Investment Management
Hedge Funds

Luxembourg Hedge Funds*

2008

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Introduction

This guide must be read in conjunction with our specific presentations available on the Investment Management Industry in Luxembourg, which provide details on the regulatory framework, basic legal corporate requirements and other relevant information useful to understanding the local environment for investment Funds.

For the purpose of this guide, the word "Hedge Fund" will cover the following structures:

- Funds using different investment strategies such as long/short equity, convertible arbitrage, fixed income arbitrage or managed futures to name a few;
- Investment strategies using investment techniques such as short sales, financing leverage or extensive use of derivatives. The latter are allowed in Luxembourg subject to certain restrictions explained in this guide;
- Funds investing in non-traditional asset classes such as commodities, OTC derivatives;
- Funds paying performance fees; indeed, any kind of performance fee calculation is possible in Luxembourg.

As some of the assets, techniques or strategies do not fall under the rules of EEC Directive 85/611/CEE as amended by Directives 2001/107 EC and 2001/108 EC (hereafter "UCITS Directives" enabling the so called "European Passport"), most Hedge Funds are Non-UCITS and the Regulator can be more flexible with the investment restrictions. These can be discussed with the Regulator (Commission de Surveillance du Secteur Financier, "CSSF").

One of the key advantages of setting up such Funds using alternative investment strategies in Luxembourg is that they are regulated products. The Regulator is very flexible; accepting new strategies and granting derogations on specific restrictions, especially when the product is sold to institutional or qualified investors.

Before launching a Hedge Fund, the following questions will have to be answered:

- What is the impact of the Hedge Fund business on our organisation?
- Can we sell these Hedge Funds in the same way we sell our traditional products?
- Do we need another organisation in the legal department, compliance department, …?
- What domicile do we need for our Hedge Fund?
- Are we sure that our product is tax efficient? (The answer depends on the targeted countries).
- What legal form do we want (contractual type or corporate type of Fund)?
- Have we considered timing issues as the registration process can be longer than expected?
- Have we identified all the third party service providers we have to rely on?
- Have we understood the balance between cost and quality when selecting service providers? The criteria may be different from those we use for traditional products.

Whilst these questions may appear basic, they are essential to assessing whether the development of alternative investment products properly reflects the strategy and operational philosophy of the Investment Management firm.

This guide is intended to help identify and assess the implications of your choice and thus provide you with the concrete first steps you can take.

Luxembourg Hedge Funds

As at June 30, 2007, alternative investment Funds represent roughly EUR 187 billion (USD 252 bn), or 9% of the total assets under management in Luxembourg.

This figure includes all products serviced from all jurisdictions and administered in Luxembourg.

In Luxembourg, the appetite for alternative investment strategies is growing. The tables below describe the size of the market as at June 30, 2007.

Luxembourg Hedge Funds and offshore Hedge Funds administered in Luxembourg:

Single manager Hedge Funds

Entities under administration	Domiciled & administered	Administered	Total
Number of Funds	79	100	179
Total number of units	369	187	556
Assets under administration	**Domiciled & administered**	**Administered**	**Total**
Assets (EUR m)	58,566	18,515	77,081
Asset (US$ m at 30/06/07)	79,094	25,004	104,098

Funds of Hedge Funds

Entities under administration	Domiciled & administered	Administered	Total
Number of Funds	145	237	382
Total number of units	413	641	1,054
Assets under Administration	**Domiciled & administered**	**Administered**	**Total**
Assets (EUR m)	52,655	57,040	109,695
Asset (US$ m at 30/06/07)	71,111	77,033	148,144

Source: ALFI

The CSSF Circular of 1991 allows, among other things, the launch of products applying alternative investment strategies: extensive use of derivatives, short selling, leverage through borrowings, real estate investments, venture capital Funds and Funds of Hedge Funds.

When launching a Luxembourg-based Fund, the CSSF is willing to consider specific new strategies provided that the risk spreading principle is applied and reflected in the prospectus through the disclosure of investment restrictions. Such products do not benefit from the "European Passport" and this allows the Regulator to open the door to a vast array of derogations to the promoters regarding investment restrictions, especially if the Fund is sold to sophisticated investors. Indeed, the Regulator is very proactive in the development of regulated alternative investment products.

In order to simplify the rules applicable to Luxembourg-domiciled Hedge Funds and to clarify the main investment restrictions applicable to short selling, leverage and derivatives, the Regulator issued at the end of 2002, CSSF Circular 02/80 on investment Funds using alternative investment strategies. This Circular is applicable to regulated Hedge Funds and open to all investors. Retail Investors can invest in such Non-UCITS products.

This has helped to significantly reduce the time needed to approve new products.

Another vehicle has become available since the law on Specialised Investment Fund (SIF) entered into force on February 13, 2007. This law further reduces the time to market as no pre-approval from the Regulator is needed before launching the Fund.

Regulated Hedge Funds are not a common concept in the world of Hedge Funds where there are often little or no quantitative investment restrictions placed on them in the prospectus.

However, with private banking clients and institutions increasing their exposure to these products, transparency, risk management and investor protection are emerging as key selection criteria. Clearly, from this standpoint, a regulated Luxembourg-based Hedge Fund would be attractive for the following reasons:

- Strong culture of investor protection;
- Strict reporting requirements (financial statements; regulations on material errors for investor protection purposes);
- Innovation in terms of product development;
- Quality of market participants.

