

Luxembourg, 5th December, 2002

To all persons and companies
supervised by the CSSF

CIRCULAR CSSF 02/80

Concerns: Specific rules applicable to Luxembourg undertakings for collective investment ("UCI") pursuing alternative investment strategies.

Preamble

The law of 30th March, 1988 relating to UCIs does not comprise any provisions regarding restrictions applicable to UCIs governed by Part II of such law. Such restrictions are fixed in the IML Circular 91/75 of 21st January, 1991 applicable to UCIs. However, the UCIs who adopt alternative investment strategies are not specifically covered by the provisions of the above-mentioned circular. Therefore, in the past, the investment restrictions applicable to UCIs pursuing so called "alternative" investment strategies were dealt with by the Commission for the Supervision of the Financial Sector ("CSSF") on a case by case basis.

Considering the increasing number of applications for the creation and authorisation of Luxembourg UCIs which pursue investment strategies similar to those pursued by "hedge funds" or "alternative investment funds", the CSSF would like to clarify the legal and regulatory framework applicable to such UCIs.

This circular is issued in the context of the existing legal framework and its purpose is to clarify the specific rules applicable to Luxembourg UCIs which pursue alternative investment strategies. In this context and due to the high investment risks which the investment strategies pursued by the UCIs concerned by this circular may entail, the CSSF pays attention in particular to the reputation, the experience and the financial standing of the promoters of such UCIs. Moreover, the CSSF considers that the professional qualification and the experience of the directors of the management bodies, and, if applicable, of the investment managers and the investment advisers are particularly important in relation to such UCIs.

It is to be understood that the rules laid down in chapter I of IML circular 91/75 of 21 January 1991 applicable to UCIs other than UCITS and providing for specific rules for three types of specialised UCIs remain unchanged. Such rules are not applicable to UCIs concerned by this circular. UCIs which pursue alternative investment strategies are subject to part II of the law of 30 March 1988 relating to undertakings for

collective investment as the rules set forth in chapter 5 of such law are not appropriate for such UCIs.

Although these UCIs have no obligation to borrow, their investment policy may provide for the possibility to borrow on a permanent basis for investment purposes.

Such UCIs have to comply with the provisions of this circular. However, the CSSF may grant derogations to the provisions set forth hereafter on the basis of an appropriate justification or impose additional investment restrictions.

A. Rules for diversification of risks regarding short sales.

A.1. Short sales may, in principle, not result in the UCI holding:

- a) a short position on transferable securities which are not listed on a stock exchange or dealt on another regulated market, operating regularly and being recognised and open to the public. However the UCI may hold short positions on transferable securities which are not quoted and not dealt on a regulated market if such securities are highly liquid and do not represent more than 10% of the assets of the UCI;
- b) a short position on transferable securities which represent more than 10% of the securities of the same type issued by the same issuer;
- c) a short positions on transferable securities of the same issuer, (i) if the sum of the cancelling price of the short positions relating thereto represents more than 10% of the assets of the UCI or (ii) if the short position entails a commitment exceeding 5% of the assets.

A.2. The commitments arising from short sales on transferable securities at a given time correspond to the cumulative non-realised losses resulting, at that time, from the short sales made by the UCI. The non-realised loss resulting from a short sale is the positive amount equal to the market price at which the short position can be covered less the price at which the relevant transferable security has been sold short.

A.3. The aggregate commitments of the UCI resulting from short sales may at no time exceed 50% of the assets of the UCI. If the UCI enters into short sales, it must hold sufficient assets enabling it at any time to close the open positions resulting from such short sales.

A.4. The short sales of transferable securities for which the UCI holds adequate coverage are not considered for the purpose of calculating the total commitments referred to above. It is to be noted that the fact for a UCI to grant a security, of whatever nature, on its assets to third parties to guarantee its obligations towards such third parties, is not to be considered as adequate coverage for the UCI's commitments.

A.5. In connection with short sales on transferable securities, undertakings are authorised to enter, as borrower, into securities lending transactions with first class professionals specialised in this type of transactions. The counterparty risk resulting from the difference between (i) the value of the assets transferred by a UCI to a lender as security in the context of the securities lending transactions and (ii) the debt of the UCI owed to such lender may not exceed 20% of the assets of the UCI. It is to be noted that UCIs may, in addition, grant guarantees in the context of systems of

guarantees which do not result in a transfer of ownership or which limit the counterparty risk by other means.

B. Borrowings

UCIs referred to in this circular may borrow permanently and for investment purposes from first class professionals specialised in this type of transactions.

Such borrowings are limited to 200% of the net assets of the UCI. Consequently, the value of the assets of the UCI may not exceed 300% of the net assets of the UCI. UCIs pursuing a strategy which entails a high degree of correlation between long positions and short positions are authorised to borrow up to 400% of their net assets.

