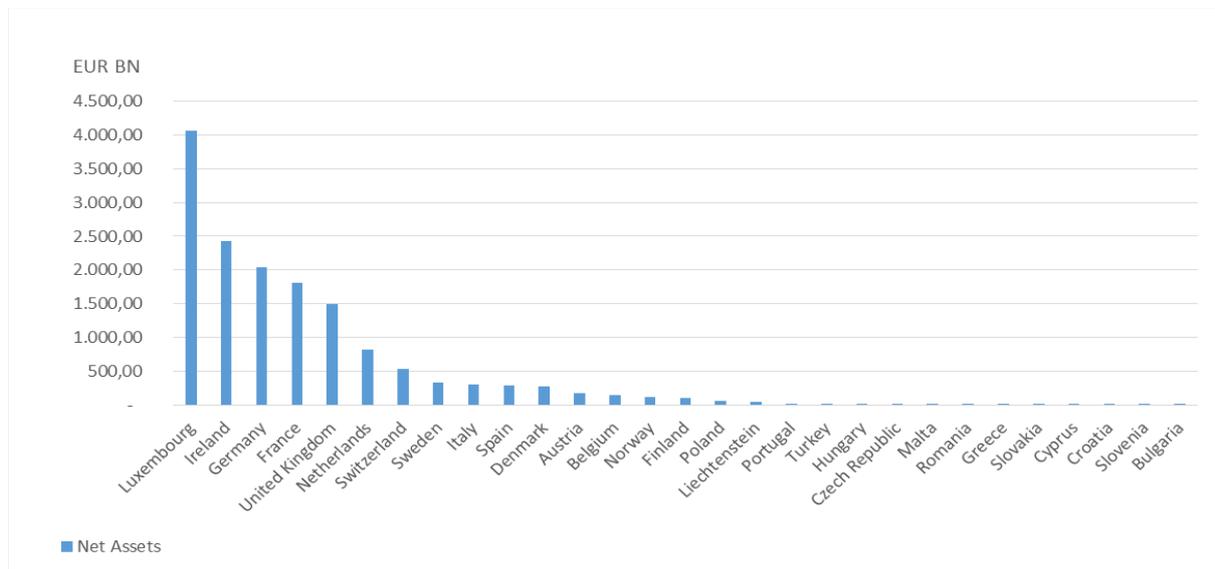
This section introduces the collective investments industry. A detailed understanding of the industry is key to identify, understand and assess ML/TF risks to which it is exposed. An overview of the landscape and its main participants must precede any ML/TF risk assessment.

## 1.1 Collective investments overview

Collective investments are companies or undertakings that invest in assets using funds collected from investors by means of issuing shares or units other than equity (e.g. partnerships). The asset gathering typically optimizes investment opportunities and reduces transaction costs.<sup>1</sup>

Luxembourg is the largest collective investment center in Europe, with more than EUR 4,000 BN in net assets (*Figure 1*).

*Figure 1: Net assets and fund units in the European collective investment sector by domicile<sup>2</sup>*

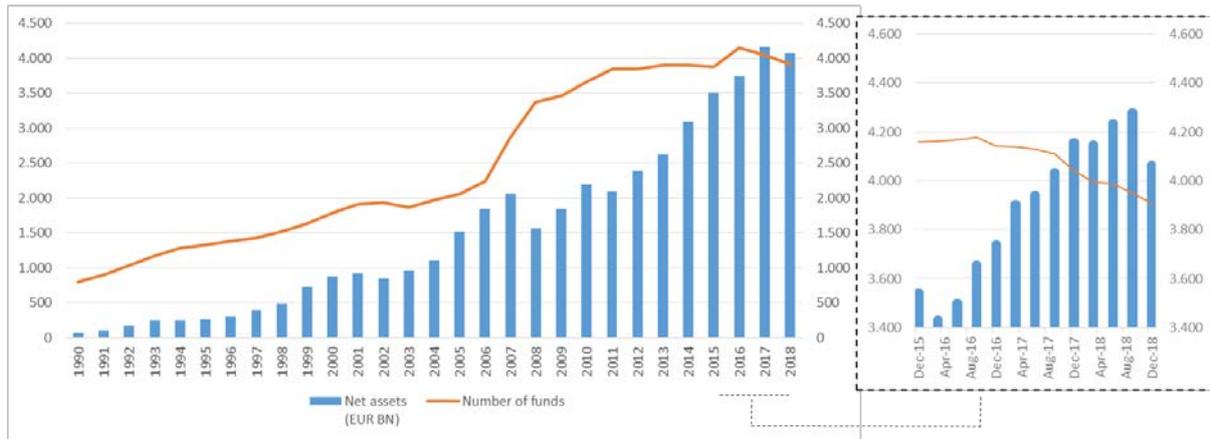


Net assets have steadily increased in the last decade, while growth in the number of collective investment funds has marginally decreased in recent years. As a result, the average net assets per fund have increased in Luxembourg (*Figure 2*).

<sup>1</sup> OECD, *Collective Investment Institutions*, OECD Benchmark Definition of Foreign Direct Investment 2008, 2009.

<sup>2</sup> EFAMA, *Quarterly Statistical Release*, as of end 2018.

Figure 2: Evolution of net assets and number of funds in Luxembourg<sup>3</sup>

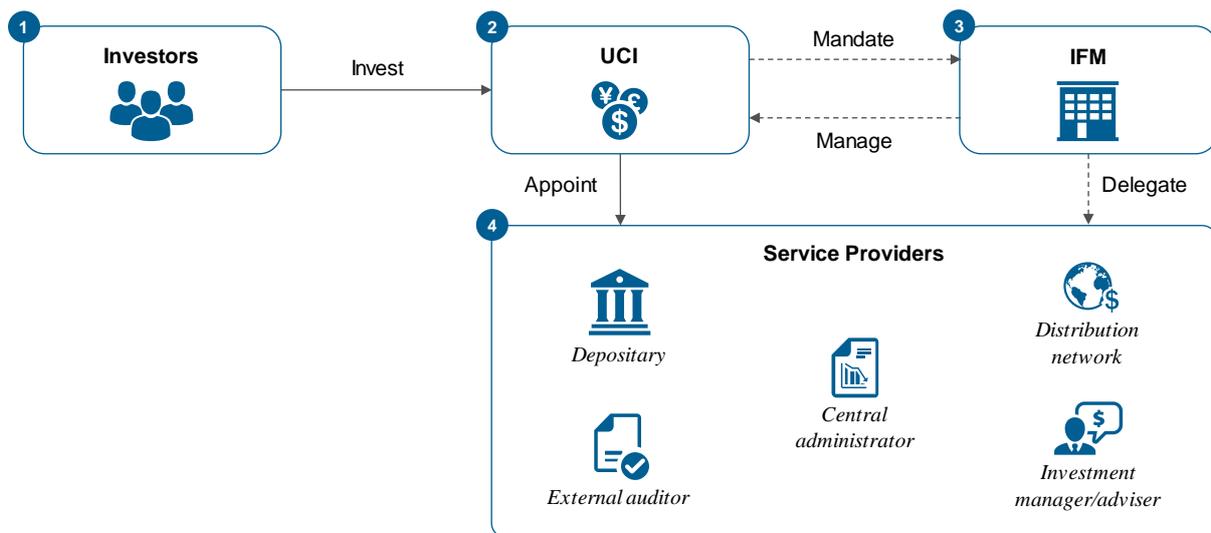


The collective investment industry relies on four main participants:

1. **Investors** providing capital to be invested in undertakings for collective investments;
2. **Undertakings for Collective Investments (UCI)**<sup>4</sup> receiving investors' capital and investing it in various assets according to a predefined investment policy;
3. **Investment Fund Managers (IFM)** managing the investment portfolio and its risks, administrating, marketing the UCI and, where applicable, overseeing the delegates;
4. **Service providers** supporting UCI and IFM with specialised activities (some providers must be appointed such as depositaries and external auditors, while other services may be delegated such as investment management and advisory, distribution and administration).

Figure 3 illustrates the collective investments landscape and the simplified interaction between its four main types of players.

Figure 3: Collective investments landscape and interaction between its players



<sup>3</sup> CSSF data as of 31 December 2018 (supervised collective investment funds only).

<sup>4</sup> Also referred to as Investment vehicles in this report.

### 1.1.1 Investors

Collective investments serve both retail and institutional investors, as well as both natural and legal persons. As per the European Supervisory Authorities (ESA), the investor may be:<sup>5</sup>

- a. *“a natural or legal person who directly purchases units of or shares in a fund on their own account, and not on behalf of other, underlying investors; or*
- b. *a firm that, as part of its economic activity, directly purchases units of or shares in its own name and exercises control over the investment for the ultimate benefit of one or more third parties who do not control the investment or investment decisions; or*
- c. *a firm, for example a financial intermediary, that acts in its own name and is the registered owner of the shares or units but acts on the account of, and pursuant to specific instructions from, one or more third parties (e.g. because the financial intermediary is a nominee, broker, multi-client pooled account/omnibus type account operator or operator of a similar passive-type arrangement); or*
- d. *a firm’s customer, for example a financial intermediary’s customer, where the firm is not the registered owner of the shares or units (e.g. because the investment fund uses a financial intermediary to distribute fund shares or units, and the investor purchases units or shares through the firm and the firm does not become the legal owner of the units or shares).”*

Financial intermediaries (category c) hold a significant portion of assets of Luxembourg UCI.

For some UCI, investors are split into retail and “well-informed” investors. “Well-informed” investors consist of institutional, professional and qualified investors.<sup>6</sup> In effect, this also allows High Net Worth Individuals (HNWI) to access a broader set of products. As highlighted in the next section, most alternative investments in Luxembourg are reserved to well-informed investors.

Luxembourg is also a leading market for cross-border distribution of funds, handling 61 % of European cross-border UCITS marketed in at least two foreign countries. Those Luxembourg funds are marketed in 73 countries.<sup>7</sup>

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<sup>5</sup> ESA, *The Risk Factors Guidelines*, June 2017.

<sup>6</sup> Law of 24 October 2008, Article 2: “Within the meaning of this law, a well-informed investor shall be an institutional investor, a professional investor or any other investor who meets the following conditions: 1) he has confirmed in writing that he adheres to the status of well-informed investor and 2) he invests a minimum of 125,000 Euro in the company, or 3) he has been subject to an assessment made by a credit institution within the meaning of Directive 2006/48/EC, by an investment firm within the meaning of Directive 2004/39/EC or by a management company within the meaning of “Directive 2009/65/EC”<sup>10</sup> certifying his expertise, his experience and his knowledge in adequately appraising an investment in risk capital”.

<sup>7</sup> Association of the Luxembourg Fund Industry, *Global Fund Distribution 2018*, 2018.

## 1.1.2 Undertakings for collective investments

Luxembourg offers a wide range of Undertakings for Collective Investments (UCI). These products may take a variety of forms, depending on their category, regime and structure.

Two main categories of collective investments are available in Luxembourg, with distinctive investment policies and investor bases.<sup>8</sup>

- **UCITS** (Undertakings for Collective Investments in Transferable Securities) were introduced in 1985 with the objective to create a single European market for open-ended investment funds investing in shares or bonds quoted on a stock exchange and aimed towards retail investors;<sup>9,10</sup>
- **AIF** (Alternative Investment Funds) encompass collective investments not covered by the UCITS Directive (e.g. hedge funds, venture capital, private equity or real estate) and are reserved to well-informed investors;<sup>11,12,13</sup>

Luxembourg collective investments are subject to various regimes under sectoral laws, mostly based on the asset class they invest in:

- **UCITS** are usually open-ended UCI focused on high levels of investor protection with strict rules relating to portfolio diversification, liquidity and leverage.<sup>14</sup>
- **UCI Part II** offer the most regulated alternative investment funds for strategies that do not meet the UCITS Part I criteria. They have no eligible assets restrictions, but are subject to investment objective approval by the CSSF. They are accessible to Luxembourg retail investors.<sup>15</sup>

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<sup>8</sup> This report focuses on *collective* investments which do not include two other categories of investment vehicles: pension funds (either SEPCAV or ASSEP) and special purpose vehicles (including securitisation vehicles).

