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At the end of 2012, assets under management by Luxembourg-domiciled funds reached a historic level at €2,383bn, representing an increase of 13.7% since the end of 2011 and over 30% of total assets under management in European funds. Over the year, assets under management have actually grown not only in Luxembourg, but in Europe as a whole, partly due to increasing market values and partly due to new inflows of some €328bn.

It is important to keep this momentum. In 2013, a major growth opportunity for the European asset management industry stems from the implementation of the Alternative Investment Fund Managers Directive (AIFMD). Through the AIFMD, the EU is forming the first regulated environment for alternative investments worldwide. Potentially, AIFMD will even allow the EU to create a ‘brand’ in the alternative investment market, similar to the global brand it has created with Ucits over the past 25 years.

One priority for ALFI in 2013 is to foster a beneficial environment for alternative investment funds in the framework of this directive.

A key measure of the AIFMD involves the introduction of a European passport for alternative investment fund managers who wish to access the entire European market. Given Luxembourg’s position as the European leader in the cross-border space, the implementation of the AIFMD is very likely to further enhance Luxembourg as a leading domicile for fund and management companies in the alternative sector. The draft law on the implementation of the AIFMD into Luxembourg law was submitted to the Luxembourg Parliament on 24 August 2012.

Two major features of the draft law are expected to present a particular interest to the alternative investment fund community. Firstly, the creation of a limited partnership structure, which will add a flexible and secure partnership structure to Luxembourg’s fund product offering. Secondly, the draft Bill provides for additional clarifications regarding the taxation regime of carried interest.

With the publication of the Level II measures in December 2012, the finalisation of the national legislative procedure in Luxembourg should be imminent. ALFI is looking forward to the numerous prospects offered.

Anouk Agnes
HEAD OF COMMUNICATIONS AND BUSINESS DEVELOPMENT, ALFI
LEGAL

TIME FOR CHANGE
With the AIFMD set to shake up how managers structure and distribute their funds, Jonathan Burger of LEXFIELD – Avocats à la Cour, takes a look at what impact the Level II implementing measures will have – and how UCits and non-UCits management companies will be affected

ADMINISTRATION

SO FAR, SO GOOD
After making the move to Luxembourg in 2011, Matthijs Visscher of Circle Partners gives his perspective on the strategic importance of this fund centre – especially with the current trends and demands of the industry

FUND SERVICES

SERVICING HEDGE FUNDS IN LUXEMBOURG
Tom Davies of Maples Fund Services Luxembourg explains how Luxembourg is adapting to new legislation and the advantages of the country’s legal framework for fund managers

LEGAL

IN THE CROSSHAIRS
With regulation set to create a European brand for venture capital funds next, Pierre Reuter of Nautadutilh Avocats Luxembourg examines what can be expected from this legislation

LEGAL

A NEW STEPPING STONE FOR LUXEMBOURG
Jean-Pierre Mernier from Elvinger, Hoss & Prussen explains how Luxembourg has been given, with the AIFMD, the opportunity to duplicate the success of UCits, and how the directive may contribute to the recognition of Luxembourg as a leading domicile for alternative investment funds

FUND SERVICES

CONVERGENCE: THE LUX ANGLE
As hedge fund managers continue to explore the benefits of convergence, HFMWeek talked to Keith Hale of Multifonds to find out where Luxembourg stands in this growing trend

FUND SERVICES

A QUESTION OF AIFMD
With the AIFMD set to revolutionise structures across the alternative investment industry, Serge Weyland of CACEIS, weighs up the options open to alternative investment managers

ADMINISTRATION

CRITICAL TO SUCCESS...
Jan Vanhoutte, of Vista Fund Services in Luxembourg, considers the challenge of time to market for a fund manager

TECHNOLOGY

SIDE POCKETS: FRIEND OR FOE?
As the hedge fund industry continues to evolve in the wake of the 2008 crisis, Brad Rowley of Pacific Fund Systems takes a look at the ongoing issue of side pockets
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The Alternative Investment Fund Managers Directive (AIFMD) introduces harmonised requirements for entities engaged in the management of alternative investment funds (AIF) addressed to professional investors in the EU. With the AIFMD, all investment funds in the EU fall into one of the following two categories: either Undertakings for Collective Investment in Transferable Securities (Ucits) or AIFs. The AIFMD covers a large variety of AIFs and their managers (AIFMs) ranging from equity funds to funds investing in illiquid assets – such as real estate, private equity, infrastructure and commodities.

The Level II implementing measures do not need any national transposition as it will be directly applicable in all EU member states. The EU Parliament and the EU Council have, however, three months (which may be extended to six months) to potentially object to this delegated regulation. If there are no objections, this will be applicable as of 22 July 2013.

The delegated regulation covers a wide range of topics which include, among other things: delegation of AIFM functions, calculation of the assets under management, method for calculating the leverage, clarification of certain operating conditions for AIFMs, specific provisions related to risk and liquidity management, clarification of a depositary’s duties and liability; and rules relating to third countries.

The Level II implementing measures will consequently have a significant impact on the alternative investment fund industry. It has to be noted that the duties of the depositary and the liability regime are defined in a strict manner.

THE AIFMD IN A NUTSHELL
To obtain authorisation, the AIFM has to comply with the requirements of the AIFMD which range from AIFMD substance requirements (including minimum share capital threshold, conducting persons requirements), risk and liquidity management, the appointment of a single depositary to rules regarding disclosure to investors and reporting to competent authorities.

In Luxembourg, the draft Bill of law N°6471 (Bill 6471) relating to the transposition of the AIFMD was deposited on 24 August 2012 with the Luxembourg Parliament. The Luxembourg authorities have taken the opportunity of using Bill 6471 to further improve the attractiveness of Luxembourg as an alternative investment fund domicile as a whole.

Further to the adoption of the Level II implementing measures, Bill 6471 has still to be discussed by the Luxembourg Parliament and some modifications may be introduced before it is finally passed into law. According to the current text of the Bill 6471, any authorised AIFM will have to perform the following internal management functions:

- Investment management function: this is a key function to be performed at a minimum by every AIFM and which includes at least portfolio management and risk management;
- Delegation of functions: subject to strict conditions laid down in the Bill 6471, some of the functions of an AIFM may be delegated (and sub-delegated) to third party service providers with the requisite resources and expertise.

As a general principle, the AIFM must remain in charge of some of its basic functions. The delegation of functions must not serve as a means to bypass the requirements of Bill 6471. As a result, sub-delegation is permitted subject
to similar conditions. Finally, the AIFM will remain liable towards the AIF and its investors with respect to the delegated (and sub-delegated) functions, and it is obliged to supervise the third party service providers on an ongoing basis, subject to conditions. Other functions (that may be provided by an AIFM only if the key function of portfolio management and/or risk management is also provided) are:

- administrative services (accounting services, legal services, valuation and pricing, regulatory compliance monitoring, maintenance of shareholder register, record keeping);
- marketing services;
- activities related to the assets of the AIFs (facilities management, services necessary to meet the fiduciary duties of the AIFM, advice to undertakings on capital structure, industrial strategy).

Once the AIFMD comes into effect as of 22 July 2013, any legal person performing the AIFM’s activity must file an application for authorisation as AIFM with the Commission de Surveillance du Secteur Financier (CSSF).

**IMPACT ON SIFS AND SICARS**

Under Bill 6471, specialised investment funds (Sif) and investment companies in risk capital (Sicar) that qualify as AIFs under the AIFMD may be self-managed, or may appoint an external asset manager. They are subject to the AIFMD substance requirements, depositary regime, delegation and valuation rules, and must meet the AIFMD transparency requirements. Sifs/Sicars qualifying as AIFs will benefit from the AIFMD marketing passport for distribution, by an authorised AIFM, of their shares or units to professional investors.