The counterparty risk resulting from the difference between (i) the value of the assets transferred by the UCI to a lender as security in the context of the borrowing transactions and (ii) the debt of the UCI owed to such lender may not exceed 20% of the assets of the UCI. It is to be noted that UCIs may, in addition, grant guarantees in the context of systems of guarantee which do not result in a transfer of ownership or which limit the counterparty risk by other means.

The counterparty risk resulting from the sum of (i) the difference between the value of the assets transferred as security in the context of the borrowing of securities and the amounts due under item A.5 above and (ii) the difference between the assets transferred as security and the amounts borrowed referred to above may not exceed, in respect of a single lender, 20% of the assets of the UCI.

C. Restrictions applicable to investments in undertakings for collective investment ("target UCIs")

The UCIs referred to in this circular may, in principle, not invest more than 20% of their net assets in securities issued by the same target UCI. For the purpose of this 20% limit, each compartment of a target UCI with multiple compartments is to be considered as a distinct target UCI provided that the principle of segregation of the commitments of the different compartments towards third parties is ensured. The UCI may hold more than 50% of the units of a target UCI provided that, if the target UCI is a UCI with multiple compartments, the investment of the UCI concerned by this circular in the legal entity constituting the target UCI must represent less than 50% of the net assets of the UCI concerned by this circular.

These restrictions are not applicable to the acquisition of units of open-ended target UCIs if such target UCIs are subject to risk diversification requirements comparable to those applicable to UCIs which are subject to part II of the law of 30 March 1988 and if such target UCIs are subject in their home country to a permanent supervision by a supervisory authority set up by law in order to ensure the protection of investors. This derogation may not result in an excessive concentration of the investments of the UCI in one single target UCI provided that for the purpose of this limitation, each compartment of a target UCI with multiple compartments is to be considered as a distinct target UCI if the principle of segregation of the commitments of the different compartments towards third parties is ensured.

UCIs which principally invest in other UCIs must make sure that their portfolio of target UCIs presents appropriate liquidity features to enable the UCI to meet its obligation to repurchase its shares. Their investment policy must comprise an appropriate description in that respect.

D. Additional Investment Restrictions.

UCIs referred to in this circular shall, in principle, not:

- a) invest more than 10% of their assets in transferable securities which are not quoted on a stock exchange or dealt on another regulated market, which operates regularly and is recognised and open to the public,
- b) acquire more than 10 % of the securities of the same nature issued by the same issuer,
- c) invest more than 20% of their assets in securities issued by the same issuer.

The restrictions set forth under a), b) and c) above are not applicable to securities issued or guaranteed by a member state of the OECD or by its local authority or by supranational institutions and organisations with European, regional or worldwide scope.

The restrictions set forth under a), b) and c) above are not applicable to units or shares issued by target UCIs. The restrictions set forth in section C. above are applicable to investments in target UCIs.

E. Use of derivative financial instruments and other techniques

The UCIs referred to in this circular are authorised to make use of the derivative financial instruments and the techniques referred to hereafter.

The derivative financial instruments may include, amongst others, options, forward contracts on financial instruments and options on such contracts as well as swap contracts by private agreement on any type of financial instruments. In addition, such UCIs may participate in securities lending transactions as well as sales with right of repurchase transactions and repurchase transactions¹. UCIs which make use of such derivative financial instruments and techniques must indicate in their prospectus a maximum leverage which may not be exceeded and include in their prospectus a description of the risks arising from the transactions which they intend to pursue. The derivative financial instruments must be dealt on an organised market or contracted by private agreement with first class professionals specialised in this type of transactions.

The aggregate commitments resulting from short sales of transferable securities together with the commitments resulting from financial derivative instruments entered into by private agreement and, if applicable, the commitments resulting from financial

¹ The French text refers to "*opérations à réméré*" and "*opérations de mise en pension*". For the distinction amongst the two, see the description under E.3. below.

derivate instruments dealt on a regulated market may not exceed at any time the assets of the UCI.

E. 1. Restrictions relating to derivative financial instruments

1. Margin deposits in relation to derivative financial instruments dealt on an organised market as well as the commitments arising from derivative financial instruments contracted by private agreement may not exceed 50% of the assets of the UCI. The reserve of liquid assets of such UCIs must represent at least an amount equal to the margin deposits made by the UCI. Liquid assets do not only comprise time deposits and regularly negotiated money market instruments the remaining maturity of which is less than 12 months, but also treasury bills and bonds issued by OECD member countries or their local authorities or by supranational institutions and organisations with European, regional or worldwide scope as well as bonds listed on a stock exchange or dealt on a regulated market, which operates regularly and is open to the public, issued by first class issuers and being highly liquid.
2. The UCI may not borrow to finance margin deposits.
3. The UCI may not enter into contracts relating to commodities other than commodity future contracts. However, the UCI may acquire, for cash consideration, precious metals which are negotiable on an organised market.
4. The premiums paid for the acquisition of options outstanding are included in the 50% limit referred to under item 1. above.
5. The UCI must ensure an adequate spread of investment risks by sufficient diversification.
6. The UCI may not hold an open position in anyone single contract relating to a derivative financial instrument dealt on an organised market or a single contract relating to a derivative financial instrument entered into by private agreement for which the margin required or the commitment taken, respectively, represents 5% or more of its assets.
7. Premiums paid to acquire options outstanding having identical characteristics may not exceed 5% of the assets.
8. The UCI may not hold an open position in derivative financial instruments relating to a single commodity or a single category of forward contracts on financial instruments for which the margin required (in relation to derivative financial instruments negotiated on an organised market) together with the commitment (in relation to derivative financial instruments entered into by private agreement) represent 20% or more of the assets.
9. The commitment in relation to a transaction on a derivative financial instrument entered into by private agreement by the UCI corresponds to the non-realised loss resulting, at that time, from the relevant transaction.