<sup>9</sup> EU Parliament and Council Directive 2009/65/EC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

<sup>10</sup> Law of 17 December 2010 – Part I (“UCITS Law”), Article 2 (2): For the purposes of this Law, and subject to Article 3, UCITS means an undertaking (a) “with the sole object of collective investment in transferable securities and/or in other liquid financial assets referred to in Article 41(1)”, of capital raised from the public and which operate on the principle of risk-spreading, and (b) with units which are, at the request of holders, repurchased, directly or indirectly, out of this undertaking’s assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to any such repurchase.

<sup>11</sup> EU Parliament and Council Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM).

<sup>12</sup> Law of 12 July 2013 (“AIFM Law”), Article 1 (39): “Alternative Investment Funds (AIFs)”: collective investment undertakings, including investment compartments thereof, which: (a) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (b) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC.

<sup>13</sup> AIF may use European labels to distribute funds to retail investors across the EU, subject to the labels’ constraints: (i) EuVECA (European Venture Capital funds) may only invest in unlisted companies with up to 499 employees and SMEs listed on SME growth markets (EU Parliament and Council Directive 2017/1991 amending EU 345/2013); (ii) EuSEF (European Social Entrepreneurship funds) must invest in social impact projects as their primary objective (EU Parliament and Council Directive 2017/1991 amending EU 345/2013); and (iii) ELTIF (European Long-Term Investment Funds) must invest at least 70% in long-term assets such as infrastructure, public buildings, transport and sustainable energy (EU Parliament and Council Directive 2015/760).

<sup>14</sup> Law of 17 December 2010 – Part I (“UCITS Law”), see footnote 12 for definition.

<sup>15</sup> Law of 17 December 2010 – Part II (“UCI Law”), Article 3: The following are not subject to this Part: UCITS of the closed-end type, UCITS which raise capital without promoting the sale of their units to the public within the European Union or any part of it, UCITS whose units, under their management regulations or instruments of incorporation, may be sold only to the public in countries which are not members of the European Union, categories of UCITS determined by the CSSF, for which the rules laid down in Chapter 5 are inappropriate in

- **SIF** (Specialised Investment Funds) provide flexible multi-purpose investment vehicles, suited for all asset classes such as hedge funds, private equity, venture capital, real estate and infrastructure funds.<sup>16</sup>
- **SICAR** (*Société d'Investissement en Capital à Risque*) are specifically designed for private equity and venture capital transactions.<sup>17</sup>

Table 2 below summarises the categories, regimes and legislations of UCI.

Table 2: Overview of UCI categories, regimes and legislations

Category	UCITS	AIF (and regulated non-AIF SIF and SICAR)		
Regime	UCITS Part I	UCI Part II	SIF	SICAR
Law	2010 UCITS Law	2010 UCI Law	2007 SIF Law	2004 SICAR Law

Collective investments may be open-ended or closed-ended.

UCI may be set up under a contractual or corporate form, which is either as a common fund or as an investment company<sup>18</sup>:

- **A common fund** (*Fond Commun de Placement, or FCP*) is a co-proprietorship of assets which has no legal personality and is governed by a contractual arrangement. It must be managed by a Luxembourg IFM.
- **An investment company** is a normal corporate entity that may be managed by an external IFM or which may be internally self-managed. Investment companies may take various legal forms, such as a limited liability company (e.g. SA, SAS, Sàrl) or partnerships (e.g. SCA, SCS, SCSp). Two legal structures are available:
  - *Société d'Investissement à Capital Variable* (SICAV), whose capital is at any given time equal to its net assets, increasing and decreasing automatically as a result of subscriptions, redemptions and net asset value variations; and
  - *Société d'Investissement à Capital Fixe* (SICAF), which are subject to formalities when changes are made to their capital (e.g. notarisation and publication).

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view of their investment and borrowing policies. Article 87: This Part shall apply to all UCITS referred to in Article 3 and to all other UCIs situated in Luxembourg not covered by Part I.

<sup>16</sup> Law of 13 February 2007 ("SIF Law"), Article 1 (1): For the purpose of this Law, specialised investment funds shall be any undertakings for collective investment situated in Luxembourg: the exclusive object of which is the collective investment of their funds in assets in order to spread the investment risks and to ensure for the investors the benefit of the results of the management of their assets, and the securities "or partnership interests" of which are reserved to one or several well-informed investors, and the constitutive documents or offering documents "or partnership agreement" of which provide that they are subject to the provisions of this Law.

<sup>17</sup> Law of 15 June 2004 ("SICAR Law"), Article 1 (1): For the purpose of this law, an investment company in risk capital, in abbreviation "SICAR", shall be any company: that has adopted the legal form of a limited partnership, "special limited partnership," a partnership limited by shares, a cooperative in the form of a public limited company, a limited company or a public limited company governed by Luxembourg law, and whose object is to invest its assets in securities representing risk capital in order to ensure for its investors the benefit of the result of the management of its assets in consideration for the risk which they incur, and the securities "or partnership interests" of which are reserved to well-informed investors as defined in Article 2 of this law, and the articles of incorporation "or the partnership agreement" of which provide that it is subject to the provisions of this law.

<sup>18</sup> Except for SICAR which must be set up in corporate form.

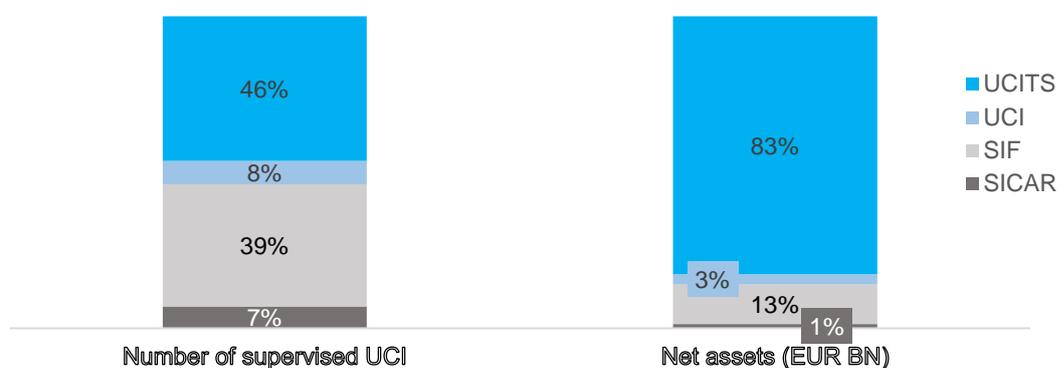
Table 3 below summarises the structures and forms available to UCI.

Table 3: Overview of UCI legal structures and forms

Basic structure	Contractual	Corporate	
Legal structure	FCP	SICAV	SICAF
Legal form	N/A	SA, SAS, Sàrl, SCA, SCS, SCSp	

The majority of UCI in Luxembourg are UCITS and SIF, both in terms of number and value (Figure 4). With nearly EUR 3,400 BN AuM, Luxembourg has a 35% market share in European UCITS.<sup>19</sup> Although relatively smaller in terms of AuM, most global private equity investments are structured using Luxembourg UCI (mostly SICAR and SIF), and 19 out of the top 20 global private equity firms have operations in Luxembourg.<sup>20</sup>

Figure 4: Number and net assets of UCI<sup>21</sup>



The asset allocation reflects the investment guidelines of IFM, meeting specific investor needs. As illustrated in Figure 5, the pattern of investments by each type of UCI may broadly be summarised as follows:

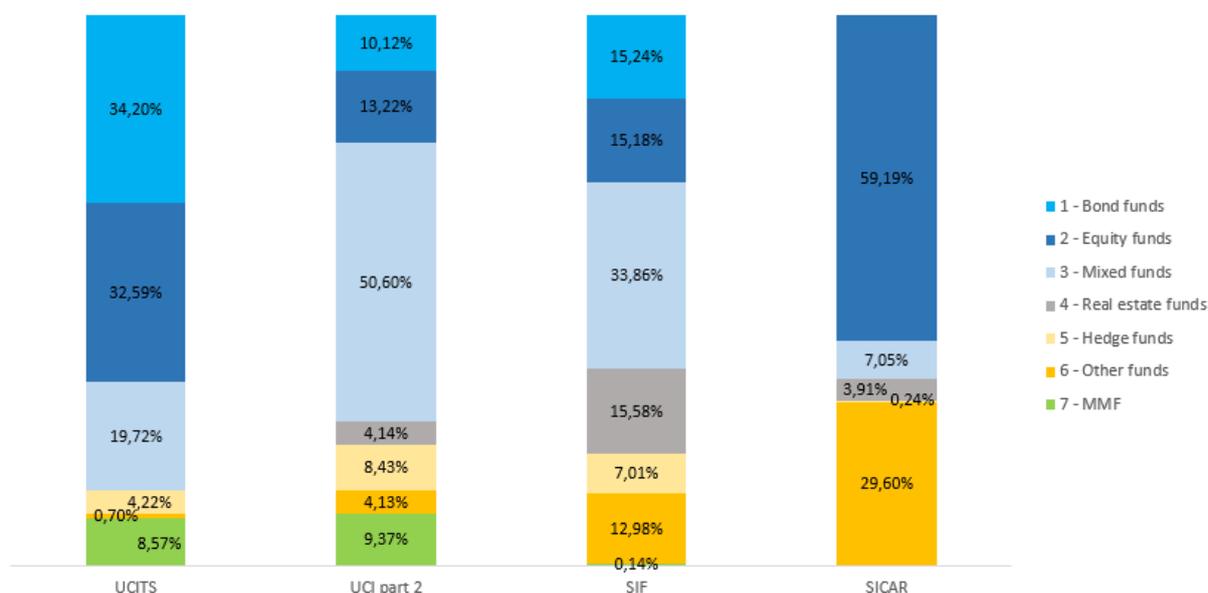
- **UCITS** are largely invested in traded (or transferable) bonds and stocks;
- **UCI Part II and SIF** are made of mixed funds, hedge funds, real estate funds and funds of funds, with varied asset classes; and
- **SICAR** are mostly used for private equity and venture capital investments.

<sup>19</sup> Luxembourg for Finance, *Financial Centre, Asset Management*, 2018.

<sup>20</sup> Luxembourg for Finance, *Financial Centre, Asset Management*, 2018.

<sup>21</sup> CSSF data as of 31 December 2018 (including supervised entities only).

Figure 5: Net assets per regime and investment strategy (EUR BN)<sup>22</sup>



### 1.1.3 Investment fund managers

Three main categories of Investment Fund Managers (IFM), are active in Luxembourg, based on the type of UCI they manage:

- **UCITS ManCo** (Management Companies) for UCITS;
- **AIFM** (Alternative Investment Fund Managers) for AIF; and
- **Self or internally-managed UCI**.

Overall, multiple regimes are available to IFM based on the UCI they manage and their country of origin (Table 4)<sup>23</sup>:

- **Luxembourg Chapter 15 ManCo** for UCITS;<sup>24</sup>
- **Foreign EU/EEA UCITS ManCo** for UCITS via EU/EEA passporting;
- **Luxembourg authorised AIFM** for AIF;<sup>25</sup>
- **Luxembourg registered AIFM** for below-threshold AIF;<sup>26 27</sup>

<sup>22</sup> CSSF data as of 31 December 2018 (including supervised entities only).

