



association of the
luxembourg fund industry

| aifmd



the alternative investment fund managers directive



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why ... a directive on alternative investment fund managers?

The Directive is the outcome of a G20 consensus for closer regulatory oversight of systemic risks emanating from actors and activities in the alternative investment funds sector. In particular, it aims, at setting-up robust risk and liquidity management systems and at enhancing transparency for investors.

The initial proposal of the Directive gave rise to vehement criticism from many industry participants and led to lengthy discussions between the EU Commission, the EU Council of Ministers and the EU Parliament before these bodies were able to reach a compromise. The Directive was finally approved by the EU Parliament on 11 November 2010 after nearly one and a half years of intense negotiations.

Although many provisions of the Directive still require Level 2 clarification, it is already clear that more stringent rules will apply with respect to, *inter alia*, capital requirements, specific operational procedures and

remuneration rules. The Directive also provides for the appointment of additional service providers (e.g. depositary bank). In exchange for increased regulatory oversight, the Directive introduces a European passport for AIFM to market AIF to professional investors, ultimately aiming at the replacement of currently existing private placement rules.

Going forward, promoters or initiators of AIF will have to identify the jurisdiction(s) that will allow them to accommodate their business model in the most efficient way.

This publication provides a comprehensive overview of the key implications of the Directive for actors in the European alternative investment management industry.

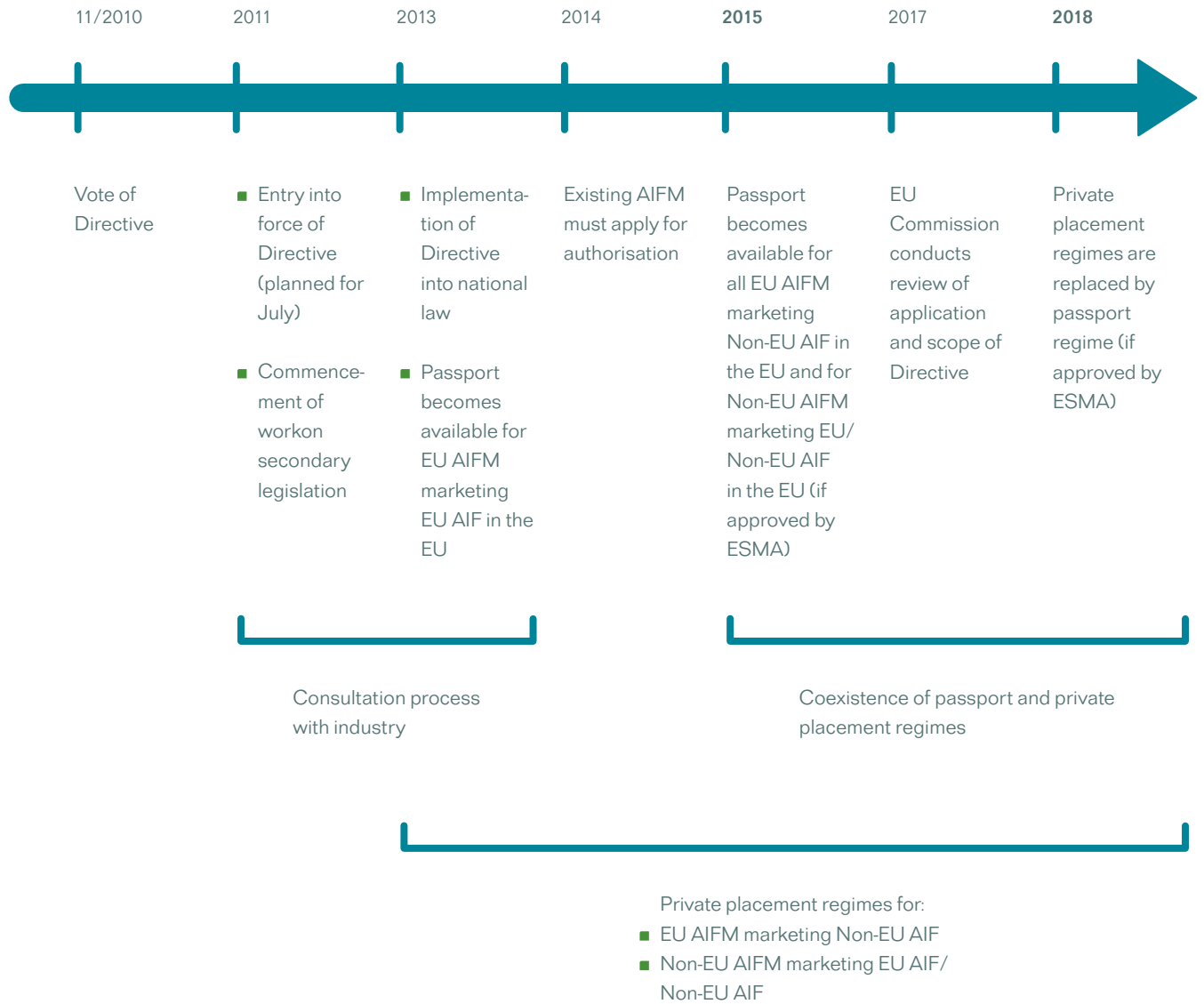
Terms in capital letters have the meaning ascribed to them in the section “Definitions” at the end of the brochure.

Why?

- Political will for more stringent regulation of activities in the alternative investment sector and closer oversight of systemic risks.
- Creation of harmonised rules for management and marketing of AIF in Europe.
- Enhanced transparency for investors and more stringent operational rules.
- Nearly 100 Level 2 provisions expected: need for further clarification.

when ... will the directive apply?

Implementation timeline



who ... will be subject to the directive?

All-inclusive scope

The Directive applies to:

- EU AIFM managing one or more EU AIF/ Non-EU AIF.
- Non-EU AIFM managing one or more EU AIF.
- Non-EU AIFM marketing EU AIF/Non-EU AIF in the EU.

The only scenario which does not fall within the scope of the Directive is the situation of a Non-EU AIFM managing and/or marketing a Non-EU AIF outside the EU given the absence of any relationship with the EU.

The Directive takes a “one-size fits all” approach by encompassing AIFM of all AIF

which are not covered by the UCITS Directive. UCIs governed by Part II of the 2010 Law, SIF governed by the 2007 Law or SICAR governed by the 2004 Law are therefore in principle subject of the Directive. The Directive may also impact non-regulated investment vehicles if they meet the AIF definition.