E.2. Securities lending transactions.

The UCI may enter into securities lending transactions in accordance with the provisions set forth in IML Circular 91/75 . However, the limitation that securities lending transactions may not extend beyond a period of 30 days is not applicable if the UCI is allowed to terminate at any time the lending transaction and obtain the restitution of the securities lent.

E.3. Sale with right of repurchase transactions (*rémeré*) and repurchase transactions (*opérations de mise en pension*).

The UCI may enter into *rémeré* transactions which consist in the purchase and sale of securities where the terms reserve the right to the seller to repurchase the securities from the purchaser at a price and at a time agreed between the two parties at the time when the contract is entered into. The UCI can also enter into repurchase transactions which consist in transactions where, at maturity, the seller has the obligation to take back the asset sold whereas the original buyer either has a right or an obligation to return the asset sold.

The UCI can either act as buyer or as seller in the context of the aforementioned transactions. Its participation in the relevant transactions is however subject to the following rules:

1. Rules to bring the transactions to a successful conclusion

The UCI may participate in sale with right of repurchase transactions or repurchase transactions only if the counterparties in such transactions are first class professionals specialised in this type of transactions.

2. Conditions and limits of the transactions

During the lifetime of a sale with right of repurchase agreement where the UCI acts as purchaser, it may not sell the securities which are the subject of the contract before the counterparty has exercised its right to repurchase the securities or until the deadline for the repurchase has expired, unless the UCI has other means of coverage. If the UCI is open for repurchases, it must make sure to keep the importance of such transactions at a level such that it is at all time able to meet its repurchase obligation. The same conditions are applicable in the case of a repurchase transaction on the basis of a purchase and firm sale where the UCI acts as purchaser (transferee).

In case where the UCI acts as seller (transferor) in a repurchase transaction, the UCI may not, during the whole lifetime of the contract, sell the ownership or pledge to a third party, or realise a second time, in any other form, the securities sold. The UCI must hold at the maturity of the repurchase transactions sufficient assets to pay, if appropriate, the agreed upon repurchase price payable to the transferee.

3. Periodical information of the public

In its financial reports, the UCI must indicate separately for the sale with right of repurchase transactions and for the repurchase transactions, the total amount of the open transactions at the dates as of which the relevant reports are issued.

F. Exceeding investment limits otherwise than by investment decisions

If the percentage limits referred to above are exceeded for reasons other than investment decisions (market fluctuations, repurchases), the priority objective of the UCI must be to remedy the situation, taking due account of the interests of the investors.

G. Management and supervisory bodies

Concerning their professional qualification, the directors of the management bodies and, if applicable, the investment managers and investment advisers, must have a confirmed experience in the area of the proposed investment policy.

H. Particular rules

H.1. The prospectus must contain a description of the investment strategy of the UCI concerned as well as a description of the specific risks inherent to its investment policy. The prospectus must, if applicable, provide that:

- the potential losses resulting from short sales on transferable securities differ from the possible losses resulting from the investment of liquid assets in such transferable securities. In the first case, the loss may be unlimited whereas, in the second case, the loss is limited to the amount of liquid assets invested in the transferable securities concerned.
- leverage generates an opportunity for higher return and therefore more important income, but, at the same time, increases the volatility of the value of the assets of the UCI and, hence, the risk to lose capital. Borrowings generate interest costs which may be higher than the income and capital gains produced by the assets of the UCI.
- due to the limited liquidity of the assets of the UCI, it may not be in a position to meet the redemption requests of its units which may be presented to it by its investors.

H.2. In addition, the prospectus must state that the investment in the UCI entails an above-average risk and is only appropriate for persons who can take the risk to lose their entire investment. If appropriate, the offering prospectus must contain a description of the investment strategy in forward contracts and options pursued by the UCI as well as the risks resulting from such investment policy. It must for example be mentioned that the forward contract and option markets are extremely volatile and that the risk to incur a loss in relation to such markets and/or in relation to short sales is very high.

Yours sincerely,

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