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INVESTMENT FUNDS

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Hedge funds in Luxembourg: regulatory overview

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HEDGE FUNDS

Market overview

1. What is the structure of the hedge funds market? What have been the main trends over the last year?

There is no specific hedge fund vehicle in Luxembourg. However, a hedge fund can normally be set up using one of the following investment fund structures:

- **Specialised investment funds (SIFs).** These are subject to the Law of 13 February 2007 relating to specialised investment funds (SIF Law) and offer great flexibility in terms of asset eligibility and diversification.
- **Undertakings for collective investment (UCIs) pursuing alternative investment strategies (Part II UCIs).** These are also used but to a lesser extent nowadays. Part II UCIs are subject to Part II of the Law of 17 December 2010 relating to undertakings for collective investment (UCI Law).
- **Undertakings for collective investment in transferable securities (UCITS).** Sophisticated and complex UCITS may be considered to be hedge funds and are governed by Part I of UCI Law.
- **Reserved alternative investment funds (RAIFs).** RAIFs are governed by the Law of 23 July 2016 on RAIFs (RAIF Law). RAIFs do not require prior authorisation from the regulator but must be managed by an authorised AIFM (for AIFM requirements, *see Question 9*).

Over the last few years, a vast majority of hedge funds in Luxembourg have been set up as SIFs.

Similarly to RAIFs and Part II UCIs, SIFs are affected by Directive 2011/61/EU on alternative investment fund managers (AIFM Directive). The AIFM Directive was transposed in Luxembourg by Law of 12 July 2013 on alternative investment fund managers (AIFM Law).

As a result, Luxembourg hedge funds that qualify as alternative investment funds (AIFs) must be managed by an alternative investment fund manager (AIFM) in compliance with certain organisational and procedural requirements.

Therefore, this chapter focuses on hedge funds that are set up as SIFs under the AIFM Law. For details on retail investment funds (including UCITS and Part II UCIs), see *Retail investment funds in Luxembourg*.

Regulatory framework and bodies

2. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

Regulatory framework

A SIF whose assets are acquired through the use of leverage exceeding a threshold of EUR100 million will be considered as an AIF and will be subject to the full scope of the AIFM Directive regime.

A SIF that qualifies as an AIF should appoint a duly authorised AIFM or be internally managed (where the legal form of the SIF permits an internal management and where the SIF's governing body has chosen not to appoint an external AIFM) in compliance with the requirements of the AIFM Directive.

In addition to the AIFM Law, a hedge fund that set up as a SIF is subject to the relevant specific product law (that is, the SIF Law) and to any applicable guidelines or regulations. These regulations apply to SIFs:

- CSSF Regulation N° 15-07 on the application of Article 42a of the SIF Law regarding the requirements in relation to risk management and conflicts of interest (CSSF Regulation N° 15-07).
- CSSF Circular 15/627 regarding monthly reporting to the CSSF.
- CSSF Circular 07/309 regarding risk-spreading in the context of SIFs (Circular 07/309).

Regulatory bodies

The *Commission de Surveillance du Secteur Financier* (CSSF) is the public institution supervising financial professionals and products in Luxembourg. It is responsible for the initial authorisation and ongoing supervision of all regulated hedge funds in Luxembourg.

However, RAIFs are not subject to any prior authorisation or to ongoing prudential supervision of the CSSF.

3. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

Luxembourg hedge funds are largely regulated and especially so since the implementation of the AIFM Directive.

Risk

SIFs are subject to specific diversification requirements and must comply with the risk-spreading guidelines set out in Circular 07/309. In particular, a SIF should not invest more than 30% of its assets or commitments in the same type of securities issued by the

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same issuer (except in specific cases or when a derogation is granted by the CSSF).

Valuation and pricing

For SIFs, the valuation of the assets must be based on the fair value, unless otherwise provided for in the constitutive documents, and when it qualifies as AIF the valuation must be performed by the AIFM or by an external valuer in accordance with the conditions set out in the AIFM Law.

Systems and controls

Pursuant to CSSF Regulation N° 15-07, SIFs must establish a permanent risk management function as well as appropriate risk management and conflict of interest policies.

Under the AIFM Law, the AIFMs managing SIFs must establish both:

- Permanent compliance and internal audit functions
- Liquidity management, valuation and remuneration policies.

Insider dealing and market abuse

Insider dealing and market abuse are generally prohibited by the Law of 23 December 2016 on market abuse. The Law implements the Regulation (EU) 596/2014 on market abuse (Market Abuse Regulation) and repeals the previous law of 9 May 2006.

