

alternative investments luxembourg

New rules reflect pro-active policy

New laws governing alternative investments in Luxembourg, says Luc de Vet, only serve to clarify the legal regime applicable to these funds

The market for European hedge funds and funds of hedge funds shows continued rapid growth. Industry research by EuroHedge reveals an increase in assets under management in European hedge funds of 43 per cent during 2002. Alternative investments have attracted a combination of wealthy and institutional investors through private placements. However, following poor performance of many long-only equity funds, alternative funds are now attracting attention from a larger group of investors. This development has encouraged changes within the European hedge fund industry, with Italy, Ireland, France and Luxembourg all implementing regulation changes for hedge funds and funds of hedge funds. Even Germany has plans to open its market for retail funds of hedge funds in 2004.

In December 2002, the Luxembourg regulator Commission de Surveillance du Secteur Financier ("CSSF") issued a circular containing specific rules applicable to Luxembourg funds pursuing alternative investment (Circular 02/80). The circular was established in cooperation between the CSSF and the fund industry, reflecting a pro-active and positive attitude from both sides towards alternative funds. Consequently, several specialized service providers have set up business in Luxembourg ensuring the availability of specific knowledge, systems and experience required to adequately service alternative funds.

The circular governing alternative funds stipulates that directors of a fund and its investment manager and advisor must prove that they have specific experience in the proposed investment strategies. The reputation, experience and financial standing of alternative investment providers are essential. The circular further requires an adequate description of the investment strategy and specific risk disclosure undertaken to make potential investors aware of the risks. Finally, Luxembourg funds are required to use approved service providers for custody and administration, with the funds themselves subject to supervision by the CSSF and to publish audited financial statements.

The regulator has taken an approach accepting the key role played by the prime broker in supporting the operations of a hedge fund, which shows an understanding of the specific needs of these funds. In providing clearing and custody services, the prime broker performs roles, which traditionally are carried out by the custodian of a mutual fund. The custodian of a regulated fund is often regulated and supervised by the same or related regulatory body as the fund, unlike a prime broker. The role of the prime broker has given rise to serious industry discussions, especially in Ireland. In Luxembourg, the regulator believes that a hedge fund may enter into a prime brokerage relationship as long as the custodian is able to adequately perform its supervisory duties. The prime broker needs to be a first class professional, however, the promoter and the custodian may determine this and acceptability of the choice is not enforced by the CSSF.

Further, there is the "hair cut" - the difference between the market value of the assets transferred to the prime broker as collateral for securities lending and the actual debt to the prime broker resulting from securities lending. Under the Luxembourg hedge fund regulations a "hair cut" of 20 per cent of total assets is allowed.

The regulations allow alternative funds to borrow permanently for investment purposes. Borrowing is limited to 200 per cent of the net assets of the fund. If a fund pursues a market neutral strategy with a high degree of correlation between long and short positions, borrowing is authorized up to 400 per cent of net assets. Additionally, the fund may short sell securities.

Rules related to short sales can be split into diversification and liquidity rules. The rules limit the short selling of securities of the same issuer, the non-realised loss on short positions on securities of one issuer and the cumulative non-realised loss on all short positions and the short selling of unlisted securities. The important point to remember regarding the new rules is that all limitations are related to total assets and not to net assets.

In Luxembourg, derivative financial instruments traded on an organized market and over-the-counter instruments are permitted. There is no list of approved derivative instruments so a new one will normally be acceptable for a Luxembourg hedge fund. The prospectus is required to contain disclosure of the maximum leverage and the risks resulting from the use of forward contracts, swap contracts, options and so on.

An estimated 200 funds of hedge funds already exist in Luxembourg. Investments may be made in any hedge fund irrespective of its domicile, track record, strategy or portfolio. The main restriction applicable to funds of hedge funds established in Luxembourg is that the investment in one underlying hedge fund is limited to 20 per cent of the net assets of the fund of hedge funds.

In reality the regulations will not change the Luxembourg landscape. Incorporating regulated hedge funds and funds of hedge funds in Luxembourg has been possible for more than a decade, however, the rules do clarify the legal framework applicable to alternative funds which makes it possible for promoters to determine whether Luxembourg actually provides the required flexibility and opportunity.

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