Whereas the Directive directly regulates AIFM, it indirectly also applies to EU and Non-EU AIF and some of their service providers. In this context, one should keep in mind that the Directive defines an AIF as “*an entity raising capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of such investors*”.

Smaller AIF exempted

Exemptions from the Directive have been expressly provided for AIFM managing “smaller” AIF, that is:

- AIFM managing AIF which are not leveraged and without redemption rights for a period of 5 years, and with aggregate assets under management below € 500 million.
- AIFM managing AIF whose assets under management, including any assets acquired through the use of leverage, do not exceed € 100 million.

Such exempted AIFM will nevertheless be subject to registration requirements with the competent authorities of their Home Member State, which may also apply stricter rules in respect of AIFM falling under one of the above exemptions. Exempted AIFM can also decide to opt for the application of the Directive and thereby benefit from the passport.

Some actors excluded

Certain actors are expressly excluded from the scope of the Directive: holding companies, captive funds, management of pension funds, employee participation or savings schemes, supranational institutions, national central

banks, securitisation special purpose entities as well as national, regional and local governments and bodies. In addition, the Directive does not apply to family office type arrangements, provided they do not raise external capital.

Grand-fathering

The Directive foresees the following two grand-fathering provisions for closed-ended AIF:

- AIFM managing existing closed-ended AIF which do not make additional investments after the final transposition date (*i.e.* July 2013), may continue to manage such AIF without authorisation under the Directive.

- AIFM managing closed-ended AIF whose subscription period for investors closed prior to the entry into force of the Directive and whose term expires at the latest in 2016, may continue to manage such AIF without authorisation under the Directive but must publish an annual report and, when applicable, comply with the disclosure requirements on acquisitions of portfolio companies.

Determination of AIFM

The Directive regulates AIFM. Under certain circumstances however, an AIF may be treated as self-managed and hence be treated as an AIFM. This is the case of internally managed AIF, *i.e.* AIF whose legal form permits internal management, such as the public limited liability company (*société anonyme*) which is

managed by a board of directors or the corporate partnership limited by shares (*société en commandite par actions*) which is managed by its managing general partner. If an internally managed AIF decides not to appoint an AIFM, then the AIF itself becomes subject to the Directive.

Interaction with other EU rules

There is some interaction between the Directive and other EU directives and regulations applicable to investment funds or their managers, as a result of which, for instance:

- Management companies authorised under the UCITS Directive may apply for authorisation as AIFM under the Directive (and *vice versa*) in order to manage both UCITS and AIF.
- MiFID compliant investment firms and credit institutions authorised under Directive 2006/48/EC are not required to obtain authorisation under the Directive in order to provide investment services to AIF or AIFM. However, such investment firms can only market shares or units of AIF in the EU if the relevant shares or units are marketable in accordance with the Directive.

Who?

- One size fits all approach.
- Directive directly applies to EU and Non-EU AIFM marketing EU AIF/Non-EU AIF in the EU.
- Directive indirectly applies to EU/Non-EU AIF.
- Small AIF are exempt.
- Certain actors are excluded.
- Grand-fathering provisions for closed-ended funds.
- Directive applies to self-managed AIF (considered as AIFM) and to AIF appointing an AIFM.

what ... does the directive regulate?

The Directive is a framework piece of legislation, establishing the core values and guide-lines for its implementation. This section summarizes the principal requirements defined at Level 1, which will need to be supplemented with more detailed rules

(*i.e.* delegated acts or implementing acts, as well as regulatory and/or implementing technical standards are expected to be adopted for almost all requirements of the Directive) to be adopted at Level 2 by the EU Commission with the assistance of ESMA.

Authorisation of AIFM

The AIFM licence requirements are substantially similar to those which apply to the authorisation of UCITS management companies. Furthermore, UCITS management companies may also apply for an AIFM license.

More specifically, the Directive expressly provides that management companies which are authorised under the UCITS regime should not be required, when applying for authorisation as AIFM, to provide information or documents already provided when applying for authorisation under the UCITS regime, provided that such information or documents are still up to date. Where Luxembourg is the Home Member State of the AIFM or the Member State of reference for a Non-EU AIFM, authorisation as AIFM is to be sought from the CSSF. The head office and registered office of the AIFM shall be located in the same Member State.

Authorisation is to be sought (i) by the AIF itself, if it is self-managed (and thus qualifies as an AIFM), in which case it will only be authorised to perform internal management functions for that AIF, or (ii) by the externally appointed AIFM which may also provide management functions to UCITS and certain other services listed below.

Authorised AIFM will be allowed to perform the following internal management functions:

- Investment management functions which comprise at least:
 - Portfolio management (only if risk management is provided).
 - Risk management (only if portfolio management is provided).

- Other functions which may additionally be provided (only if the investment management functions are provided):
 - Administration (*i.e.* legal and accounting services; customer inquiries; valuation and pricing including tax returns; maintenance of unit-/shareholders register; distribution of income; unit/share issues and redemptions; contract settlements; record keeping).
 - Marketing.
 - Activities related to the assets of the AIF.

Member States may authorise AIFM (other than self-managed AIF) to provide the following services (only if the portfolio management and the risk management functions are provided):

- Management of portfolios of investments, including those owned by pension funds and institutions for the provision of occupational retirement in accordance with mandates given by investors on a discretionary, client-by-client basis.
- Non-core services (*i.e.* investment advice; safe-keeping and administration in relation to shares/units of UCI; reception and transmission of orders in relation to one or more financial instruments) (only if the management of portfolios of investments are provided).

MiFID provisions concerning the initial capital endowment and organisational requirements apply to the above services of management of portfolios of investments and non-core services.

The authorisation as an AIFM will be valid in all Member States provided however that the conditions of the Directive are complied with on a continuous basis.