Transparency

See *Question 8*.

Money laundering

Hedge funds, their managers and their service providers must all comply with the Law of 12 November 2004 on the fight against money laundering and terrorist financing (as supplemented by various regulations).

Short selling

CSSF Circular 07/309 concerning risk-spreading in the context of SIF does not impose any limitation to short selling. However, short selling cannot result in the SIF breaching its obligations under the circular. A SIF cannot invest more than 30% of its:

- Assets in uncovered securities of the same issuer.
- Assets or commitments to subscribe to securities of the same type that issued by the same issuer.

Marketing

4. Who can market hedge funds?

Onshore hedge funds

A hedge fund set up as a SIF that is subject to the AIFM Law can be marketed by its AIFM or an intermediary on their behalf. Intermediaries include credit institutions or financial sector professionals that are authorised under the Law of 5 April 1993 on the financial sector.

Offshore hedge funds

A non-EU hedge fund can be marketed in Luxembourg if it complies with the AIFM Law (*see Question 13*).

5. To whom can hedge funds be marketed?

Onshore hedge funds

When certain conditions are met, Part II UCIs can be marketed to all investors in Luxembourg (retail and institutional). For Part II UCIs to be marketed to retail investors outside Luxembourg, the relevant member state must also allow them to do so.

UCITS can be marketed to all types of investors, including retail and institutional investors. However, a UCITS can also choose to create sub-funds or share/unit classes that are reserved for certain investors only. For more information on retail investment funds, including UCITS and Part II UCIs, see *Retail Investment Funds in Luxembourg*.

SIFs and RAIFs. Shares/units of SIFs or RAIFs can only be marketed to "well-informed" investors (that is, institutional, professional or other investors who meet specific criteria set out in the SIF and RAIF Laws).

Well-informed investors are defined under SIF Law as:

- Institutional investors.
- Professional investors.
- Any other investor that invests at least EUR125,000 in the SIF or has been the subject of an assessment made by:
  - a credit institutions within the meaning of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (Banking Consolidation Directive);
  - an investment firm within the meaning of Directive 2004/39/EC on markets in financial instruments (MiFID); or
  - by a management company within the meaning of Directive 2009/65/EC on undertakings for collective investment in transferable securities (UCITS) (UCITS IV Directive) certifying the investor's expertise experience and knowledge to adequately appraise an investment in the SIF.

Offshore hedge funds

Under the AIFM Directive marketing passport regime, foreign AIFs managed by an authorised AIFM can be marketed to professional investors in Luxembourg. However, the foreign AIFs must meet certain conditions and comply with the AIFM Directive.

Under the AIFM Law, foreign AIFs can be marketed to retail investors in Luxembourg provided both:

- In their home member state they are subject to regulations that require the same level of investor protection and prudential supervision.
- They comply with the requirements set out in CSSF Regulation N° 15-03.

Investment restrictions

6. Are there any restrictions on local investors investing in a hedge fund?

There are no special restrictions on local investors investing in a hedge fund. The restrictions apply equally to local and foreign investors.

Assets portfolio

7. Who holds the portfolio of assets? What regulations are in place for its protection?

SIFs must appoint a depositary under both the SIF Law and the AIFM Law.

The duties of the depositaries include safekeeping the assets of the hedge fund. The hedge fund assets must be:

- Segregated from the own assets of the depositary and the AIF manager.
- Properly registered and recorded.

In practice, hedge funds often appoint a prime broker who may be entrusted with some of the assets of the hedge fund. As a result, the depositary is not directly safekeeping the assets of the hedge fund.

Therefore, to comply with the AIFM Directive and to ensure the depositary is properly informed on the ownership, segregation and use of the assets, specific arrangements are entered into between the:

- Depositary.
- Prime broker.
- Hedge fund.

Requirements

8. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

Investors

SIFs must publish an offering document under the SIF Law. Additionally, Law of 10 July 2005 must be complied with and an audited annual report must be published within six months from the end of the financial year.

Furthermore, a SIF that qualifies as an AIF must disclose certain information (for example regarding investment strategy and objectives), as well as publish an audited annual report within six months from the end of the financial year. It must also:

- Provide a certain amount of information prior to the investment, as specified in the AIFM Law.
- Disclose periodically to the investor information concerning the liquidity risk and the level of leverage.

Regulators

SIFs must submit monthly and annual financial reports to the CSSF. If it qualifies as an AIF, SIFs are required to submit periodic financial reports to the CSSF. In addition, they must also submit the following to the CSSF:

- Regular reporting (regarding the principal trading instruments and markets as well as leverage levels).
- Ad hoc reporting upon request.
- Specific reporting in case of acquisition and/or control of major holdings of certain unlisted companies.

