

Luxembourg

Regulation

HEDGE FUNDS 2009

Hedge fund managers/advisors

Regulation

Authorization requirements and process

A Luxembourg Management Company is subject to prior authorization by the Regulator, the Commission de Surveillance du Secteur Financier (CSSF), and falls under the scope of the law of 20 December 2002 on Undertakings for Collective Investment. If the management company manages non-UCITS only it would be subject to a so-called light regulatory regime under Chapter 14 of the law. However if the management company were to manage UCITS funds as part of its activities it would have to comply with Chapter 13 of the law that contains more detailed provisions and rules with regard to authorization, capital, operating conditions, and delegation.

The collective portfolio management functions of a management company include investment management, administration, and marketing. A chapter 13 management company may be authorized to provide additional services such as discretionary portfolio management on a client-by-client basis and the provision of investment advice. Chapter 14 management companies may not engage in activities other than the management of Undertakings for Collective Investment. Management companies are permitted to delegate their activities to third parties subject to certain conditions.

A firm that wants to seek authorization as a management company will have to submit a file to the CSSF describing the organizational structure, information on the reputability and professional experience of the directors, and the identity of the shareholders.

A management company may only start business when authorization has been granted.

Managers and advisors of Luxembourg hedge funds may be located in Luxembourg or abroad, and there is no requirement for the asset management activity to be performed in Luxembourg. The CSSF will pay special attention to

the relevant experience and reputation of the manager before authorizing the scheme.

The law of 5 April 1993 on the financial sector, as amended, provides for the authorization of a particular category of financial sector professional (FSP) established under Luxembourg law, the Managers of non-coordinated Undertakings for Collective Investment (UCIs). These are firms that would be engaged in the management of foreign non-UCITS only and could therefore manage foreign hedge funds. The activities of this FSP may include the provision of central administration services to entities that they manage. Authorization would only be granted to legal entities and is subject to an authorization application procedure. The applicant is required to demonstrate that it has sound administrative and accounting organization and adequate internal control procedures, and that the management and shareholders are of professional standing and experience.

Typical timescale to receive approval

An applicant shall be informed within six months of submitting a complete application whether or not authorization has been granted.

Regulatory capital requirements

The minimum regulatory capital for management companies of Luxembourg domiciled non-UCITS is EUR 125,000 and for a management company of a foreign non-UCITS is EUR 125,000.

Significant restrictions on marketing to investors

A non-UCITS fund domiciled outside Luxembourg must seek approval by the CSSF to distribute to the public. The CSSF will only approve those funds that are subject to sufficient prudential supervision in their country of domicile.

It must appoint a banking or savings institution (within the meaning of Luxembourg law on the supervision of such institutions) to ensure that facilities are available in Luxembourg to make payments to unitholders and repurchase units.

Hedge fund structures

Regulation

Authorization requirements

In Luxembourg, hedge funds may take the form of non-UCITS retail funds (Part 2 of the law of 20 December 2002) or Specialized Investment Funds (SIF)

dedicated to qualified investors (Law of 13 February 2007). The Part 2 non-UCITS funds require prior regulatory approval by the Luxembourg Supervisory Authority (CSSF) before the fund may be launched. However the SIF has the possibility to seek regulatory approval after the launch and must submit its application to the CSSF for approval at the latest one month after launch date.

The promoter and the investment manager of the SIF are not subject to CSSF approval which may be important in the hedge fund sector for smaller boutique managers. However, the SIF's Board of Directors, the depositary, and the auditor are all subject to regulatory approval by the CSSF.

The Promoter of a Part 2 non-UCITS fund would have to be approved by the CSSF. The CSSF will base their assessment on the financial standing, reputation, and experience of the Promoter in the particular investment strategy.

Location of manager

A Luxembourg Common Fund (Fonds Commun de Placement (FCP)) which is similar to a U.K .unit trust has no legal personality and must be managed by a Luxembourg management company. A Luxembourg SICAV is an investment company and will have the corporate form of a public limited company (société anonyme (S.A.)). There is no requirement for a hedge fund set up as a SICAV to appoint a management company.

The Management Company of an FCP and a SICAV may appoint an investment manager that is located abroad. Luxembourg fund law does not place any restriction on the location of the investment manager. However, in the case of a Part two non-UCITS, the CSSF will ensure that the investment managers and investment advisers have experience in the fund investment strategy.

Restrictions on types of investments, concentration levels, and the manner in which hedge funds can invest and/or strategies

Funds under part 2 of the law of 20 December 2002

The Circular 02/80 (the Circular) issued on 5 December 2002 provides the rules that generally apply to hedge funds set up under the 2002 law. Compliance with these rules will generally speed up the CSSF approval process of the hedge fund. However, certain derogations from the rules may be granted by the CSSF if appropriately justified.

The Circular provides for the possibility for hedge funds to undertake short sales, to borrow for investment purposes and to make use of derivative financial instruments and some other techniques. It also sets diversification rules in relation to these investments to ensure adequate risk spreading.

The most important limits applicable in relation to some of these investments and techniques can be summarized as follows:

Borrowings and leverage rules

Funds may borrow permanently and for investment purposes from first class professionals who are specialized in this type of transaction. The conditions under which a fund may borrow are:

- Borrowings are limited to 200 percent of the net assets of the fund. Consequently, the value of the assets of the fund may not exceed 300 percent of its net assets. Funds pursuing a strategy with a high level of correlation between long positions and short positions are authorized to borrow up to 400 percent of their net assets.
- Counterparty risk: the difference between the value of the assets transferred by the fund to a lender as security in the context of borrowing transactions and the debt of the fund owed to such lender may not exceed 20 percent of the assets of the fund.
- The counterparty risk resulting from the sum of:
 - the difference between the value of the assets transferred as security and the amounts due to the lender in the context of securities lending transactions; and
 - the difference between the value of the assets transferred as security and the amounts borrowed referred to above may not in respect of a single lender, exceed 20 percent of the assets of the fund.

