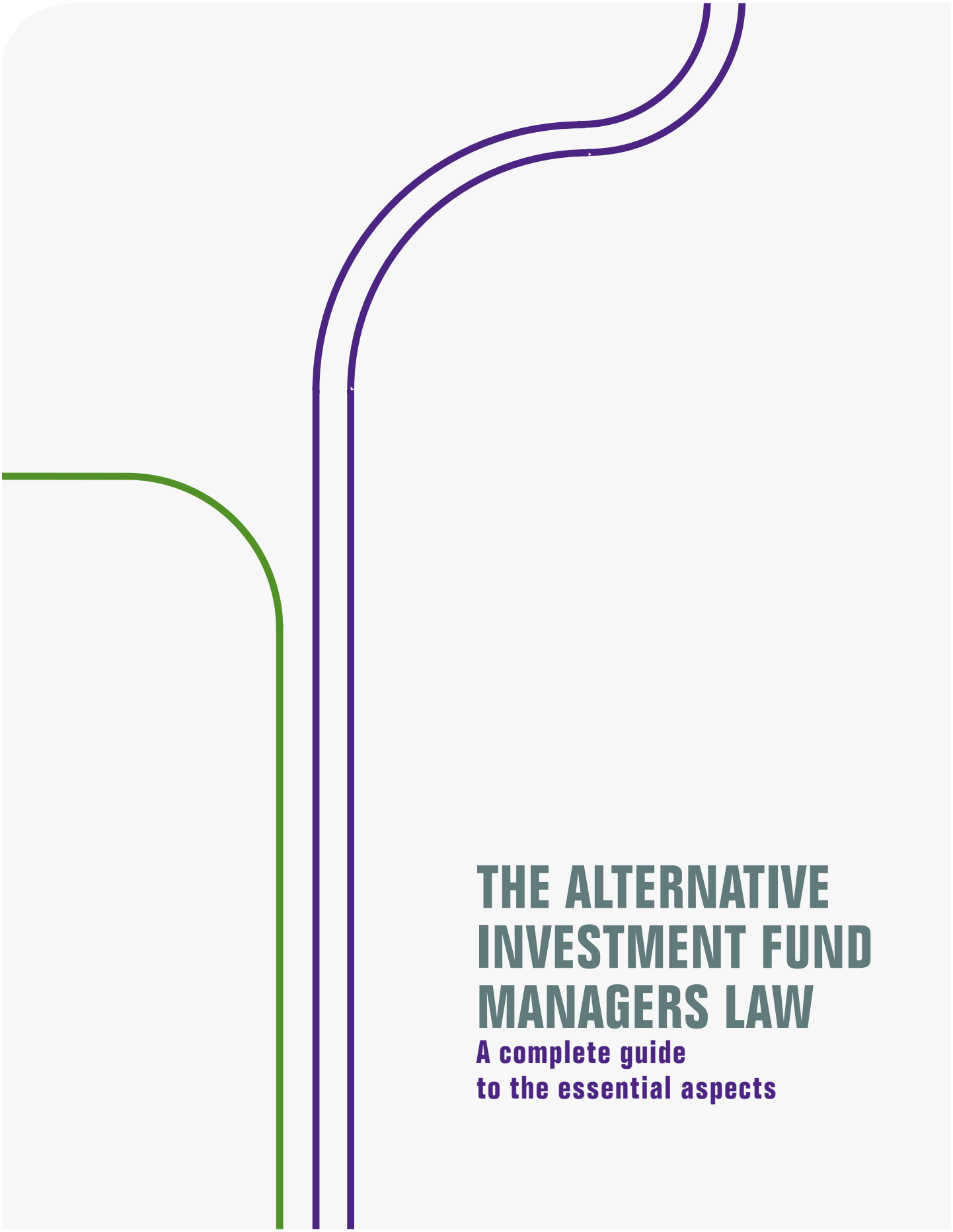
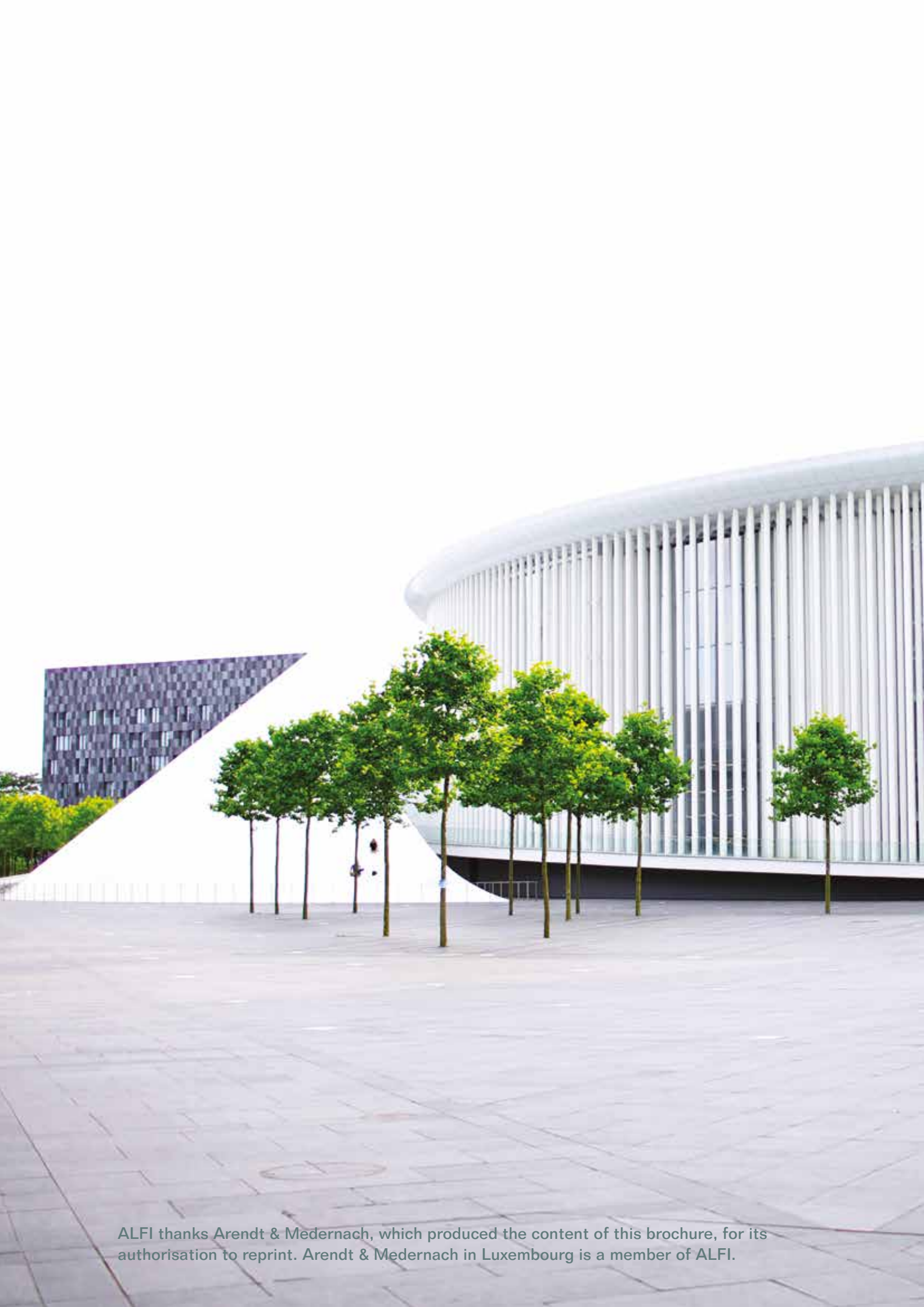
association of the
luxembourg fund industry



