Portfolio Management in Luxembourg

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1. Definition of portfolio management

Portfolio management may be defined as the discretionary and personalised management of a client's financial portfolio pursuant to a power of attorney given by the client to a professional of the financial sector . The portfolio may comprise one or more types of financial instruments.

Portfolio management relieves the client of the duty to actively manage his or her portfolio and entrusts this task to a financial sector professional. Clients typically entrust the management of their portfolios, including the power to dispose of and administer assets, to a bank.

2. Contractual and statutory basis for portfolio management

The contractual basis for portfolio management is the portfolio management agreement. The extent of the manager's powers will depend in particular on the scope of the power of attorney given by the client.

Therefore, an institution that acts as a portfolio manager shall:

- respect the scope of the power of attorney;
- not exceed the limits of its authority;
- be diligent and loyal (for example, not manage the assets of two investors with conflicting interests);and
- inform and report to the investor.

In Luxembourg, the main legislation governing portfolio management by financial institutions is the Act of 13 July 2007 on financial instruments (the "MiFID Act"), transposing the MiFID Directive into Luxembourg law and amending the Act of 5 April 1993 on the financial sector (the "Financial Sector Act"). The Grand Ducal Regulation of 13 July 2007 (the "MiFID Regulation") sets forth further organisational requirements and operating conditions for institutions that provide portfolio management services.

3. Categorisation of clients

The application of the conduct-of-business rules will depend on the type of client. A distinction is made between retail clients and professional clients.

Retail clients are persons that by default do not meet the definition of a professional client or an eligible counterparty. They are granted an additional level of protection compared to professional clients; in particular, a financial institution acting as a portfolio manager is obliged to provide its retail clients with detailed information about the financial services and instruments being offered. The institution must assess the retail client's knowledge, experience and expertise before providing portfolio management services

4. Obligations when entering into a portfolio management agreement

Portfolio management services may only be provided pursuant to a written agreement between the portfolio manager and the investor. The main purpose of this requirement is to avoid possible misunderstandings with respect to the scope of the authorisation given to the institution, the objectives of the investment and the risk accepted by the client.

The agreement must indicate:

- the return objectives of the portfolio managed by the institution;
- the different types of financial instruments that may form part of the investor's portfolio;
- the acceptable financial risks;
- the information provided to the investor concerning the management of the portfolio;
- the methods of payment for the services provided;
- the term and conditions for termination of the agreement; and
- the financial instruments that make up the portfolio under management.

An institution that enters into a portfolio management agreement with a client must take into account the client's knowledge and experience in the investment area, as well as the client's financial situation and investment objectives (the so-called suitability test). This information must be obtained at the outset of the parties' relationship in order to determine the types of products best suited to the client.

Information about the client's investment knowledge and experience should include: (i) the types of services, transactions and financial instrument with which the client is familiar; (ii) the nature, volume and frequency of the client's transactions in financial instruments and the period over which these transactions have been carried out; and (iii) the client's level of education and profession or relevant former profession.

An institution is entitled to rely on information provided by its clients or potential clients, unless it is aware or ought to be aware that the information is obviously out of date, inaccurate or incomplete.

Professional clients are deemed to have adequate experience and knowledge. If the client is not categorised as a professional for all services, products and transactions offered, the client will be deemed a professional only for those products, services and transactions for which he or she is categorised as such.

5. Due diligence obligation

5.1. Investment guidance

The institution managing the portfolio chooses the appropriate investments based on the investment policy set out in the portfolio management agreement and taking into account financial and economic criteria. The appropriateness of the institution's choices is evaluated at the time the investment is made, not in light of any subsequent facts. The institution must take into consideration the scope and overall objectives of the portfolio management agreement.

5.2. Custodian

The best execution principle of portfolio management is an obligation to use one's best endeavours, not an obligation to produce a specific result. In other words, the institution managing the portfolio is not obliged to achieve specific results or a particular return on the assets under management, which will depend on factors outside its control, such as the economic climate and fluctuations of the financial markets.

The MiFID Regulation sets out the measures an institution is required to take in order to comply with the best execution principle as established in the Financial Services Act, meaning reasonable steps the institution is obliged to take in order to achieve the best possible result for the client, taking into account price, costs, speed, likelihood of execution and settlement, the size and nature of the investment, and any other factors relevant to execution of the agreement.

According to CSSF Circular 07/307, institutions that offer portfolio management services on a discretionary, client-by-client basis are in principle exempt from the best execution obligation set forth in Article 37(5) of the Financial Services Act ("obligation to execute orders on terms most favourable to the client"). However, if the institution executes the orders itself, it must comply with the abovementioned provision. It should also be noted that Article 53 of the MiFID Regulation contains a list of specific duties for institutions that provide portfolio management services. In particular, as a general rule, the institution is required to provide investment services in a fair, respectable and professional manner.

Therefore, the institution cannot be held liable simply because the client does not realise a particular return on its investment or suffers a lost. In order for the institution to be held liable, it must be proven that the institution did not act with the requisite degree of diligence and care.