9. What are the key requirements that apply to managers or operators of hedge funds?

Onshore hedge fund managers

Generally, if a SIF qualifies as an AIF, it must be managed by a duly authorised AIF manager (AIFM). If the AIFM is established in Luxembourg, it must be authorised by the CSSF. The AIFM cannot delegate its functions to the extent that it:

- Can no longer be considered to be the manager of the SIF.
- Would become a letter-box entity.

To avoid this, AIFMs must:

- Retain the necessary expertise and resources to supervise the delegation.
- Have the power to take decisions in key areas, which fall under its responsibility.
- Not lose its contractual rights to inquire, inspect, have access or give instructions to its delegates, or make it impossible to exercise these rights in practice.
- Not delegate investment management functions if they will substantially exceed the ones performed by the AIFM itself.

Offshore hedge fund managers

EU AIFMs are granted an AIFM passport which allows them to manage hedge funds based in Luxembourg. If a non-EU AIFM meets certain conditions, it can also manage Luxembourg hedge funds (*see Question 13*).

Legal fund vehicles and structures

10. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

SIFs can choose from a wide range of corporate forms. The most common forms for SIFs under SIF Law include:

- **Partnership limited by shares (*société en commandite par actions*).** Partnerships limited by shares offer a great protection for promoters as they will typically act as general partner (and as such retain the control over the fund) while investors will act as limited partners.
- **Public limited company (*société anonyme*).** Public limited companies have their capital divided into shares. They are formed by one or more persons that contribute a specific amounts to which their liability is limited. Public limited companies are formed by notarised deed and can be listed.
- **Common limited partnership (*société en commandite simple*).** Common limited partnerships have a legal personality and are entered into for a limited or an unlimited period of time. They can be formed either by notarial or private deed. Common limited partnerships have one or more:
  - unlimited partners with unlimited, joint and several liability for the debts and obligations of the common limited partnership; and
  - limited partners who contribute capital to the common limited partnership. This can (but does not need to) take the form of securities provided in the partnership agreement.
- **Special limited partnership (SLP) (*société en commandite spéciale*).** SLPs were introduced by the AIFM Law and they offer great structural and organisational flexibility. They have no legal personality. SLPs are based on the common law limited partnership and have similar features.
- **Mutual funds (*fonds commun de placement*) (FCP).** This is an undivided co-ownership of assets without legal personality that issues units. An FCP must appoint a management company. Due to its contractual form, an FCP is not subject to company law requirements, and therefore provides its participants with more organisational flexibility than a SICAV.

All type of corporate forms can also be set up as an investment company with variable capital (*société d'investissement à capital variable*) (SICAV). A SICAV can be self-managed or can appoint a management company. SICAVs issue shares.

Advantages. The share capital of a SICAV is equal to its total net asset value (NAV), which facilitates the subscription and redemption procedures, without any intervention of a notary.

Disadvantages. Due to their corporate nature, SICAVs are subject to:

- Requirements under the Law of 10 August 1915 on commercial companies.
- The legal obligations that apply to commercial companies (unless disregarded by the specific law regulating the relevant type of fund, such as the SIF Law or SICAR Law).

Tax treatment

11. What is the tax treatment for hedge funds?

Funds

SIFs must pay an annual subscription tax of 0.01% on their total net asset value. Exemptions apply to:

- Assets that are represented by shares/units held in collective investment undertakings, if already subject to subscription tax.
- Special institutional money market funds.
- Pension funds.
- SIFs investing in microfinance.

Resident investors

Distribution are not subject to withholding tax. However, they are included in the recipient's taxable income.

Non-resident investors

No withholding tax is charged in Luxembourg.

Restrictions

12. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

Redemption of interest

SIFs can be open or closed-ended. The redemption rules must be specified in the fund documents.

Transfer to third parties

Under the SIF Law, there are no restrictions on the transfer of rights held in a SIF to third parties (subject to the investor eligibility criteria being met). Any contractual restrictions should be provided for in the fund documents.

Private placement

13. Are private placements of hedge funds permitted under national private placement rules in your jurisdiction?

Private placement of hedge funds is permitted in Luxembourg if certain conditions are met. To market the unit or shares of a hedge fund that qualifies as an AIF to professional investors, a non-EU AIF manager must:

- Inform the CSSF.
- Fulfil the requirements set out in Article 45 of the AIFM Law.