Additionally, the other traditional advantages of Luxembourg remain valid for Hedge Funds equally:

- Well-established financial centre;
- Professional expertise in the Hedge Fund business with selected providers with many years of experience;
- Marketability of the country from an investor perspective;
- Multilingual staff;
- Relatively inexpensive quotation on a recognised Stock Exchange (and very short delay to get the listing).

Throughout this practical guide, we are going to develop the main issues you have to deal with when launching a Luxembourg-based Hedge Fund.

It should, however, be noted that Luxembourg-based service providers are ready to serve Hedge Funds whatever their domiciles. Offshore based Funds represent today 30% of single manager Hedge Funds and 53% of Funds of Hedge Funds administered in Luxembourg. We strongly believe that the development of Luxembourg-based Hedge Funds will be obtained parralelly to the development of Bermudean, Cayman and other offshore center's Funds administered in Luxembourg.

1. Setting up a Hedge Fund in Luxembourg

1.1 Quality of market participants

The Regulator will always consider the quality, reputation and experience of promoters when approving Hedge Funds. As a general rule, promoters must be regulated and authorised in their home countries to perform the same type of activities as those contemplated in Luxembourg. For new promoters, the CSSF will in many cases contact the home country Regulator of the promoter before providing its approval.

In general, it is recommended that new promoters meet the Regulator to explain their projects; in particular, the investment strategies used, how the Fund will be distributed and the countries and investors targeted. Some service providers dedicated to Hedge Funds may act as co-sponsors to facilitate the approval process.

Once the promoter has decided on the investment strategy and the general characteristics of the Fund, a custodian bank must be designated. This custodian bank must be approved by the CSSF. To give its approval, the CSSF will assess the financial and administrative capacity of the bank to perform its duties as custodian and/or co-sponsor.

These rules, however, do not apply to the launch of offshore based Funds administered in Luxembourg.

Furthermore, these rules are neither applicable to Specialised Investment Funds (SIF) as no criteria is imposed as to the nature of market participants since such Funds are created for qualified and/or institutional investors.

1.2 Alternative investment vehicles allowed in Luxembourg

When launching Luxembourg-based Funds, the CSSF is open to discuss new strategies not foreseen in the current regulation on a case-by-case basis provided that the risk spreading principle is applied and mentioned in the prospectus' investment restrictions. As previously indicated, the Regulator has a very flexible approach to such products.

The regulatory framework for investment Funds in Luxembourg is further detailed in our specific presentations available on the Investment Management Industry in Luxembourg.

In Luxembourg four broad categories of Hedge Funds are readily available:

- UCITS III sophisticated Funds for retail investors: Such Funds, created as UCITS, benefit from the European Passport and may, to a certain extent, use Hedge Fund techniques but with a lot of investment restrictions and risk management constraints;
- Funds investing mainly in derivatives and subject to a specific and flexible set of provisions (Chapter I of Circular 91/75). For retail, qualified and institutional investors;
- Funds using alternative investment strategies such as leverages and short sales subject to CSSF Circular 02/80 (the "Alternative Circular"). Such Funds can be sold to retail investors and are not subject to minimum investment requirements;
- Specialised Investment Funds for qualified investors and institutional investors only.

The second category is made up of Hedge Funds investing mainly in derivatives. They have been permitted since 1991 and have proven to be successful as they benefit from a flexible regulatory framework. They have to follow investment restrictions expressed in terms of margin deposits allowing a significant level of leverage. They can also use OTC derivatives if commitment restrictions are added in the prospectus. They can be constructed to follow standard Hedge Funds strategies such as market neutral, long/short equity, fixed income arbitrage and systematic trading with or without leverage. Vehicles created under this Circular are less and less frequent however.

Concerning the third category, following the issuance of Circular 02/80 (the "Alternative Circular"), Luxembourg regulations stipulate a specific set of provisions but they have a flexible framework for the launch of products using alternative investment strategies.

The last category of Hedge Funds is the SIF following the law of February 13, 2007 which allows for the creation of more flexible Funds with a quick time to market. These are dedicated to only certain categories of investors however.

1.2.1 UCITS III Sophisticated Funds

The law of December 20, 2002, translates, in the Luxembourg regulatory framework, the "UCITS III" Directive.

Under this law, it is possible to create UCITS for retail investors applying certain Hedge Fund techniques. The concept of global exposure limiting the use of derivatives is calculated as follows:

- For traditional UCITS, the commitment approach is applicable and leverage is limited.
- For sophisticated UCITS, global exposure is linked to the Value at Risk (VaR) of the Fund without a predefined limitation of leverage.

Short selling of securities and borrowings are prohibited as stated in the UCITS III European Directive, but the use of derivatives may allow equivalent economic results. For example, Contracts For Difference (CFD) may be shorted.

Prime brokers may be appointed by UCITS if the counterparty risk specific to UCITS III is respected (limited to 10% for UCITS).

Long/short equity, futures Funds, Absolute Return products, have already been launched in Luxembourg as UCITS following the implementation of this Directive. But the counterparty of the European Passport granted thanks to this UCITS status is a huge set of regulations and of investment restrictions as this kind of products is mainly created for retail investors.

1.2.2 The Alternative Circular: CSSF 02/80

The Alternative Circular has been an important development for the Luxembourg Investment Fund industry. The Circular allows the Luxembourg Fund industry to compete with other jurisdictions while aiming to providing a "regulated" alternative product that continues to promote the positive reputation of the Luxembourg financial centre.

