CSSF publishes its activities report for 2018

On 4 July, 2019, the *Commission de Surveillance du Secteur Financier*, the Luxembourg financial supervisory authority (the "**CSSF**")[1], published its annual report for 2018. The report provides a valuable overview of the significant developments in the Luxembourg financial sector and offers a unique insight into the CSSF's regulatory approach and supervisory practices.

The first part of this insight scans the high-level trends that the financial watchdog is confronted with. Part II looks at how the CSSF carried out supervision of entities under its control, including enforcement action, to see to which questions the CSSF is particularly sensitive. Special focus is given to the policy towards the investment fund sector. The final part considers the authority's dispute resolution powers that it exercises through handling consumer complaints.

I. Salient themes

I.1 International and internal economic factors

Similarly to the 2017 edition (see our insight for last year's report), Brexit still figures high on the CSSF's agenda, as evidenced by its latest appeal to UK firms with business activities in Luxembourg to submit their plans regarding a hard Brexit[2] as soon as possible (see the relevant press releases 19/33, 19/34 and 19/41). When examining firms' relocation plans, special attention was given to adequate local substance.

Similarly, at the macro level, the CSSF has expressed financial stability concerns arising from the domestic real estate market. Household indebtedness has continued to build up considerably because of rising residential prices coupled with a decrease in lending standards. In response, a countercyclical capital buffer will be applied to banks as of 1 January, 2020. As supplementary measures, the CSSF has started to collect residential real estate data via its circular 18/703 and publishing its real estate market overview quarterly.

[1] *Commission de Surveillance du Secteur Financier*, the Luxembourg financial supervisory authority.

[2] Defined as the *"date the UK leaves the EU without concluding a withdrawal agreement based on Article 50(2) of the Treaty on European Union"*.

At the micro level, the CSSF noticed a decline in profitability across the board, which it attributes to the need for supervised entities to undertake important investments in technology on the one hand, and to intensified regulatory pressure on the other.

I.2 Principal challenges

The digital and ecological transitions have been identified as both key challenges and opportunities for the Luxembourg financial sector. According to the CSSF, they should thus be embedded in all investment and other strategic decisions of a company, including its remuneration system. The authority's managing director Claude Marx believes the Grand Duchy should take the lead in sustainable finance and channel to it at least 10% of its €4.5 trillion assets under management ("**AuM**") in the short term.

Digitalization for its part has engendered the arrival of fresh players and services in the financial industry, e.g. FinTech and the *cloud*. This has brought with it new dangers, such as cybercrime, in addition to the familiar pitfalls of money laundering. Reacting to the accelerated trend of information technology ("**IT**") outsourcing, the CSSF has put more focus on controlling material IT systems following a risk-based approach ("**RBA**").

Moreover, the CSSF will continue to inform the market about the conditions in which the use of new technology is acceptable. In particular, it is working towards establishing a framework for virtual assets, for instance by elaborating recommendations in the domain of distributed ledger technology. However, the CSSF does not intend to introduce a regulatory sandbox as authorities in some other countries have done.

I.3 Internal developments

To answer the regulatory and technological demands it is facing, the CSSF is itself going through a major organizational and IT transformation. The number of its staff has risen to 845 as of 31 December, 2018, largely to conform to the new banking supervision scheme and to the heightened need for on-site controls. Special emphasis is given to data management under the strategy "CSSF 4.0", where the CSSF aims to process in real time data submitted to it electronically. Machine learning is also foreseen to be applied to authorization procedures.

The CSSF has recently launched its eDesk portal for dematerialized filing, which is designed to facilitate regulatory reporting through secured transmission channels and by standardized filing forms and procedures. The real-time processing of electronically submitted data is supposed to not only increase transparency and responsiveness towards supervised entities but also improve the quality of the risk assessment of its activities.

II. Supervisory practices

II.1 Preliminary remarks – methodology

The CSSF chiefly implements its firm-level oversight in two ways, either off-site at its premises or via on-site controls at the supervised entities.

Off-site supervision mainly consists in analyzing periodic information submitted to it, such as annual reports. The job may, however, also comprise desk-based research related to other information channels, e.g. consumer complaints or publicly available information.