Application requirements for authorisation as AIFM

- Information on the persons effectively conducting the business of the AIFM:
Such persons who effectively conduct the business of an AIFM shall be of sufficient good repute and sufficiently experienced in relation to the investment strategies pursued by the AIF they manage.
- Information on the identities of the AIFM shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings and information on the amounts of those holdings.
The shareholders of the AIFM must be suitable.
- A programme of activity setting out the organisational structure of the AIFM including information on how the AIFM intends to comply with the authorisation requirements, the operating conditions, the transparency requirements, and where applicable, the requirements applying to leveraged AIF, to AIF acquiring control of non-listed companies and issuers, passport conditions, third countries rules and conditions for marketing to retail investors.
- Information on the remuneration policies and practices.
- Information on arrangements made for the delegation and sub-delegation of functions to third parties.
- Information about the investment strategies.
- Information on where the master AIF is established if the AIF is a feeder AIF.
- The fund rules or incorporation documents of each AIF the AIFM intends to manage.
- Information on arrangements made for the appointment of the depositary.
- Any additional information concerning disclosure to investors for each AIF the AIFM manages or intends to manage.

In addition, the AIFM will have to demonstrate to the CSSF that it has sufficient capital and own funds.

Internally managed AIF will have to maintain an initial capital of €300,000 while externally appointed AIFM will have to maintain an initial capital of €25,000.

AIFM will have to maintain appropriate own funds (in liquid assets only) to cover potential liability risks, arising from professional negligence, or appropriate professional indemnity insurance.

Furthermore, externally appointed AIFM will have to maintain own funds equal to the higher of

- one quarter of the AIFM overhead costs; and
- 0,02% of the AIF portfolio values in excess of €250 millions (capped at €10 millions which can be reduced by 50% if such amount is covered by a bank/insurers' guarantee).

No similar requirements are imposed on internally managed AIF other than the obligation to maintain funds to cover potential liability for professional negligence, which applies to externally appointed AIF as well.

Operating conditions

While the Directive might have onerous practical implications on certain AIFM and to a certain extent the AIF they manage, many

principles enshrined in the Directive are not new and are generally UCITS or MiFID inspired.

General principles

The Directive contains several principle-based rules on general operating conditions. In summary, the general operating principles that apply to AIFM are similar to the rules of conduct laid down in the UCITS Directive for self-managed SICAVs and/or their designated management companies. For example, the Directive requires that an AIFM will act honestly, with due skill, care and diligence and in the best interests of the AIF or its investors and the integrity of the market.

In addition, the Directive requires that AIFM shall treat all investors fairly. Preferential

arrangements may still be possible as long as this is disclosed to all investors through the AIF's rules or incorporation documents. This might impact the way side-letter arrangements are currently drafted. In particular, investors must be informed on how the AIFM ensures the fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment as well as, where relevant, their legal or economic links with the AIF or AIFM, will have to be provided.

Conflicts of interest

The general requirement to identify and manage conflicts of interest that arise in the course of managing AIF is not a new concept. However, the Directive imposes specifically that: (i) conflicts of interest notably between the AIFM and its managers and employees and the AIF managed by the AIFM (or, for example between the investors of the AIF and another client of the AIFM) are identified, (ii) organisational and administrative

arrangements designed to identify, prevent, manage and monitor conflicts of interest be put in place, and (iii) where the above mentioned arrangements are not sufficient to ensure that risks of damage to investors' interests will be prevented, the AIFM shall clearly disclose the general nature or sources of conflicts of interest to the investors before undertaking business on their behalf, and develop appropriate policies and procedures.

Remuneration

In order to address the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk, and control of risktaking behaviour by individuals, AIFM must establish and maintain remuneration policies and practices in line with the Directive for those categories of staff whose professional activities have a material impact on the risk profiles of the AIF they manage (*i.e.* at least senior management, risk takers, control functions and employees receiving a global remuneration that puts them in the same remuneration bracket as senior management and risk takers). In particular, AIFM will need to include aggregate information on remuneration (split into fixed and variable and, where

relevant, amounts paid by the AIF) in the annual report (as part of the transparency requirements of the AIFMD). The Directive allows AIFM to apply the relevant provisions of the Directive in different ways according to their size and the size of the AIF they manage, their internal organisation and the nature, scope and complexity of their activities.

The principles laid out in the Directive are consistent with the principles governing sound remuneration policies set out in the Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector, which will serve as a basis for ESMA when implementing guidelines on sound remuneration

policies to comply with the principles set out in Annex II to the Directive, which lists the specific remuneration requirements.

It is worth mentioning in this context that the CSSF has already implemented the above

Commission Recommendation via CSSF Circular 10/437 regarding guidelines concerning remuneration policies in the financial sector, which applies namely to managers of collective investment schemes.

Risk management

AIFM are required to functionally and hierarchically separate the functions of risk management from the operating units, including the portfolio management.

There is a general requirement to implement adequate risk management systems which shall be reviewed and adapted as needed and at least annually. The following minimum requirements will thus apply:

- Conducting due diligence when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF.

- Ensuring that the risk associated to each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured and monitored on an ongoing basis including through the use of appropriate stress testing procedures.
- Ensuring that the risk profile of the AIF is consistent with the size, portfolio structure and investment strategies and objectives of the AIF, as laid down in the AIF rules or incorporation documents, prospectus and offering documents.

Leverage

AIFM will be required to set a maximum level of leverage and a limit on the re-use of collateral or guarantees that could be granted under a leveraging arrangement taking into account, *i.a.*, the type of AIF, their strategy, the sources

of their leverage, the relationship with financial services institutions that could pose systemic risk, counterparty exposure, and the extent to which the leverage is collateralised.

Liquidity management

Except for AIFM of unleveraged closed-ended funds, AIFM are required for each AIF they manage, to apply appropriate liquidity management systems and procedures, including regularly conducting stress tests under

normal and exceptional conditions. In addition, AIFM shall ensure that for each AIF they manage, the investment strategy, the liquidity profile and the redemption policy are consistent.

Operating conditions

- Principle-based rules of conduct.
- Identification and management of conflicts of interests.
- Remuneration policies and practices consistent with sound and effective risk management.
- Adequate liquidity and risk management systems.

Valuation

Applicable rules to valuation of assets and NAV calculation

The Directive requires that AIFM establish appropriate and consistent procedures in respect of each AIF they manage to ensure that a “proper and independent” valuation of the AIF’s assets can be performed in accordance with applicable national rules (*i.e.* rules laid down in the law of the country where the AIF has its registered

office), and/or with such AIF’s rules (*i.e.* rules laid down in the AIF documentation).

Calculation of the NAV per share or unit of the AIF and disclosure of such NAV to the investors shall also follow such rules along with the rules set forth in the Directive.