Where Sifs/Sicars do not qualify as AIFs (for instance, when they have a single investor), and for Sifs and Sicars benefitting from one of the exemption regimes provided for by Bill 6471 (such as group and de minimis exemptions), they remain under the current Luxembourg regulatory regime. In that case Sifs/Sicars have to register with the CSSF and to comply with ongoing reporting requirements.

It has however to be highlighted that no AIFMD passport will be available for Sifs/Sicars that do not qualify as AIFs, including Sifs/Sicars benefitting from one of the exemption regimes provided for by the AIFMD.

**IMPACT ON LUXEMBOURG MANAGEMENT COMPANIES**

*Ucits management companies:* Ucits management companies subject to Chapter 15 of the Luxembourg law of 17 December 2010 relating to undertakings for collective investment (the UCI Law) may be appointed as an external manager of an AIF under a double licence Ucits/AIFM.

In such a case, these management companies will have to cumulate two licences: the Ucits licence according to Chapter 15 of the UCI Law and the AIFM licence according to Bill 6471.

It is expected that the AIFM authorisation requirements will be lighter for these management companies cumulating the Ucits and AIFM licences. However Ucits management companies cumulating the Ucits and AIFM licences will nevertheless need additional own funds or hold professional indemnity insurance to cover potential liability risks resulting from the performance of their functions as AIFMs under Bill 6471.

The EU passport under both Ucits and the AIFMD regimes will be available for Ucits management companies cumulating the Ucits and AIFM licences, provided that certain conditions are complied.

Two passports are introduced by the AIFMD: a marketing passport and a management passport.

The marketing passport will be available as of 22 July 2013 and will allow Ucits management companies cumulating the Ucits and AIFM licences to market EU AIFs they manage to professional investors domiciled in the EU, by using a simplified regulator-to-regulator notification procedure. The management passport will allow Ucits management companies cumulating the double licence Ucits/AIFM to manage EU AIFs established in another member state than Luxembourg.

*Non-Ucits management companies:* Chapter 16 of the UCI Law will continue to apply to non-Ucits management companies, but will be deeply amended so as to introduce a distinction between (i) non-Ucits management companies with AIFM status; and (ii) non-Ucits management companies without AIFM status.

A non-Ucits management company authorised under Chapter 16 of the UCI Law managing AIFs must seek authorisation from the CSSF as an AIFM. Non-Ucits management companies may however, without further authorisation, act as management company to investment vehicles that fall outside the scope of the AIFMD.

Like Ucits management companies cumulating the double licence Ucits/AIFM, non-Ucits management companies with AIFM status will benefit from the AIFMD management and marketing passports, provided that certain conditions are complied with.

Considering the imminent amendments to Bill 6471 with the Level II implementing measures, industry participants should prepare to change their current operating model. LEXFIELD can provide you with tailor-made solutions related to all the AIFMD issues and will be pleased to assist you during the implementation phase of the AIFMD.
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Circle Partners is a relative newcomer in the Luxembourg marketplace, having obtained its licence as a Professional of the Financial Sector from the Commission de Surveillance du Secteur Financier (CSSF) in 2011. The expansion to Luxembourg was a logical step to make, as we noticed a keen interest from, in particular, Swiss asset managers to build up their investment funds within Europe.

THE ROLE OF THE ADMINISTRATOR POST-2008
A lot has changed in the hedge fund industry since the change of the economic tide in Autumn 2008, with the Madoff fraud in December that year taking away whatever was left of confidence and trust in the sector. These developments have enormously accelerated the need for transparency, state-of-the-art information systems and tighter controls.

The role of the third-party administrator has increased immensely and is constantly transforming to meet today’s requirements from stakeholders, as well as regulators. The Luxembourg regulator sets strict guidelines on how an administrator must conduct its business, which are published as circulars. Among other things, these circulars highlight the importance of having the proper procedures and checks and balances in place on a variety of areas, such as anti-money laundering and investor due diligence, avoidance of conflicts of interest, handling inside and sensitive information, and NAV calculations. Internal and external audits are part of the day-to-day running of the operation in Luxembourg and on-site inspections by the CSSF will also take place. Financial reporting must also take place on a regular basis and will contain the key data of the funds under administration and their net assets.

CONSOLIDATION
The pace of consolidation in the fund administration industry has not gone unnoticed and, as yet, there is no sign of slowing down. While some of these mergers may stem from a desire to cover different geographical areas, or to combine hedge funds and private equity offerings under the same roof and brand name, others go back to acquiring certain technology platforms and systems. The main driver, however, is the need to cope with the continual low cost pressure – paradoxically as this may seem in a world where everybody is looking to fund administrators to defend investors’ interests by conducting due diligence, verifying the source and accuracy of financial data and performing independent valuations.

At Circle Partners, we expect the name of the game in the coming years will be both efficiency and cost effectiveness. With this in mind, we are continuously improving our information systems with cloud solutions and remote connections of our operational offices to a centralised platform and data warehouse. Obviously, local privacy rules must be respected and at all times we must offer ready access to regulators. As an example, Luxembourg bank secrecy rules will ensure that an investor’s identity will remain protected and is only kept, and accessible, within the jurisdiction.

It is worth noting that we had the foresight to set up an office in Bratislava, Slovakia, more than five years ago. Our Dutch manager Simon Hiemstra has collected a great pool of talent and our staff of 10 is still expanding. The Bratislava office helps us to provide an alternative choice in today’s market of fierce competition.

THE AIFMD
Luxembourg was among the first jurisdictions to an-
announce the introduction of new legislation in anticipation of the Alternative Investment Fund Managers Directive (AIFMD) in the EU. The long-awaited Level II guidance was published just before Christmas 2012 by the European Commission and will have an impact on how alternative investment fund managers (AIFMs) will be conducting and organising their businesses.

**SERVICE IS CRITICAL**

Amid these developments and challenges, we will stick to our core values of strong client and investor services. We have built our business gradually over the past 12 and half years by gaining a reputation as a trustworthy partner and by clients referring us to other managers. This relationship model is based on reliability, responsiveness and accessibility – to staff members and senior management alike.

Only in the last year have we felt compelled to deviate from our business model of organic growth, when we acquired the fund services business ATC in Curaçao, a transaction swiftly completed when it appeared that the same work ethics and drive to meet clients’ expectations prevailed – in addition to sharing key systems.

We hired a client relationship and business development manager for the European and US markets last year – they both bring a new breadth of experience and skill with them.

**START-UP ASSISTANCE AND CORPORATE SERVICES**

We recognise that a fund start-up is in fact the start of a new business, where the manager will have limited or no prior experience in actually running an investment fund. Often as not, the fund manager will have had a career at a prop desk at a bank or brokerage firm with multi-disciplined back-up provided in-house. As more of these traders decide to go it alone, we will be on hand to steer them in the right direction and assist with their selection of counter parties – as well as reviewing and commenting on a fund’s offering documents.

The Luxembourg regulatory regime of the Specialised Investment Fund (SIF) is widely used for alternative investment funds and can take the form of a so-called Sicav or a mutual fund. With a minimum subscription amount of €125,000, the SIF will attract high-net-worth individuals and institutional investors and is off-limits to retail investors, who tend to be invested in Luxembourg UCits funds, for which Luxembourg is, by far, the market leader.