The Alternative Circular speeds up the approval process for Funds using alternative investment strategies as the following issues have now been clarified:

- The appointment of prime brokers for Luxembourg-domiciled Funds;
- The limits governing borrowings for investment purposes;
- The possibility of combining leverage through borrowings and short selling;
- The rules for Funds of Hedge Funds;
- The use of derivatives for Funds governed by this new Circular.

1.2.2.1 Use of prime brokers

The use of prime brokers is clearly foreseen in the Alternative Circular. In order to secure the financing of leverage provided by prime brokers, it is possible to transfer ownership of the Funds' assets to the prime broker. The amount can exceed the debt of the Fund by 20% of the market value of the assets. This is important for prime brokers as market fluctuations may reduce the value of assets transferred.

1.2.2.2 Restrictions on short selling and long positions

Most of the investment restrictions outlined in the Alternative Circular are based on gross assets and not net assets. Therefore, the use of leverage does not exaggerate the number of lines in the portfolio.

For the long portfolio, the Fund cannot invest more that 20% of its assets in any one issuer. In addition, unquoted securities should not represent more than 10% of the Fund's assets.

On the "short side", the proceeds from short selling applicable to any one issuer cannot exceed 10% of the Fund's assets. Furthermore, there is a stop loss limit when a short sale results in an unrealised loss representing 5% of the Fund's assets. But this stop loss on short selling does not apply to Funds using market neutral or relative value strategies.

For both long and short positions, it is not possible to buy or sell more than 10% of the securities issued by any one issuer.

1.2.2.3 Borrowings

The amount of allowable leverage is restricted through limits on borrowings based on net assets.

In principle, a Fund should not borrow more than 200% of it's net assets if it follows a directional strategy. For market neutral or relative value strategies – for which short positions are covered by long positions – this limit is raised to 400% of the Fund's net assets.

However, if additional leverage is needed for a specific strategy (fixed income arbitrage for example), the CSSF has shown itself to be open to such discussions.

1.2.2.4 Derivatives

The Alternative Circular allows derivatives of any kind to be used: futures, forwards, options, interest rate swaps, equity swaps, …
The list is not limited.

The constraints put on the use of derivatives are driven by the principle of risk spreading. The Alternative Circular defines the applicable risk spreading principles as follows:

- For derivatives admitted to trading on a regulated market: margin deposits on any one position cannot exceed 5% of gross assets;
- For OTC derivatives: any unrealised loss on any one position cannot exceed 5% of the gross assets;
- Total margin deposits and/or total unrealised losses for OTC derivatives cannot exceed 50% of gross assets;
- Premiums paid on options are taken into account in the 5% and 50% limits described above.

As the use of derivatives may increase the level of leverage mentioned in the "Borrowings" section above, the prospectus must indicate a maximum level of leverage resulting from the combination of borrowings and derivatives.

The Alternative Circular is flexible enough to allow investment managers to achieve their investment objectives through the use of borrowings and short selling or with derivatives or a combination of both.

The Alternative Circular also foresees the possibility of using securities lending and repo/reverse transactions.

1.2.2.5 Funds of Hedge Funds

The rules concerning Funds of Hedge Funds have also been clarified and simplified.

Investment in a non-regulated underlying Hedge Fund cannot exceed 20% of net assets, whatever the domicile of underlying Funds. This restriction is to be understood at the sub-Fund level, implying that it is possible to invest in 5 sub-Funds of the same umbrella for 100% of net assets. In addition, it is possible to hold up to 100% of the shares/units issued by the underlying Funds.

The use of leverage is allowed.

Investment in regulated underlying Hedge Funds is subject to more flexible rules.

1.2.3 Specialised Investment Funds (SIF)

In February, 2007, the Luxembourg parliament adopted a law destined to replace the 1991 law on UCIs dedicated to institutional investors; the concept of Specialised Investment Funds (SIF) was thus created.

The main change, when compared to previous regulation, probably concerns the scope of eligible investors, which is broadened to include not only institutional investors but professional and sophisticated ones.

This latter category includes private individuals who fulfil the following criteria:

- They formally adhere to the status of "sophisticated" investors (meaning in substance, that they are able to understand the risks associated with investing in the SIF) and;
- They invest a minimum of 125,000 EUR in the SIF.

The latter minimum investment amount may be waived if they receive a positive assessment from a credit institution, an investment firm or a management company on their ability to adequately appraise investments in SIFs.

Other differences with the Alternative Circular are:

- Starting SIF activities without prior approval from the CSSF; application for approval will have to be filed with the CSSF within the month following the creation of the SIF;
- Promoters are no longer required; investment managers will not be subject to CSSF scrutiny and depositary banks, while required in Luxembourg, have less responsibilities;
- No requirement for publication of the net asset value ("NAV"), to subscribe and redeem at NAV or to have fully paid shares in SIFs set up in the form of SICAVs;
- Semi-annual non-audited reports and long form reports will not be required (only an annual audited report with more flexibility as to portfolio disclosure);
- Even if the risk diversification requirement remains (as this is the essence of a UCI), the quantitative limits that exist under the Alternative Circular will not apply. Consequently, it is up to the managers of each SIF to determine such quantitative limits[1];
- Investors will be able to invest in the SIF via equity or debt allowing effective tax optimisation.

The range of eligible assets (nature of assets or associated risks) is unlimited: private equity, alternative strategies, real estate and commodities are just a few examples of assets eligible for a SIF. The annual tax duty also remains at 1 basis point calculated on the SIF's net assets.

