

Leveraging market practices and technology amid regulatory complexity

The uncharted waters of AML on assets

In the ever-evolving landscape of the investment fund industry, regulatory compliance remains a critical but sometimes not fully comprehended topic. In Luxembourg the CSSF Circular 18/698 and the CSSF Regulation 12-02, as amended, are setting the regulator's requirements and expectations on market players, including investment fund managers (IFMs) and IFM delegates. Aiming to serve as a beacon, the Association of the Luxembourg Fund Industry (ALFI) released a guideline in May 2021, outlining practices and recommendations based on AML/CTF requirements and practical applications for the fund industry. However, market actors still face challenges in implementing these guidelines on a day to day basis.

Implementing AML/CTF due diligence on assets must be adapted to the different businesses' contexts and circumstances. Charting a route on this course can be complex and requires a comprehensive, organized and proactive approach – but how does this translate into practical implications? And who will be at the helm?

A dive into asset classification and due diligence

While due diligence steps may align across asset classes, the depth required varies, reflecting the inherent risks and complexities associated with each asset class. Due diligence on these assets should include identifying and, at times, verifying the counterparties involved in the deal and their related parties, as well as screening against the relevant watchlists (i.e., sanctions and politically exposed people) and adverse media.

Liquid assets, typically characterized by greater transparency due to their presence in regulated environments, often necessitate lighter AML/CTF due diligence, focusing mainly on: screening of issuing company names and ISINs, a lighter risk scoring approach, including jurisdictions' assessment, among others, could suffice in most cases.

However, **alternative assets**, with their increased complexity and non-traditional nature, often warrant more extensive due diligence. Let's explore a few examples, highlighting observed market practices.

In **Private Equity** transactions, due diligence should be extended beyond the seller to encompass the asset's shareholding structure and other investors, when relevant. Consider a scenario where an investment in an asset involves multiple investors. In such case, other management companies involved in the deal are under no legal obligation to disclose information about other co-investors, shifting the discussion from a regulatory dimension to a business one. Complexity can also come from the sector of activity of the underlying asset, which can be often underestimated.

For **Real Estate** transactions, it is important to consider the property's nature and circumstances. If we use a multi-tenant property building as an example, tenants may be subject to at least watchlist screening if they have significant materiality, such as contributing to 10% (high risk jurisdictions) or 25% or more of the property's cash flow.

In practice, asset/property managers tend to use a single and more conservative threshold, avoiding to recalculate property's cashflow distribution. You should also take into account other counterparties, such as co-in-



vestors, property companies, holding companies and property managers that are involved in the transaction or the day to day life of the property.

With regard to **Infrastructure** transactions, the due diligence process extends beyond the asset itself. For instance, the construction of a solar farm, due diligence must be performed not only on the target company receiving the financing but also on the main service providers involved in the solar farm's construction.

In **Private Debt** investments, guided by the principle of "follow the money," due diligence focuses on borrowers and underlying investments, among other counterparties. Essential to this process is a comprehensive understanding of the underlying financing purpose, the substance of returns on the asset paid back to the lender, and the risks faced by the fund.

Certain underlying assets, such as real estate, art, vessels or aircrafts, present their own inherent risk and, thus, expose the deal and the transaction to a higher level of due diligence.

A knotty case

In the case of "Funds of Funds" investing in private equity, there is no clear one size fits all approach to due diligence. The first step would be to check if the target fund (the asset) is within the IFM's defined risk appetite and investment strategy. For that, you need to consider which jurisdictions you want to do business with, which underlying products you don't want in your portfolio, if the fund's investment strategy is in line with your investment policy, among others.

Then, you need to conduct screening against relevant watchlists and adverse media for your identified parties – e.g. a target fund, its IFM, and associated shareholding structure and stakeholders, such as directors, sellers (could be the IFM) and beneficial owners.

Most market participants, when identifying the beneficial ownership of the target fund and the shares procured from the seller, rely on an AML letter provided either by the IFM, which is obligated to perform AML checks on the investors/limited partners, or the target fund's transfer agent, who has conducted Know Your Counterparty (KYC) checks on the investors/limited partners. This assumes equivalent regulations in their respective countries; otherwise an AML comfort letter will most likely not be sufficient.

The next step is to define the fund's risk level. It's important to consider where the underlying assets are located and if there are other co-investors involved. The latter is not necessarily known when deciding to invest in a fund; the target fund's IFM has no obligation to provide the names of the other investors (most likely other Private Equity firms), so considering this as a risk factor is advisable.