On-site visits consist in in-depth investigations at the offices of the supervised entities. They permit the CSSF to better understand their operation and the risks they are exposed to, as well as to scrutinize regulatory compliance. The visits are usually made based on an annual plan approved by the CSSF's executive board and cover pre-identified subjects. The controls can also be ad hoc to address a specific matter.

The entities subject to on-site visits are selected pursuant to a RBA. A lump sum of €25,000 for banks and EUR 10,000 for other entities is invoiced for every on-site visit on a given subject. Each on-site visit results in an internal report on potential shortcomings detected during the procedure. In general, the CSSF then sends a letter of observations to the concerned entity.

In case of minor defaults, the authority often intervenes by simple phone calls or by post correspondence. The CSSF has the ultimate power to take appropriate enforcement action when it considers the breaches serious enough. Its arsenal ranges from injunctions and fines to the withdrawal of an entity's authorization.

Our present analysis considers the investment fund sector (undertakings for collective investments ("**UCIs**") and their management companies ("**ManCos**"), as well as UCI service providers[3]) separately from other supervised entities (the "**Other Firms**") as more granular data is available for the former.

II.2 General supervision

II.2.1 Other Firms

Certain thematic reviews were solely directed at banks. The CSSF's on-site supervision teams thus evaluated the banks' business model, credit risk, internal capital adequacy assessment process, interest rate risk in the banking book and operational risk.

Four of the themes that the CSSF screened concerned several entity types, namely corporate governance, anti-money laundering ("**AML**"), MiFID[4] and IT. These are studied below in more detail.

II.2.1.1 Corporate governance

Corporate governance reviews focused on the operation of the board of directors (*conseil d'administration*) and the authorized management (*direction autorisée*)[5], including their specialized committees (collectively, the "**Management**"), and the internal control functions[6] (the "**Internal Control**"), as well as the cooperation between all of them.

The most considerable deficiencies encountered on the level of the Management related to the lack of a regular critical evaluation of the internal governance system and the lack of assessment of the fitness of authorized directors to exercise their functions. Additional shortcomings were found regarding the Management's approval of the general guidelines and key procedures, as well as the notification of the CSSF, within the required deadlines, of changes in the shareholder structure.

As regards the Internal Control, it was revealed that its oversight is regularly insufficient. On top of that, the Management did not implement corrective measures in a prompt and efficient manner to remedy weaknesses, even significant ones, identified by the Internal Control.

Likewise, an insufficient knowledge of certain critical information by the Management as a whole was unveiled in certain instances, either because that information had not been escalated to it by their branches and subsidiaries or because the information had not been shared between all the members of the Management.

As regards the second line of defense, the results show that the compliance function does not systematically establish a control plan following a RBA or document the controls accomplished. A deficit in its authority and independence was also exposed in certain cases. It was further discovered that incomplete information is often furnished to the compliance function of the parent company.

At the level of the risk control function, the CSSF ascertained that without a global risk evaluation or a critical review of limits it does not have sufficient coverage of certain risks. Furthermore, the lack of the risk control function's participation in the process of approving new products was discerned on numerous occasions.

Finally, it was exposed that the internal audit function of certain supervised entities is not organized in a way to preserve its independence or does not have a permanent nature. Also, internal audit plans were found to be incomplete or not elaborated pursuant to a RBA.

The CSSF encouraged supervised entities generally to appoint independent directors to their Management to tackle the above issues.

II.2.1.2 AML

Apart from general corporate governance matters, the CSSF took a pronounced interest in AML issues. This was not only a result of the recent transposition of the 4th AML Directive[7] into Luxembourg law

[3] Depositaries and central administration agents. The CSSF annual report covers these two categories together with other firms but for our purposes we have added them to UCIs and ManCos.

[4] Directive 2014/65/EU on markets in financial instruments.

[5] The persons in charge of the management of the supervised entity that are approved by the CSSF.

[6] The internal control functions comprise on the one hand, the risk control function and compliance function which are part of the second line of defense, and on the other hand, the internal audit function which is part of the third line of defence. The operational management forms the first line of defense.