Corporate governance is becoming increasingly important (not least because of the AIFMD) and we will provide corporate management and secretarial services.

**CENTRE OF EXCELLENCE**

Operating in different jurisdictions and facing continuing changes in local regulations and legislation, we recognise the need to be knowledgeable on all matters that are part of the services offered by the administrator. Therefore, our teams of fund accountants are complemented by in-house professionals, such as corporate and tax lawyers, certified auditors, IT specialists and compliance staff. Fund managers and fund investors have always recognised our knowledge and responsiveness, ever since we first opened our doors as a fund administration and trust company in The Netherlands in 2000.

With an ISEA 3402 accreditation on our key business process of fund accounting and investor services in all our operational offices, we are confident that we have taken the right steps to remain at the forefront of demands by clients, banks, custodians, pension funds and other parties involved.

While we have only been active with a presence in Luxembourg for a relatively short time, the experience has so far been extremely rewarding and beneficial to our multi-jurisdictional coverage. As industry trends and characteristics continue to evolve, we have endeavored to follow these developments closely and an office in one of the most important – and exciting – fund centers in Europe was a natural progression of this. Yes, there is an element of uncertainty in the future for some fund managers (in regards to significant regulation such as the AIFMD), but we are confident that we will be able to help these firms progress and continue to succeed.
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THE LANDSCAPE TODAY
Since the implementation of the Specialised Investment Fund (Sif) law in 2007, and the earlier private equity vehicle (Sicar) law of 2004, Luxembourg has come a long way in its ability to service hedge funds and alternative asset managers. Until recently, Luxembourg was almost entirely focused on Ucits funds and retail distribution, but recognised that in order to remain Europe’s leading funds domicile, it needed to diversify and cater for newer asset classes and different kinds of asset managers and investors.

Going into 2013, Luxembourg has €276bn in Sif assets and €32bn in Sicar vehicles, which represents around 13% of the Luxembourg domiciled investment funds market of €2.34trn. This has been a major development over a relatively short period of time, and is seen as a strong vote of confidence in Luxembourg as a place to domicile alternative investment funds. In addition, there is another €201bn in other non-Ucits funds, taking the total of non-Ucits Luxembourg domiciled funds to €511bn, or 21% of the total Luxembourg funds industry*.

Hedge fund managers now have a comprehensive legal framework within which they are able to structure all kinds of alternative investment products. We are also seeing increasing demand from certain European investors, wanting the greater levels of security and transparency that our environment offers. Both sides of the equation continue to show great confidence in the Luxembourg funds industry and our ability to manage risk, volumes and complexity.

Alongside the regulated investment funds industry, Luxembourg also has a range of private and public corporate vehicles, which allow alternative managers to structure their target investments in the most efficient manner possible. Luxembourg is a leading domicile for structured investment products and private portfolio companies. Securitisation companies (stemming from the Securitisation Law of 2004) and SOPARFI Holding companies (structured primarily according to the Law of 2005), are increasingly popular and offer alternative managers a Luxembourg product or service without the cost and ongoing infrastructure of a regulated investment fund. Private equity managers, and also M&A deal structures, have historically used such routes where there is no distribution requirement and capital is already in place.

UPCOMING CHANGES
While Luxembourg already has a framework for all types of managers, products and investors, along with our EU partners we are also implementing the Alternative Investment Fund Managers Directive (AIFMD). Following years of debate and consultation, with the recent publication of Level II measures, we finally have clarity on the outcome of some contentious AIFMD provisions, most notably on the liability of the depositary bank framework and liquidity management.

Along with the AIFMD legislation, Luxembourg is rolling out a new legal form known as the SCSp. This will be broadly similar to the English law limited partnership used with Cayman hedge funds. The SCSp brings a range of ownership and tax transparency advantages to Luxembourg vehicles where needed, which were previously absent or difficult to implement.

There is no doubt an element of convergence whereby Sif today and AIFMD funds tomorrow will broadly follow the same overall operating structure and service provider base as Ucits funds.

“There is no doubt an element of convergence whereby Sif today and AIFMD funds tomorrow will broadly follow the same overall operating structure and service provider base as Ucits funds.”

Tom Davies
is managing director of Maples Fund Services Luxembourg. Prior to Maples Fund Services, Tom held senior positions at BNP Paribas, JPMorgan and Morgan Stanley.

TOM DAVIES OF MAPLES FUND SERVICES LUXEMBOURG EXPLAINS HOW LUXEMBOURG IS ADAPTING TO NEW LEGISLATION AND THE ADVANTAGES OF THE COUNTRY’S LEGAL FRAMEWORK FOR FUND MANAGERS
al and execution efficiency, such that hedge fund managers can continue their usual prime broker relationship/s and custodians can fulfil their depositary bank responsibilities.

Europe is implementing the AIFMD at the same time as other major changes taking place such as Fatca, Dodd-Frank and the upcoming Tobin tax. The next two to three years will see a raft of global and local regulatory changes sweep over our industry, all of which will generate additional costs and complexity for regulated investment funds in Europe.

TRENDS AND OPPORTUNITIES
A key component of the AIFMD is the ability to passport funds throughout the EU. In our view, however, private placement will continue until such time as asset managers need to have a domiciled European fund to satisfy specific investors. Many, if not most alternative managers operate quite happily today with their Cayman fund, using Luxembourg to structure target investments. While many larger alternative managers have operated in Europe for many years, those North American managers, which Luxembourg is looking to attract, will only be setting up structures when there is clear investor demand for their specific funds. When the EU passport becomes widely accepted, Luxembourg is perfectly positioned to take advantage of any swing in this area.

There has been no trend to redomicile to Luxembourg or Europe generally. There are most commonly parallel structures put in place that service US and European investors separately and we see this trend continuing in the years ahead.

Hedge funds are not falling as neatly into the long/short or strategy specific silos as we have seen in the past. We are seeing many larger groups launching new product lines in the re-insurance space and venture capital style deals, as well as an increase in single investor funds and managed account vehicles. As alternative managers evolve and diversify in their hunt for a greater and wider range of returns, service providers will need to be adept at servicing these new requirements as they crop up. Failure to do so puts relationships at risk.

Servicing UCits funds is a massive technological commitment where the leading custodian banks and administrators are increasingly turning into standardised IT platform providers. In the alternatives world, there is greater reliance on having outstanding people servicing hedge funds, as systems are not able to deal with the complexity and range of issues that come up. IT will need to be increasingly flexible and tailored to each hedge fund manager so we see developers and business analysts as being critical resources to have within the administrator’s organisation. The winners on the IT side will be those with the greatest flexibility and adaptability, a standardised product simply does not work for hedge funds.

The AIFMD requirements for additional services and providers will generate additional costs and also some investment restrictions. The scissors effect of rising costs and likely lower returns means there will probably be a clear gap between the performance of an AIFMD fund and its offshore equivalent. European institutional investors are generally prepared to accept this difference provided there are clear benefits in increased security and risk management. Service providers have a great opportunity to differentiate themselves in this area and show the value of their contracted services in risk management, risk reporting, depositary bank due diligence and oversight, quality of safekeeping, valuations and so on.

Luxembourg has had remarkable success with the core UCits product and is positioning itself to follow the same template in the Alternatives sector. To make this happen, Luxembourg service providers will need to carefully balance AIFMD laws with the very demanding requirements of leading alternative managers. Once operating flows are agreed, then overall flexibility and outstanding client service delivery will be critically important to keep alternative managers happy.