[1] Supplemented by a CSSF circular 07/309 issued over the summer 2007.

Conclusion

In the table below, we have summarised the main characteristics of Hedge Fund categories under the different regulatory regimes available.

	UCITS III Sophisticated	Funds Chapter I of CSSF 91/75	Funds under CSSF 02/80	SIF
European Passport	Yes	No	No	No
Retail investors	Yes	Yes	Yes	No
Qualified investors	Yes	Yes	Yes	Yes
Institutional investors	Yes	Yes	Yes	Yes
Minimum investment	No	12,394.68 EUR[1]	No	125,000 EUR
Investment restrictions	Yes	Yes	Yes	No[3]
Pre-approval by CSSF	Yes	Yes	Yes	No
Compliance with European Directive	Yes	No	No	No
Disclosure of portfolio	Yes	Yes	Yes	No[2]

The CSSF Circular 02/80 is flexible enough to accommodate most of the investment strategies developed by Hedge Fund managers while protecting the reputation of Luxembourg's financial centre through selective investment restrictions.

Regulated Hedge Funds are an attractive concept where transparency, risk management and investor protection are key factors in the investment decision process. New types of alternative investors interested in non-correlated returns, such as institutional investors, pension plans and others, may find that Luxembourg alternative products meet their investment criteria.

The SIF law will significantly reduce the time to market for new investment Funds dedicated to sophisticated investors. It will allow high net worth individuals and their advisors/managers to launch products tailored to their very own needs and institutional players – tempted by alternative strategies – to create new, or repatriate existing Funds in a safe, regulated environment.

Beyond these rules, however, and due in part to a fast changing environment, it is important that new strategies be discussed and that the Regulator be open to new products which may lead to new recommendations and Circulars.

[1] Conversion into Euro by virtue of the Law of August 1, 2001.
[2] Quantitative/qualitative information only.
[3] Supplemented by CSSF circular 07/309.

1.3 The selection of a legal structure

1.3.1 Legal forms: SICAV, SICAF or FCP

Luxembourg law offers three main types of legal structures to promoters who are looking to set up Hedge Funds. However, if the Fund is created as a SIF, other legal forms are allowed.

Two corporate structures exist: the SICAV ("Société d'Investissement à Capital Variable") which can be based only on the legal form of a public company (S.A.), or the SICAF ("Société d'Investissement à Capital Fixe") that can be either a public company, a partnership limited by shares (S.C.A.) or a Limited Liability Company (S.à r.l.). The main difference between these two legal forms is that, for the SICAF, the capital of the company is fixed whereas for the SICAV, the capital of the company is at any time equal to the net value of its assets.

However, a SICAV created under the SIF law has more flexibility as to the choice of legal forms. It can be created as a public company (S.A.), a Limited Liability Company (S.à r.l.), a partnership limited by shares (S.C.A.), a limited partnership (S.C.S.) and a "Société Coopérative".

The alternative is of a contractual type, a FCP ("Fonds Commun de Placement"), consisting of a pool of assets managed by a Luxembourg-based Management Company which has the form of a public company, a Limited Liability Company or a partnership limited by shares. FCP's are generally open-ended, but they may be closed-ended.

The choice between these three structures (FCP-SICAV-SICAF) is driven mainly by the objective of the Fund in terms of investments and marketing. The SICAF and the closed-ended FCP are the vehicles principally used to establish venture capital and real estate Funds in Luxembourg. The two other forms, because of their flexibility, are more often reserved for Funds investing in transferable securities or derivatives and for Funds where shareholders/unit-holders need to purchase or redeem their shares/units freely.

The key elements one needs to take into consideration when deciding between an FCP and a SICAV are:

- The tax issues at various levels: investors, Funds, investments (refer to the tax section of this guide on page 16 in section 1.4);
- The intention of the Hedge Fund promoter: do they want to maintain tight control over the Fund or not;
- In a SICAV, the promoter generally holds a majority of the Board of Directors.

However, such directors remain fully liable to their shareholders and may, theoretically, be removed from office at any time by a general meeting. In the FCP structure, unit-holders generally have no voting rights; the promoter, through control of the Management Company, maintains decisional power through the life of the Fund. Please note however, that in such cases, and in order to ensure adequate protection of unit-holders, the custodian bank has additional duties and a significant supervisory role. In practice, it is perfectly possible to find a custodian accepting this responsibility for a Hedge Fund.

1.3.2 Multiple classes of shares

Multiple classes of shares are not yet allowed by all European countries. They have been available in Luxembourg however for many years and can be dealt with by most service providers.

Class types usually found in Luxembourg include:

- Capitalisation/distribution;
- Different distribution frequencies;
- Different currency hedging policies;
- Different loads (level, deferred, …);
- Different management fees;
- Different performance fees (equalisation method called “multi-series”).

1.3.3 Master/feeder

Although master/feeder Funds are outside the scope of the UCITS Directives, it is possible to structure such Funds under Part (II) of the Luxembourg Law of December 2002. Under that regime, however the investee Funds need to be open-ended and subject to risk diversification.

In the Hedge Fund business, such structures may be very useful to optimise distribution by adapting the legal form of the distribution vehicle to the tax environment of the targeted country and/or group of investors.

1.4 Tax optimisation

1.4.1 Tax structuring

One of the advantages of Luxembourg as a domicile for alternative investment products is the flexibility it provides for tax structuring which can be employed to mitigate tax at all product levels as described below.

