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SPECIALISED INVESTMENT FUNDS

THE LUXEMBOURG REGIME FOR INVESTMENT FUNDS DEDICATED TO SOPHISTICATED INVESTORS

By the Law of 13 February 2007 on specialised investment funds (the "SIF Law"), Luxembourg adopted a new type of investment fund in replacement of the former institutional investment fund. This vehicle, referred to as "Specialised Investment Fund" ("SIF"), offers greater flexibility in terms of available corporate structures and investment rules as well as a lighter prudential regime, notably in that the intervention of a financial institution as promoter is not required. The scope of eligible investors covers not only institutional investors but also other types of well-informed investors, including sophisticated private investors. The purpose of this Memorandum is to describe the main features of the SIF regime, namely its scope (I), the investment rules applicable to SIFs (II), the structural aspects and the functioning rules governing SIFs (III), the regulatory aspects (IV) and, finally, the tax features of the SIF regime (V).

I. SCOPE

The SIF regime is applicable to undertakings for collective investment ("UCIs") whose securities are restricted to one or several well-informed investors and whose constitutive documents are subject to the SIF regime.

(i) Undertakings for collective investment

Contrary to the investment company in risk capital ("SICAR"), SIFs are a specific category of UCIs subject to the principle of risk-spreading. This status is of importance, notably concerning the possible non application to SIFs of certain European directives such as Directive 2003/71/EC (the so-called "Prospectus Directive").

(ii) Well-informed investors

Investment into SIFs is limited to well-informed investors that are able to adequately assess the risks associated with the investment in such a vehicle.

The SIF Law defines well-informed investors as (i) institutional investors and (ii) professional investors but also (iii) other well-informed investors who confirm in writing that they adhere to the status of well-informed investors and either invest a minimum of 125,000 Euros or benefit from an assessment made by a credit institution within the meaning of Directive 2006/48/EC, an investment firm within the meaning of Directive 2004/39/EC or a management company within the meaning of Directive 2001/107/EC certifying their expertise and knowledge to adequately appraise the contemplated investment and the risk thereof. Within this category sophisticated retail or private investors are authorised to invest in SIFs.

The above conditions do not apply to the persons involved in the management of a SIF.

(iii) Optional regime

Submission to the SIF regime is an available option and such an option must be specifically exercised by inserting a mention to that effect in the constitutional documents (articles of incorporation or management regulations) and offer documents of the investment vehicle. Accordingly, any investment vehicle reserved for one or several well-informed investors will not necessarily be governed by the SIF regime but could for instance opt to be established as an unregulated company subject to the general rules of Luxembourg company law.

II. INVESTMENT RULES

(i) Flexibility with respect to eligible assets

In contrast to the SICAR Law of 15 June 2004 relating to the SICAR, the SIF Law allows significant flexibility with respect to the assets in which SIFs may invest. The SIF regime can be adopted by UCIs investing in any type of assets and pursuing any type of investment strategies and permits the structure of, *inter alia*, transferable securities funds, money market funds, real estate funds, hedge funds, private equity funds and loan funds.

(ii) Applicability of the principle of risk-spreading

In the same manner as the UCIs governed by the law of 20 December 2002 (the "Law of 2002"), SIFs are subject to the principle of risk-spreading. The SIF Law does not provide for specific investment rules or restrictions but only refers to the concept of risk-spreading. The Commission du Surveillance du Secteur Financier (the "CSSF"), via its circular 07/309 relating to risk-spreading in the context of SIFs (the "Circular"), has however issued regulatory guidelines in this regard which are detailed below. In case the SIF is structured as an umbrella fund, any reference to SIF must also be understood as a reference to any of its compartments.

- (1) A SIF may not invest more than 30% of its assets or subscription commitments in securities of the same nature issued by the same issuer.