Frequency

Valuation of the assets and calculation of the NAV per share or unit shall be performed at least once per year.

to the frequency of the issuance/redemption of shares or units.

For open-ended AIF, such valuation and calculation shall be carried out at a frequency which corresponds to the type of assets and

For closed-ended AIF, such valuation and calculation shall be carried out in case of increase or decrease of capital.

Who can perform valuation functions?

Valuation may be performed by either:

- An independent (and suitably qualified) external valuer; the AIFM must notify its competent authority of the valuer’s appointment; or

- The AIFM itself, but the competent authority of the Home Member State of the AIFM may require such AIFM to have its valuation, procedures and/or valuations verified by an external valuer or an independent auditor.

An externally appointed valuer cannot delegate the valuation function to a third party.

Independence of the valuation function

- The AIF’s depositary cannot be appointed as its external valuer unless it has functionally and hierarchically segregated its depositary function from its valuation function.

- When performing the valuation functions itself, the AIFM must ensure that the valuation task is functionally independent from portfolio management and from the remuneration policy.

Appropriate measures must be taken to mitigate conflicts of interest.

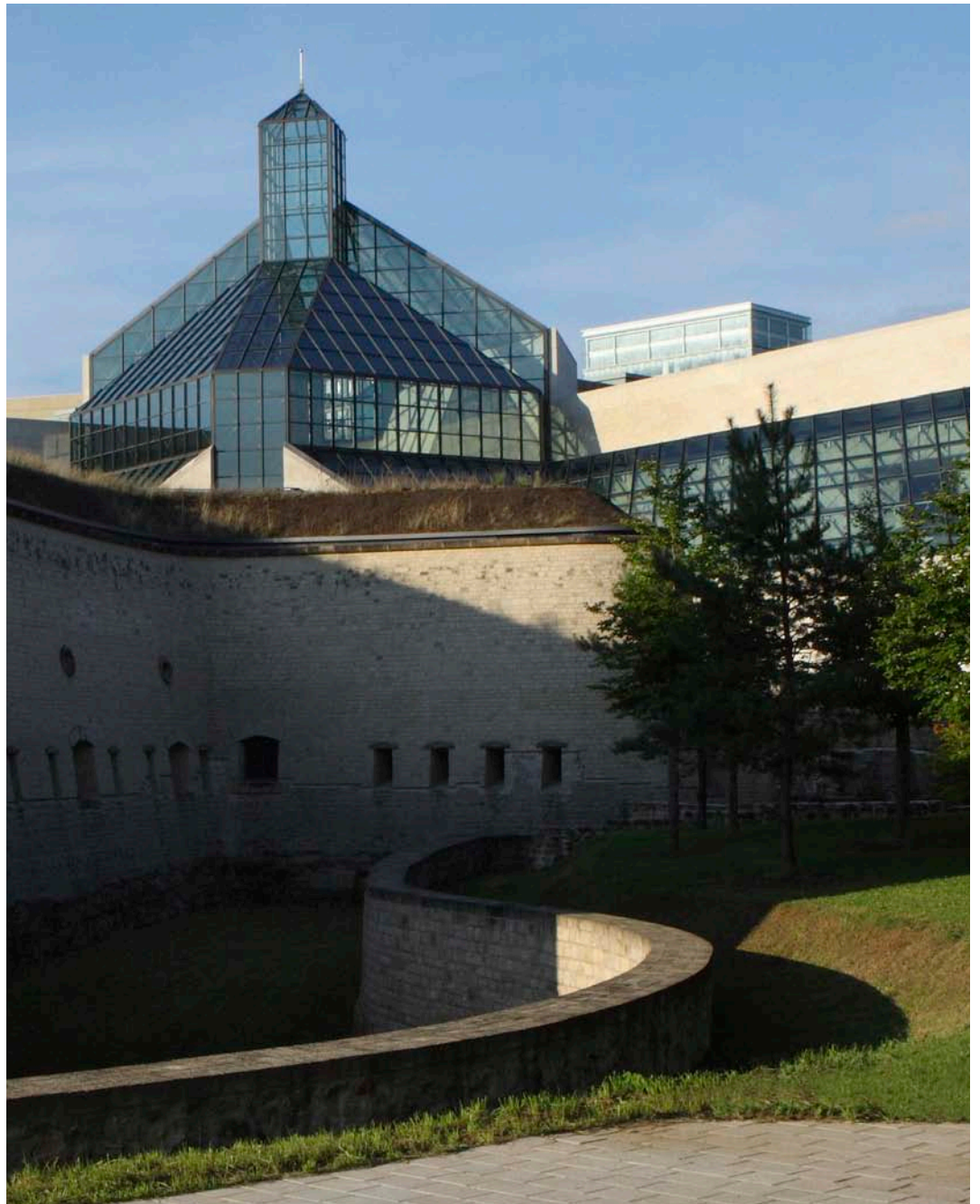
Liability

The AIFM is ultimately liable for the valuation of the AIF’s assets and for the calculation and publication of the AIF’s NAV and is, therefore, liable to the AIF and its investors. However,

where an external valuer is used, the valuer is liable to the AIFM for losses suffered as a result of the valuer’s negligence or intentional failure to perform its tasks.

Valuation

- Proper and independent valuation.
- At least once a year (valuation frequency depends on type of assets).
- Independent external valuation or by the AIFM (subject to conditions).
- AIFM is liable for valuation.



Delegation of AIFM functions

AIFM may, subject to strict limitations and requirements, delegate part (but not all) of their management functions to third parties so as to increase the efficiency of their business. Subject to the same limitations and requirements, including the approval of the AIFM, sub-delegation may be allowed. Here again, the rules provided by the Directive in this regard are to a large extent carried over from the UCITS Directive.

AIFM will have to be able to justify the entire delegation structure with objective reasons to the competent authorities of their Home Member State, and to demonstrate that the delegatee is qualified and capable of undertaking the delegated functions.

No delegation or sub-delegation of portfolio management or risk management may be made to the depositary or a delegatee of the depositary, nor to any other entity which may give rise to potential conflicts of interest, unless a functional and hierarchical segregation from other potentially conflicting tasks is ensured and the latter are properly identified, managed, monitored and disclosed to the investors of the AIF.