Use of derivative financial instruments and other techniques

The use of exchange-traded/OTC financial derivative instruments such as futures, options, swaps and forwards are permitted providing certain conditions are met. The circular aims to manage the exposure to derivative financial instruments in three different forms:

- Limit on leverage from derivative instruments
 - Margin deposits in relation to derivative financial instruments may not exceed 50 percent of the assets of the fund. The fund must have an adequate reserve of liquid assets which must represent an amount at least equal to the margin deposits made by the fund.
 - The fund may not borrow to finance margin deposits.

- o The aggregate commitments resulting from the financial derivative instruments entered into may not at any time exceed the value of the assets of the fund.
- Limit on the underlying
 - o The fund may not hold an open position in a single commodity or a single category of financial futures for which the required margin/commitment represents 20 percent or more of the assets
 - o The fund may not enter into contracts relating to commodities other than commodity futures contracts.
 - o The fund must ensure an adequate spread of investment risks by sufficient diversification.
- Limits on the contracts or identical options
 - o The fund may not hold an open position in anyone single contract for which the required margin/commitment represents 5 percent or more of its assets.
 - o Premiums paid to acquire options outstanding having identical characteristics may not exceed 5 percent of the assets

The method for calculating the exposure/commitment depends on the type of instruments:

- derivatives dealt on an organized market: required margin
- options acquired: premium paid
- commitment on OTC derivatives (includes premium written under this category): non-realized loss

Sale with right of repurchase transactions and reverse repurchase transactions.

The fund may enter into sale with right of repurchase transactions (repo) and reverse repurchase transactions (reverse repo) provided:

- The counterparty is a first class professional specialized in these types of transactions.
- During the duration of a sale with right of repurchase agreement where the fund acts as purchaser, it may not sell the securities of the contract unless the fund has other means of coverage at its disposal.

- Where the fund acts as seller in a repurchase transaction, must not sell the securities under the repo or pledge them to a third party, or repo them a second time, in whatever form.
- The fund must hold sufficient assets to pay the agreed upon repurchase price payable to the transferee.

Specialized Investment Funds (SIF)

The SIF should maintain the principle of risk spreading and there are no restrictions on the types of assets held. In terms of investment limits, the SIF should ensure a maximum issuer exposure of 30 percent.

Rules regarding the publishing of the accounts and prospectuses

Funds under part 2 of the law of 20 December 2002

Luxembourg hedge funds under Part 2 of the 2002 law are subject to the same legal and regulatory requirements than all the other Luxembourg funds in relation to the preparation of a prospectus and the timing and content of annual and semi-annual financial statements.

In addition, Circular 02/80 specifies the requirements for the content of the prospectus of hedge funds. It must contain a description of the investment strategy of the fund concerned as well as, a description of the specific risks inherent to its investment policy and must state that investing in the fund in question entails a higher than average risk and is only suitable for investors prepared to lose the total value of their investment.

The prospectus must also disclose the following specific items, if applicable:

- potential losses resulting from short selling of transferable securities differ from those where the fund acquires such securities for cash
- the leverage effect creates an opportunity for increased yield, and hence higher income, but at the same time increases the volatility of the fund's asset values and hence the risk of capital loss
- any borrowings involve an interest cost which may exceed any income or gains generated by the fund's assets
- the low liquidity of the fund's assets means that the fund may not be in a position to meet investors' redemption requests

Specialized Investment Funds (SIF)

The law requires that the SIF prepares an offering document that must contain the information necessary for the investor to make an informed decision on the investment proposed. It must also inform the investor on the risks inherent to this investment.

In relation to the publication of financial statements, the law only requires the preparation of annual financial statements that must be produced within six months of the year end.

Time-scale of establishment of a hedge fund

Funds under part 2 of the law of 20 December 2002

The time to obtain approval for the structure will mainly depend on its complexity. The compliance with all the investment policies and limits as set in Circular 02/80 will ease the process considerably. Policies that depart from the prescriptions of Circular 02/80 will raise more questions and requests from the CSSF and this will increase the time required for registration.

Specialized Investment Funds (SIF)

As specialized funds are dedicated to qualified investors, the legislator allows for a post launch regulatory approval, a significant speed to market advantage.

Investors

Regulation

Restrictions on which type of investors can invest in a hedge fund and/or the minimum/maximum number of investors in a hedge fund

Funds under part 2 of the law of 20 December 2002

For those funds, there are no restrictions on investors or minimum investment amount. Therefore, hedge funds created under Part 2 of the law of December 2002 can be distributed to retail investors.

Specialized Investment Funds (SIF)

Specialized funds are restricted to the concept of well-informed investors. The law defines qualified investors as institutional investors, professional investors or any other investor provided the latter comply with the following criteria:

- The investor confirms in writing that he/she adheres to the status of well-informed investor; and
- A minimum investment of EUR 125,000; or
- He/She will hold a certificate from a banking institution or a professional of the financial sector in which they confirm his/her expertise, experience, and his/her knowledge and therefore its ability to decide knowledgeably of the investment made in the specialized fund.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.