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# Client Alert

## Financial Services

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# CSSF FAQs on measures to address liquidity due to Ukraine/Russia conflict

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A number of UCITS funds holding Russian and Belarussian assets have declared suspension of dealings because of the impaired market trading conditions due to the conflict between Ukraine and Russia and the restrictive measures taken by the various countries against Russia. While circumstances associated with the Ukraine/Russia situation have not been alleviated and the fund dealings remain suspended, on 31 March 2022 the CSSF, Luxembourg's financial regulator, issued a set of FAQs to provide guidance to fund houses on liquidity management in this context.

Specifically, the FAQs suggested the following possibilities to UCITS funds with significant exposure to illiquid assets to achieve the segregation of such assets through the creation of "side-pockets":

1. Creating a new share class within the same fund, and applying an "accounting segregation" of the illiquid assets by allocating the illiquid assets to a new share class. The new share class shall be closed to new subscriptions and suspended for redemptions.

2. Restructuring the impacted fund into two funds: the original fund will keep the illiquid assets, and the liquid assets will be transferred to a new fund to be created. After the "spin-off", existing investors will be allotted with shares in both the original fund and the new fund. The total value of the holdings will be equivalent to that immediately prior to the restructuring. The original fund with the illiquid assets shall be closed to subscriptions and redemptions.

3. Restructuring the impacted fund into two funds: the original fund will keep the liquid assets, and the illiquid assets will be transferred to a new fund to be created. After the "spin-off", existing investors will be allotted with shares in both the original fund and the new fund. The total value of the holdings will be equivalent to that immediately prior to the restructuring. The new fund with the illiquid assets shall be put into immediate liquidation.

The CSSF has highlighted that the creation of "side-pockets" is not explicitly envisaged in the UCITS legal framework. Therefore, it remains the responsibility of the governing body of the fund to decide, having regard to constitutive documents of the UCITS, whether a side-pocket would be allowed, and if so, under what circumstances and conditions.

From a Hong Kong regulatory perspective, all of the three options would give rise to SFC-regulatory issues. The first option may appear to be relatively more "simple", and the creation of a new share class does not **normally** require the SFC's prior approval. However, since the new share class created will be used to hold illiquid assets, this will no doubt cause regulatory concerns. According to the SFC's FAQ 27B under the FAQs on the Code on Unit Trusts and Mutual Funds, fund managers are required to consult the SFC in advance if they would like to create a new share class with such specific features. In contrast, options 2 and 3 are likely to be challenging as they involve applying to the SFC for the authorisation of a new fund holding the illiquid assets and/or the SFC's approval of restructuring/termination of a fund whose assets cannot be realised or transferred appropriately. No matter which option a fund house choses, prior consultation with the SFC would be essential.

Unfortunately, the solutions suggested above may offer little help to UCITS or SFC authorised funds with substantial exposure to Russia, e.g. funds investing at least two thirds or 70% of their NAVs in Russia.

For funds with only limited exposure to illiquid assets, the CSSF has indicated that they can continue to rely on the relatively standard and temporary liquidity risk management tools, such as fair valuation adjustments, or the closure of funds to subscriptions for new investors, to deal with the situation. In this connection, please be reminded that, pursuant to the SFC's circular to management companies of SFC-authorised funds on liquidity risk management dated 4 July 2016, a manager of SFC-authorised funds is expected to consult the trustee/custodian before the use of liquidity risk management tools.

We would recommend fund managers with SFC-authorised funds affected by the Ukraine/Russia conflict to engage in an ongoing dialogue with the SFC as to the next steps to be taken, in light of the CSSF FAQs.

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