The rules regarding the delegation of portfolio and risk management functions are similar to

the rules applicable to existing business models of UCITS outsourcing the portfolio management function. For example, where the delegation concerns the portfolio management or the risk management, the delegatee must be authorised or registered for the purpose of asset management and subject to prudential supervision in its home country. In addition, if the delegatee is located in a Non-EU jurisdiction, a cooperation agreement must be in place between the EU competent authorities and the competent authorities of the Non-EU jurisdiction. This means that a Luxembourg AIFM will be able to delegate portfolio and risk management functions to an investment manager who does not qualify as an AIFM¹.

AIFM shall at all times remain responsible for the proper performance of their functions and compliance with the rules set out in the Directive. Their liability towards the AIF and its investors may in no case be affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation. AIFM will thus have to closely monitor at any time any delegatee's activities, to give at any time further instructions to the delegatee and to withdraw the delegation with immediate effect when this is in the interest of the AIF investors.

Delegation

- Part of the management functions may be delegated.
- Sub-delegation is possible.
- Delegation rules similar to UCITS provisions.
- AIFM remains liable in case of delegation.

¹ The delegation of portfolio and risk management functions must not be confused with the designation by an internally managed AIF of an external AIFM. Please refer to the section entitled "Who?" under "Determination of AIFM".

Depositary

Single depositary rule

The Directive introduces the appointment of a single depositary for each AIF managed by an AIFM.

Who may not act as depositary?

The Directive stresses the need to separate the safekeeping functions from the management functions and to segregate the investor's assets from those of the AIFM. For this reason, an AIFM is not allowed to act as depositary.

Who may act as depositary?

The depositary of an EU AIF shall either be (i) a credit institution or (ii) a MiFID investment firm which also provides ancillary services of safekeeping and administration of financial instruments (which satisfies minimum capital adequacy requirements), or (iii) other categories of institutions subject to prudential regulation and ongoing supervision and which are eligible to act as a depositary under the UCITS Directive). The depositary of an EU AIF must have its registered office or a branch in the same country as the AIF. However, the competent authorities of the Home Member State of the AIF or the AIFM may, during a period of four years from the implementation of the Directive (*i.e.* until 2017), allow that the depositary (which must be an EU credit institution) be established in another Member State.

The depositary of a Non-EU AIF can also be a credit institution or any other entity (of the same nature as the entities under (i) and (ii) above for an EU AIF) which is subject to effective prudential regulation and supervision of the same effect as the provisions laid down in EU law and which are effectively enforced. The depositary of a Non-EU AIF must be established (i) in the third country where the

AIF is established (provided certain conditions are complied with) or (ii) in the Home Member State of the AIFM managing the AIF or (iii) in the Member State of reference of the Non-EU AIFM managing the AIF.

Member States may in addition allow that for certain AIF which (i) have no redemption rights exercisable during a period of five years from the date of the initial investments; and (ii), in accordance with their core investment policy, generally do not invest in assets that must be held in custody or generally invest in issuers or non-listed companies in order to potentially acquire control over such companies, such as private equity funds, venture capital funds and real estate funds, the depositary may be an entity which carries out depositary functions as part of its professional or business activities. Such entity must be subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct, furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depositary functions, and meet the commitments inherent to those functions (such as notaries, lawyers or registrars).

Prime brokers

A prime broker may be appointed as a depositary if *i.a.* it has functionally and hierarchically separated its tasks as prime broker from its

depositary functions, and potential conflicts of interest are properly identified, managed and disclosed to the investors of the AIF.

Core duties of the depositary

Most of the requirements of the Directive are UCITS inspired and therefore familiar to a number of initiators and promoters of regulated investment funds. However, some of the core functions have been adapted and/or clarified by the Directive.

- **Monitoring of cash flow:** The depositary shall be responsible for the proper monitoring of the AIF's cash flows and for ensuring that investor money and cash belonging to the AIF is booked correctly on accounts opened in the name of the AIF, the AIFM acting on behalf of the AIF, or the depositary acting on behalf of the AIFM.
- **Safekeeping of assets:** The Directive clarifies the concept of safekeeping. The depositary is responsible for the safekeeping of assets of the AIF, including (i) the holding in custody of all financial instruments that can be registered in a financial instruments account opened in the depositary's books and that can be physically delivered to the depositary and registered in its books within segregated accounts, and (ii) the verification of ownership of all other assets of the AIF (which cannot be held in custody) for which the depositary shall maintain up-to-dates records.

- **Oversight duties:** In addition to the above tasks, the depositary must perform oversight duties which are similar to those performed by UCITS depositaries, except that they all apply irrespective of the corporate or contractual form of the AIF. The depositary must (i) ensure that the sale, issue, repurchase, redemption and cancellation of shares or units of the AIF are carried out in accordance with applicable national law and the AIF rules or incorporation documents, (ii) ensure that the value of the shares or units of the AIF is calculated in accordance with the applicable law of the AIF and its rules or incorporation documents, (iii) carry out the instructions of the AIFM, unless they conflict with applicable national law or the AIF rules or incorporation documents, and (iv) ensure that, in transactions involving the AIF's assets, any consideration is remitted to the AIF within the usual time limits. Depositary agreements of existing SIF and SICAR falling within the scope of the Directive will have to be reviewed as the 2007 Law and 2004 Law currently do not foresee such additional oversight duties. Existing corporate UCIs subject to Part II of the 2010 Law will also need to amend their depositary agreements in order to add the oversight functions mentioned under (iii) and (iv).

Delegation

The depositary may only delegate the safekeeping duty as defined above to a third party which in turn and under the same conditions, may sub-delegate this function. Delegation of the safekeeping functions is strictly circumscribed by the Directive. Both delegation and sub-delegation must be objectively justified and are subject to stringent requirements in relation to the suitability of the third party entrusted with this function as well as to the due skill, care and diligence that the depositary must employ to select, appoint and review the third party to whom the depositary wants to delegate part of its functions.

However, where the law of a third country requires that certain financial instruments are held in custody by a local entity that does not satisfy the delegation requirements, the Directive exceptionally authorises the depositary to delegate its safekeeping functions to such local entity provided certain conditions are met and notably that the investors of the relevant AIF have been duly informed of this delegation and that the AIF or the AIFM on behalf of the AIF instructed the depositary to appoint such local entity.

