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Specific rules for Luxembourg Hedge Funds and Funds of Hedge Funds

Over the past years an increasing number of Hedge Funds, and especially Fund of Hedge Funds, have been set up in Luxembourg and authorised by the competent supervisory authority, the Commission for the Supervision of the Financial Sector (*Commission de Surveillance du Secteur Financier*- "CSSF"). The precise number of existing Luxembourg Funds of this type is difficult to assess partly because Fund of Hedge Funds are classified, by the CSSF, for statistical purposes, as Fund of Funds and such latter category comprises not only funds of Hedge Funds but also Funds which invest in investment funds pursuing a traditional investment policy, i.e. investing long in bonds, equities and/or money market instruments.

For not being compliant with the provision of the EU UCITS Directive 95/611/EEC and the corresponding provisions of part I of the law of 20 December 2002 regarding undertakings for collective investment (the "2002 Law"), Hedge Funds and Fund of Hedge Funds have to be organised under part II of the 2002 Law.

Until December 2002, there was no CSSF Circular or other written position of the CSSF on the specific rules applicable to Hedge Funds. IML Circular 91/75, the purpose of which is to specify rules applicable to Funds and thereby complements the 2002 Law, comprises rules applicable to Venture Capital Funds, Real Estate Funds and Futures and Option Funds but does not specifically deal with Hedge Funds or Funds of Hedge Funds.

In the absence of any written position from the CSSF on the specific rules applicable to Hedge Funds, the constitutive documents, and more specifically, the investment restrictions, had to be negotiated with the CSSF on a case by case basis.

On 5 December 2002, CSSF published a new Circular CSSF 02/80 concerning specific rules applicable to Luxembourg undertakings for collective investment pursuing alternative investment strategies.

The purpose of the new Circular is to clarify the investment restrictions generally applicable to these types of Luxembourg Funds, which should also result in a more expedient CSSF approval process. Because of the difference in nature of "Hedge Funds" and "Funds of Hedge Funds" we will summarise separately the rules applicable to these Funds as set forth in the new Circular.

1) Funds of Hedge Funds

The investment restrictions applicable to Funds of Hedge Funds set forth in the circular can be summarised as follows:

- The Fund may not invest more than 20% of its net assets in one single hedge fund. If an underlying hedge fund is an umbrella fund, each sub-fund of the hedge fund is to be considered, for the purpose of this 20% limit, as a separate hedge fund if the legal form of the umbrella hedge fund ensures the segregation of liabilities of its different sub-funds towards third parties.
- There is no limit as to the maximum percentage of the units/shares issued by an underlying hedge fund which the Fund may acquire. Thus, the Fund may hold all the units/shares issued by a hedge fund. However, in case where the hedge fund is an umbrella fund, and the Fund holds more than 50% of the units/shares issued by such umbrella hedge fund, the total value of the Fund's holding in such umbrella hedge fund may not represent more than 50% of the net asset value of the Fund.
- The aforesaid restrictions are not applicable, or are only applicable to a limited extent (as further described in the Circular), in relation to investments in underlying funds of the open-ended type which operate

under the principle of risk spreading and which are subject in their home country to supervision by a supervisory authority.

- The Fund must ensure that its underlying portfolio of hedge funds is sufficiently liquid to allow the Fund to meet its obligation to redeem its shares from its shareholders. This requirement is set forth in the Circular as a general statement, but there is no specific restriction or requirement for the underlying hedge funds to be listed on an exchange or otherwise to present any specific liquidity criteria.

2) Hedge Funds

The Circular provides for the possibility for Hedge Funds to undertake short sales, to borrow for investment purposes and to make use of derivative financial instruments and certain other techniques.

In respect of all of these investments, the Circular provides for diversification rules to ensure adequate risk spreading.

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

- A Hedge Fund may borrow (cash and securities) for investment purposes up to 300% of the NAV (and in certain circumstances up to 400% of the NAV).
- The risk diversification rules in relation to long positions and short sales are expressed in percentages by reference to the assets (and not the net assets) of the Hedge Fund.
- The total commitments (defined as unrealised losses) resulting from short sales of securities and from derivative financial instruments may not exceed the assets (and not the net assets!) of the Hedge Fund.
- The Circular does not provide for a maximum permitted total leverage but requires for a maximum total leverage to be indicated in the prospectus.

- The counterparty risk on a single lender (such as the prime broker), being defined as the difference between the value of the assets transferred by the Hedge Fund to a lender as security and the amounts due by the Hedge Fund to such lender, may not exceed 20% of the assets of the Hedge Fund. This shall however not prevent the Hedge Fund from granting additional guarantees or a pledge on its assets to such lender if such arrangements do not result in a transfer of ownership of those assets or the counterparty risk is limited by other means.

The Circular also provides for the possibility for these Funds to make use of the techniques of securities lending, repurchase transactions and sale with right of repurchase transactions.

The Circular provides that the CSSF pays particular attention to the reputation, the experience and the financial standing of the promoter of such Funds. It also states that they consider the professional qualification and the experience of the directors of the management bodies and the investment managers as particularly important.

Finally, the Circular requires that the prospectus must contain a description of the investment strategy of the Funds as well as a description of the specific risks inherent to its investment policy.

The Circular does not comprise any specific rules or limitations in relation to the possibility for the Fund to appoint a prime broker. In the same manner as for all other Luxembourg Funds, the custodian has to supervise the Fund's assets which it can generally achieve by making sure that it receives on a continuous basis appropriate information from the prime broker on the investment transactions undertaken on behalf of the Fund.

It is to be noted that the Circular does not provide for any specific investor eligibility requirements or minimum investment or minimum holding requirements. Accordingly, these Funds are not restricted, as is the case in certain other jurisdictions, to certain types of investors, such as institutional or professional investors.

In all other respects, Luxembourg Hedge Funds are subject to the same legal and regulatory requirements than all other Luxembourg Funds, comprising the permanent supervision by the CSSF, the obligation to appoint a custodian and an auditor, the

obligation to produce a monthly NAV (at least) and to publish annual and semi-annual reports, etc.

As a result of the "regulated environment" applicable to Luxembourg Hedge Funds, it has been possible to have them registered for public offering in other jurisdictions. This has been typically the case for the Netherlands, Hong Kong and Switzerland. More recently, Luxembourg Fund of Hedge Funds have been registered for public distribution in Germany. To achieve these registrations, the Luxembourg Fund of Hedge Fund has to comply, in addition to the Luxembourg requirements described above, with the local requirements in the jurisdictions concerned.

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