<sup>23</sup> Note that managers may combine several regimes, e.g. "Super ManCo", being managers with both Luxembourg Chapter 15 and AIFM licences.

<sup>24</sup> Law of 17 December 2010 – Chapter 15 ("OPC Law").

<sup>25</sup> Law of 12 July 2013 ("AIFM Law").

<sup>26</sup> EU Parliament and Council Directive 2011/61/EU on Alternative Investment Fund Managers; (17) This Directive further provides for a lighter regime for AIFM where the cumulative AIFs under management fall below a threshold of EUR 100 million and for AIFM that manage only unleveraged AIFs that do not grant investors redemption rights during a period of 5 years where the cumulative AIFs under management fall below a threshold of EUR 500 million.

<sup>27</sup> Defined in accordance with Article 3 of the Law of 12 July 2013 ("AIFM Law")

- **Luxembourg Chapter 16 ManCo** not authorised as an AIFM;<sup>28</sup>
- **EU/EEA AIFM and Non EU/EEA AIFM** of Luxembourg domiciled AIF;
- **Société d'Investissement Autogérée (SIAG)**;<sup>29</sup> and
- **Fonds d'Investissement Alternatif Autogéré (FIAAG)**, including **self-managed AIF, as well as self-managed non-AIF UCI**.<sup>30</sup>

For the rest of this report, IFM with multiple licences will be included in the most stringent regime (e.g. “Super ManCo” with Chapter 15 and authorised AIFM licences will be treated as Chapter 15 ManCo) and all self-managed AIF, as well as self-managed non-AIF UCI, will be treated together as FIAAG.

Table 4 summarises the categories, regimes and legislations of IFM.

*Table 4: Overview of IFM categories, regimes and legislations*

Category	UCITS ManCo		AIFM				Self or internally-managed	
	Lux Chap 15 ManCo	EU/EEA ManCo	Lux auth. AIFM	Lux reg. AIFM	Lux Chap 16 ManCo	EU/EEA and non EU/EEA AIFM	SIAG	FIAAG
<b>Law</b>	2010 OPC Law	2010 OPC Law	2013 AIFM Law	2013 AIFM Law	2010 OPC Law	2013 AIFM Law	2010 OPC Law	2013 AIFM Law

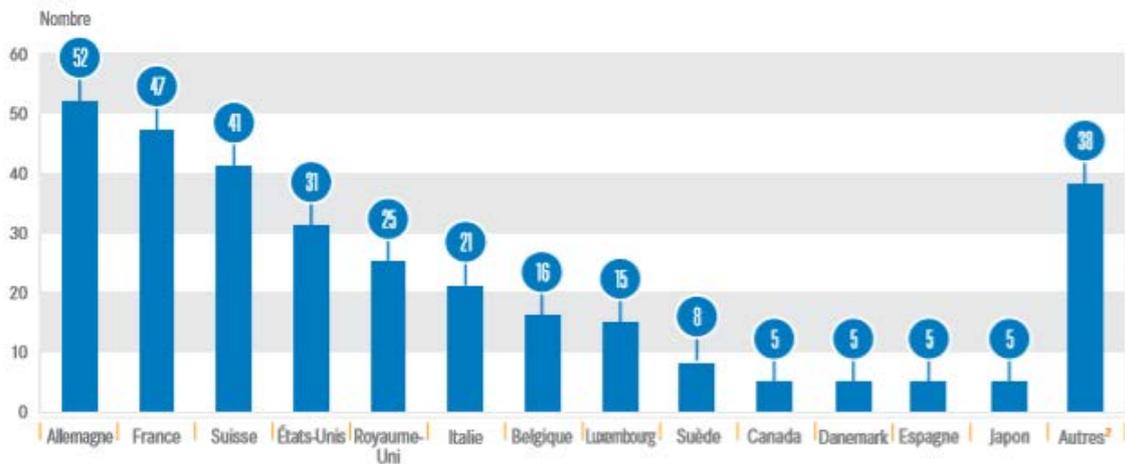
Luxembourg Chapter 15 ManCo and Luxembourg authorised AIFM originate mainly from other EU/EEA countries and the United States of America (USA) (*Figure 6*).

<sup>28</sup> Law of 17 December 2010 – Chapter 16 (“OPC Law”).

<sup>29</sup> Law of 17 December 2010 – Chapter 3, Article 27 (“OPC Law”).

<sup>30</sup> Law of 12 July 2013 – Chapter 1, Article 4 (1) b (“AIFM Law”).

Figure 6: Number of Lux Chapter 15 ManCo and authorised AIFM per country of origin<sup>31</sup>



Other Luxembourg IFM, although more numerous, have a much smaller share of net assets.

IFM also differ by management model, especially with regards to the third parties they appoint and the services they delegate. These services are outlined in the next sub-section.

#### 1.1.4 Service providers

Some UCI (i.e. UCITS), via their Board of Directors, *are required by law* to appoint competent third parties for specific activities, in particular:

- **Depository (or custodian)** for the safe-keeping of assets, the day-to-day administration of assets and for overseeing asset valuations, for subscriptions and redemptions, to carry out manager instructions, for transaction settlement and income distribution; and
- **External auditor** (*Réviseur d'Entreprise Agréé*) for certifying financial reports and other legal reports.<sup>32</sup>

A broad range of service providers may also support the UCIs and/or their managers, typically including:

- **Investment manager and advisors** by respectively making and advising on investments and portfolio allocation decisions (note that investment management is the core function of the IFM, which can be directly provided by the IFM itself or by delegation);
- **Distributor** by marketing and distributing the fund units through a variety of channels (e.g. private banks, financial advisers, platforms);
- **Central administrator** by providing accounting, portfolio valuation and unit pricing (e.g. NAV calculation), contract settlements, customer enquiries and record keeping services;

<sup>31</sup> CSSF annual report, 2018. Other countries of origin include Australia (3), Greece (3), Jersey (3), Netherlands (3), Andorra (2), Austria (2), Finland (2), Liechtenstein (2), Malta (2), Portugal (2), Qatar (2), Russia (2), Bermuda (1), BVI (1), Chile (1), Guernsey (1), Ireland (1), Mauritius (1), Norway (1), Poland (1), South Africa (1), United Arab Emirates (1).

<sup>32</sup> Independent auditors are authorised and supervised on AML controls when on-boarding clients by the *Institut des Réviseurs d'Entreprises* (IRE), their appointment must be approved by CSSF (their prudential supervisor).

- **Transfer agent (or registrar)** by executing unit subscriptions and redemptions, maintaining the unit-holder register and monitoring regulatory compliance, often including AML/CFT controls;
- **Paying agent** by arranging distributions to investors; and
- **Domiciliation agent** by managing domiciliation, office facilities, correspondence and payment of bills.

The majority of these service providers in Luxembourg are regulated by the Law of 5 April 1993 on the financial sector.

The board of directors of the UCI and the IFM appointed by the UCI retain the overall responsibility over the outsourced activities and must perform initial and ongoing due diligence on their delegates.<sup>33</sup>

The expansion of collective investments has led to the development of many specialised service providers in Luxembourg, across the entire value chain. Most service providers offer multiple services listed above (e.g. distribution and paying agency, or central administration and transfer agency).

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<sup>33</sup> Delegation is also assessed by CSSF during the licensing process.

## 1.2 Collective investments ML/TF context

The CSSF applies a risk-based approach to AML/CFT supervision, in line with FATF guidelines and recommendations. This implies identifying, assessing and understanding ML/TF risks faced by the collective investments sector, its specific products and services, the customers and jurisdictions, the channels of delivery involved; and taking AML/CFT measures commensurate to those risks in order to mitigate them effectively.<sup>34</sup>

The **FATF** has highlighted the securities sector, including collective investments, as being exposed to ML/TF schemes. Indeed, the sector is generally characterised by its complexity, internationality, high level of interaction, high volumes, speed and anonymity. These characteristics create opportunities for those who would abuse or misuse the sector for illicit purposes, including for ML/TF.<sup>35</sup>

**The EU Supra-National Risk Assessment (SNRA)** noted that despite mitigating measures in place, the risk of ML remains significant for certain segments of the financial sector, and in particular for institutional investments. This is due to the overall higher exposure to product and customer risks, pressure from competition in the sector and a limited understanding of operational AML/CFT risks.<sup>36</sup>

**The National Risk Assessment (NRA)** also considered the investment sector generally to be vulnerable to ML/TF, as the sector is large and diverse with a variety of entities and large amounts of money being invested on behalf of wealthy individuals or entities. The detection challenges are not to be underestimated due to high market fragmentation in terms of number of providers and also high volume of investors and related transactions.

Recent years have seen an increasing number of reports to the Ministry of Finance for Targeted Financial Sanctions (TFS) and Suspicious Activity Reports (SAR) and Suspicious Transaction Reports (STR)<sup>37</sup> involving IFM and UCI to the Financial Intelligence Unit, which supports the FATF, SNRA and NRA conclusions.

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<sup>34</sup> FATF, *Guidance for a Risk-Based Approach*, Securities sector, October 2018.

<sup>35</sup> FATF, *Report on ML/TF in the Securities Sector*, October 2009.

<sup>36</sup> European Commission, *Report from the commission to the European Parliament and the Council on the assessment of the risks of money laundering and terrorist financing affecting the internal market and relating to cross-border activities*, 2017.

<sup>37</sup> Historic analysis of FIU reports on SARs and STRs filing.

### 1.3 Collective investments regulation and supervision

The CSSF is responsible for the financial regulation in Luxembourg. It supervises the professionals and products of the Luxembourg financial sector, including their compliance with AML/CFT obligations.

Dedicated CSSF OPC departments supervise both IFM and UCI active in Luxembourg (through the application of a double layer of supervision), under the sectoral laws listed in Table 5.

Table 5: Laws setting the supervision requirements for IFM and UCI

Supervisory dept.	Sector	Law	Regime
OPC	IFM	2010 OPC Law – Chapter 15	Chapter 15 ManCo
		2010 OPC Law – Chapter 16	Chapter 16 ManCo
		2013 AIFM Law	AIFM
	UCI	2010 OPC Law – Part I	UCITS – Part I
		2010 OPC Law – Part II	UCI – Part II
		2004 SICAR Law	SICAR
		2007 SIF Law	SIF

Some particular regulatory and supervisory treatments should be noted for both IFM and UCI:

- **Registered AIFM** include IFM managing AIF whose assets under management are below the thresholds specified in the Law of 2013 (“AIFM Law”), who therefore must be registered with the CSSF and who benefit from a lighter regime as the one prescribed for authorised AIFM by the AIFM Law. The lighter regime does, however, not apply to AML/CFT obligations to which registered AIFM are fully subject.
- **Regulated non-AIF** include SICAR and SIF not meeting the AIF definition in accordance with the Law of 2013 (“AIFM Law”) (e.g. not raising capital from a number of investors), but which qualify as SICAR or SIF under the Law of 2004 (“SICAR Law”) or the Law of 2007 (“SIF Law”).

Other CSSF departments supervise most of the other market participants referred to in Section 1, such as institutional investors (e.g. banks and specialised service providers such as investment firms, and (specialised) professionals of the financial sector).

Luxembourg IFM and their UCI benefit from EU/EEA passporting rights, if they fall under the UCITS or AIFM regimes:

- **A management passport** permitting IFM to perform authorised activities in other EU/EEA Member States; and
- **A marketing passport** permitting UCI to be marketed in other EU/EEA Member States under the UCITS (fund-level) or AIFM (manager-level) regimes.

Passported activities may be provided via:

- **Free provision of services** (i.e. cross-border activity without local presence); or
- **Free establishment of branches** (i.e. cross-border activity with local presence).

Both passports do not necessitate prior authorisation or additional requirements from *host* Member States, but require a pre-notification to be filed with the *home* Member State.