[7] Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

but also due to the upcoming peer review by the Financial Action Task Force of the Grand Duchy's implementation of its AML recommendations.

One of the main findings of its on-site supervision was the lack of a gap analysis between the RBA already applied by the professionals and the new requirements stemming from the 4th AML Directive and Joint Guidelines. In particular, certain risk factors and risk variables were not taken into account in the risk classification of business relationships.

Other recurring flaws include the lack of updating the AML risk evaluation to which supervised entities are exposed, the non-application of enhanced due diligence measures to situations that, by their nature, represent high AML risks, and a lack of regular review of clients' files according to their risk level.

Particular stress was given to the respect of AML rules in relation to potential offences of aggravated tax evasion (*fraude fiscale aggravé*) and tax swindle (*escroquerie fiscale*). The supervisory officers detected the non-inclusion of tax risk under the risk classification of business affairs, as well as the lack of sufficient analysis to conclude whether a client is tax transparent and to reasonably exclude that a predicate tax offence has been committed.

Furthermore, so-called name-matching controls under financial sanctions lists were often found to be insufficiently frequent, poorly documented and incomplete in general. The CSSF also regularly notes failures to declare suspicions of AML to the national financial intelligence unit (*Cellule de renseignement financier* – "**CRF**").

II.2.1.3 MiFID

MiFID-themed on-site visits detected the following substantial flaws:

- shortcomings in evaluating the adequacy and appropriateness of products and services offered;
- weaknesses in identifying conflicts of interests and insufficiency of arrangements aimed at preventing or managing those conflicts;
- failings in communicating information to clients, notably ex ante information related to costs and expenses of financial instruments and investment or auxiliary services;
- insufficiency of measures in the area of product governance at the level of product manufacturing and product distribution, as well as at the level of information exchange between the involved actors; and
- weaknesses at the controls carried out by the internal control function.

II.2.1.4 IT risks

In line with its efforts in digitalization, the CSSF gives particular consideration to IT risks. During its on-site visits, it noted the major weaknesses below:

- IT security, namely the management and control of privileged access, as well as the management of cyber threats, especially in respect of fixing critical vulnerabilities;
- management of IT risks, with a very weak coverage or even lack of coverage of those risks by the second line of defense;
- internal audit, in particular the weak coverage of IT activities and problems with independence and competence to evaluate the related risks;
- the continuity of activity in its entirety (governance, plans, tests); and
- outsourcing, especially contractual aspects and operational monitoring.

II.2.2 Investment fund sector

II.2.2.1 Off-site supervision of UCITS[8], Part II UCIs[9], SIFs[10] and SICARs[11] ("Regulated Funds")[12]

Off-site supervision of Regulated Funds is principally done through analyzing periodic financial reporting. The most important documents are annual reports and the related auditor's management letters and audit reports[13].

[8] Undertakings for collective investment in transferable securities subject to part I of the Law of 17 December 2010 (the "**UCI Law**").

[9] UCIs subject to part II of the UCI Law.

[10] Specialized investment funds subject to the Law of 13 February 2007 (the "**SIF Law**").

[11] Investment companies in risk capital subject to the Law of 15 June 2004 (the "**SICAR Law**").

[12] The CSSF annual report only covers regulated funds. Certain investment funds are subject to the CSSF's supervision only indirectly, such as reserved alternative investment funds (RAIFs) under the Law of 23 July 2016 and non-regulated funds, through their alternative investment fund managers ("**AIFMs**"), which are subject to the Law of 12 July 2013 (the "**AIFM Law**").

[13] Whereas all Regulated Funds have to provide annual reports accompanied by management letters, the audit report only applies to UCITS.

Audit reports still raise most issues (more than a quarter of them), followed by the auditor's management letters and the annual reports. CSSF's interventions in this respect by way of letters mostly related to AML, in particular to incomplete documentation of clients/investors and to internal procedures and processes that were ill adapted to regulatory requirements.

The second major source of the CSSF's desk-based activities are declarations made under the CSSF Circular 02/77 on protection of investors in case of net asset value ("**NAV**") calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to Regulated Funds.