In the US, investors have weighted their investment decisions primarily on the ability and performance of the asset manager in a given sector. In Europe, in a post-Madoff and AIFMD world, we believe that European institutional investors will of course also weigh such decisions on manager performance, but will add further bias toward the quality and security of the overall fund product. Alternative fund managers and promoters will therefore need to make sure that they have industry leading service providers appointed to act on behalf of the fund in all areas, with experienced people on the ground to ensure good governance and compliance practices.

There are tremendous changes happening to our landscape. At Maples, we focus almost entirely on the alternatives sector and as one of the leading Luxembourg providers of services to hedge funds, we are very confident that Luxembourg is well positioned to meet these challenges.

"THE WINNERS ON THE IT SIDE WILL BE THOSE WITH THE GREATEST FLEXIBILITY AND ADAPTABILITY"
IN THE CROSSHAIRS

WITH REGULATION SET TO CREATE A EUROPEAN BRAND FOR VENTURE CAPITAL FUNDS NEXT, PIERRE REUTER OF NAUTADUTILH AVOCATS
LUXEMBOURG EXAMINES WHAT CAN BE EXPECTED FROM THIS LEGISLATION

According to the European Commission, there are about 23 million small- and medium-sized enterprises (SMEs) in the EU. SMEs are seen as one of the key drivers for economic growth and the creation of jobs in the EU. They account for nearly 99% of all European businesses and provide around 90 million jobs (two-thirds of all private sector jobs). Hence, SMEs are seen as being crucial to the development of the European economy.

However, SMEs are still prevented from availing themselves of their full innovation and growth potential due to the difficulties that they are facing to raise capital.

Venture capital funds are operators that typically provide mostly equity finance to SMEs. Venture capital remains, however, very niche in comparison to other sectors.

Researchers have proven that an increase in venture capital investments, in particular early-stage funding, is associated with an increase in GDP. Indeed, venture capital is considered to foster innovation, increase research and bolster competitiveness.

As a consequence, the support and increase of venture capital investments can be a driver for the real economy.

As of today, the EU lacks a set of common rules that facilitate fund raising by venture capital funds and their managers. In line with the objectives of the EU 2020 Strategy, and in the context of the long-term challenges as identified in the European Strategy and Policy Analysis System’s report, Global Trends 2030, the EU Council and the European Parliament reached on 7 December 2012 a political agreement on a proposal for a Regulation on European Venture Capital Funds (EuVECAR) that was originally released on 7 December 2011.

A plenary vote by the European Parliament is expected in March 2013, which will be followed by formal approval by the EU Council. It is expected that EuVECAR will come into force on 22 July 2013 to coincide with the mandatory implementation date of Directive 2011/61/EU on alternative investment funds managers (AIFMD).

EuVECAR aims to boost venture capital investments and to restart the venture capital cycles through a simple common framework that will streamline the process of raising, designing and exiting of venture capital funds. Its goal is the creation of an internationally recognisable industry standard of excellence for venture capital investments, which should trigger a sustainable and robust venture capital industry.

EuVECAR lays down comprehensive and uniform rules for managers of qualifying collective investment undertakings (EuVECAs) that wish to avail themselves of this brand for the marketing of their funds to eligible investors in the EU. I will now go through the main implications of EuVECAR applicable to EuVECAs and their managers.

ELIGIBLE FUNDS AND MANAGERS

EuVECAR will only apply to managers that manage at least one EuVECA (with the aggregate AuM of all managed EuVECAs not exceeding €500m), are established in the EU, are subject to registration with their home member state’s authority (in accordance with the AIFMD) and wish to use the designation of “European Venture Capital Fund”.

EuVECAs are defined as funds that intend to invest at least 70% of their aggregate capital contributions and uncalled committed capital (not taking into account short term holdings in cash and cash equivalents) in qualifying investments (as detailed infra) and cannot use leverage by which their exposure is increased beyond the level of their committed capital (they can only borrow, issue debt obligations or provide guarantees where such borrowings, debt obligations or guarantees are covered by uncalled commitments).

It is to be noted that non-EU funds are outside of the scope of EuVECAR. However, the EU Commission will eventually determine whether it would be appropriate to extend the scope of EuVECAR to non-EU funds based in countries applying minimum standards of good governance in tax matters.

QUALIFYING INVESTMENTS

Qualifying investments are either:
• equity or quasi-equity investments in SMEs, or
• secured or unsecured loans granted by the EuVECAs to SMEs, provided that the EuVECA already holds investments in the SME and that no more than 30% of its aggregate capital contributions and uncalled committed capital are used for such loans, or
• shares of SMEs acquired from their existing shareholders, or...
• units or shares of one or several EuVECA, provided that these do not invest themselves more than 10% of their aggregate capital contributions and uncalled committed capital in other EuVECA.

For the purpose of EuVECAR, SMEs are defined as undertakings (other than credit institutions, investment firms under the MiFID, insurance undertakings, financial holding companies or mixed activity holding companies) that at the time of the investment are not admitted to trading on a regulated market or a multilateral trading facility, have an annual turnover not exceeding €50m or an annual balance sheet that in total does not exceed €43m and employ less than 250 employees.

EuVECAR will permit to make investments in SMEs that are established in a non-EU country, provided that such country (i) is not listed as a non-cooperative country and territory by the FTAF and (ii) has signed an agreement with the home member state of the venture capital fund manager and with each member state in which the units or shares of the EuVECA are intended to be marketed (in order to ensure compliance with Article 26 of the OECD tax convention relating to the exchange of information).

**ELIGIBLE INVESTORS**

EuVECA can solely be marketed to investors that are considered to be professional clients (or may, on request, be treated as professional clients as defined under MiFID) or investors that commit to a minimum invest of €100,000 and state in writing that they are aware of the risks associated with the envisaged investment – the fund manager needs to comply with additional procedures to ensure that the investor is able to make its own investment decision and to understand the risks involved.

**APPLICABLE REGULATIONS**

The basic principles introduced by the AIFMD will be applicable to the managers of EuVECA, although EuVECAR provides for a regime that can be considered as less stringent (for instance, there is no obligation for a depositary obligations in the latter).

The managers must comply with general principles governing the conduct of business and the relationships with investors as well as organisational requirements. It is to be noted though that, unlike under the AIFMD, managers of EuVECA have no obligation to employ a risk management system. However, they have to put into place a conflicts of interest policy. Further, valuation procedures must be in place to ensure that the assets are valued properly.

Managers may delegate functions to third parties without such delegation, however, affecting their liability and without them becoming letterbox entities. A delegation must not undermine the effectiveness of their supervision and must not prevent them from acting, or the EuVECA from being managed, in the best interests of their investors.

Managers must have sufficient own funds and use, subject to proportionality, adequate and appropriate human and technical resources as are necessary for the proper management of their EuVECA.

As part of the EuVECA transparency obligations, managers must provide a certain amount of information to investors prior to their investment. EuVECAR, however, does not prescribe the establishment of an offering memorandum. This information includes a description of the EuVECA’s investment objectives and policy (and how these can be amended), of its risk profile, of its fees and charges as well as its remuneration policy and of its valuation procedure.

Also, EuVECAR requires the manager to make available to the competent authority of the home member state for each EuVECA an annual report not later than six months following the end of its financial year. This report must describe the composition of the EuVECA’s portfolio, the activities of the past year and must contain its audited financial accounts.

In Luxembourg, EuVECAR should give a further stimulus to its nascent venture capital industry. Mainly SIFs and SICAR will be able to benefit from EuVECAR, in particular as these vehicles do already now abide by its rules to a great degree. No doubt that fund sponsors that are looking to set up products to be marketed to investors throughout the EU will consider Luxembourg as a jurisdiction of choice for the setting-up of the EuVECA and their managers.