Such structuring depends on the nature of underlying investments and on the targeted countries and/or the group of investors for distribution and should be considered at various levels:

- Investor level;
- Fund level;
- Investment level;
- Promoter and manager levels.

At investor level, a detailed check must be done in the targeted country for distribution. The fact that Hedge Funds do not benefit from the "European Passport" (as they are not foreseen by the UCITS Directives) may cause some problems in certain countries. The product may face discriminatory tax barriers even if it can be registered in such countries. In addition, for a given country of distribution, the methods of achieving a tax efficient product may largely depend on the types of investors targeted (individuals, corporate, institutional investors, …).

A detailed check of the tax status of potential investors can help in choosing the most efficient regulatory structure from a tax point of view (SICAV, FCP, …).

At Fund level, the only tax to be paid in Luxembourg is the "taxe d'abonnement" (subscription tax) representing 5 basis points of the quarterly net asset value. This tax may be reduced to 1 basis point if the product is sold to institutional investors only. If the product is sold both to retail and institutional investors, then it is possible to create a specific class of shares paying 1 basis point for institutional investors. For a SIF, this tax is limited to 1 basis point.

A detailed check can be done to optimise the return on investments. This optimisation, depending on the countries of investment and/or the nature of these investments, may be possible with special purpose vehicles.

Regarding taxation at the manager level, proper tax planning must be considered in order to accommodate transfer pricing rules from different jurisdictions with the lowest acceptable taxation of the manager. Moreover, one of the most technically complex, less considered and potentially costly tax aspects is VAT. It must be managed carefully and can be reduced depending on the distribution channels, the location of the asset manager and the distributor.

1.4.2 Hedge Funds and European withholding tax/exchange of information

On January 21, 2003, European Union members reached an agreement on a Directive on taxation of savings income. The Directive's goal is to prevent European investors from escaping their personal tax obligations regarding their savings income.

Following this agreement, all EU member states, certain associated and dependent territories, as well as some third countries – with the exception of Austria, Luxembourg and Belgium – are now automatically exchanging information on cross-border EU interest payments originating in their territories. These will be paid out after the Directive has come into effect as at July 1, 2005.

Austria, Luxembourg and Belgium as well as some of the associated or dependent territories/third countries are allowed to levy a withholding tax on such payments instead of exchanging information. (Exchange of information remains possible for these countries however upon express election by investors). The rate of withholding tax is 15% initially, rising to 20% in 2008 and 35% in 2011.

However, it is important to note that the agreement does not necessarily commit Austria, Luxembourg and Belgium to automatically exchange information after 2011. Rather, it makes this move dependent on the EU reaching unanimous agreement on satisfactory information exchange arrangements with Switzerland and other territories.

When structuring a Hedge Fund, it is essential to take into account the impact of this tax requirement, as the location of service providers (like the paying agent for example), is even more important than the Fund's domicile. The choice of legal form and investment strategy is also a key factor for determining whether the Fund may be subject to this tax harmonisation.

In order to maintain its competitiveness, Luxembourg is adapting its banking system by providing additional advantages that go beyond banking secrecy.

1.5 Tax reporting: the German case

Hedge Funds remain one of the hottest topics in the German investment market. Institutional and private investors alike are looking at this asset class with significant interest. Previously, due to disadvantageous tax consequences, such investments generated little interest, but now appropriate tax reporting opportunities exist to successfully enter the market.

Major legislative changes initiated at the beginning of 2004 are the prime reason for renewed interest and activity in this class. Hedge Fund promoters can now market their products on a private placement basis without investors suffering disadvantageous tax treatment (registration with the German Regulator is required only for public marketing). Notwithstanding the introduction of an advantageous tax regime, the key to successful market entry requires detailed tax reporting by Hedge Funds.

Under the provisions of the 2004 law, Hedge Funds and Funds of Hedge Funds may be distributed to German private and institutional investors.

To permit public marketing, a Fund must undertake a complex registration process with the German Regulator. However, private placement, as well as the Funds of Funds market, provides Hedge Fund promoters with easier access to German investors whilst permitting the same tax treatment afforded to registered Funds. This occurs because registration with the German Regulator is no longer regarded as a condition for achieving the most favorable tax status.

Under the 2004 law, foreign Hedge Funds and Funds of Hedge Funds distributed on a private placement basis are as attractive to the German investor market as Funds registered with the German Regulator provided the same tax reporting requirements are satisfied. The same conditions apply to foreign Hedge Funds intending to be on the buy list of Fund of Funds distributed to German resident investors. These tax-reporting requirements include, amongst others:

- Providing tax reporting to German investors within four months after the Fund's financial year-end as well as upon dividend distributions;
- Submitting certification of this tax reporting by either a certified tax advisor or an auditor;
- Reporting the accumulated deemed income at each evaluation day;
- Filing the tax return with the German tax administration.

Further tax advantages are available to institutional investors if a Fund provides additional tax related information (so-called "Aktiengewinn") at each valuation day. Indeed, this tax advantage may be so significant that institutional investors may insist Funds provide such information.

For private investors, current rules permit all income and gains from derivatives to be fully tax exempt.

1.6 The selection of service providers

The selection of service providers is essential in starting a Hedge Fund. Typically, the expertise of specialists in the alternative investment industry is needed not only for the day-to-day operations, but also during the pre-launch and launch phases of the product. This will enable the sponsor to optimise the product from a regulatory, tax and operational point of view.