Once the deal is closed, according to your risk-based approach, a periodic review of the asset will need to be performed to confirm that the asset is still within your risk appetite. We observe most market players use a 1-2-3 or 1-3-5-year cycle for enhanced, normal and simplified due diligence files.

Challenges faced and way forward

When navigating the due diligence and performing KYC processes for assets, especially for alternative assets, you will find the waters very similar to those navigated in other KYC processes. We are faced with the scarcity of highly-qualified staff, no comprehensive end-to-end system for efficient KYC file management, gap in real-time risk assessment, and absence of smooth decision-making process and a robust audit trail.

On top of that, continuous watchlist and adverse media, timely periodic reviews and document management present its own set of challenges.

All these crucial elements are too often scattered across separate systems, managed by different departments (or even legal entities), and with some pieces of data still rooted in legacy excel sheets. This fragmented approach contributes to the complexity of identifying entities, individuals and details behind the assets, ultimately adding up to the inherent challenges of the due diligence process.

While obliged entities' supervisory boards are pushing for the automation and sustainable implementation of AML/KYC frameworks, there is also a need to navigate the waters of recent sanctions packages, which influence due diligence elements and create the need to swiftly adapt processes according to established risk approaches.

This can only be achieved when legal counsels, portfolio managers, the deal team and compliance representatives collaborate effectively and are supported by the right end-to-end solutions. This by itself represents another set of hurdles when establishing a long-term, yet flexible KYC framework. Currently, IFMs primarily rely on sparse guidance available and market practices shared among the industry working groups in Luxembourg.

To address identified challenges and meet expectations of supervisory bodies, our compass points toward one significant lifebuoy – an end-to-end KYC solution that allows effective lifecycle management for assets and other counterparties. Such a solution would facilitate ongoing monitoring, real time risk assessment and offer an improved end-user experience alongside a robust audit trail.

Although technology might feel like a tailwind, it cannot solve all challenges faced during KYC process on assets; skilled KYC analysts are essential for understanding complex structures and challenging potentially inconsis-

structured data from documentation. Ultimately, technology's role is to lighten the operational load, allowing KYC analysts to focus on activities where their expertise adds the most value to the due diligence process, such as assessing key information, probing inconsistencies, building a clear understanding of the assets and their underlying details, and making management decisions.

Regardless of the conditions, the key to navigate this rough sea lies in enhancing industry collaboration to share best practices and lessons learned to create a sounder market and leveraging on the use of technology to streamline processes and relieve pressure on operational costs.