Accounting errors continue to be the main cause of NAV calculation errors, followed by errors in securities valuation. Investors received over €40 million as compensation for NAV calculation errors. Investment rules are most often breached by not observing diversification rules, followed by the non-respect of temporary borrowings and single investment limits.

II.2.2.2 On-site supervision of ManCos[14]

The CSSF conducted 45 on-site controls of ManCos in 2018 that covered 19% of AuM in the Grand Duchy. The controls primarily focused on corporate governance and AML questions but also addressed risk management, CSSF Circular 02/77, monetary funds and MiFID-related topics.

Similarly to previous years, the CSSF found shortcomings in the delegation of activities. In particular, the initial and ongoing due diligence were frequently incomplete or even inexistent. In addition, certain due diligence did not contain an analysis of the results obtained. When tasks are delegated to group entities, the ManCos are inadequately involved in the ongoing monitoring. Moreover, key performance indicators are frequently unsuitable to delegated activities

Furthermore, regarding the internal audit function, the audit plan does not always cover all functions of Mancos, as well as their subsidiaries and branches. Besides, the internal auditor's recommendations are not subject to systematic follow-ups.

Procedural manuals are often not updated to reflect the evolution of ManCos' activities and the regulation in force. In addition, managers often do not possess management information that would permit them to handle their duties appropriately and they do not record their decisions in writing.

Finally, in the area of IT, the CSSF has ascertained deficiencies related to the management of access rights, as well as the design and implementation of continuity plans.

AML was obviously on the top of the CSSF's agenda in 2018 as it dedicated a special chapter to financial crime. The authority conducted 13 AML-related on-site visits of ManCos.

One of the most notable weaknesses concerns due diligence, namely insufficient documentation relating to enhanced due diligence towards intermediaries, partial or total lack of information or documentation on the source of funds and insufficient documentation of initial and ongoing due diligence on sponsors and distributors.

The CSSF also noted that ManCos often use programs of continuous AML training elaborated by their group or foreign parent company, without adapting it to the features of the investment funds managed or to rules applied in Luxembourg. Similarly, the risk evaluation of business activities was sometimes not up-to-date or did not cover individual risks to which the ManCos or the investment funds managed were exposed to.

What is more, various shortcomings were revealed involving verifications of business relationships with sanctioned or politically exposed persons.

The CSSF announced it will pay special attention in its future supervision to the following topics:

- application of enhanced due diligence with respect to intermediaries acting on behalf of their clients, including regular updates to the additional documentation;
- source of funds: supporting documents have to be obtained in the presence of risk factors, such as substantial amounts in play. The CSSF will also consider the potential impact on tax offences via the CRS self-certification;

[14] ManCos most notably include those subject to the UCI Law and AIFMs.

- monitoring of delegated functions: verifying if initial and ongoing due diligence are sufficiently underpinned to identify and evaluate adequately risks caused by delegation.
- ManCos should also register for the CRF's IT tool "goAML" to ensure the timely and confidential declaration of any AML suspicion.

II.2.3 Service providers

The CSSF also carried out 24 on-site visits of UCI service providers that included depositaries, central administration agents and transfer agents.

The CSSF carried out 14 on-site visits of depositaries. It identified numerous weaknesses in relation to the monitoring of UCI's cash flows and other oversight obligations, either due to incomplete controls or inadequate frequency of controls.

The CSSF stressed that a depositary has to develop ex post oversight procedures that are appropriate to the features of the different UCIs and their investments. The depositary should also take into account the quality of the controls carried out by and processes in place at the level of the UCIs and their service providers.

Moreover, the management of conflicts of interests and the oversight of delegates responsible for the safekeeping of assets remain problematic neighborhoods.

With respect to the central administration of UCIs, the major deficiencies noted during the visits concerned the lack of implication, coordination and monitoring by the central administration agents when operation processes linked to the NAV calculations are conducted by other service providers.

The CSSF reminded the central administration agents that they cannot discharge themselves of their liability in that respect and need to have solid processes to be in a position to validate the NAV. In addition, the formalization and documentation of the controls performed by the CAAs continue to be regular defaults spotted during investigations.