## 2. APPROACH

This section describes the approach used to assess ML/TF risks in the collective investment industry.

### 2.1 Stakeholders

The CSSF led this sub-sector risk assessment, which integrates input from other competent authorities and market participants. In particular, this report was drafted by the following parties:

- **CSSF:** internal AML/CFT teams and sub-sector experts drafted the assessment. The document was disseminated within the CSSF on a regular basis to discuss progress and to solicit input and feedback from respective departments (including data and expert insights on service providers);
- **Cellule de Renseignement Financier (CRF):** the CRF was a primary stakeholder for the compilation of the report. It provided SAR/STR data pertaining to collective investments; and
- **Industry associations and private sector:** the CSSF held regular meetings with a formally institutionalised external AML/CFT Expert Working Group, composed of the Association of the Luxembourg Fund Industry (ALFI), the Luxembourg Private Equity and Venture Capital Association (LPEA), the Real Estate Association of Luxembourg (LuxReal), the Association Luxembourgeoise des Compliance Officers (ALCO), the Institut des Réviseurs d'Entreprises (IRE) and the Luxembourg Barreau (Ordre des Avocats du Barreau de Luxembourg), as well as the ABBL Depository Banking cluster and the Financial Intelligence Unit.

## 2.2 Process

This assessment follows the general CSSF risk assessment approach defined in the AML/CFT risk assessment policy.<sup>38</sup> The process is made of six steps, as described in *Figure 7* below.

- The OPC AML Division in charge of the risk assessment defined the scope and methodology of the report.
- The OPC AML Division performed desk-based research, reviewing national and international sources, and gathering input from relevant CSSF experts across departments. Based on these initial findings, the OPC AML Division drafted a preliminary report.
- The OPC AML Division used the input of an external AML/CFT Expert Working Group composed of all major industry associations.
- Building upon the information collected as part of desk-based research and expert input, the OPC AML Division consolidated findings into a refined report. All outputs defined as part of the scope were articulated, including areas for further enhancement. Two versions of the risk assessment were created, one for internal CSSF purposes and one to be shared with the private sector.
- The OPC AML Division presented the refined report to the private sector via formal consultation, during which the consulted parties could provide feedback. Where appropriate, the OPC AML Division then incorporated the feedback into the final report.
- The CSSF published the final report and used it during events to raise awareness with the private sector.

*Figure 7: Sub-sector risk assessment approach*



<sup>38</sup> CSSF, Note de Service 19/477, *ML/TF Risk Assessment Policy*.

## 3. METHODOLOGY

### 3.1 Scope and clustering

A clustering aims to group together elements with similar characteristics and risk profiles into a manageable number of classes, in order to assess their relative ML/TF risk.

This report groups IFM and UCI in three main classes. The classes are defined according to common characteristics used to compare ML/TF risk, such as eligible asset classes, eligible investors, net assets under management and management models. Each class is mutually exclusive, and all classes taken together cover the full spectrum of regulated collective investments in Luxembourg.<sup>39</sup> The three classes subject to a detailed risk assessment are:

1. UCITS ManCo (including Super ManCo);
2. AIFM; and
3. Self or internally-managed UCI.

#### 3.1.1 Inherent risk – threat assessment

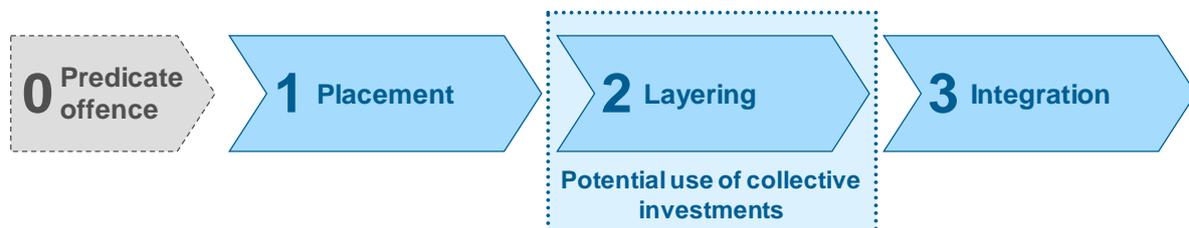
Threats are types of predicate offences generating illicit proceeds which could give rise to ML/TF. The objective of the threat assessment is to understand the environment in which predicate offences are committed, to identify their nature and to assess the exposure of collective investments to them.

This report examines the most relevant threats for collective investments, considering “very high” and “high” threats highlighted in the NRA, as well as the additional “medium” and “low” risk threats which may be perpetrated via UCI. The NRA threats are themselves based on the FATF list of designated categories of predicate offences.<sup>40</sup>

This report outlines why collective investments may be at risk of being abused or misused for ML, in particular for the layering stage illustrated in *Figure 8*:<sup>41</sup>

1. **Placement**: introduction of illicit proceeds into the financial system
2. **Layering**: transactions and movements of these proceeds to distance them from their source
3. **Integration**: re-entry of “cleansed” proceeds/assets into the legitimate economy

*Figure 8: Money laundering stages*



<sup>39</sup> CSSF data as of 31 December 2018 (including supervised entities only).

<sup>40</sup> FATF, [Glossary](#).

<sup>41</sup> FATF FAQ, [How is money laundered?](#)

Some predicate offences may be perpetrated within the collective investments industry itself, which increases the likelihood of the three stages of money laundering also occurring within collective investments. This report details four particular threats, namely: fraud and forgery, tax crimes, corruption and bribery, as well as insider trading and market manipulation.

However, in practice, the illicit proceeds from all threats highlighted in the NRA may potentially be channelled via collective investments, even if the predicate offences are not committed in the collective investments industry. This is an important nuance between this sub-sector risk assessment and the NRA: the more granular the risk assessment is and the more effective the risk mitigation measures are, the less likely illicit proceeds will be laundered through the same sector in which the underlying predicate offence was committed. When analysing threats, this report hence makes a distinction between specific threats that could be perpetrated within collective investments and general threats that are not perpetrated within collective investments.

TF threats are presented separately given the different nature of criminal activity, in line with the NRA.

While primary exposure may be during the layering phase, it is to be noted that collective investments may be abused for money laundering purposes in the other stages, notably in the placement phase through contributions in kind (“CIK”) and integration through distributions in kind (“DIK”).

### 3.1.2 Inherent risk – vulnerability assessment

Vulnerability is the relative exposure of a sector or sub-sector for ML/TF purposes. FATF defines vulnerabilities as “things that may be exploited by the threat or that may support or facilitate its activities”.<sup>42</sup> This may also include the features of a particular sector, a financial product or type of service that make them exposed to ML/TF.

In the context of this sub-sector risk assessment, the vulnerability assessment was conducted at the level of each element of the clustering. Vulnerability arises from collective investment activities which are particularly exposed to abuse or misuse for ML/TF purposes. The objective is to determine the level of ML/TF risk posed by each element of the collective investments clustering presented in Section 5.

Vulnerability is driven by multiple factors in the collective investment industry, including market structure, geography, customers (investors in UCI), product, services and transactions, as well as channels of distribution.

### 3.1.3 Mitigating factor assessment

Mitigating factors are all the elements in place that contribute to combat ML/TF. This includes both supervisory measures and controls at entity level (e.g. legal, judicial, supervisory and internal AML/CFT frameworks) in place to reduce ML/TF risks.

In the context of this sub-sector risk assessment, the assessment of mitigating factors was conducted at the level of each element of the clustering. Mitigating factors may be distinguished with the following dimensions: Risk Based Approach, AML/CFT supervision, Ongoing Monitoring and Procedures & Trainings.

The mitigating factor assessment was used to determine specific actions and recommendations where gaps were identified.

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<sup>42</sup> FATF, *FATF Guidance on National Money Laundering and Terrorist Financing Risk Assessment*, February 2013

## **3.2 Data sources**

This assessment uses both quantitative and qualitative data. This includes international sources (e.g. from international organisations, foreign competent authorities, industry bodies, academia), other domestic competent authorities (e.g. CRF, Parquet and tax administrations), CSSF internal data collected as part of supervisory measures, CSSF expert input, information provided by the private sector (e.g. via questionnaires, interviews or workshops) and other domestic sources.

## 4. INHERENT RISK – THREAT ASSESSMENT

The objective of this section is to understand the environment in which predicate offences are committed, to identify their nature and to assess the exposure of collective investments to them. Threats are types of predicate offences generating illicit proceeds which could give rise to ML/TF. It should be noted that threats are analysed within the inherent risk assessment, that is, in the absence of mitigating factors and controls.

### 4.1 ML/TF threat overview

The NRA identified several predicate offences which may occur in Luxembourg. Starting from the FATF list of designated categories of predicate offences, and using a weighted average of external and domestic exposure, it concluded that drug trafficking, fraud and forgery, tax crimes and corruption, as well as bribery were very high threats (Table 6).

Table 6: National exposure to ML/TF threats map from the NRA

Designated predicate offence <sup>43</sup>	External exposure (75 %)	Domestic exposure (25 %)	Weighted average exposure
<b>Money laundering (average ML threat)</b>	<b>Very high</b>	<b>Medium</b>	<b>Very high</b>
Drug trafficking	Very high	High	Very high
Fraud and forgery	Very high	High	Very high
Tax crimes	Very high	Medium	Very high
Corruption and bribery	Very high	Medium	Very high
Participation in an organised criminal group & racketeering	High	Medium	High
Counterfeiting and piracy of products	High	Medium	High
Sexual exploitation, including sexual exploitation of children	High	Medium	High
Smuggling	High	Low	High
Robbery or theft	Medium	High	High
Trafficking in human beings and migrant smuggling	Medium	Medium	Medium
Insider trading and market manipulation	Medium	Low	Medium
Illicit trafficking in stolen and other goods	Medium	Low	Medium
Environmental crimes	Medium	Low	Medium
Illicit arms trafficking	Medium	Low	Medium
Counterfeiting currency	Low	Low	Low
Extortion	Low	Very Low	Low
Murder, grievous bodily injury	Low	Very Low	Low
Kidnapping, illegal restraint, and hostage taking	Low	Very Low	Low
Piracy	Low	Very Low	Low
<b>Terrorism and terrorist financing</b>	<b>Medium</b>	<b>Medium</b>	<b>Medium</b>

This report considers both domestic and international threats. The NRA noted that the threat of ML proceeds from domestic crimes is significantly smaller, due to Luxembourg's relatively

<sup>43</sup> Proliferation of weapons of mass destruction and its financing has also been added by FATF in its Recommendation 7 as another category of predicate offence (FATF, *Guidance on Counter-Proliferation Financing*, February 2018). It is out of scope of this report.

low crime rate and limited presence of organised crime. The threat of ML proceeds from international crime is however higher, given the international exposure of Luxembourg UCI.

**With respect to ML**, as observed by FATF, collective investments may be abused or misused both to launder illicit funds obtained elsewhere and to generate illicit funds within the industry itself through fraudulent activities.<sup>44</sup>

**With respect to TF**, collective investments may be abused or misused to raise, move and use funds related to terrorism in Luxembourg or abroad. However, there has been no identified case of TF involving Luxembourg UCI to date. This report evaluates TF as a separate type of threat for collective investments, in line with the NRA.

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<sup>44</sup> FATF, *Report on ML/TF in the Securities Sector*, October 2009.

## 4.2 ML threats

### 4.2.1 General ML threats for collective investments

Generally, collective investments may be abused or misused to launder the proceeds from any predicate offences identified as threats in the NRA.