The author would like to thank Jean-Florent Richard for his valuable input to this article.

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A NEW STEPPING STONE FOR LUXEMBOURG

JEAN-PIERRE MERNIER FROM ELVINGER, HOSS & PRUSSEN EXPLAINS HOW LUXEMBOURG HAS BEEN GIVEN, WITH THE AIFMD, THE OPPORTUNITY TO DUPLICATE THE SUCCESS OF UCITS, AND HOW THE DIRECTIVE MAY CONTRIBUTE TO THE RECOGNITION OF LUXEMBOURG AS A LEADING DOMICILE FOR ALTERNATIVE INVESTMENT FUNDS

IMPACT OF THE AIFMD ON THE HEDGE FUND INDUSTRY

Although the AIFMD is more a manager directive than a product directive, it comprises a number of provisions that affect both managers and the investment vehicles (the AIFs) they manage.

It therefore also comprises a number of requirements which will apply at the level of the AIFs, such as the requirement for a depositary, a valuation agent, the publication of an annual report, the provision of information to investors by means of an offering memorandum or otherwise and reporting requirements to regulators. Most of these won’t be revolutionary for Luxembourg-based hedge funds (HF) and funds of hedge funds (FoHF) since they are usually governed either by Part II of the Law of 17 December 2010 on undertakings for collective investment (the UCI Law) governing non-Ucits investment vehicles that may be distributed to the public or the Law of 13 February 2007 regulating specialised investment funds or Sifs (the Sif Law) and, as such, are already subject to similar requirements under their current regulated status.

Among the major regulatory and operational challenges introduced by the AIFMD that will affect the hedge fund industry (including, for example, the delegation and outsourcing rules) are the depositary requirements considering, in particular, the traditional and core involvement of prime brokers or the provision of custody-related services by AIFMs to the AIFs they manage.

AIFMs will have to ensure that a single eligible depositary is appointed for each AIF they manage. In line with the conflicts of interest provisions contained in the AIFMD, an AIFM can also never act as depositary, nor can the prime broker when acting as counterparty to an AIF, unless the prime broker has functionally and hierarchically separated both functions and unless the potential conflicts of interest are properly identified, managed and disclosed to investors. Similarly, the provision of prime brokerage services by the depositary would only be permitted if the latter has the same functional and hierarchical separation between both functions.

The requirement to appoint a single eligible depositary already applies to Luxembourg HF and FoHFs set up under Part II of the UCI Law or the Sif Law. The main tasks of the depositary will include (i) cash monitoring of inflows and outflows of the relevant AIF, (ii) safe-keeping of the AIF’s assets and (iii) oversight duties.

The AIFMD will also necessarily trigger the need for depositaries to update their existing contractual arrangements to reflect the AIFMD provisions covering the depositaries’ role and their specific responsibilities vis-à-vis the AIFs, as well as their ability to delegate.

The strong experience and high flexibility gained over time by Luxembourg-based depositaries acting for regulated investment vehicles will enable them to appropriately adjust their business model to the AIFMD provisions.

THE OVERALL STRUCTURE OF THE BILL

On 24 August 2012, the bill of law (the Bill) transposing the AIFMD was submitted to the Luxembourg Parliament for approval. This law is expected to be adopted by the end of March.

As outlined above, the AIFMD aims to regulate the AIFM and, indirectly, the funds they manage (the AIFs). Therefore, the Bill not only transposes the AIFMD, but also amends a number of other existing laws, mostly those governing regulated investment vehicles such as Part II of the UCI Law and the Sif Law. As indicated, most HF and FoHFs set up in Luxembourg fall within the scope of either the UCI Law or the Sif Law.

Overall, the Bill reflects a consistent approach to avoid any so-called super equivalence or gold plating, meaning that the AIFMD is substantially implemented without any provisions that are more restrictive than the terms of the Directive. But in the areas which are not covered by the Directive, changes have been proposed to increase the efficiency of the Luxembourg legal, tax and regulatory framework.

The changes made by the Bill to Part II of the UCI Law and the Sif Law aim at distinguishing, on the one hand, such Part II funds and Sifs that qualify as ‘Full Scope AIF’ under the AIFMD which, on the basis of the provisions of the Bill, are required to be managed by a duly authorised AIFM and, on the other hand, such Part II funds and Sifs that are not AIFs (this can actually only be the case for Sifs since the Bill provides that all Part II funds shall qualify as...
AIFs) or are AIFs benefiting from and using the de minimis exemption introduced by the Directive. For the latter Part II funds and SiFs, the requirements remain substantially unchanged compared to their current regimes.

A new non-Ucits and non-AIFMD management company regime is introduced by the Bill.

The Law of 5 April 1993 on the financial sector is also amended to introduce a new type of depositary. Amendments are also made to the Law of 10 August 1915 on commercial companies to modernise the existing limited partnership regime and to introduce the new tax-transparent special limited partnership. Finally, amendments are made to certain tax laws to introduce a new carried-interest regime.

The implementation is made without losing sight of the need for investor protection. Indeed, the Bill appears to have implemented all of the AIFMD investor protection measures and the supervisory powers of the Luxembourg regulator have also been increased.

MARKETING OPPORTUNITIES

Although the AIFMD triggers many challenges and constraints for the whole alternative investment fund world, it also entails a European passport for AIFM in that, once they are authorised in an EU member state they can market the AIF they manage to professional investors in all other EU member states. This shall create numerous marketing opportunities for HFs and FoHFs, which, so far, could in principle be distributed in other EU member states on a private placement basis only.

Luxembourg HFs and FoHFs with EU-based AIFMs will have the benefit of the European passport for marketing to professional investors from July 2013, whereas those with non-EU based AIFMs will, until July 2015, only be able to continue to market in the EU on the basis of the local private placement rules (as is the case for now) subject to the compliance with some requirements of the AIFMD. Should the private placement rules appear to be too restrictive, a restructuring can be contemplated by interposing a Luxembourg AIFM between the Luxembourg AIF and the non-EU AIFM (such as an AIFMD-compliant Luxembourg management company). The Luxembourg AIF would thus be managed by a Luxembourg AIFM, which would delegate investment management functions to a non-EU manager. On this basis, the AIF would have the benefit of the passport from July 2013.

Luxembourg has always been proactive. The implementation of the Ucits Directive, first implemented in the early 1980s, has contributed to the building-up of a solid reputation and a strong financial infrastructure. The business-friendly environment of Luxembourg, as well as its political, economic and regulatory stability, explain in particular why Luxembourg has positioned itself as a leader in the investment funds cross-border distribution. The experience gained in the field of regulated investment funds and its close and long-standing relationships with the authorities of Ucits distribution countries make Luxembourg confident it is equipped to extend its Ucits success story to the alternative investment fund world and in particular, the hedge fund industry.
The fact that more fund managers are exploring the merits of converging fund structures to tap into new money markets is testament to the reliance and innovation of the fund industry. Even though the industry is struggling through a period that has proved significantly difficult in terms of capital raising, fund managers are starting to step back and re-examine money that is out there that they previously haven’t been chasing. With more firms investigating the possibilities of converging fund strategies (especially with the forthcoming Alternative Investment Fund Manager Directive (AIFMD) bearing down on the industry), HFMWeek decided to talk to Keith Hale, executive vice-president of client and business development of Multifonds, to find out how this trend is impacting Luxembourg.

HFMWeek (HFM): The convergence of traditional and alternative funds is a growing trend. To what extent has this been seen within a Luxembourg context?