An EU AIFM can market to professional investors the shares or units of a non-EU hedge fund that qualifies as an AIF without a passport if it complies with Article 37, AIFM Law.

14. What are the requirements for making a private placement of hedge funds?

Under certain conditions, both non-EU AIFMs and EU AIFMs can market hedge funds to professional investors in Luxembourg by way of private placement.

Essential requirements to qualify for the regime

Non-EU AIFMs must comply with the rules set out in Article 45 of the AIFM Law and section XIII (Guidelines on disclosure) of the ESMA's guidelines on sound remuneration policies under the AIFM Directive. They are generally not required to apply to be authorised under Article 32(5) of the Law of 5 April 1993 on the financial sector.

For EU AIFMs, the applicable minimum conditions are set out in Article 37 of AIFM Law.

There is an information form for the marketing of non-EU AIFs by EU AIFMs to professional investors in Luxembourg under Article 37 of the AIFM Law is available for download on the website of the CSSF (see, *http://www.cssf.lu/fileadmin/files/AIFM/Form_Article_37_Law_2013.doc*).

Registrations/permits/licences

Both EU AIFMs and non-EU AIFMs must inform the CSSF before commencing any marketing activity.

Documents to be filed

An information form is available for download on the website of the CSSF.Depending on the nationality of the AIFM and/or the AIF one of the following forms must be used:

- Marketing of AIFs managed by a non-EU AIFM to professional investors in Luxembourg (Article 45 of the AIFM Law) – (*http://www.cssf.lu/fileadmin/files/AIFM/Marketing_AIF_Art_45.doc*).
- Guidance for the use of the Information Form related to Article 45 of the AIFM Law (*http://www.cssf.lu/fileadmin/files/AIFM/Guidance_use_Information_Form.doc*).
- Marketing of non-EU AIFs managed by AIFMs established in an EU Member State to professional investors in Luxembourg (Article 37 of the AIFM Law) (*http://www.cssf.lu/fileadmin/files/AIFM/Form_Article_37_Law_2013.doc*).
- Guidance for the use of the Information Form related to Article 37 of the AIFM Law (*http://www.cssf.lu/fileadmin/files/AIFM/Guidance_Form_Article_37_Law_2013.doc*).

Regulatory timescales

The process is not subject to prior approval by the CSSF. Only notifying the CSSF is required.

Registration/permit/licence fees

Initial fees. A notification fee of EUR2,650 must be paid when notifying the CSSF and thereafter annually. This fee is subject to change.

Ongoing fees. After the notification fee is paid, an annual lump sum fee must be paid to the CSSF. The fees may vary depending on the number of sub-funds.

Content requirements for offering memorandum

Not applicable.

Restrictions on investments/leverage

Not applicable.

Requirements for local service providers

EU AIFMs must ensure that at least one entity is appointed to carry out the duties under Article 21 of the AIFM Directive. These duties are often referred to as "depo lite" services and include cash-monitoring, safekeeping of assets and overseeing certain operational functions.

Requirements for non-local service providers

See above, *Requirements for local service providers*.

Requirements for directors

Not applicable. Directors of Luxembourg hedge funds must provide evidence of:

- Sufficiently good repute. A criminal records extract must be provided.
- Honourability. A "declaration of honour" must be signed by each applicant director of a SIF and an extract of criminal record must be produced.
- Sufficient experience in relation to [##managing] the concerned hedge fund.

Ongoing filing/consent requirements

Non-EU AIFMs marketing AIFs in Luxembourg under Article 45 of the AIFM Law are subject to the reporting requirements set out in Article 24 of the AIFM Directive.

Non-EU AIFMs must also inform the CSSF if they stop marketing AIFs to professional investors in Luxembourg (*Article 45, Law of 2013*).

Other

Not applicable.

Reform

15. What (if any) proposals are there for the reform of hedge fund regulation?

There is one current proposal to reform how hedge funds are regulated - Bill No. 6936. The Bill will amend laws, including the:

- SIF Law.
- AIFM Law.
- Collective Investment Law.

Under the Bill, UCIs and SIFs investors that are not professional investors under MiFID II can only invest in a certain type of assets (as determined by the CSSF). Also, closed-ended UCIs will no longer be required to issue shares based on the total net asset value. Instead, this will be based on a price fixed in accordance with their constitutional documents.

ONLINE RESOURCES

Commission de Surveillance du Secteur Financier (CSSF)

W *www.cssf.lu* **Description.** Official website of the Luxembourg financial supervisory authority. The website contains electronic versions of the applicable laws and regulations. The website also contains relevant information and documents relating to authorisation procedures.

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