The risk of ML for collective investments mainly lies in the *layering* stage of money laundering.<sup>45</sup> The following points provide examples of causes:

- **The sector is large and diverse**, with numerous UCI in Luxembourg (UCITS, AIF, etc.).
- **The high number of service providers and third parties** to perform AML/CFT controls.
- **The international nature of business** with a wide distribution of UCI outside the borders of Luxembourg.
- **The volume of transactions**, due to the high number of transactions and their value in the UCI industry.

### 4.2.2 ML threats more significant for collective investments

This section details four predicate offences that could involve the abuse and misuse of collective investments, and hence more significant threats to be considered within this sub-sector risk assessment, namely: fraud, tax crimes, corruption and bribery, as well as insider trading and market manipulation (see summary Table 7 below).

ML offences could be perpetrated by abuse or misuse of UCI, investors, IFM and their service providers, as well as by any type of UCI described in Section 1. The large sums involved, high competition and an incentive-driven environment may lead to a higher risk appetite and to a failure to adhere to internal controls, increasing the risk of attracting criminal investors to the industry.

The next sections define each threat in turn, presenting global risks for collective investments, and then focusing on specific risks for the Luxembourg industry. Red flag indicators are available at the back of the document under “FATF Suspicious activity indicators in relation to securities”.

The reader is advised to also take into account the findings and analyses which are further detailed in section 3.3 of the annual report 2018 of the Luxembourg FIU (“*Cellule de Renseignement Financier*”).<sup>46</sup>

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<sup>45</sup> FATF, *Report on ML/TF in the Securities Sector*, October 2009.

<sup>46</sup> Rapport 2018 de la Cellule de Renseignement Financier: <https://justice.public.lu/fr/organisation-justice/crf.html>

*Table 7: Overview of predicate offences perpetrated within collective investments*

<b>Predicate offence</b>	<b>Features increasing risk (non-exhaustive)</b>
Fraud	<ul style="list-style-type: none"> <li>• International exposure</li> <li>• Complexity and opacity of setup</li> <li>• Cross-border delegation of services</li> <li>• Diversity of asset classes</li> <li>• Conflicts of interest</li> </ul>
Tax crimes	<ul style="list-style-type: none"> <li>• International exposure</li> <li>• Complexity and opacity of setup</li> <li>• Concealed beneficial ownership</li> <li>• Cross-border operations</li> <li>• Cross-border investments</li> </ul>
Corruption and bribery	<ul style="list-style-type: none"> <li>• Ties and connections with public officials</li> <li>• Over-reliance on government approval</li> <li>• Use of third parties or local agents</li> <li>• Unconstrained discretion over investment and portfolio allocation decisions</li> <li>• Large stakes in portfolio companies</li> </ul>
Insider trading and market manipulation	<ul style="list-style-type: none"> <li>• International portfolio of securities, especially from less transparent markets</li> <li>• Active portfolio management in highly competitive environment</li> </ul>

## Fraud

Fraud in this section generally refers to deceptive practices related to collective investments. In this regard, fraud encompasses tax crimes, corruption and bribery, as well as insider trading and market manipulation. However, these predicate offences are treated separately in this report, and fraud here includes all other deceptive practices that could be committed via the abuse or misuse of collective investments.

Globally, collective investments risk to be abused or misused for different types of fraudulent practices, including for example “Ponzi” schemes, confidence or “boiler room” scams<sup>47</sup>, use of fictitious or “shell” companies<sup>48</sup>, misleading investments and misstated value determination.

Luxembourg’s position as an investment hub increases the likelihood for criminals to commit fraud by abusing or misusing Luxembourg-based UCI, and then launder the proceeds from that fraud through Luxembourg-based UCI.

The complexity of some UCI setups increases the risk of abuse and misuse from fraudulent activities. For example, a network of feeder funds and umbrella fund structures can be used to distance a fraudulent master fund from end-investors.<sup>49</sup>

Delegation of services, in particular cross-border delegation, can also make UCI less transparent and more vulnerable to fraud by segregating key control functions and reducing oversight over the full operations.

## Tax crimes

Tax crimes involve the intentional breach of the law in order to evade tax payments. They are considered to be predicate offences relative to ML in Luxembourg should significant amounts be defrauded (aggravated tax fraud, or *fraude fiscale aggravée*) or should they be committed via the systematic use of fraudulent practices (tax swindle, or *escroquerie fiscale*).<sup>50</sup>

Tax crimes are one of the main sources of crime proceeds across the world. The International Monetary Fund (IMF) estimates that tax evasion (illegal) and avoidance (legal) represent about USD 400 BN annually in OECD countries. However, they do not distinguish between legal and illegal schemes. The European Commission mentions the lack of conclusive figure regarding the amount of tax avoidance and evasion, although there is a consensus that it is substantive.

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<sup>47</sup> High-pressure sales tactics to sell overpriced or worthless securities to investors, often via “cold calls”.

<sup>48</sup> A shell company is a company with no operations used as a vehicle for financial transactions.

<sup>49</sup> Feeder funds invest the majority of their capital through a master fund, which performs all the investments.

<sup>50</sup> Law of 23 December 2016 and CSSF Circular 17/650, February 2017, clarifying the amendment of the General Tax Law of 22 May 1931 (Article 7, points 12 and 13, paragraph 396:

- (5) “If the fraud relates to a tax amount exceeding a quarter of the annual tax due and without being lower than EUR 10,000 or to an undue reimbursement exceeding a quarter of the annual reimbursement due without being lower than EUR 10,000 or if the eluded annual tax or annual reimbursement exceeds EUR 200,000, such fraud will be punished as **aggravated tax fraud** by imprisonment from one month to three years and a fine of between EUR 25,000 and an amount equal to six times the amount of eluded tax or unduly received reimbursement.”
- (6) “If the fraud relates to a significant amount either in absolute terms or in relation to the annual tax due or annual reimbursement due and has been committed through the systematic use of fraudulent acts with the purpose of dissimulating pertinent facts from tax authorities or of persuading them that inaccurate information is factual, such fraud shall be punished as **tax swindle** by imprisonment of one month to five years and a fine of between EUR 25,000 and an equal to ten times the amount of eluded tax or unduly received reimbursement.”

Luxembourg collective investments are exposed to being abused or misused for tax crimes due to their international exposure. As noted above, Luxembourg has added aggravated tax fraud (*fraude fiscale aggravée*) and tax evasion (*escroquerie fiscale*) to the list of predicate offences for ML, helping to reduce the likelihood of such crimes by extending AML/CFT measures to these offences (e.g. KYC and Suspicious Activity Reporting (SAR) obligations).

## Corruption and bribery

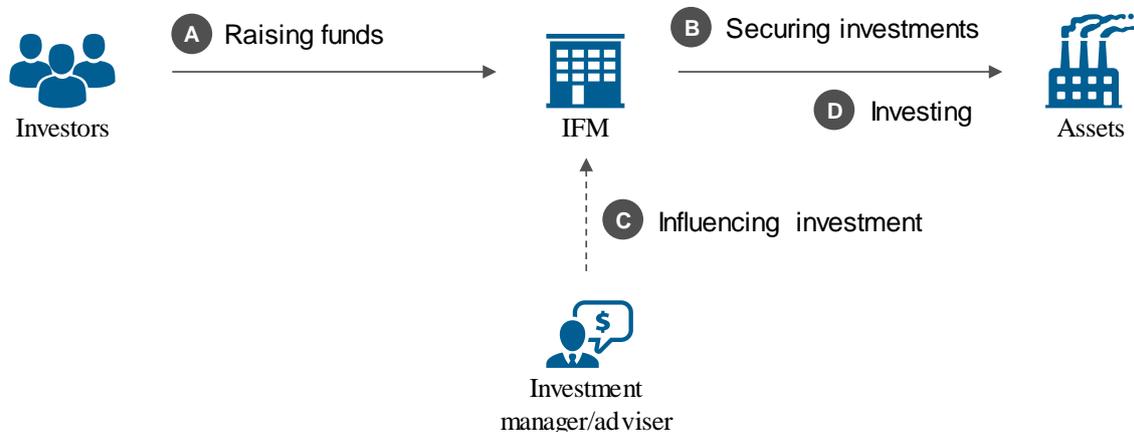
Transparency International defines corruption as the “abuse of entrusted power for private gain”, and bribery as the “offering, promising, giving, accepting or soliciting of an advantage as an inducement for an action which is illegal, unethical or a breach of trust”.<sup>51</sup> Under the Luxembourg legal framework, the criminal offence can be committed by both public officials and private individuals and/or entities.<sup>52</sup>

Overall, collective investments can be abused and misused for different types of corruption and bribery on both the liability (inbound investments) and asset (outbound investments) sides, including through:

- A. **Raising funds** from corrupt government-related investors (inbound investments);
- B. **Securing investments** in corrupt government-related projects (outbound investments);
- C. **Influencing investment** and portfolio allocation decisions (outbound investments);
- D. **Investing** in corrupt portfolio companies (outbound investments).

Figure 9 provides a schematic illustration of these four types of corruption and bribery scenarios, which are described in turn in this section.

Figure 9: Types of corruption and bribery abusing and misusing collective investments



<sup>51</sup> Transparency International, Anti-Corruption Glossary.

<sup>52</sup> Luxembourg Criminal Code, *Chapitre III. - Du détournement, de la destruction d'actes ou de titres, de la concussion, de la prise illégale d'intérêts, de la corruption, du trafic d'influence, et des actes d'intimidation commis contre les personnes exerçant une fonction publique, Art. 240 et seq. (public corruption) and Chapitre VIII. - Des infractions relatives à l'industrie, au commerce et aux enchères publiques, Art. 310 et seq. (private corruption).*

## A. Raising funds

Funds are frequently soliciting capital from public investors, increasing the risk of abuse or misuse for bribing of public officials in charge of capital allocation. The rise of state-owned, sovereign wealth funds or pension funds related to nationalised industries has further increased the relationship between these funds and public officials.

## B. Securing investments

Collective investments could also be abused or misused to bribe public officials to obtain or retain businesses. Some investments rely on government approval, licences or other legal agreements. This typically applies to investments in natural resources, infrastructure and public real estate, but also to other assets with large government contracts such as telecommunication projects. The risk increases when partnering with third parties or using local agents in jurisdictions with greater corruption and bribery risk.

## C. Influencing investment

Portfolio advisors and IFM are exposed to abuse and misuse through bribes in order to influence their investment decisions. The high stakes involved in most collective investment decisions and the concentration of decision-making powers increase the risk of abuse and misuse of portfolio managers via bribes.

## D. Investing

UCI taking significant stakes in companies, such as private equity or venture capital funds, are also exposed to the risk of investing in portfolio companies that engage in corrupt practices. As owners of these companies, UCI could be abused or misused to conceal, or even continue, such activities.

In Luxembourg, as noted in the NRA, the risk of corruption of domestic officials is limited given the low level of domestic criminality in Luxembourg, the size of its economy and public sector. Transparency International ranks the country 8<sup>th</sup> out of 180 in its Corruption Perception Index<sup>53</sup>, and the World Bank ranks Luxembourg 8<sup>th</sup> out of 247 in its Controls of Corruption Index<sup>54</sup>.

Luxembourg collective investments are however exposed to the risk of foreign corruption and bribery illustrated above. The concentration of capital, high-value and cross-border operations of Luxembourg UCI increases the threat of corruption and bribery.

## Insider trading and market manipulation

Insider trading refers to the buying or selling of a security based on material non-public information about the security or the issuer of a security, in violation of a fiduciary duty or other relationship of trust and confidence.<sup>55</sup> Luxembourg defines the following acts of market abuse as criminal offences when they are committed with the intention to procure, to the relevant person or to a third party, through any kind of fraudulent behaviour, an illegitimate, even indirect profit: insider trading, recommending or inducing another person to engage in insider trading, unlawful disclosure of inside information and market manipulation.<sup>56</sup>

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<sup>53</sup> Transparency International, *Corruption Perception Index*, 2017.