The restriction under (1) does not apply to:

- (i) securities issued to OECD member states or supranational organisations; and,
 - (ii) target UCIs which are subject to risk-spreading requirements at least comparable to those applicable to a SIF, it being understood that a compartment of such UCI is deemed a distinct issuer if the compartments of such UCI are "ring-fenced" against claims of third parties.
- (2) The Circular provides that short sales on securities of the same nature issued by the same issuer may not represent more than 30% of its assets.
 - (3) When using derivative financial instruments, a SIF must ensure risk-spreading comparable to the above via an appropriate diversification of such derivatives' underlying assets. With the same objective, counterparty risk in an OTC transaction must, as the case may be, be limited in consideration of the relevant counterparty's quality and qualification.

The CSSF may award exemptions on a case by case basis. It is expected that compliance with stated quantifiable limits may, subject to an appropriate wording in the SIF offering document, benefit from reasonable latitude so that limited and temporary overrun thereof may be permitted without resulting in a breach of the principle of risk-spreading.

The Circular does not provide for a specific "grace period" during which SIFs may depart from the above diversification rules. They do, however, benefit from such

tolerances which are applicable to all types of Luxembourg investment funds. For example, Luxembourg investment funds generally benefit from a six-month grace period to comply with certain risk-spreading rules to permit the construction of the portfolio. Similarly, Luxembourg investment funds investing in real estate benefit from a four-year grace period during which they may be allowed to concentrate investment in one single target.

III. STRUCTURAL ASPECTS AND FUNCTIONING RULES

(i) Legal forms and structures available

Legal forms available

The SIF Law specifically refers to the *fonds commun de placement* ("FCP") and the investment company with variable capital ("SICAV") but does not limit the legal forms under which a SIF can be established. Other legal forms are therefore possible. It would for example be possible to establish a SIF under a fiduciary contract.

Fonds commun de placement

The FCP itself is not a legal entity, but a co-proprietorship of assets which is managed, on behalf of the joint owners, by a management company established under and governed either by Chapter 13 of the Law of 2002 (i.e. a management company whose corporate object is to manage, in addition to the management of the relevant SIF, at least one undertaking for collective investment in transferable securities / "UCITS") or by Chapter 14 of the Law of 2002 (being a management company exclusively managing SIFs or UCIs subject to Part II of the Law of 2002).

Investors subscribe for units in the FCP which represent a portion of the net assets of the fund. Unitholders are only liable up to the amount contributed by them.

The rights and obligations of the unitholders and their relationship with the management company are defined in the management regulations.

The management company, on behalf of the FCP, takes all decisions relating to the investments and the operations of the FCP.

Unlike investors in an investment company (as explained below), investors in an FCP are entitled to vote only if and to the extent that the management regulations provide for such a possibility. This is usually not the case, which makes the FCP a flexible vehicle also attractive for those initiators who wish to increase control over the SIF.

Investment company

Alternatively, a SIF can be established under the form of a corporate-type fund.

An investment company subject to the SIF regime could be created either with variable capital ("SICAV") or with fixed capital ("SICAF").

The capital of a SICAV is increased or reduced automatically as a result of new subscriptions or redemptions, with no need for formalities such as an approval of the general meeting of shareholders or the intervention of a notary.

Under the SIF Law, a SICAV is not required to be a limited liability company (*société anonyme*) as is the case for SICAVs subject to the Law of 2002. A SIF created under the form of a SICAV can adopt one of the corporate forms listed by the SIF Law, i.e. a public limited company (*société anonyme*), a partnership limited by shares (*société en commandite par actions*), a private limited company (*société à responsabilité limitée*) or a cooperative set up as a public limited company (*société coopérative organisée sous forme de société anonyme*). In addition, the SIF Law does not limit SICAFs to specific corporate forms.

Except where the SIF Law derogates therefrom, investment companies are subject to the provisions of Luxembourg company law. However, the SIF Law departs from such rules on a series of aspects so as to offer a flexible corporate framework for SIFs.

Multiple class structures

The SIF Law specifically refers to the possibility to create a SIF with multiple compartments (a so-called "umbrella fund").