Keith Hale (KH): The convergence issue is really driven by three main elements. Firstly, institutional investors are increasing their allocations to hedge funds. Secondly, there is a growth in retail investor demand for absolute return funds. And finally, these issues are both being pushed along by the catalyst of new regulations – namely the Alternative Investment Fund Managers Directive (AIFMD). This is causing traditional funds and alternative funds to adopt similar characteristics, such as alternative funds being forced to become more traditional in terms of daily liquidity and UCits-like risk management, as well as traditional funds taking on alternative characteristics like performance fees. We are seeing evidence of this convergence across our client base, with a significant growth over the last few years in alternatives on our platform, alongside traditional funds. In an industry survey conducted by Multifonds last year, 86% of respondents agreed that convergence will continue.

What we find in Luxembourg specifically, is that there tends to be more of a focus upon the retail aspect of investment geared towards alternative UCits-type structures with Luxembourg recognised as having a highly rated distribution network. So from a Luxembourg perspective, they will be well positioned to leverage this distribution experience for future convergence moves within the industry.

HFM: How will the 2012 modernisation of Luxembourg’s limited partnership regime ease structuring requirements for fund managers for 2013?

KH: Non-EU hedge funds, such as Cayman and particularly Delaware-domiciled funds, are often structured as limited partnerships for tax transparency reasons where incisive management fees are allocated to each individual investor. With the introduction of the AIFMD, we expect to see more non-EU funds either being co-domiciled or re-domiciled within the EU so funds can be ‘marketed’ to European investors. As a result, Luxembourg is becoming increasingly considered as one of the likely options for EU domiciliation. Luxembourg is now also bringing US-style or ‘offshore’ limited partnership (LP) structures into law, meaning in theory these funds can be administered and domiciled in Luxembourg whilst retaining the same LP structures as they have now. It will be interesting to see how widely Luxembourg LPs are taken up within the whole AIFMD ‘shake-up’ and whether this will result in a shift between offshore and onshore locations.

HFM: How will fund convergence projects impact service provider agreements on the whole?

KH: For administrators our view is that, like many things in life, the convergence trend presents both opportunities and possible threats.

FOR ADMINISTRATORS, OUR VIEW IS THAT, LIKE MANY THINGS IN LIFE, THE CONVERGENCE TREND PRESENTS BOTH OPPORTUNITIES AND POSSIBLE THREATS

Keith Hale is executive vice-president, Client and Business Development at Multifonds. He has more than 20 years of experience in the investment industry, working on more than 50 projects with more than 30 leading buy-side, sell-side and asset servicing clients.

Keith Hale (KH): The convergence of traditional and alternative funds is a growing trend. To what extent has this been seen within a Luxembourg context?
established, you will be well placed to service both markets as they come together. However, for service providers that specialise in just one area, most commonly the niche hedge fund only administrators, they are under more of a threat because they lack the ability to cover both sides of the fence. They will have to source and build out those relationships with depositaries and also work towards a level of systems integration that their competitors already have in place. That’s one of the reasons that we have already seen mergers and acquisitions within the service provider market – most recently Goldman Sachs’ hedge fund administration services being acquired by State Street – so that these parties can leverage both capabilities and thus capitalise on this growing trend.

The real trick in our mind is to bring the efficiency associated with traditional funds together with the flexibility associated with hedge funds in terms of asset classes, structures and incisive fees. This means that while administrators in Luxembourg have a proven track record in Ucits and retail type structures, they will also need to offer the flexibility to deal with more hedge fund type investment vehicles as the convergence trend continues to build momentum.

HFM: When accessing retail money, what changes and new mechanisms does an alternatives manager need to enact?

KH: Traditionally, hedge funds have been sold directly to investors rather than via distributors, whereas retail money is sold through a distribution network. For instance, UK retail distribution is typically via IFAs through platforms, compared with continental Europe where distribution is generally through retail or private banks. Alternative funds traditionally haven’t used or even had access to this type of asset gathering via distributors. From a volume perspective, the inflow of new institutional and retail investors to alternative funds will require new approaches for alternative funds and its administrators to maintain levels of efficiency through STP processing and control mechanisms such as four-eyes processing. That said, Luxembourg already has distribution networks and experience in place, but in order to accommodate the growth in alternative funds that may come to Luxembourg, managers and administrators will need to combine institutional and retail controls as well as automation, with the complexities and flexibility required by alternative funds.

HFM: What can you see 2013 holding for convergence of fund structures in Luxembourg?

KH: With the AIFMD coming to fruition, we expect fund managers of offshore domiciled funds to view the regulation as an opportunity to retain and indeed gather additional assets. When looking at the results of the Multifonds survey mentioned earlier, 72% agreed that non-EU managers would look to set up some form of European operations to take advantage of the AIFMD. There is a good opportunity for Luxembourg in the coming months and years to leverage its well established Ucits capabilities and distribution expertise with a growing number of alternatives funds and assets.

Luxembourg’s version of its draft rules are likely to be transposed into law in August to meet the AIFMD’s requirements with local law compliance incorporated, which will make Luxembourg one the first jurisdictions to implement the Directive. So there is good opportunity for Luxembourg to leverage this convergence of the investment fund industry, but it will need to ensure it does so on a cost effective basis, through the types of efficiency that are more common in traditional fund administration. Otherwise the lower cost European centres will quickly gain market share purely because they are cheaper.
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WE CANNOT DIRECT THE WIND
BUT WE CAN ADJUST YOUR SAILS
The alternative investment fund industry, particularly in the US, has remained very vibrant, especially in terms of single hedge funds which are seeing frequent fund launches and rising capital inflows. To ensure that fund assets continue to rise, many alternative investment managers (AIMs) are seeking ways to attract foreign investment to their funds. However, in the European marketplace, direct sales of offshore funds will be subject to far tighter restrictions under the Alternative Investment Fund Managers Directive (AIFMD). The new Directive seeks to better regulate the sale of hedge funds and private equity funds to European investors, and its provisions will have to be written into national statute books by July 2013. Hedge fund managers are realising that if they want to attract investor capital from Europe they will have to look into the impacts of the AIFMD in greater detail.

It should be noted that not all alternative managers are taking the new directive into account. Many believe that they can still distribute their funds under the private placement regimes and others still have taken the decision to discount Europe altogether due to the sovereign debt crisis and concerns surrounding the euro, and look to new markets like Asia and the Middle East. However, most of the larger non-European players (and an increasing number of small and medium sized players) are looking at how to benefit from the 'European passport', which will allow them to offer their management services and distribute their funds in all EU member states. This increasing interest has been accelerated by the prospect of private placement regimes in certain European countries (for instance, France and Germany) becoming more restrictive or subject to more scrutiny going forward. In addition, as Europe’s economic situation shows signs of stabilising, interest from AIMs is rekindling.

RETHINKING THE AIM’S ORGANISATIONAL MODEL

For those European and non-European AIMs intending to raise capital in Europe, partnering with an asset servicing bank like CACEIS can be an essential step in developing an AIFMD-compliant sales strategy. Experience in servicing alternative fund vehicles domiciled in US offshore jurisdictions and European domiciles (such as Dublin and Luxembourg) is essential to designing the most suitable operational set-up and fund structure for a leading European private bank.
vestor funds (SIs), Irish qualifying investor funds (QFs) or simply Ucits structures – enabling them to market their funds to investors in the European marketplace and beyond.