<sup>54</sup> World Bank, *Data Bank: Worldwide Governance Indicators, Control of Corruption*, 2016.

<sup>55</sup> FATF, *Report on ML/TF in the Securities Sector*, October 2009.

<sup>56</sup> Law of 27 December 2016 on Market Abuse, Chapter 3, Art. 17-23.

In general, the threat of insider trading for IFM and collective investments is high. This is more acute in situations of active portfolio management with intense competition.

In Luxembourg, the threat of domestic insider trading was assessed as low in the NRA due to the low volume and low complexity of domestic trading, the type of financial instruments admitted to trading (mostly debt instruments), the likely low proceeds and the enhanced transparency of the activity in Luxembourg (members and participants of the Luxembourg Stock Exchange are exclusively regulated firms). However, the significant presence of active IFM with international stocks increases the threat of insider trading via Luxembourg UCI.

Market manipulation consists in deceiving investors by artificially influencing the market for a security. This typically involves influencing the price of a security to benefit from price differentials.<sup>57</sup> Low priced, illiquid and/or low volume securities are particularly vulnerable to market manipulation. The following types of market manipulation could be conducted via the abuse or misuse of collective investments:<sup>58</sup>

- **“Trash and cash”** consists in artificially lowering the price of a stock with false or misleading statements in conjunction with securities sales (“trash”) before buying it for a profit (“cash”);
- **“Pump and dump”** consists in artificially raising the price of a stock with false or misleading statements in conjunction with securities purchases (“pump”) before selling it for a profit (“dump”);
- **“Pools”** are agreements between investors to let one party trade in specific securities for a specific period of time and then share the resulting profits or losses;
- **“Churning”** takes place when an investor makes both buy and sell orders at the same time to increase activity, attract investors and raise prices;
- **“Runs”** are activities or rumours created to drive up the price of a security;
- **“Ramping”** artificially raises the price of a security and gives the impression of voluminous trading in order to make a quick profit;
- **“Wash sale”** consists in selling and repurchasing the same or substantially same security for the sole purpose of generating activity and raising its price; and
- **“Bear raid”** attempts to drive down the price of security by heavy selling or short selling.

Globally, there have been some cases of market manipulation via the abuse or misuse of collective investments. For example, the IFM could collude over the price of a security before an IPO. The risk of price collusion is increased in situations with a limited number of investors making high value investments, in particular in securities which are difficult to price.

The threat of market manipulation for Luxembourg collective investments exists due to the volume and value of transactions. While there have been few cases of market manipulation in Luxembourg in the last years, the threat remains, as highlighted by the EUR one million fine the CSSF imposed in 2017 for market manipulation infringements.

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<sup>57</sup> FATF, *Report on ML/TF in the Securities Sector*, October 2009.

<sup>58</sup> Moneyval, *Typology research: Use of securities in money laundering schemes*, 2008.

### 4.3 TF threats

Terrorist financing encompasses the raising, movement and use of funds by terrorist actors and is considered as one of the most important threats to global security.<sup>59</sup>

The impact of terrorist financing in collective investments is limited. As reported by the FATF, there has been “relatively little evidence of the securities industry being used to finance terrorism”.<sup>60</sup>

The risk of terrorist financing via Luxembourg collective investments is estimated to be low.

Several factors explain this pattern:

- **Short-term and transitory cash flow requirements** to move cash from one party to another (especially uncommon and unrelated parties) are less compatible with an industry focused on individual medium to long-term asset appreciation;
- **Strong preference for transfer methods outside of the regulated banking system** (e.g. Hawala, cash couriers) is incompatible with custodian obligations; and
- **Low value financing requirements** are unsuited to the common higher minimum subscriptions, and better served by the use of smaller amounts below the reporting thresholds.

However, despite estimated to being low, terrorist financing risks in the Luxembourg collective investments cannot be excluded, in particular given the size and international exposure of this sector.

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<sup>59</sup> FATF, *International standards on combating money laundering and the financing of terrorism and proliferation – the FATF recommendations*, 2012.

<sup>60</sup> FATF, *Money Laundering and Terrorist Financing in the Securities Sector*, 2009.

## 5. INHERENT RISK – VULNERABILITY ASSESSMENT

This section assesses vulnerability, which is the relative exposure of a sector or sub-sector for ML/TF purposes, for UCITS ManCo, AIFM and self or internally-managed UCI.

### 5.1 Inherent risk – vulnerability overview

The Luxembourg collective investments' largest inherent vulnerabilities arise from UCITS ManCo, Luxembourg Authorised and Registered AIFM, EU/EEA AIFM, as well as FIAAG. The vulnerabilities are medium-low for Lux Chapter 16 ManCo and for Non EU/EEA AIFM, and low for SIAG.

Table 8 below provides an overview of the inherent vulnerabilities for each clustering element and each class of elements.

Table 8: Summary of inherent risk – vulnerability assessment

Class	Inherent Risk (IR)	Element	Inherent Risk (IR)
UCITS ManCo (incl. Super ManCo)	High Risk	Lux Chap 15 ManCo	High Risk
		EU/EEA UCITS ManCo	Medium-High Risk
AIFM	Medium-High	Lux authorised AIFM	Medium-High Risk
		Lux registered AIFM	Medium-High Risk
		Lux Chap 16 ManCo	Medium-Low Risk
		EU/EEA AIFM	Medium-High Risk
		Non EU/EEA AIFM	Medium-Low Risk
Self or internally-managed UCI	Medium-High	SIAG	Low Risk
		FIAAG	Medium-High Risk

The vulnerability assessment considers five main **risk factors**: (1) Intermediaries; (2) Clients/Investors and geography; (3) Market structure; (4) Products, services and transactions; and (5) Channels of distribution. It analyses how these five risk factors influence the ML/TF risk in each clustering element and each class.

The number of customers as per the article 219-c of Chapter 9 of ESAs' Risk Factors Guidelines represents a large portion across the entire investor base. As the use of intermediaries to invest on behalf of underlying investors reduces the transparency in relation to of the end-investors in Luxembourg investment vehicles, the CSSF, in accordance with FATF RBA Guidance on the Securities Sector published in October 2018, pays strong attention to the effective application of Enhanced Due Diligence to cross-border intermediaries invested in Luxembourg investment vehicles.

## 5.2 UCITS ManCo (incl. SuperManCo)

**Luxembourg Chapter 15 ManCo** include an important number of entities who manage the large majority of assets in Luxembourg in a sector characterized by a relatively high degree of concentration. This element of the cluster is the category with the largest presence of PEPs in terms of customers as well as other business relationships. Luxembourg Chapter 15 ManCo heavily rely on cross-border distribution networks to market their UCI across Europe and in a number of non-EU jurisdictions.

The high inherent risk presented by this category is also explained by the volume of assets under management and the inclusion of entities benefitting from a double license (CH15 and AIFM) in this category. Therefore the AIFM component of this cluster increases the inherent risk notably because of the types of investments made by AIFs.

**EU/EEA UCITS ManCo** act as designated IFM of Luxembourg investment vehicles and are primarily located and supervised in five countries: Germany, France, United Kingdom, Ireland and Italy. Volumes of assets under management are a key risk driver.

The quality and transparency of distribution channels is also an important risk factor for EU/EEA AIFM. Indeed, the relationship between the IFM and end-investors is further distanced due to cross-border management and cross-border distribution which increases the ML/TF risks.

## 5.3 AIFM

**Lux authorised AIFM**<sup>61</sup> are generally of moderate size with most Luxembourg AIFM groups or parents originating from Switzerland, Germany and Belgium. The sector is characterized by a certain degree of fragmentation, with the top 10 entities representing 31% of total assets and the top 50 entities representing 71% of total assets.

They manage a diverse set of UCI, across different regimes, generally subject to less rules and diversification requirements than UCITS. The diversity of such types of investments statistically increases the risk of investing in high ML/TF risk assets.

The geographical reach of Luxembourg authorised AIFM facilitated by EU/EEA passporting agreements increases general ML/TF vulnerability. A portion of the overall distributors marketing funds managed by these AIFMs are not supervised by NCAs or self-regulated bodies for AML/CFT purpose which increases the overall risk of this category.

**Lux registered AIFM** include a high number of IFM, but their net assets remain low given the AIFMD regulatory threshold capping assets under management at EUR 100 million or EUR 500 million for unleveraged and close-ended AIF. Larger AIF over EUR 100 million managed by registered AIFM must be closed-ended, restricting investor redemption rights during a period of five years. The resulting longer-term nature of the investment limits the risk of ML/TF by developing the business relationship with the investor and delaying the integration of funds back into the economy. However, the types of investments remain less plain vanilla and therefore present higher ML/TF risks.

An important number of **Lux Chap 16 ManCo** are active in Luxembourg, Similarly to AIFM, this sector is fragmented. Chapter 16 ManCo not authorised as AIFM do not benefit from a passport to carry out activities outside of Luxembourg. Given this lack of EU/EEA equivalence,

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<sup>61</sup> Please note that AIFM with a CH15 license as well (Super ManCo) are counted in the Chapter 15 ManCo section of this report.

Chapter 16 ManCo remain less international than Luxembourg authorised AIFM, reducing ML/TF vulnerability.

Chapter 16 ManCo may manage regulated non-UCITS and non-AIF. These vehicles are subject to less harmonised rules than UCITS and AIF, and have to abide by less requirements. The investment types and areas of Chapter 16 ManCo are relatively diverse, increasing the risk of being exposed to higher ML/TF risk. Chapter 16 ManCo typically invest in less transparent and less liquid assets, potentially increasing ML/TF risks.

A portion of the distributors used for the marketing of their UCIs are not subject to AML/CFT supervision and few UCIs managed are considered by their designated IFMs as having a complex distribution scheme.

**EU/EEA AIFM** act as designated AIFM of Luxembourg investment vehicles and are primarily located and supervised in five countries: UK, France, Ireland, the Netherlands and Germany. Most IFM's groups or parents originate from North America (Canada and USA) and European countries.

Volumes of assets under management are a key risk driver. EU/EEA AIFM have predominantly global and European investment targets. Over half of asset classes are alternative investment, private equity or venture capital. These asset classes are typically less transparent and less liquid than traded securities and thus subject to higher ML/TF risk.

The quality and transparency of distribution channels is also an important risk factor for EU/EEA AIFM. Indeed, the relationship between the IFM and end-investors is further distanced due to cross-border management and cross-border distribution which increases the ML/TF risks.

**Non EU/EEA AIFM** also act as designated AIFM of Luxembourg investment vehicles but are supervised by non EU/EEA National Control Authorities. The funds managed are typically less transparent and less liquid than traded securities and subject to higher ML/TF risk.

The quality and transparency of distribution channels is also an important risk factor for non EU/EEA AIFM. Indeed, the relationship between the IFM and end-investors is further distanced due to cross-border management and cross-border distribution which increases the ML/TF risks.

## 5.4 Self or internally-managed UCI

Luxembourg only has a very limited number of **SIAG** with relatively low assets under management and the market is very concentrated. SIAG initiators originate from nine different jurisdictions, exclusively in Europe and North America.

SIAG are self-managed UCITS investment companies (SICAV), which present lower ML/TF vulnerabilities due to the nature of their investments and regulatory restrictions. As UCITS, SIAG invest in traded securities such as bonds and equities, the transparency of which and liquidity reduces risk of abuse or misuse for ML/TF.

The **FIAAG** are composed of internally self-managed AIF. The FIAAG are initiated from a very diverse set of countries but in terms of net assets and number of sub-funds most initiators originate from Luxembourg.

Those funds appear to primarily invest in traded securities (e.g. bonds and equities), therefore reducing their ML/TF risk exposure on assets.