The SIF Law further provides that each compartment of such a vehicle is linked to a specific portfolio of investments which is segregated from the portfolio of investments of the other compartments. Pursuant to this "ring-fencing" principle, although the umbrella fund constitutes one single legal entity, the assets of a compartment are exclusively available to satisfy the rights of investors in relation to that compartment and the rights of creditors whose claims have arisen in connection with the operation of that compartment, unless a clause included in the constitutional documents of the SIF provides otherwise.

Besides, different classes of securities can be created within a SIF or even within a compartment of a SIF established under the form of an umbrella fund. Such classes may

have different characteristics notably as regards the fee structure, the type of targeted investors or the distribution policy.

(ii) Capital structure and debt financing

The SIF Law provides that the minimum capitalisation for a SIF is 1,250,000 Euros. This minimum must be reached within 12 months from the authorisation of the SIF, compared to six months for UCIs governed by the Law of 2002. Except for FCPs, the reference for this minimum is the subscribed capital plus any issue premium paid, rather than the net assets.

A SIF, whatever its form, can issue partly paid shares/units. Shares must be paid up to a minimum of 5% per share on issue.

As mentioned above, it is possible to set up a SIF with a fixed or variable share capital. Besides, a SIF may be of the open-ended or closed-ended type (in terms of redemptions and/or subscriptions) independently of the variability or not of its capital.

A SIF may also finance its activities and the acquisition of its portfolio of investments, as the case may be on a substantially predominant basis, via borrowings as well as via the issuance of bonds or other types of debt instruments.

(iii) Issue and redemption of securities

The conditions and procedures for the issue and redemption of securities are relaxed compared to the rules applicable to UCIs governed by the Law of 2002. In this regard, the SIF Law provides that the conditions and procedures applicable to the issue and, if applicable, the redemption or repurchase of securities are determined in the constitutive documents, without imposing more precise rules. As a result, there is for example no requirement that the issue, redemption or repurchase price be based on the net asset value as is the case for a SICAV or an FCP governed by the Law of 2002. Under the new regime, SIFs can thus issue shares at a predetermined fixed price (for example on the exercise of warrants issued by the SIF) or repurchase shares below net asset value (for example to reduce the discount in case of a closed-ended SIF). Similarly, the issue price can comprise a portion of par value and a portion of issue premium.

As SIFs can issue partly paid shares, subscriptions in different tranches can therefore be achieved not only by successive subscriptions of new shares ascertained at the initial subscription through subscription commitments but also by means of partly paid shares, the remaining amount of the issue price of the shares initially issued being payable in

further instalments.

(iv) Dividend policy

A SIF is not required to maintain a legal reserve and the SIF Law does not provide for any restriction on the distribution of dividends, provided the minimum capitalisation referred to above is complied with.

(v) Valuation of assets

In light of the virtually unlimited types of assets in which a SIF can invest, it was considered important to provide for flexible valuation rules. For that reason, the SIF Law provides that, unless otherwise provided for in the constitutive documents, the assets of a SIF must be valued at fair value. Such value is to be determined in accordance with the rules set forth in the constitutive documents.

Further, SIFs are not required to calculate and publish the asset value per share on a regular basis (although some type of determination of total net assets will have to be performed on a quarterly basis for the purpose of assessing the amount of *taxe d'abonnement* to be paid on a quarterly basis as discussed in V. below).

IV. REGULATORY ASPECTS

(i) Prudential regime

SIFs are regulated vehicles subject to permanent supervision by the CSSF. However, in light of the fact that well-informed investors do not need similar protection to that required for retail investors, SIFs are subject to a somewhat "lighter" regulatory regime than UCIs governed by the Law of 2002 both in terms of approval procedure and regulatory requirements.

As for UCIs governed by the Law of 2002, the CSSF has to approve the constitutive documents, the choice of the directors/managers, the central administration agent, the custodian and the auditor of SIFs. During the life of a SIF, any change of the constitutive documents and any change of director or of the aforementioned service providers also requires CSSF approval.