Liability of the depositary

The Directive considers that the depositary should be liable for the losses incurred in the performance of its obligations, suffered by the AIFM, the AIF and its investors. It distinguishes between the loss of financial instruments held in custody (“strict liability”), and any other losses (“liability for fault”):

- In the case where the depositary holds the assets in custody and those assets are lost, the depositary has an obligation to return a financial instrument of the identical type or the corresponding amount to the AIF or, as the case may be, the AIFM acting on behalf of the AIF, without undue delay, unless it can prove that the loss arose as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.
- For any other losses, the depositary shall be liable to the AIF or the investors of the AIF, as the case may be, as a result of its negligent or intentional failure to properly perform its obligations.

The depositary’s liability shall not be affected by any delegation to a third party. Where the financial instruments held in custody by such third party are lost, the depositary would therefore remain liable. However, provided that the depositary can show that the delegation was made in accordance with the Directive and where (i) a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF expressly allows such a discharge, and (ii) a written contract with the third party delegate expressly transfers such liability and permits the AIF or the AIFM to make a claim directly against the delegatee, the depositary can discharge itself in such case of its liability.

Depositary

- Single depositary per AIF.
- In principle, AIFM may not act as depositary.
- Only limited eligible entities may act as depositary.
- Core functions:
 - Monitoring of cash flow.
 - Safekeeping of assets.
 - Oversight duties.
- Delegation possible, but strictly circumscribed.
- Two-pronged liability regime:
 - Strict liability.
 - Liability for fault.

Transparency

The Directive ensures increased transparency in 3 different ways:

- The AIFM must prepare an annual report for each of the AIF it manages or markets in the EU. This report must be completed within 6 months following the end of the financial year of the relevant AIF.
- Disclosure to investors: some information must be disclosed to investors before they invest in the AIF. The content thereof must include, inter alia, the investment strategy of the AIF, a description of the delegation of management functions as applicable, the valuation procedure and the percentage of assets held in a “side pocket”.
- Disclosure to the regulator: AIFM must report, for each AIF, inter alia, the markets in which they trade, any potential “side pockets”, the risk profile of the AIF, the risk management systems in place, the level of leverage and the liquidity management tools.

Leveraged AIF

AIFM are required to set a leverage ratio for each AIF they manage and this ratio must be complied with at all times. AIFM that use leverage for investment purposes are subject to additional disclosure requirements. Indeed, AIFM shall periodically disclose to their investors the amount of leverage used for each AIF they manage as well as any changes to the maximum level of leverage which may be used on behalf of each AIF.

Disclosure on leverage must also be made to the regulator which shall be informed about the leverage conditions of each AIF, including the overall amount of leverage used by each AIF and its five principal lenders of cash/securities (with the corresponding amounts). The regulator has a controlling power over these leverage limits and may request such ratio to be adjusted if it considers it as unreasonable or likely to contribute to the risk of creating market disorder.

Portfolio company disclosures

The Directive imposes reporting obligations when an AIF acquires, individually or jointly, a substantial stake in a non-listed company (other than a SME). The acquisition thresholds are set at 10%, 20%, 30%, 50% and 75% of the voting rights of the portfolio company. In other words, if an AIF reaches any of these thresholds when acquiring a non-listed company, the AIFM shall, as soon as possible, notify such information to the portfolio company itself, its shareholders as well as the competent regulator. Similar disclosure shall be made to the representative(s) of the employees of the portfolio company.

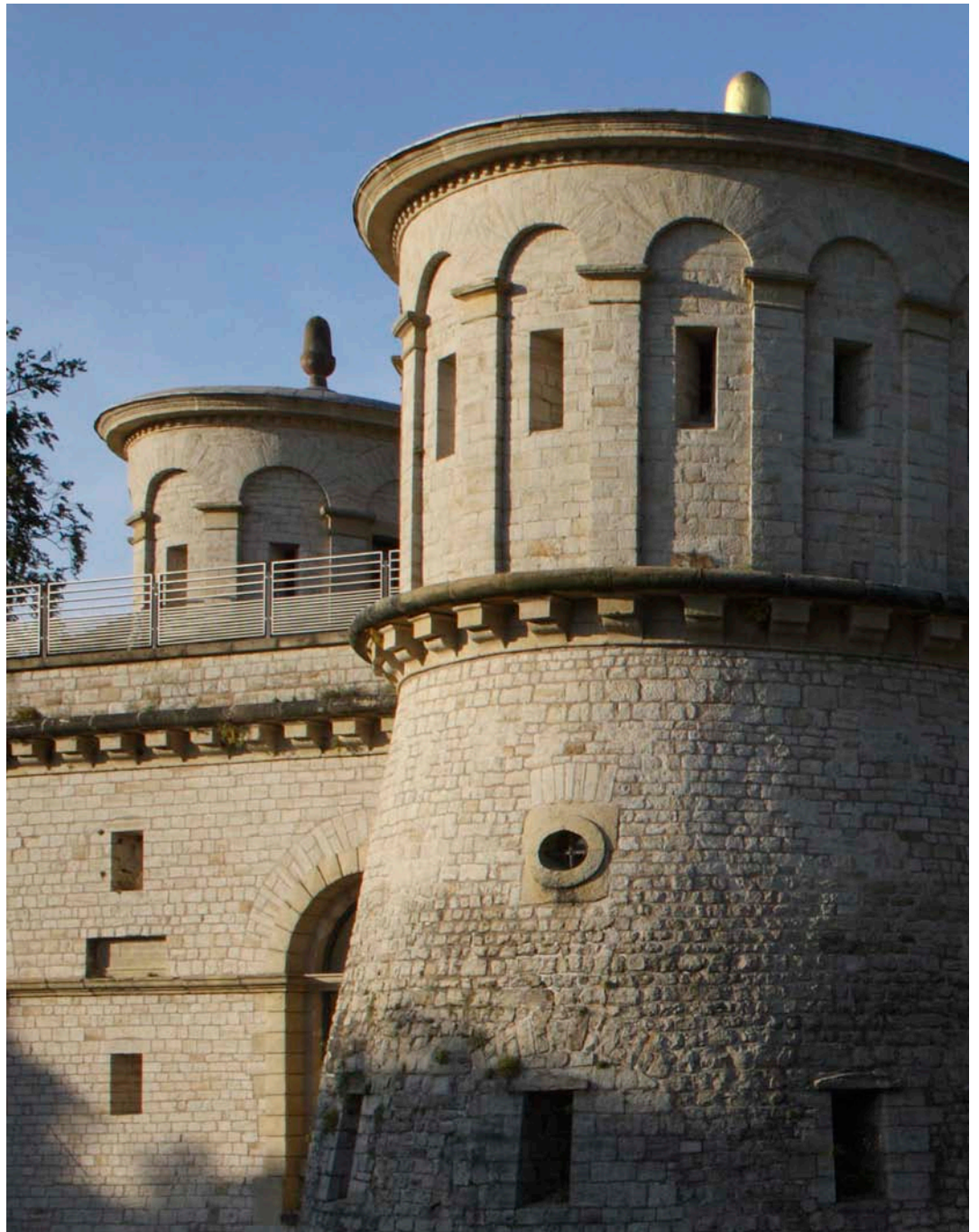
Similar notification obligations are imposed on AIFM when the relevant AIF acquires, individually or jointly, control of a non-listed company (“control” being understood as the holding of more than 50% of the voting rights of the non-listed company). In such case, the information to be disclosed must contain the identity of the AIFM which manages the AIF