FIAAG are reserved to well-informed investors. However, this may include HNWI and complex corporate structures with less transparent beneficial ownership which increases the ML/TF risk.

## 6. MITIGATING FACTORS AND RESIDUAL RISK ASSESSMENT

This section assesses mitigating factors, both supervisory measures and controls at entity level, and resulting residual risk for the different clusters. The elements are grouped into three classes: UCITS ManCo, AIFM and self or internally-managed UCI in analogy to the risk scoring.

### 6.1 Mitigation factors and residual risk overview

The assessment of mitigation is based on four mitigating factors: Risk Based Approach, AML/CFT Supervision, Ongoing Monitoring and Procedures & Trainings.

Luxembourg collective investments' largest residual risk remains in UCITS ManCo due to the inclusion of AIFM with double license (CH15 and AIFM) in that category which increases the AuM and therefore act as a force multiplier as well as with internally-managed AIF and non-AIF SIF/SICAR.

Table 7: Summary of mitigating measures – residual risk assessment

Class	Inherent Risk (IR)		Residual Risk (RR)
UCITS ManCo (incl. Super ManCo)	High Risk	Impact of mitigating factors	Medium-High Risk
AIFM	Medium-High	Impact of mitigating factors	Medium-Low Risk
Self or internally-managed UCI	Medium-High	Impact of mitigating factors	Medium-High Risk

### 6.2 UCITS ManCo (incl. SuperManCo)

For the **Lux Chap 15 ManCo**, the CSSF concluded that the implementation of detailed AML/CFT procedures and regular AML/CFT trainings within the entities improved the overall mitigation quality. On the downside, weaknesses have been identified for some entities through CSSF supervision in relation to the frequency of name screening on business relationships, risk scoring on assets and automation of investors' transaction monitoring; these had a negative impact on the overall assessment of the mitigation measures. The CSSF assessed as well the quality of the oversight on delegates and service providers performing AML/CFT controls on behalf of the UCIs and their designated IFMs and identified areas of improvement for a number of supervised entities.

For **EU/EEA UCITS ManCo**, the quality of the mitigation measures implemented by these IFMs was assessed mostly through the results of the international cooperation performed by the CSSF with other European National Control Authorities.

### 6.3 AIFM

Similarly to the Lux Chap 15 ManCo, the CSSF's supervision on **Lux authorised AIFM** concluded to some weaknesses in particular with respect to the frequency of name screening

and the quality of oversight on delegates and service providers performing AML/CFT controls on behalf of the UCIs and their designated IFMs.

Lux authorised AIFM do, however, largely implement an investments' risk scoring along with tailored procedures and AML/CFT trainings. Furthermore, overall good compliance is confirmed by the internal Compliance functions and the external auditors.

The assessment of the quality of mitigation measures implemented by **Lux registered AIFM** concludes that there subsist some inconsistencies in terms of the frequency of the screening of targeted financial sanctions and with regard to the implementation of detailed AML/CFT procedures and the definition of a Risk Based Approach. The CSSF has collected detailed information on the mitigation measures implemented by these IFMs in 2019 and will continue to do so on a yearly basis.

Some **Lux Chap 16 ManCo** do not perform adequate risk scoring of the UCI they service, despite having implemented overall solid procedures and dispatching adequate AML/CFT trainings. The insufficient frequency of the screening of targeted financial sanctions however negatively impacts the assessment of the overall quality of their mitigation measures.

Comparable to EU/EEA UCITS ManCo, the quality of the mitigation measures implemented by **EU/EEA AIFM** and **Non EU/EEA AIFM** was assessed mostly through the results of the international cooperation performed by the CSSF with other European National Control Authorities.

## 6.4 Self or internally-managed UCI

Overall good compliance is confirmed for most **SIAG** by the internal Compliance functions and the external auditors, especially in the light of appropriate AML/CFT procedures and AML/CFT trainings in place. Notwithstanding this, a limited number of SIAG will have to improve the screening frequencies for targeted financial sanctions and review their risk scoring methodologies for the UCI they service.

With regards to **FIAAG**, the CSSF observed similar mitigation issues as with the Lux registered AIFM cluster.

## 6.5 Most frequent off- and on-site findings

CSSF will communicate to supervised entities on a periodic basis (e.g. when meeting with the *Responsable du Respect* and *Responsable du Contrôle*<sup>62</sup> or other executives of Investment Fund Managers) the **most frequent on-site and off-site inspection findings** in the Luxembourg Collective Investment Sector.

Best practices identified include:

- Establishing a clear AML/CFT risk appetite statement;
- Performing at least yearly an AML/CFT training for all staff members, including typologies relevant to the Investment Fund industry and an update of the IFM's internal procedure;
- Performing daily Targeted Financial Sanctions, PEP and adverse media screening;
- Performing transaction monitoring by using automated systems including rules of volume, pattern and frequency; and
- Ensuring close oversight over branches, subsidiaries and all delegates and service providers performing AML/CFT controls on behalf of the UCIs and their designated IFMs.

Most common shortcomings identified include:

- Lack of challenge of positive conclusions by internal and external control functions by the Conducting Officers and the Board of Directors of IFMs despite shortcomings becoming visible when filing the annual AML/CFT questionnaire with the CSSF;
- Risk Based Approach not taking into consideration the investment side ("assets") of the UCI;
- Lack of discussion of AML/CFT topics at the management and senior management level of the IFMs;
- Insufficient frequency of Targeted Financial Sanctions screening;
- Lack of evidence of application of Enhanced Due Diligence to cross-border intermediaries;
- Lack of update of AML/CFT procedures and related controls after a license extension granted to the IFM;
- Lack of Targeted Financial Sanctions screening on the investments made by the UCI; and
- Insufficient oversight on delegates and service providers belonging to the same Group in relation to AML/CFT controls.

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<sup>62</sup> Please refer to the CSSF FAQ 25 November 2019.

## 7. AREAS FOR FURTHER ENHANCEMENT

This section outlines high-level recommendations to enhance the regulatory and supervisory framework. Each of these recommendations will be integrated as part of the CSSF's current AML/CFT strategy and action plan.

### 7.1 CSSF recommendations to the private sector

	Recommendations	How Investment Fund Managers may show compliance (examples)
1	Develop a clear AML/CFT risk appetite and strategy	AML/CFT risk appetite discussed and approved by BoDs in a written, detailed document, including the types of investors, geographies, products and services
2	Engage the Board of Directors in the IFM's AML/CFT strategy, policies and processes	Board minutes demonstrating engagement with AML/CFT issues
3	Integrate the information provided in this Sub-Sector Risk Assessment in the internal risk assessments	Internal risk assessments should make a clear reference to this Sub-Sector Risk Assessment
4	Promote a strict compliance risk culture throughout the whole organization.	Appropriate training programs in place including typologies relevant to the fund industry
5	Ensure robust processes are in place to reliably know and assess the channels of delivery risk of the funds	Develop a detailed matrix of distribution channels (i.e. type of distributor, countries) used by each fund with a corresponding risk scoring
6	When being part of a Luxembourg-based group, ensure that foreign branches and majority-owned subsidiaries apply AML/CFT measures consistent with Luxembourg and the host country requirements <sup>63</sup>	AML/CFT measures clearly documented at both Group and branch/subsidiary level, with evidence that the central AML/CFT functions effectively control the implementation of group-wide policies and procedures
7	When being part of a foreign-based group, ensure that the Luxembourg branch or subsidiary implement the Luxembourg requirements in addition to the policies and procedures of the group <sup>64</sup>	
8	Collaborate closely with competent national authorities and contribute to the effectiveness of the national AML/CFT framework	Provide prompt and accurate responses to requests by CSSF, the FIU; share best practices or provide feedback on publications (e.g. publications by industry associations)
9	Report without delay suspicious activities and transactions to the CRF and targeted financial sanction breaches to the Ministry of Finance	STR/SAR/TFAR/TFTR reporting in line with risk exposure
10	Formalize the Enhanced Due Diligence performed on cross border intermediaries	Evidence the application of Enhanced Due Diligence measures on cross border intermediaries at the level of the IFM or of the delegate for instance through a summary sheet detailing the documents collected and the conclusion of the analysis
11	Ensure that name screening against Targeted Financial Sanctions screening is performed immediately as required notably by EU regulations	Implement daily TFS screening or be in a position to demonstrate that a mitigation measure has been put in place to ensure TFS screening immediately after release of a new TFS list
12	Ensure that the transaction monitoring process is effective and adapted to the number and type of investors in the funds.	Implemented automated transaction monitoring rules if the number of investors prevent manual ongoing monitoring
13	Ensure that the funds' risk scoring take into account the ML/TF risks presented by their investments (assets).	Evidence the risk scoring of a fund with a matrix detailing the computation of the risks with several criteria including investments (assets).

<sup>63</sup> FATF, Recommendation 18

<sup>64</sup> FATF, Recommendation 18

## 7.2 CSSF initiatives

CSSF has also identified opportunities and defined initiatives to further enhance its approach to supervise AML/CFT activities in the Collective Investment Sector. These initiatives are structured around three primary strategic axes, summarized below.

1. The CSSF will continue to promote the understanding of AML/CFT obligations and ML/TF risks. The CSSF intends to actively support the efforts from the industry in improving their understanding of AML/CFT obligations and ML/TF risks. To achieve this, the CSSF is undertaking several initiatives, including regular meetings of the AML/CFT Expert Working Group with the private sector, the organization of additional AML/CFT conferences with the private sector, the issuance of additional guidance, where relevant.
2. The CSSF is committed to further enhancing the effectiveness of AML/CFT supervision within the Collective Investment Sector. For instance, CSSF is committed to increasing the coverage of registered investment fund managers when assessing ML/TF risks, as well as to using a broader set of remediation and enforcement measures.
3. The CSSF is committed to improve data availability and quality to perform offsite AML/CFT supervision. This covers both data obtained from the sector (e.g. by refining and enhancing the existing AML/CFT questionnaire) as well as data created by CSSF during its own supervisory activities.

## APPENDIX A. FATF SUSPICIOUS ACTIVITY INDICATORS IN RELATION TO SECURITIES<sup>65</sup>

### A.1. FATF Guidance for a risk-based approach, Securities Sector, October 2018

#### A.1.1 Product/Customer transactions suspicious activity indicators

1. Transactions do not have apparent economic rationale.
2. Transactions appear to be undertaken in a structured, sequential manner in order to avoid transaction monitoring/reporting thresholds.
3. A concentration ratio of transactions relating to a particular and/or higher risk jurisdiction that is notably higher than what is to be expected considering its normal patterns of trading of a customer.
4. Frequent trades resulting in losses for which the customer appears to have no concern.
5. Sudden spike in transaction volumes, which deviates from previous transactional activity absent any commercial rationale or related corporate action event.
6. Mirror trades or transactions involving securities used for currency conversion for illegitimate or no apparent business purposes.
7. A pattern of securities transactions indicating the customer is using securities trades to engage in currency conversion. Examples of securities that can be used in this manner include dual-currency bonds, American Depositary Receipts (ADRs) and foreign ordinary shares traded in the Over-the-Counter Market.
8. Securities transactions are unwound before maturity, absent volatile market conditions or other logical or apparent reason.
9. Trading or journaling in the same security or securities between numerous accounts controlled by the same people (e.g. potential wash sales and/or directed trading).
10. Two or more unrelated accounts at the securities firm trade an illiquid or low-priced security suddenly and simultaneously.
11. Purchase of a security does not correspond to the customer's investment profile or history of transactions (e.g. the customer may never have invested in equity securities or may have never invested in a given industry) and there is no reasonable business explanation for the change.
12. Transactions that suggest the customer is acting on behalf of third parties with no apparent business or lawful purpose.
13. Funds deposited for purchase of a long-term investment followed shortly by a customer request to liquidate the position and transfer the proceeds out of the account.