However, the SIF Law provides that SIFs may be created before having received regulatory approval, provided that an application for authorisation is filed with the CSSF within the month following their creation. This allows for SIFs to be set up and launched and to secure CSSF approval thereafter only.

A SIF does not necessarily need to be initiated by a financial institution, with significant financial resources. Also, the financial standing or regulatory status of its investment manager will not need to be checked by the CSSF. Only the directors who formally represent a SIF, i.e. in the case of limited partnerships, the general partners and, in the case of public limited companies and private limited companies, the members of the board of directors or managers, must be approved by the CSSF. The CSSF will check that these directors are of sufficiently good repute and have sufficient experience to perform their functions. This waiver of the requirement to have a promoter has boosted the development in Luxembourg of certain products, such as hedge funds and private equity funds, where the expertise is developed by smaller institutions.

(ii) Requirement for a depository

Like UCIs, a SIF has to entrust the custody of its assets to a depository which is either a credit institution having its registered office in Luxembourg or the Luxembourg branch of a credit institution having its registered office in another member state of the European Union. The custody of the assets is to be understood in the sense of "supervision", which implies that the depository must have knowledge at all times of how the assets of the SIF are invested and where and how these assets are available. This does not prevent the physical safekeeping of the assets to be entrusted to local sub-depositories.

The SIF Law does not require the depository to perform additional monitoring duties in relation to certain operations of the SIF in the same manner as they are imposed by the Law of 2002. CSSF circular 08/372 further clarifies the relationship between the depository and the appointed prime brokers and the liability of the depository in that respect.

(iii) Requirement to appoint an auditor

The annual accounts of a SIF must be audited by a Luxembourg independent auditor, which can prove it has an appropriate level of professional experience.

(iv) Information to be supplied to investors and reporting requirements

An offering document will have to be produced and approved by the CSSF. However, the SIF Law does not impose a specific schedule with respect to the minimum content of this document. A continuous updating of the offering document will not be required but the essential elements of such document must be up to date when new securities are

issued to new investors.

SIFs have to publish an audited annual report within six months from the period to which such report relates. The SIF Law comprises an Annex which describes the information to be included in the annual report. Whereas for UCIs, the Law of 2002 requires the portfolio composition to be disclosed in the annual report, the Annex to the SIF Law only requires qualitative and/or quantitative information to be given on the portfolio of investments in a manner which will permit investors to make an informed judgment on the evolution of the activity and the results of the SIF. This would allow, for example, information to be published only on the ten largest holdings rather than the entire portfolio composition. The SIF Law does not require a semi-annual report to be prepared and published.

SIFs are exempt from the obligation to prepare consolidated accounts imposed by Luxembourg company law.

The CSSF has issued various circulars, namely CSSF 07/310, CSSF 08/334, CSSF 08/344 and CSSF 08/371, detailing the financial reporting duties to be complied with, inter alia, by SIFs.

V. TAX FEATURES

SIFs are subject to an annual subscription tax (*taxe d'abonnement*) at a rate of 0.01% (compared to 0.05% for most UCIs existing under the Law of 2002), this tax being determined on the basis of the total net assets valued at the end of each calendar quarter.

In the same manner as the Law of 2002, the SIF Law exempts from the subscription tax the portion of assets invested in other Luxembourg UCIs subject to this tax, certain institutional cash funds and pension pooling funds. In respect of the latter, the SIF Law innovates by not requiring (unlike the Law of 2002) that the participating pension schemes be of the same group.

Individual compartments and classes reserved to pension schemes may also benefit from the exemption.

There is no tax on income received and capital gains realised by SIFs.

CONCLUSION

The SIF Law provides a separate legal framework specifically designed for investment funds dedicated to sophisticated investors offering additional flexibility for structuring

Luxembourg vehicles and a favourable tax treatment in a regulated environment.

CONTACT DETAILS

For further information, please liaise with your usual contact person at Elvinger, Hoss & Prussen or any of the partners/counsels of the investment fund department:

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