The main service providers needed for a Hedge Fund are:

- A prime broker for certain strategies;
- An administrative agent;
- A custodian;
- A transfer agent;
- An auditor specialised in the alternative investment industry;
- A lawyer able to optimise the agreements between the Fund and the other service providers.

1.6.1 The appointment of a prime broker

The use of prime brokers has always been possible in Luxembourg. Using a prime broker is essential in the Hedge Fund industry if the Fund intends to use derivatives extensively or for making short sales.

The main services provided by Prime Brokers are the following:

- **Technology –** reporting of trade and other information such as risk management tools as well as interaction with other service providers;
- **Leverage financing –** to enable the Hedge Fund to employ leverage and gain greater exposure to a given asset class or strategy;
- **Securities lending –** the ability of a Hedge Fund to make short sales is a key part of their trading strategy and the prime broker can provide a securities lending desk;
- **Clearing and custody –** clearing trades executed with the prime broker or other executing brokers and acting as global sub-custodian for the resulting positions.

The appointment of a prime broker needs to be approved by the CSSF. The Alternative Circular allows for a counterparty risk of up to 20%, meaning that the level of assets transferred to the prime broker for guaranty purposes can exceed the indebtness of the Fund to the prime broker by 20%. Remaining assets may be pledged in favour of the prime broker.

As with other service providers, the prime broker may be helpful during Fund set up. It is important to clearly identify the various workflows and communication processes. If the launched Fund uses derivatives with significant leverage, it is essential that the prime broker provides the Fund with risk management tools enabling management to clearly monitor the risks involved in the trading strategies to be implemented.

To summarise, the following criteria has to be taken into consideration when appointing a prime broker:

- Technology;
- Risk management tools;
- Ability to work with other service providers (custodians, administrative agents, executing brokers, …);
- Ability to deal with OTC instruments;
- Qualifications of staff.

1.6.2 The appointment of an administrative agent

The administrative agent will perform a great deal of tasks which go beyond calculating the Net Asset Value ("NAV"). The NAV calculation is obviously the most visible aspect of Fund administration. But in the Hedge Fund industry, the administrative agent would normally need to demonstrate specific skills such as:

- Ability to deal with complex instruments such as OTC derivatives, complex swap structures, various types of structured notes involving embedded derivatives, …;
- Ability to provide the Fund with prices for all kinds of investments supporting the investment strategy;
- Ability to understand market practices and legal requirements for all relevant jurisdictions;
- Availability of specific risk management tools;
- Experienced staff used to working in alternative investments;
- Ability to deal with any kind of performance fee calculation (including equalisation);
- Understanding of specific compliance issues;
- Understanding of IT infrastructure enabling effective interface with other service providers;
- Ability to implement pooling techniques.

When a Fund of Hedge Funds is to be launched, the administrative agent has a specific role to play in the pricing of the Fund. Specific procedures should exist concerning:

- The use of estimated, final or last available NAVs for the investee Funds;
- Alternative pricing procedures if there is a mismatch between the NAV calculation frequency of the Fund of Hedge Funds and its investee funds;
- Understanding and ability to recompute equalisation amounts provided by the underlying service providers;
- Identifying any lock-up provision having an impact on the liquidity of underlying Funds.

This list is not exhaustive and is only a sample of the specific requirements that need to be taken into account when selecting an administrative agent.

1.6.3 The appointment of a custodian bank

The appointment of a custodian bank is mandatory for any Luxembourg-domiciled Fund. However, depending on the investment strategy selected by the Fund sponsor, the custodian bank may have to work closely with the prime broker. The prime broker could act as the global sub-custodian. This is generally accepted without difficulty by the Regulator for Hedge Funds. The custodian must be a Luxembourg bank or a branch of a bank located outside Luxembourg or even outside the European Union.

Some of the criteria to be taken into account when selecting a custodian bank are listed below:

- IT infrastructure and ability to work with prime brokers;
- Quality of compliance reporting: day-to-day control of investment restrictions. It should be noted that for a SICAV, the bank has no legal responsibility for checking investment restrictions before accepting transactions but it may be included in the agreement as a contractual responsibility;
- Quality and experience of staff in alternative investments or in similar complex strategies;
- Ability to implement pooling techniques.

Custodian requirements are more flexible for a SIF: the custodian bank is responsible for the custody of assets but not for the supervision/ control of the Fund.

1.6.4 The appointment of a transfer agent

The transfer agent may be the administrative agent or an agent specialised in this function.

The appointment of a transfer agent depends on several factors:

- The way the fund is distributed;
- The number and the quality of investors (institutional/retail);
- The targeted countries for distribution;
- The level of services required for tax reporting and registration in targeted countries;
- The use of equalisation methods;
- The IT capacity and the ability to work efficiently with other service providers.

1.6.5 The appointment of an auditor

Luxembourg regulation requires that all Luxembourg Funds be audited annually by a local auditor. The choice of auditor must be approved by the CSSF who will ensure that the auditor is able to audit investment Funds.

Furthermore, the auditor has an important role to play in applying the requirements of the CSSF Circular 02/77. This Circular aims at providing investors in Luxembourg-domiciled Funds with a higher level of protection by establishing a strict framework ruling how investors are compensated for losses resulting from errors in NAV calculations and breaches of investment restrictions. The auditor must issue special reports on the correctional process implemented and related payments to be made in relation to the Remedial Action Plan presented by the administrative agent of the Fund.