#### A.1.2 Distribution channel suspicious activity indicators

1. Intermediaries whose transaction volume is inconsistent with past transaction volume absent any commercial rationale or related corporate action event.
2. A transaction pattern indicating a value of transactions just beneath any applicable reporting threshold.

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<sup>65</sup> Please note that the indicators provided in this appendix are not exhaustive and for illustrative purposes only.

3. Unclear or complex distribution channels that might limit the ability of the investment fund or asset management company to monitor the transactions (e.g. use of a large number of sub-distributors for distributions in third countries).

### **A.1.3 Selected indicators of suspicious trading or market manipulation**

1. Making a large purchase or sale of a security, or option on a security, shortly before news or a significant announcement is issued that affects the price of the security, which may be suggestive of potential insider trading or market manipulation.
2. A request is made to execute and/or clear a buy order and sell order for the same security or similar or correlated securities (and/or on behalf of the same beneficial owner), in close chronology.
3. Accumulation of stock in small increments throughout the trading day to increase price.
4. Engaging in prearranged or other non-competitive securities trading, including wash or cross trades of illiquid or low-priced securities.
5. Marking the closing price of a security.
6. Front-running suspected with regard to other pending customer orders

### **A.1.4 Suspicious indicators associated with CDD and interactions with customers**

1. Customer has no discernible reason for using the securities provider's services or the firm's location (e.g., customer lacks ties to the local community or has gone out of the way to use the firm).
2. Customer's legal or mailing address is associated with other, apparently unrelated, accounts.
3. Locations of address of the customer, bank or financial institution seem unconnected to the customer and little or no explanation can be given by the customer for the disparate addresses.
4. Customer is a trust, shell company, or private investment company that is reluctant to provide information on controlling parties and underlying beneficiaries.
5. Customer is a legal person having issued bearer securities for a large part of its capital.
6. Customer is publicly known to have criminal, civil or regulatory proceedings against it for corruption, misuse of public funds, other financial crimes or regulatory non-compliance, or is known to associate with such persons. Sources for this information include news items or Internet searches.
7. Customer's background is questionable or differs from expectations based on business activities.
8. Customer has been rejected or has had its relationship terminated as a customer by other financial services firms.
9. Customer's account information reflects liquid and total net worth that does not support substantial account activity.
10. Customer maintains multiple accounts, or maintains accounts in the names of family members or corporate entities with no apparent business or other purpose.
11. Non-profit or charitable organizations engage in financial transactions for which there appears to be no logical economic purpose or in which there appears to be no link between the stated activity of the organization and the other parties in the transaction.

12. Customer is reluctant to provide information in relation to its identity and/or transactions.
13. Customer is reluctant to provide information needed to file reports to proceed with the transaction or requests an inordinate amount of secrecy around a transaction.
14. Customer exhibits unusual concern with the firm's compliance with government reporting requirements, the firm's systems or the firm's AML/CFT policies and controls.
15. Customer tries to persuade an employee not to file required reports or not to maintain the firm's required records.
16. Law enforcement or regulators have issued subpoenas and/or freeze letters regarding a customer and/or account at the securities firm.
17. Customer wishes to engage in transactions that lack business sense or apparent investment strategy, or are inconsistent with the customer's stated business strategy.
18. Customer does not exhibit a concern with the cost of transactions or fees (e.g. surrender fees, higher than necessary commissions) or of investment losses.

#### **A.1.5 Suspicious indicators in deposits of securities, particularly low-priced securities; these can often be indicators of low-priced securities fraud, distribution of an unregistered offering, or market manipulation schemes**

1. Customer opens a new account and deposits physical certificates or delivers in shares electronically representing a large block of thinly traded or low priced securities.
2. Customer has a pattern of depositing physical shares certificates or a pattern of delivering in shares electronically, immediately selling the shares and then wiring or otherwise transferring out the proceeds of the resale(s).
3. A sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security.
4. The lack of a restrictive legend on shares physically or electronically deposited seems inconsistent with the date the customer acquired the securities, the nature of the transaction in which the securities were acquired, the history of the stock, and/or the volume of shares trading.
5. Customer with limited or no other assets at the firm receives an electronic transfer or journal transfer of large amounts of low-priced, non-exchange listed securities.
6. Customer's explanation of how the customer acquired the securities does not make sense or changes.
7. Customer deposits physical securities or delivers in shares electronically and requests to journal the shares into multiple accounts that do not appear to be related, or to sell or otherwise transfer ownership of the shares.

#### **A.1.6 Movement of funds or securities**

1. The securities account is used for payments or outgoing wire transfers with little or no securities activities (i.e. account appears to be used as a depository account or a conduit for transfers with no reasonable business explanation for such).
2. Funds are transferred to financial or depository institutions other than those from where the funds were initially received, specifically when different countries are involved.
3. Customer "structures" deposits, withdrawals or purchase of monetary instruments below a certain amount to avoid reporting or recordkeeping requirements.
4. Customer engages in excessive journal entries of funds or securities between related or unrelated accounts without any apparent business purpose.

5. Payment by third party check or money transfer from a source that has no apparent connection to the customer.
6. Customer uses a personal/individual account for business purposes.
7. Payment to a third party to which the customer has no apparent connection.
8. Frequent transactions involving round or whole dollar amounts.
9. The customer requests that certain payments be routed through nostro or correspondent accounts held by the financial intermediary instead of its own accounts.
10. Funds transferred into an account that are subsequently transferred out of the account in the same or nearly the same amounts, especially when origin and destination locations are high risk jurisdictions.
11. A dormant account suddenly becomes active without a plausible explanation (e.g. large amounts are suddenly wired out).
12. Frequent domestic and international automated teller or cash machine activity out of character with the customer's expected activity.
13. Many small, incoming wire transfers or deposits made using checks and money orders that are almost immediately withdrawn or wired out in a manner inconsistent with the customer's business or history. This may be an indicator of, for example, a Ponzi scheme.
14. Wire transfer activity, when viewed over a period of time, reveal suspicious or unusual patterns.
15. Transfers of funds or securities are made to the same person from different individuals or to different persons from the same individual with no reasonable explanation.
16. Unusually large aggregate wire transfers or high volume or frequency of transactions are made with no logical or apparent reason.
17. Customer transfers/receives funds to/from persons involved in criminal or suspicious activities (as per the information available).
18. In/out transactions for substantial amounts on a short-term basis.
19. Receipt of unexplained amounts, followed, shortly thereafter, by a request to return amounts.
20. Frequent transfers of securities' ownership.
21. Use of bearer securities with physical delivery.
22. Frequent change of bank account details or information for redemption proceeds, in particular when followed by redemption requests.
23. The usage of brokerage accounts as long term depository accounts for funds.

## ACRONYMS

Acronym	Definition
ABBL	<i>Association des Banques et Banquiers, Luxembourg</i>
AED	<i>Administration de l'Enregistrement et des Domaines</i>
AFM	Netherlands Authority for the Financial Markets
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Manager Directive
ALCO	<i>Association Luxembourgeoise des Compliance Officers</i>
ALFI	Association of the Luxembourg Fund Industry
ALRiM	<i>Association Luxembourgeoise de Risk Management</i>
AMF	<i>Autorité des Marchés Financiers</i>
AML	Anti-Money Laundering
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
AMLDD	Anti-Money Laundering Directive
AuM	Assets under Management
B	Banks
BCL	<i>Banque Centrale de Luxembourg</i>
BEPS	Base Erosion and Profit Shifting
BN	BN
BVI	British Virgin Islands
BO	Beneficial Ownership
CAA	<i>Commissariat aux Assurances</i>
CAC	<i>Commissaire aux Comptes</i>
CBI	Central Bank of Ireland
CCO	Chief Compliance Officer
CDD	Customer Due Diligence
CEO	Chief Executive Officer
CFT	Combating the Financing of Terrorism
CRF	<i>Cellule de Renseignement Financier</i>
CRS	Common Reporting Standard
CSSF	<i>Commission de Surveillance du Secteur Financier</i>
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
EFAMA	European Fund and Asset Management Association
EI	<i>Entreprises d'Investissement</i>
ESA	European Supervisory Authorities
ESMA	European Securities and Markets Authority
EU	European Union
EUR	Euro
FATF	Financial Action Task Force
FAQ	Frequently Asked Questions
FCA	Financial Conduct Authority
FCP	<i>Fond Commun de Placement</i>

FIAAG	<i>Fond d'Investissement Alternatif Autogéré, internally managed alternative investment funds within the meaning of point (b) of Article 4(1) of the 2013 Law</i>
FIU	Financial Intelligence Unit
GFI/OT	<i>Gestion de Fonds d'Investissement/Organismes de Titrisation</i>
HNWI	High Net Worth Individuals
IFM	Investment Fund Managers including internally managed UCIs
IIA	Institute of Internal Auditors
ILA	<i>Institut Luxembourgeois des Administrateurs</i>
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
IR	Inherent Risk
IRE	<i>Institut des Réviseurs d'Entreprises</i>
JMLSG	Joint Money Laundering Steering Group
JST	Joint Supervisory Team
KRI	Key Risk Indicators
KYC	Know Your Customer
KYCC	Know Your Customer's Customer
LPEA	Luxembourg Private Equity and Venture Capital Association
MF	Mitigating Factor
ML/TF	Money Laundering and Terrorist Financing
MLRO	Money Laundering Reporting Officer
MM	Million
MoU	Memorandum of Understanding
NAV	Net Asset Value
NCA	National Competent Authority
NPO	Non-Profit Organisation
NRA	National Risk Assessment
OECD	Organisation for Economic Cooperation and Development
OPC	<i>Organisme de Placement Collectif</i>
OPC-CSP	<i>Organisme de Placement Collectif-Contrôle sur Place</i>
OPC/FIA	<i>Organisme de Placement Collectif/Fonds d'Investissement Alternatifs</i>
OPC REGL-EER	<i>Organisme de Placement Collectif International, Réglementation et Enforcement</i>
OPCVM/FOP	<i>Organisme de Placement Collectif en Valeurs Mobilières/Fonds de Pension</i>
OSI	On-Site Inspection
PANC	<i>Procédure Administrative Non-Contentieuse</i>
PC	Partially Compliant
PEP	Politically Exposed Person
PFS	Professional of the Financial Sector
PSF	<i>Professionnels du Secteur Financier</i>
RAIF	Reserved Alternative Investment Fund
RBA	Risk Based Approach
RBO	Register of Beneficial Owners
RR	Residual Risk
SA	<i>Société Anonyme</i>
SAR	Suspicious Activity Report

Sàrl	<i>Société à responsabilité limitée</i>
SAS	<i>Société par Actions Simplifiée</i>
SCA	<i>Société en Commandite par Actions</i>
SCS	<i>Société en Commandite Simple</i>
SCSp	<i>Société en Commandite Spéciale</i>
SEC	Securities and Exchange Commission
SIAG	<i>Société d'Investissement Autogérée, investment companies which did not designate a management company within the meaning of Article 27 of the 2010 Law</i>
SICAF	<i>Société d'Investissement à Capital Fixe</i>
SICAR	<i>Société d'Investissement en Capital à Risque</i>
SICAV	<i>Société d'Investissement à Capital Variable</i>
SIF	Specialised Investment Fund
SME	Small and Medium Enterprises
SNRA	(EU) Supra-National Risk Assessment
SR	Social Responsibility
STR	Suspicious Transaction Report
TCSP	Trust and Corporate Service Provider
TF	Terrorist Financing
TFAR	Terrorist Financing Activity Report
TFS	Targeted Financial Sanction
TFTR	Terrorist Financing Transaction Report
UCI	Undertakings for Collective Investment
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
USA	United States of America
USD	United States Dollar