acquiring control, the policy set-up with respect to preventing and managing conflicts of interest and the policy with respect to communications to employees. In addition, the AIFM shall disclose its intentions with respect to the future business of the portfolio company as well as any implications this may have on employment. Again, the notification must be made as soon as possible to the portfolio company itself, its shareholders, the representative of its employees as well as to the competent regulator (the latter, along with the investors of the AIF, shall also receive information on the financing of the acquisition).

Finally, “asset stripping” is limited by the provisions of the Directive which impose on the AIFM to use its best efforts to prevent redemptions, capital reductions and certain distributions during a period of 2 years following the acquisition of control of the portfolio company.

Transparency

- Enhanced transparency through annual reports, disclosure to investors and regulators.
- Additional disclosure requirements for leveraged AIF.
- Specific reporting obligations applicable to portfolio companies.



Marketing

Marketing is to be understood as any direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of AIF it manages, to or with investors domiciled in the EU. Investments made at the initiative of professional investors are therefore not covered by the Directive. They may thus continue to invest at their own initiative in AIF subject to compliance with domestic private placement rules. Retail investors are also not covered by the Directive. In this regard, Member States may at their discretion allow AIFM to market AIF they manage to retail investors on their territory, irrespective of whether AIF are marketed on a domestic or cross-border basis or whether they are EU or Non-EU AIF.

The marketing provisions of the Directive do not apply to the marketing of shares or units of AIF which are subject to a current offer to the public under a prospectus drawn up and published according to the Prospectus Directive before 2013 as long as this prospectus is valid.

The different scenarios below explain the functioning of the passport regime introduced by the Directive and the private placement rules which will continue to apply or coexist during a certain period, as well as the timing in relation thereto. The dates indicated are however indicative and will depend on the progress of the Level 2 implementation process.

Scenario 1: Passport for EU AIFM marketing EU AIF in the EU as from mid-2013

EU AIFM will benefit from a passport to market EU AIF to professional investors in the EU immediately upon transposition of the Directive into national law *i.e.*, in principle, no later than mid-2013. Such marketing across the EU will be subject to a straightforward notification procedure, which will be further

specified through technical standards developed by ESMA at Level 2.

EU AIFM will therefore no longer be able to market EU AIF to professional investors in the EU via private placement regimes.

Scenario 2: EU AIFM marketing Non-EU AIF in the EU

Passport regime as from 2015

The Directive intends to make the passport regime available to EU AIFM marketing Non-EU AIF to professional investors in the EU in 2015, *i.e.* after a period of 2 years as from the latest date of transposition of the Directive into national law. EU AIFM willing to market a Non-EU AIF in the EU via the passport will have to comply with the Directive and a notification procedure. In addition, appropriate cooperation agreements for efficient exchange of information, including in tax matters, will need to exist between the EU and Non-EU competent authorities and between the Non-EU AIF home jurisdiction and the Member State of the AIFM. Also, the Non-EU country of the Non-EU AIF must not figure on the FATF blacklist.

marketed under the national private placement regimes (on a country-by-country basis), as the passport shall become available as from 2015 only. During a transitional period of 3 years (*i.e.* from 2015-2018), the passport regime will coexist with the private placement regime. Thereafter, the private placement regimes shall be replaced by the passport regime.

Private placement regime between 2013 and 2018

Between 2013 and 2015, Non-EU AIF which are managed by EU AIFM may continue to be

EU AIFM willing to market a Non-EU AIF in the EU under private placement rules must comply with the Directive save for the provisions on depositaries. However, in this respect, one or more entity(ies) must be appointed to perform some of the depository functions and the identity of such entity(ies) must be communicated to the supervisory authority of the AIFM. Furthermore, a cooperation agreement for the purpose of systemic risk oversight must exist between the relevant EU and Non-EU competent authorities. Finally, the Non-EU country must not figure on the FATF blacklist.

**Scenario 3:
Non-EU AIFM marketing
AIF in the EU**

**Authorisation requirements and passport
regime for marketing EU AIF/Non-EU AIF
in the EU as from 2015**

Non-EU AIFM intending to market EU or Non-EU AIF in the EU via the passport regime must be authorised under the Directive by their Member State of reference, which is determined in accordance with a certain number of criteria laid down in the Directive, such as e.g. the Home Member State of the AIF managed by the Non-EU AIFM, or the Member State where most of the AIF managed by the AIFM are established. The Non-EU AIFM will have to comply with the Directive, except if a provision of the Directive is incompatible with the law to which the Non-EU AIFM and/or the Non-EU AIF marketed in the EU is submitted. In this case, the Non-EU AIFM will however need to prove that i.a. the regulatory purpose of the local law the Non-EU AIFM and/or Non-EU AIF is subject to, offers the same level of protection.

A Non-EU AIFM will also have to appoint a legal representative in the Member State of reference (*i.e.* contact point of the Non-EU AIFM in the EU who will perform the compliance function in relation to management and marketing activities in the EU).

Non-EU AIFM intending to manage EU AIF without however marketing them in the EU shall also need to obtain an authorisation by the relevant Member State of reference.