5.3. Obligation of loyalty and obligation to inform

An institution that manages portfolios is also subject to a duty of loyalty and a duty to inform its clients about, for example, the results of the portfolio management so as to allow the client to modify the scope or content of the portfolio management agreement, if it wishes to do so.

5.4. Obligation to manage conflicts

The institution is obliged to (i) manage the portfolio in the sole interest of the client and (ii) avoid harming the client for its own benefit or for the benefit of other clients. The institution shall take all reasonable steps to identify potential conflicts of interest with its clients as well as between two or more clients to which the institution owes specific duties. The institution is obliged to inform its clients of any potential conflicts of interest and, where the conflict cannot be avoided, make all efforts to solve it in an equitable way for the client. In particular, the institution shall refrain from carrying out, at its own initiative, transactions for a client that are unnecessary or contrary to the client's interests. Nor shall it execute transactions that, given their frequency and volume, could be considered as being solely in its own interest.

The MiFID Regulation sets out several situations that could give rise to a conflict of interest between the institution and its clients, in particular when the institution (i) is likely to make a financial gain, or avoid a financial loss, at the client's expense; (ii) has a personal interest in the outcome of a service provided to a client or of a transaction carried out on behalf of a client, which is distinct from the client's interest in that outcome; (iii) has a financial or other incentive to favour the interests of another client or group of clients over the interests of a particular client; (iv) engages in the same business as a client; or (v) receives or will receive from a person other than the client an inducement in relation to a service provided to the client, in the form of cash, goods or services, other than the standard commission or fee for that service.

To this end, the institution shall establish a conflicts-of-interest policy appropriate to its size, organisational structure and the nature, scale and complexity of its business. Furthermore, it shall prepare procedures to be followed and measures to be adopted in order to manage such conflicts of interest.

5.5. Obligation to provide information to the client

Institutions that engage in portfolio management are also obliged to regularly inform their clients of the results of their management. The MiFID Act has considerably enhanced the duty to inform incumbent on portfolio management institutions. All information addressed by the institution to its clients should be fair, clear and not misleading. Information shall be considered misleading if it is liable to mislead the person or persons to whom it is addressed or by whom it is likely to be received, regardless of whether the person providing the information considers or intends for it to be misleading.

The MiFID Regulation contains a detailed list of information which an institution must communicate to its clients. In particular, in order to allow clients to take informed investment decisions, they must be provided with general information about the institution itself, its services, the financial instruments offered and the proposed investment strategies, including appropriate guidance on risk and risk warning, arrangements made to protect the portfolio, and the fees and charges associated with the financial instruments or investment services.

The MiFID Act is intended to ensure an appropriate level of investor protection without placing an undue burden on institutions.

5.6. Obligation to report to the client

The MiFID Act provides that reports concerning the management of the portfolio as well as portfolio statements shall be sent to the client on a regular basis. The information to be provided to the client and the periodicity of such reports vary depending on the type of investment service provided and the category of client.

In particular, an institution that provides portfolio management services to retail clients must report to its clients on any losses that exceed a threshold agreed beforehand between the institution and the client, no later than the end of the business day on which the threshold is exceeded. However, it should be noted that this obligation only applies when the institution has agreed a predetermined threshold with the client.

Portfolio management institutions are also required to maintain a list of minimum records, as detailed in the MiFID rules (see Article 37-1(6) of the MiFID Act and Articles 60 and 61 of the MiFID Regulation).

5.7. Scope of liability and relevant case law

An institution entrusted with portfolio management may be held contractually liable under the portfolio management agreement. The investor must prove that:

- the institution committed a negligent act (faute);
- the investor sustained damage; and
- there is a causal link between the act and the damage.

In a decision of 16 February 1990 (case no. 76/1990), the Luxembourg District Court defined the liability of a financial institution when the portfolio management agreement contains a limitation-of-liability clause as well as the institution's liability in general.

According to the abovementioned decision, the general rule is that the portfolio management agreement allows the institution to act as it deems fit and necessary in order to achieve the objectives set out in the agreement. The institution is not obliged to achieve a specific result per se and is only obliged to manage the portfolio with due care and in accordance with the portfolio management agreement, in order to achieve the objectives set out therein.

In the abovementioned case, the investor failed to explain how the institution's action could be considered as negligent, claiming only that the promised returns were not achieved. Consequently, the investor failed to prove that the institution had breached its duty of care.

5.8. Investment funds - no additional obligations

There are no other specific requirements applicable to investment funds. An investment manager entrusted with the day-to-day management of an investment fund's assets provides individual portfolio management services to the fund or its management company and is thus subject to the provisions of the MiFID Act in the same way as a portfolio manager. However, it should be noted that the provisions of the MiFID Act do not apply to a UCITS that has entrusted the day-to-day management of its assets to a management company authorised under chapter 13 of the Act of 20 December 2002 on undertakings for collective investment.

Contact

We hope you found this publication useful and welcome the opportunity to answer any questions you may have with respect to its contents.

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