Europe’s leading fund jurisdictions, Ireland and Luxembourg, offer attractive solutions for non-European hedge fund managers to set up their European AIFs and AIFs, and enable them to have access to the European passport from as soon as the Directive is brought in. To facilitate the process of complying with the Directive and obtaining an EU passport, some asset servicing banks like CACEIS can offer a full end-to-end management company solution, which includes governance and risk management solutions. A level of uncertainty remains as to the exact nature of restrictions under the AIFMD on delegation of the governance, risk management and other related duties; however, we are convinced that there will be a number of options available both in Ireland and Luxembourg which are cost effective and comply with the spirit of the AIFMD.

**DEPOSITARY LIABILITY AND PRIME BROKERS**

AIFMs which provide an in-house custody service for their own AIFs and those that rely on prime brokers will be required to appoint an independent depositary for their investors’ assets under the AIFMD. A prime broker can still act as depositary for an AIF only if it has separated its depositary functions from a functional and hierarchical perspective. The relationship between the prime broker and the depositary creates one of the main challenges resulting from the change of regulation regarding depositary liability and the restitution of assets under the AIFMD.

A close relationship between the depositary and prime brokers will be key to the success of the AIFs regulated under the AIFMD. The parties must discuss and agree on issues including the level of transparency and the standards applied in the sub-custodian selection and monitoring process, the reporting on assets at sub-custodian level in order to enable the depositary to identify which assets are reused by the prime broker, and the asset restitution arrangement if the sub-custodian of the prime broker goes bankrupt. CACEIS has been very proactive in this respect, initiating discussions with all the large prime brokers early on and it has played an active role in industry forums sponsored by the Irish Funds Industry Association (IFIA) and the Association of the Luxembourg Fund Industry (ALFI) to come up with operating models and contractual arrangements that work for both parties under the AIFMD.

**AIFMD-COMPLIANT MANAGEMENT COMPANY SERVICES**

Many AIFMs are daunted by the complexity and rigorousness of the AIFMD’s regulations regarding the matters of risk management and governance, and may experience difficulty in ensuring compliance with the directive’s rules from their home jurisdiction whether inside or outside of the EU. To simplify this administrative aspect for AIFMs, the experience behind ‘Luxcellence’, the group’s affiliate which provides Ucits-compliant management company and governance support services, is now available to alternative investment funds, with a specific focus on hedge funds, private equity, real estate, infrastructure and debt funds. Luxcellence is a management company in Luxembourg, regulated by the Luxembourg Commission de Surveillance du Secteur Financier (CSSF) in accordance with the regulations for conventional and alternative funds. Luxcellence, which is separated from CACEIS from a functional and hierarchical perspective, meets every aspect of the directive’s requirements concerning the delegation of risk management by an investment company. It has developed expertise and a complete range of services adaptable to different management profiles. Leveraging the experience it has acquired from international managers in conventional and alternative vehicles, Luxcellence may notably act as a delegate to support risk management.

With its own governance framework and a large team of risk analysts dedicated to this function, Luxcellence is independent of CACEIS’s operational services but still benefits from the integration with CACEIS for accessing all key data.

**A COMMITMENT TO THE ALTERNATIVE INVESTMENT INDUSTRY**

CACEIS is also committed to the ongoing enhancement of services to the alternative investment sector, and in the first half of 2013 the group will be launching a bespoke private equity system able to handle performance measurement and risk analytics including all middle-office functionality and regulatory requirements under the AIFMD.

CACEIS supports the AIFMD initiative not only because we believe it will achieve what it has set out to do in terms of bringing greater stability to the alternative investment industry, and in turn, benefiting the investors, but also because if the alternative investment industry gets it right, then AIFMD-compliant funds could gain the same brand recognition as Ucits funds have enjoyed. And like Ucits, this could mean that an initiative which started out as a purely European focused regulation goes on to enable managers to tap into investor capital from a far broader range of countries and regions than initially intended, reaching outside of the EU, into markets such as Asia or the Middle East.
Time to market can be a critical factor in determining the success or otherwise of a new fund, so fund managers will be well aware of the importance of being able to deliver their administration solution quickly and on a platform that also allows for flexibility and growth.

The traditional fund administration model is both complex and time consuming with the legal development process being one that requires careful planning. A variety of regulatory issues will come into play when developing a fund such as taxation, registration, entity type and classification, jurisdiction, security type and so on. Once the structure of a fund has been agreed upon, the legal development process can begin in earnest, with issues such as jurisdiction choice being decided. Therefore, it is important for the fund manager to retain flexibility and choose a fund administrator who can operate from a range of jurisdictions, some onshore, some offshore, depending upon the manager’s requirements at that time.

Jan Vanhoutte, managing director, has an extensive knowledge of fund structuring, particularly in fund of funds, hedge funds, real estate and private equity funds. Before Vistra, Jan was a lawyer and worked for seven years in the fund departments of many law firms in Luxembourg.

The role of fund administrators is wide ranging and central to the success of the fund. At one level they act as gatekeepers, forming an important link between the fund manager and the investors. On another, the back office administration can be the key to success of a fund. In its capacity as a centralised administrator of funds, Vistra Fund Services can perform all the accounting, net asset value calculation, maintenance of the financial and statutory records, tax and regulatory reporting, support annual audits and act as the point of contact for the investment manager or advisor.

JAN VANHOUTTE, OF VISTRA FUND SERVICES IN LUXEMBOURG, CONSIDERS THE CHALLENGE OF TIME TO MARKET FOR A FUND MANAGER

A FUND ADMINISTRATOR’S ROLE

The role of fund administrators is wide ranging and central to the success of the fund. At one level they act as gatekeepers, forming an important link between the fund manager and the investors. On another, the back office administration can be the key to success of a fund. In its capacity as a centralised administrator of funds, Vistra Fund Services can perform all the accounting, net asset value calculation, maintenance of the financial and statutory records, tax and regulatory reporting, support annual audits and act as the point of contact for the investment manager or advisor.
Vistra Fund Services also acts as registrar and transfer agent, handling the registration of shares, liaising with shareholders with regard to subscriptions, redemptions and transfers, keeping the share register and issuing all relevant shareholders’ information/documentation. The company also acts as company secretary and will therefore be responsible for arranging and preparing board meetings and convening the shareholders’ meetings.

Vistra Fund Services’ duties will also extend into areas which touch upon the control of investment strategy and practice. These duties include ensuring that the fund remains invested in accordance with the constitutive documents and does not exceed risk guidelines or investment restrictions.

However, the skill of fund establishment relies upon a simple truth: many of the processes which need to be undertaken, numerous contracts which need to be prepared, the compliance and anti-money laundering and ‘know your customer’ hurdles which need to be overcome, have much in common, irrespective of the vehicle being established.

Recognising this communality and potential for labour-saving, and so delivering a dramatically reduced time to market, was one of the factors which led Clayton Heijman of Darwin Platform to work with Vistra Fund Services to create the Privium fund platforms in Luxembourg and the Cayman Islands. These fund platforms have been designed to simplify the problems of fund establishment by offering a series of off-the-peg solutions to the most commonly encountered problems. Privium’s streamlined approach allows for rapid fund establishment, with Privium providing support in the areas of marketing, set up and design, compliance and approval, physical office and risk management models. These are of particular relevance to those first time or start-up managers launching their funds, with the pressure to hit the ground running being paramount. So with fund administration issues resolved, fund managers can concentrate on their core skills of asset management and performance delivery.

For fund managers wishing to establish hedge, private equity and other fund styles, using the Privium platforms additionally enables them to benefit from attractive pricing options.