The authorisation by the Member State of reference shall be subject to a number of additional conditions, such as the Non-EU country of the Non-EU AIFM not being listed on the FATF blacklist, appropriate cooperation agreements being in place between the competent authorities of the Member State of reference, the competent authorities of the EU AIF and of the Non-EU AIFM. Furthermore, cooperation arrangements for effective exchange of information in tax matters between the Non-EU country of the Non-EU AIFM with the Member State of reference must also be in place, and effective supervision must not be prevented by the national laws or regulations of the Non-EU AIFM.

The passport in these cases shall be available as from 2015, *i.e.* after a period of 2 years as from the date of transposition of the Directive into national law, subject to a notification procedure.

In case the Non-EU AIFM wishes to market Non-EU AIF in the EU via the passport regime, cooperation agreements must be in place between the competent authorities of the Member State of reference and the competent authorities of the Non-EU AIF, the country of the Non-EU AIF must not figure on the FATF blacklist and there must be cooperation arrangements for effective exchange of information in tax matters between the country of the Non-EU AIF, the Member State of reference and the Member States in which the Non-EU AIF shall be marketed.

**Private placement regime between
2013 and 2018**

Between 2013 and 2015, Non-EU AIFM may continue to market EU AIF or Non-EU AIF under the national private placement regimes (on a country-by-country basis). During a transitional period of 3 years (*i.e.* from 2015-2018), the private placement regime will coexist with the passport regime. Thereafter, it is intended to replace the private placement regime by the passport regime.

Non-EU AIFM willing to market an EU AIF or a Non-EU AIF in the EU under private placement rules must comply with the transparency requirements and the reporting obligations under the Directive, as well as, if applicable, with the requirements regarding AIFM managing AIF which acquire control of non-listed companies and issuers. Additionally, cooperation agreements for the purpose of systemic risk oversight must be agreed between the relevant EU and Non-EU competent authorities. The Non-EU country of the Non-EU AIFM/Non-EU AIF must not figure on the FATF blacklist.

Summary of marketing scenarios

Scenario 1



2013

Passport for marketing in the EU to professional investors

Scenario 2



2013 - 2015

Private placement in the EU

2015

Passport for marketing in the EU to professional investors

2015 - 2018

Private placement in the EU and passport will coexist

Scenario 3



2013 - 2015

Private placement in the EU

2015

Passport for marketing in the EU to professional investors

2015 - 2018

Private placement regime and passport will coexist

definitions

AIF	Alternative Investment Fund(s)
AIFM	Alternative Investment Fund Manager(s)
Commission Directive 2006/73/EC of 10 August 2006	Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive
CSSF	<i>Commission de Surveillance</i> du Secteur Financier Directive AIFM Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC
Directive 2006/48/EC	Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast)
ESMA	European Securities and Markets Authority
EU	European Union
EU AIFM	Means any AIFM which has its registered office in a Member State of the European Union
FATF	Financial Action Task Force
Home Member State of an AIF	Means (i) the Member State in which the AIF is authorised or registered under applicable national law, or in case of multiple authorisations or registrations, the Member State in which the AIF has been authorised or registered for the first time; or (ii) if the AIF is not authorised or registered in a Member State, the Member State in which the AIF has its registered office and/or head office
Home Member State of an AIFM	Means the Member State in which the AIFM has its registered office
Member State	Member State of the European Union
Member State of reference	Means the Member State of reference for a Non-EU AIFM
MiFID	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC
NAV	Net Asset Value

Non-EU AIFM	Means any AIFM which is not an EU AIFM
Parliament	European Parliament
Professional Investor	Means any investor which is considered to be a professional client or may be treated as a professional client on request within the meaning of MiFID
Prospectus Directive	Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC
SICAR	<i>Société d'investissement en capital à risque</i> (investment company in risk capital)
SIF	Specialised investment fund
SME	Small and medium sized enterprise
UCI	Undertaking for collective investment
UCITS	Means an undertaking for collective investment in transferable securities authorised in accordance with Article 5 of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
UCITS Directive	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) which shall repeal Directive 85/611/EEC, as amended, with effect from 1 July 2011
2002 Law	Law of 20 December 2002 on undertakings for collective investment, as amended
2004 Law	Law of 15 June 2004 on investment companies in risk capital (SICAR), as amended
2007 Law	Law of 13 February 2007 on specialised investment funds (SIF), as amended
2010 Law	Law of 17 December 2010 on undertakings for collective investment (UCI)

The Association of the Luxembourg Fund Industry (ALFI), the representative body for the Luxembourg investment fund community, was founded in 1988. Today it represents over a thousand Luxembourg-domiciled investment funds, asset management companies and a wide variety of service providers including depository banks, fund administrators, transfer agents, distributors, law firms, consultants, tax advisers, auditors and accountants, specialist IT providers and communications agencies.

Luxembourg is the largest fund domicile in Europe and its investment fund industry is a worldwide leader in cross-border fund distribution. Luxembourg-domiciled investment structures are distributed in more than 50 countries around the globe, with a particular focus on Europe, Asia, Latin America and the Middle East.

ALFI defines its mission as to **“Lead industry efforts to make Luxembourg the most attractive international centre”**.

Its main objectives are to:

- **Help members capitalise on industry trends**

ALFI's many technical committees and working groups constantly review and analyse developments worldwide, as well as legal and regulatory changes in Luxembourg, the EU and beyond, to identify threats and opportunities for the Luxembourg fund industry.

- **Shape regulation**

An up-to-date, innovative legal and fiscal environment is critical to defend and improve Luxembourg's competitive position as a centre for the domiciliation, administration and distribution of investment funds. Strong relationships with regulatory authorities, the government and the legislative body enable ALFI to make an effective contribution to decision-making through relevant input for changes to the regulatory framework, implementation of European directives and regulation of new products or services.

- **Foster dedication to professional standards, integrity and quality**

Investor trust is essential for success in collective investment services and ALFI thus does all it can to promote high professional standards, quality products and services, and integrity. Action in this area includes organising training at all levels, defining codes of conduct, transparency and good corporate governance, and supporting initiatives to combat money laundering.

- **Promote the Luxembourg investment fund industry**

ALFI actively promotes the Luxembourg investment fund industry, its products and its services. It represents the sector in financial and in economic missions organised by the Luxembourg government around the world and takes an active part in meetings of the global fund industry.

For more information, visit our website at www.alfi.lu





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