The auditor also has to issue a Long Form Report according to Circular CSSF 02/81. This report is addressed to the CSSF and the Fund's Board of Directors. It is not a document for public viewing. The Long Form Report is designed to focus on both the organisation of the Fund and its procedures and controls.

The Long Form Report is not required for a SIF.

Finally, the auditor may issue specific certificates at the request of the CSSF concerning, for instance:

- The pricing of OTC derivatives acquired as part of a given investment strategy whereby the auditor may need to confirm the pricing model and the list of parameters.
- The calculation of performance fees. As any kind of performance fee is possible in Luxembourg, details of the calculation methodology may be requested by the Regulator.

1.7 The use of pooling techniques

In their development, the promoters of investment Funds are currently subject to two forces which act in opposite directions.

On the one hand, promoters tend to amalgamate their resources, network, systems and products in order to achieve economies of scale.

On the other hand, market forces require promoters to move closer to the needs and demands of individual investors. As a consequence, promoters tend to create more products and develop new distribution channels.

We refer to this as the "Promoter's Dilemma". The investment Fund industry has been trying to resolve this dilemma for many years.

The first solutions implemented were the multiple classes of shares and master/feeder Fund structures.

Since these solutions did not address the dilemma completely, technical solutions have been created, namely Intra-Pooling and Extra-Pooling.

1.7.1 Extra-Pooling

Extra-Pooling allows the management and administration of assets belonging to legally independent Funds to be globalised through the management of "virtual" portfolios (pools).

For legally distinct Funds, the idea behind Extra-Pooling is to concentrate/manage all assets invested in different markets in order to globally manage these Funds. Each pool dedicated to a single market is managed by a single investment manager, no matter how many Funds are pooled together.

The use of Extra-Pooling requires that the custodian be able to identify the investments that are owned by each legal entity separately. In the context of Extra-Pooling, this becomes a rather cumbersome process and requires that each pooled entity be administered by the same administrative agent and custodian bank.

Note however that all pooled Funds do not have to share the same investment policies as each Fund can be linked to several pools in order to reflect their own investment policy. As a consequence, the Extra-Pooling technique is perfectly suitable for multi-management structures: each pool would be managed by a specialised advisor. Through investments in different pools, a single Fund could benefit from the expertise of different advisors.

Advantages

- **Rationalisation** of Investment Management and administrative activities:
  - Extra-Pooling allows for a centralised management of assets belonging to various independent legal structures;
  - The investment manager of the pooled Funds manages the assets globally through the use of a consolidated management report;
  - Transactions are made for the whole pool and their frequency is limited by possible compensation of transactions between pooled Funds experiencing opposite cash flows.

- **Customisation of product range for distribution:**

  Since each pooled Fund is a separate entity, its legal form and fee structure can be adapted to different markets and types of investors.

- **Private labelling:**

  Pooled Funds are separate legal entities. As a consequence, Extra-Pooling allows for full private labelling solutions between managers and distribution powerhouses.

- **Cross-border pooling:**

  The cloning of Funds resident in different countries is very complex and subject to approval but it has already been accepted between Caribbean and Luxembourg jurisdictions, which is important for Hedge Funds.

1.7.2 Intra-Pooling

The sub-funds of a single umbrella Fund invest their respective net assets in internal portfolios (pools) of the Fund based on an allocation defined in advance or on a discretionary basis. In the Intra-Pooling structure, pools have no legal existence. They are set-up only as management tools.

Compared to Extra-Pooling, the main difference is that the pool and the sub-funds are part of the same single legal entity.

Advantages

- **Intra-Pooling allows for the segregation of management activities (at pool level) and for the distribution activities (at sub-fund level).**
  - Rationalisation of Investment Management activities:
    The Investment Management activities are limited to pool management. The management at sub-fund level is limited to the "asset allocation" between pools. Note that sub-funds may also hold specific assets which are not in pools.
  - Efficient structuring of product offering:
    Different sub-funds could mean:
    - a different cost policy (private/institutional);
    - a different currency hedging policy;
    - guaranteed/not guaranteed.
- **Multiply product offering:**

  Sub-funds with different investments in pools can be created, without limit or major additional costs, to fit with the investor's demand.
- **Private labelling:**

  Since it is possible to have separate marketing materials and financial statements for each sub-fund, it is possible to market specific sub-funds under different labels. However, this private labelling is only partial since the separate materials always refer back to the full prospectus or financial statements. Only Extra-Pooling would allow for full private labelling.
- **Multi-advisors:**

  Intra-Pooling perfectly fits with multi-advisor structures i.e. the management of different pools is allocated to different advisors based on their specialities.

2. Marketing and distribution of Hedge Funds

The experience gained by Luxembourg as the gateway for cross-border distribution of retail Funds (95% of Funds registered for public sales in more than 5 EU countries are domiciled in Luxembourg), provides significant potential for Hedge Funds managers seeking to access a wider international marketplace.

Local service providers have considerable expertise concerning the registration process of Funds (with or without the European Passport) in many target countries but they are also familiar with private placement possibilities that allow Hedge Funds to be sold abroad without local registrations and the packaging of unit-linked products involving Hedge Funds.

Luxembourg service providers have also made extensive use of technical solutions such as multiple classes of shares, Intra-Pooling, Extra-Pooling or "master/feeder" structures which can be effective tools for distribution as demonstrated in section 1.7.