Vistra Fund Services provides fund administration services to the Privium Selection Fund, a Luxembourg investment company with a variable capital-specialised investment fund (the Privium Selection Fund) via its fund services operating out of Luxembourg. The Privium Selection Fund is managed by Privium Fund Management (UK) Limited. This umbrella platform proves a flexible one-stop-shop, Luxembourg-based solution for the launch of differing styles and sizes of funds, each backed by competitive pricing options.

Vistra Fund Services also provides fund administration services to the Privium Capital Fund, a Cayman Islands-based umbrella fund structure. This platform allows clients to establish their own segregated portfolio or sub-funds and build fund management expertise located in any of four major jurisdictions – Hong Kong, Cayman, the Netherlands and the UK. Vistra Fund Services will provide the fund administration and associated services from its Hong Kong, Luxembourg or Jersey office.

Vistra Fund Services offers centralised administration of funds, providing bespoke administration solutions to fund managers. It is the fund administration and fund formation division of the Vistra Group, a leading global provider of corporate, fund administration and outsourcing services which has 27 offices spread across 20 jurisdictions. Specialist funds teams are based in Jersey, Luxembourg, Hong Kong and Singapore – on hand to fully service the most critical aspects of their client’s funds.

Vistra Fund Services was also established to provide consultancy services alongside administration and its team of specialists are equipped to work closely with clients and their advisers to develop fund structure and its processes. As an independent service provider, they are free from many potential conflicts of interest: Vistra Fund Services do not manage proprietary funds, nor do they provide legal advice, tax advice, banking or investment services. Vistra Fund Services is focused solely on the core tasks of providing clients with ‘virtual’ middle and back offices and infrastructure.
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As the global financial crisis unfolded, the use of side pockets among hedge fund managers quickly became commonplace and, indeed, was a particularly useful mechanism that assisted the industry in maintaining some form of momentum and coherence in the midst of near-unprecedented financial turbulence. Some research even suggested 30% of hedge fund managers had to implement side pockets, or gates, during the recent financial crisis. As a result, side pockets became a key area of focus for hedge fund administrators as a mechanism to be used by the fund manager to house and ring-fence illiquid or hard-to-value assets.

From a conceptual perspective, a side pocket is fairly straightforward and allows continuity of the fund activities so the future performance of new subscriptions are not tainted by the historical problematic securities.

However, moving assets in and out of side pockets, correctly valuing them, quantifying associated performance fees, and whether or not a performance crystallisation event has taken place are much more convoluted issues of which the fund manager and administrator have to take cognisance.

Managing these moving parts is an area especially well-served by a sophisticated fund administration and accounting platform owing to the nuances in calculations and the need to generate accurate NAVs. Having an integrated system is of great assistance given that side pockets create a direct relationship between specified portfolio holdings and specific investors.

As securities are moved from the core portfolio into the side pocket, each investor at the time of side pocket creation will receive an entitlement equal to their proportional share of securities transferred to the side pocket. In PFS-PAXUS, our integrated share registry/fund accounting platform, the problematic securities positions can be automatically transferred to a side pocket while retaining the lot history, original purchase dates and original foreign exchange rate costs which will also transfer the unrealised profit and loss to the side pocket investors.

In parallel, the generation of the side pocket shares to the specified investors is also automated. Any subsequent income including dividends, interest, realised or unrealised gains are automatically allocated to the side pocket investors. Portfolio reports can separate the side pocket positions for the core portfolio positions. The allocation of other income, expenses and accruals to the side pocket is supported by PFS-PAXUS.

There has been some guidance issued by fund industry governing bodies. The September 2009 Guide to Sound Practices for Hedge Fund Administrators is a joint venture publication between the Alternative Investment Management Association (Aima) and the Irish Funds Industry Association (IFIA) that provides guidance to hedge fund administrators regarding the various functions that form part of their responsibilities as administrators.

One of the functions that the guide covers relates to fund structures. A particularly important issue emphasised in the guide, is that of NAV suspensions and the treatment of illiquid assets and a key driver for this emphasis was the major disruption in the global capital markets that were triggered during 2008. According to the guide, side pockets can be considered as “miniature portfolios of illiquid investments held within a fund’s investment portfolio”.

MANAGEMENT FEES
An additional area of interest (and a somewhat contentious one) relates to management fees, as these types of fees may be charged on side pockets whereas the investor’s capital is restricted and hence the investor cannot exit the side pocket. Complexities can also arise when considering fund performance when an investor has holdings in both

SIDES POCKETS: FRIEND OR FOE?

As the hedge fund industry continues to evolve in the wake of the 2008 crisis, BRAD ROWLEY of PACIFIC FUND SYSTEMS takes a look at the ongoing issue of side pockets

Bradford Rowley
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the core portfolio and side pockets. By moving the problematic securities into a side pocket the investment manager may be entitled to claim performance fees on the core portfolio even though the investor is suffering a loss or unable to liquidate the side pocket. A more equitable treatment would be to combine the performance of the core and side pocket investments in determining if a performance fee is due based on the overall investor experience.

The creation of a side pocket may also trigger performance fee claw-backs whereby performance fees have been paid in previous periods on investments which default in later periods and are moved into side pockets.

Another issue that managers and administrators need to address is the allocation of the fund’s general expenses to side pockets. Whether or not the side pocket should participate in the general expenses of the fund and/or whether it should attract its own specific expenses can be contentious. From an administrative perspective, managing a complex expense allocation process will require the involvement of senior level staff, but the burden can be reduced by having a system capable of supporting complex allocations.

It is also commonplace for hedge funds to apply redemption penalties and lockups and this can be particularly onerous with regards to side pocket investments. An alternative to side pocket creation is to create gates whereby investors’ redemptions are restricted and in some cases they cannot redeem fully until the problematic securities have been realised or fairly valued. PFS-PAXUS has the ability to monitor investor level gates and provide user warnings where there has been a breach of investor level gates upon redemption. The key to these calculations is to be able to look through a sequence of transfers and series rollups to establish the true date of the lot being redeemed.

**CONFLICT OF INTEREST**

It should also be mentioned that there is a nefarious side to the use of side pockets or gates. Any entity in the value-chain that is being remunerated on the basis of the value of the NAV may have a conflict of interest if the fund implements policies to force the retention of assets in side pockets or implements gates which restrict investor ability to redeem their investments. Therefore great care must be taken to ensure side pockets or other liquidity restrictions cannot be used for purposes other than those stipulated in the fund prospectus. Management fees based on side pocket investment value can be calculated in PFS-PAXUS.

It is clear that the consequences of the global financial crisis has placed the management of illiquid securities in side pockets or other substitutes (such as the previously mentioned gating) right at the centre of the swathe of responsibilities required to be undertaken by hedge fund administrators. Disruptions in the capital markets between business cycles are not going to go away so therefore the role of side pockets are here to stay. With the Madoff investment scandal rates of recovery now reaching 34%, eventually Madoff and other scandals triggered by events in 2008 will come to their close.

The fast actions by the hedge fund managers have enabled the industry to recover and keep moving forward over a tumultuous period. A sophisticated approach is needed by the administrator to accurately account for these assets, not only in terms of ultimately generating accurate NAVs, but also to abide by regulatory requirements and standards and fiduciary duties to investors.

**AN ALTERNATIVE TO SIDE POCKET CREATION IS TO CREATE GATES WHEREBY INVESTORS’ REDEMPTIONS ARE RESTRICTED AND IN SOME CASES THEY CANNOT REDEEM FULLY UNTIL THE PROBLEMATIC SECURITIES HAVE BEEN REALISED OR FAIRLY VALUED**
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