II.3 Enforcement action

II.3.1 General findings

The CSSF was not as severe with fines as in 2017, when it wrote tickets to supervised entities totaling almost €18 million. In 2018, it imposed fines of €5.5 million, of which a hefty €4 million fine was levied on a single entity for deficiencies in the areas of internal governance and AML rules. On the other hand, an individual was penalized €250,000 for market manipulation.

A notable event in 2018 was the suspension of payments of ABLV Bank Luxembourg SA subsequent to the CSSF's successfully applying to the Luxembourg District Court. This was followed by the first intervention of the Luxembourg deposit guarantee fund (*Fonds de garantie des dépôts Luxembourg*) in its mandate as deposit insurer since its establishment in December 2015. The bank has recently been put into judicial liquidation, as its financial condition did not recover satisfactorily.

II.3.2 Investment fund sector[15]

II.3.2.1 Regulated Funds

Under the SIF Law, the CSSF charged fines in the amount of either €2,000 or €4,000 to managers of 23 SIFs for the failure to submit the annual financial report and to managers of 23 SIFs for the failure to submit management letters or incomplete submissions of management letters.

Under the SICAR Law, fines of €500 were received by managers of five SICARs for not submitting the annual financial report, managers of five SICARs for not submitting the management report and managers of two SICARs for their failure to submit monthly reports (report U 1.1).

Three individuals received €4,000 fines for submitting incomplete declarations of honor.

The CSSF also prohibited a SIF manager from exercising its professional activities for four years.

[15] Certain fines are still subject to an application for reconsideration (*recours gracieux*) or a judicial appeal before administrative courts.

In the course of 2018, the CSSF withdrew one UCITS, seven SIFs and one SICAR from their respective lists due to severe violations of applicable rules.

II.3.2.2 ManCos

A UCITS ManCo was imposed a fine of €91,000 for not complying with requirements regarding (i) sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms; (ii) delegation; and (iii) business conduct rules.[16]

Another UCITS ManCo was fined €61,000 for violating rules related to the (i) provision of documents or other information that proves to be incomplete, incorrect or false; (ii) sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms; and to the (iii) risk-management process or a process for accurate and independent assessment of the value of OTC derivatives.[17]

An AIFM had to pay €5,000 for breaches in relation to the valuation function.[18]

In two cases, the CSSF judged the violations of legal provisions so serious that it withdrew the ManCos from the official list.

II.3.2.3 Service providers

For the breaches detected with depositaries, the CSSF issued three fines of €37,000, €55,400 and €143,735.Two UCI central administration agents received an injunction from the CSSF to comply with the applicable rules.

III. Consumer complaints

One of the CSSF's functions involves the out-of-court settlement of consumer disputes. In 2018, the CSSF received 738 complaints from consumers of financial services. Over 30% of complaints came from German residents, followed by 18% from Luxembourg.

With respect to the subject raised, almost half of the complaints relate to payment services (especially the bank's right to levy bank charges and payment order fraud), followed by payment accounts, private banking, payment cards and inheritance matters with 13%, 10%, 9% and 9% respectively.

One fifth of the complaints was classified as falling outside its competence. Over half of the complaints got settled upon the initial investigation of the CSSF. In around 10% of the cases, the CSSF issued an opinion favorable to the investor, whereas 7% of disputes reached an amicable solution. Less than 1% of the complaints ended up before court.

IV. How Dentons can help

Dentons Luxembourg's Investment Funds and Capital Markets team has a profound understanding of financial markets, services and participants, matched by an expertise in EU and Luxembourg financial legislation and supervisory policy. You can partner with us not only to steer through the regulatory maze and ensure your ongoing compliance but also to tackle your future business challenges.

[16] Articles 148(2)(g), 148(2(j) and 148(2)(k) of the UCI Law.

[17] Articles 148(1)(b), 148(2)(g) and 148(2)(n) of the UCI Law.

[18] Article 17(8) of the AIFM Law in conjunction with articles 67(4), 68(1)-(2), 69(1) and 70(1) of the Commission Delegated Regulation 231/2013.