As Non-UCITS, Hedge Funds, being Funds of Hedge Funds or "pure" Hedge Funds, they are very difficult to register for public distribution in targeted countries except in certain jurisdictions such as Germany, Switzerland, the Netherlands and Hong-Kong. In such places, public distribution is actually possible and done with Luxembourg-based Hedge Funds. It should be noted that Luxembourg Hedge Funds created according to the Alternative Circular are not subject to minimum investment and can be sold to retail investors.

To clarify whether such Funds can be sold in the targeted countries, it is essential to answer the following questions:

- Does the legislation of the targeted country provide clear rules regarding the private placement of securities?
- What rules does the Fund need to follow so as to keep the local Regulator from declaring itself competent to rule over the sale?
- Does private placement trigger any kind of special taxation for investors compared to the sale of a registered Fund?
- Is it possible to sell the Fund in a manner (i.e. through a listing on a Stock Exchange) that would avoid adverse taxation even if the Fund is not registered?
- If the rules applying to private placements are not clear enough, is there a quicker registration process for Hedge Funds sold to institutional investors?
- What about the use of the Internet and is the Internet considered as a medium for public offerings?

Answering these questions will be crucial in defining how effectively your product can be distributed.

Finally, if the product is sold to institutional investors only, the prospectus will not be a public document and the know-how included within it will remain confidential.

For more information, we recommend reading our brochure "Regulation and Distribution of Hedge Funds in Europe" available on www.pwc.com/lu.

3. Listing Hedge Funds on the Luxembourg Stock Exchange

3.1 Listing Luxembourg-based Hedge Funds

As with all other Luxembourg investment Funds, Hedge Funds may be listed on the Luxembourg Stock Exchange.

The quotation of a Luxembourg Hedge Fund on the Stock Exchange often eases its promotion and permits purchase by certain categories of non-resident investors and/or institutional investors who would otherwise not be entitled to buy securities of this sort.

Furthermore, listing on the Luxembourg Stock Exchange is a straightforward and inexpensive formality, one that can be done in a very short timeframe.

A listing file has to be submitted to the Stock Exchange by one of its members. Since many Luxembourg banks are members of the Stock Exchange, the listing file is generally prepared and submitted by the Fund's central administration or custodian bank.

The listing file has to be composed of:

- The duly completed application form provided by the Luxembourg Stock Exchange;
- The legal notice (in the case of a SICAV);
- The Fund's legal documents (copy of articles of association, copy of the management regulations for FCPs, copy of the various agreements, 45 copies of the prospectus);
- An Engagement Letter addressing the requirements of Article 7/ Chapter VI of the "Règlement d'Ordre Intérieur de la Bourse de Luxembourg";
- The ISIN and Common Code of each category of security to be listed;
- In case of bearer shares/units, a specimen copy of securities together with a printer's certificate.

As previously mentioned, the listing costs for admission and maintenance to the official list are marginal:

A fee of EUR 1,250 has to be paid by Luxembourg and EU-domiciled UCIs when an application for listing is not followed by a listing. Currently the listing fee stands at EUR 1,250 per EU-domiciled UCI.

In addition, there is a visa fee of EUR 1,250 for UCI-domiciled in the European Union. This visa fee does not apply to Luxembourg-domiciled Funds however.

Then, a maintenance fee has to be paid on an annual basis as follows:

- EUR 1,875 for the 1st line of quotation;
- EUR 1,250 for the 2nd line of quotation;
- EUR 875 for the 3rd line of quotation;
- EUR 500 for the 4th and following lines of quotation.

In terms of time limit, the Admission Committee of the Luxembourg Stock Exchange examines new listing requests once a week. Provided the file submitted is complete, the first quotation can be made approximately one week following submission of documents.

3.2 Listing offshore based Hedge Funds

Under certain conditions, it is also possible to list a foreign collective investment scheme on the Luxembourg Stock Exchange.

If an application for listing a UCI-domiciled outside the EU is not followed by a listing, a fee of EUR 2,500 has to be paid. The listing fee itself for a non-EU UCI is EUR 2,500. In addition, there is a visa fee of EUR 2,500 for non-EU-domiciled UCI.

Then, a maintenance fee has to be paid on an annual basis as follows:

- EUR 2,500 for the 1st line of quotation;
- EUR 1,875 for the 2nd line of quotation;
- EUR 1,250 for the 3rd line of quotation;
- EUR 625 for the 4th and following lines of quotation.

The rules for the listing of offshore based Funds, including Hedge Funds, have been amended by an “Arrêté Ministériel” dated June 11, 2004.

It is now quite easy to list a Fund domiciled in Bermuda or the Cayman Islands for example, provided the following conditions are met:

- The Fund promoter must have appropriate professional experience and financial resources;
- The service providers of the Fund must have appropriate professional experience (such service providers include: asset managers, management companies, custodian banks, administrative agents, transfer agents, …);
- The service providers must belong to a group regulated and supervised in their home country;
- The functions of asset manager, management company, custodian bank and transfer agent can not be cumulated;

- The Fund must be domiciled in a country that applies the anti-money laundering standards of the Financial Actions Task Force;
- The Fund must publish an annual and a semi-annual report. The annual financial statements must be audited by a qualified auditor having appropriate experience;
- The Fund must report financial data to the Luxembourg communication central (CCLux) along with its prospectus and financial statements.

As at the end of December 2006, 511 issuers coming from 15 different countries listed 6,887 lines of UCIs.

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