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BOURSE DE LUXEMBOURG						
Actions luxembourgeoises	Devise	au 31/01	au 29/12	Var	Plus haut	Plus bas
ArceLorMittal	EUR	25.6	25.6	-0.14%	26.0	23.7
SEO .prvb	EUR	170.0	166.0	2.41%	173.0	170.0
ReinetInvest	EUR	22.6	22.4	0.89%	23.2	21.2
Socfinaf	EUR	10.2	10.8	-5.56%	11.1	10.0
SocFinCaoutchcs	EUR	31.0	31.0	0.00%	32.4	31.0
RTLGroup	EUR	35.7	34.9	2.17%	37.2	33.5
SEO 1/5prvb	EUR	34.0	36.0	-5.56%	34.6	34.0
Socfinasia	EUR	15.0	15.4	-2.60%	15.8	14.8
Brederode	EUR	109.2	101.6	7.48%	110.8	98.7
SES FDR	EUR	5.7	5.9	-4.45%	6.1	5.2
Aperam	EUR	28.6	32.8	-12.96%	33.1	28.3
Actions étrangères	Devise	au 31/01	au 29/12	Var	Plus haut	Plus bas
FidRealEstate	EUR	181.0	178.0	1.69%	190.0	170.0
FiducOffSolut	EUR	28.0	28.0	0.00%	28.0	28.0
Brait ord	EUR	0.0	0.0	1.12%	0.1	0.0
VelcanHoldings ordinary shares	EUR	13.8	12.8	7.81%	14.0	12.3
Bolinco ord A	EUR	58.5	56.5	3.54%	59.0	54.5
ProsiebensatMe	EUR	6.5	5.5	18.36%	6.5	5.3
Engie	EUR	14.8	15.9	-7.28%	16.6	14.5
Wonovia	EUR	29.0	28.5	1.79%	29.1	26.2
HeliaOmbHGaa	EUR	82.1	82.5	-0.48%	83.4	80.9
RobSGloStBqFd cat A	EUR	69.0	65.5	5.34%	69.0	65.0
OPC	Devise	au 31/01	au 29/12	Var	Plus haut	Plus bas
Fidelity Funds European Growth Fund A EI Distribution	EUR	17.8	17.4	1.83%	17.8	17.2
Candriam Equities L Biotechnology I Cap USD	USD	5661.2	5559.0	1.84%	5661.2	5661.2
BlackRock Global Funds BGF US Mid-Cap V USD Fund A2 USD Capitalisation	USD	345.3	346.0	-0.22%	345.5	334.2
Xtrackers Xtrackers S&P 500 Swap UCITS I USD Capitalisation	USD	96.7	93.9	3.05%	96.8	92.0
Obligations d'Etat	Devise	au 31/01	au 29/12	Var	Plus haut	Plus bas
Luxembourg 2,25% 19/03/2028	EUR	99.7	99.5	0.14%	100.4	98.8
Luxembourg 2,75% 20/08/2043	EUR	96.6	98.6	-2.00%	98.0	95.1
Luxembourg 0% 14/09/2032	EUR	81.2	82.2	-1.25%	82.0	80.4
Obligations LuxPrime	Devise	au 31/01	au 29/12	Var	Plus haut	Plus bas
SiemensFinancie 1,375% 06/09/2030	EUR	91.2	92.5	-1.46%	91.9	90.0
SAP 1,75% 22/02/2027	EUR	99.1	99.8	-0.78%	99.8	99.0
Heineken 3,5% 19/03/2024	EUR	99.9	100.0	-0.07%	100.0	99.8
Fresens&CO 2,875% 15/02/2029	EUR	99.0	99.9	-0.87%	99.4	97.8
SiemensFinancie 2,875% 10/03/2028	EUR	101.0	101.8	-0.74%	101.4	100.0
Argentina 0,125% 09/07/2041	EUR	29.2	29.3	-0.27%	29.8	28.7
Romania 3,875% 29/10/2035 Reg S	EUR	84.9	85.9	-1.18%	85.7	83.2
PreseniusFintrl 3% 30/01/2032	EUR	95.0	96.0	-0.97%	95.8	93.2
SiemensFinancie 1,25% 28/02/2031	EUR	90.1	91.1	-1.11%	90.4	88.6
PreseniusFintrl 1,25% 01/02/2027	EUR	96.3	97.1	-0.77%	96.7	95.7
Obligations les plus négociées	Devise	au 31/01	au 29/12	Var	Plus haut	Plus bas
CasinoGuichardP FRN pp	EUR	0.7	0.7	0.00%	0.7	0.7
VWIntlFin 3,5% pp	EUR	89.4	89.2	0.20%	90.0	87.4
Pemex 6,5% 02/06/2041	USD	67.3	67.9	-0.83%	68.2	65.6
Italy 5,2% 31/07/2034	EUR	110.2	110.5	-0.26%	111.3	108.7
EskomHldgsSOC 100 31/12/2032	ZAR	21.7	19.5	11.38%	22.0	21.0
GrenkeFinancie 3,95% 09/07/2025	EUR	100.0	100.2	-0.22%	100.4	99.8
AXA FRN pp	EUR	93.4	90.2	3.52%	93.8	91.1
DtacheLufthansa 0,25% 06/09/2024	EUR	98.0	97.6	0.43%	98.1	97.5
Obligations vertes	Devise	au 31/01	au 29/12	Var	Plus haut	Plus bas
WorldBk 0,625% 22/04/2025	USD	95.1	94.9	0.22%	95.2	94.9
NedWaterBank 1% 03/09/2025	EUR	97.3	97.5	-0.19%	97.5	97.1
CouncilEurDevBk 0% 09/04/2027	EUR	92.2	93.2	-1.08%	93.2	91.8
IberdrolaFinanz 0,875% 16/06/2025	EUR	96.6	96.6	0.03%	96.6	96.2
IberdrolaIntl 1,45% pp Reg S	EUR	92.1	90.9	1.32%	92.1	90.8
ORSTED A/S 2,25% 24/11/3017	EUR	98.9	98.6	0.31%	98.9	97.9
Nouveaux instruments listés	Devise	au 31/01	au 29/12	Var	Plus haut	Plus bas
DtacheLufthansa 3,75% 11/02/2028	EUR	99.1	98.8	0.33%	99.1	97.2
UE 0,3% 04/11/2050	EUR	50.5	52.4	-3.62%	51.5	49.2
UE 0% 02/06/2028	EUR	89.8	90.5	-0.71%	90.4	89.3
DtacheLufthansa 2,875% 11/02/2025	EUR	98.6	98.5	0.13%	98.8	98.3
Iliad 1,875% 11/02/2028	EUR	91.9	92.2	-0.31%	92.0	90.0