THE ALTERNATIVE INVESTMENT FUND MANAGERS LAW

A complete guide to the essential aspects



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why ... regulate Alternative Investment Fund Managers?

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

The AIFMD was finally approved by the EU Parliament on 11 November 2010 after 18 months of intense negotiations.

Luxembourg has fully implemented the AIFMD. With the introduction of the AIFM Law on 12 July 2013, this was an important step for the ongoing development of the alternative investment fund industry and continues Luxembourg's position as a global investment fund hub.

In exchange for increased regulatory oversight, a European passport for AIFMs has been introduced for the marketing of AIFs to professional investors within the EU, leading to the phasing out of existing private placement rules, within the EU Member States.

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

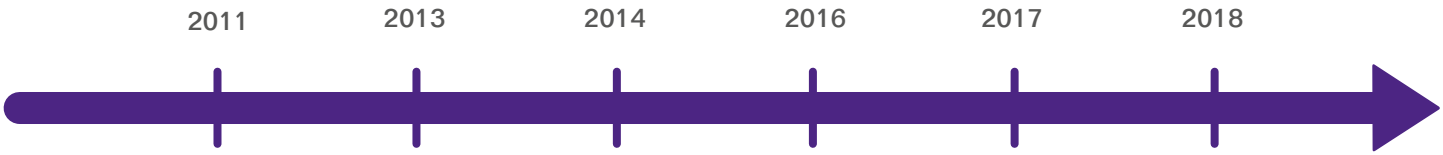
Terms in capital letters have the meaning ascribed to them in the section "Glossary of terms" at the end of the brochure.

Why?

- Regulation of the activities in the alternative investment fund sector and monitoring of systematic risks.
- Creation of harmonised rules for the management and marketing of AIFs within the EU.
- Enhanced transparency for investors.

when ... does the AIFM regime apply?

Timeline



- 2011
  - Entry into force of the AIFMD on 21 July 2011
- 2013
  - Commission, delegated regulation 231/2013
  - Passport becomes available for EU AIFMs marketing EU AIFs in the EU
- 2014
  - End of transition period for existing AIFMs and compliance with the AIFM Law required from 22 July 2014
- 2016
  - Passport becomes available for all EU AIFMs marketing non-EU AIFs in the EU and for non-EU AIFMs marketing AIFs in the EU (subject to ESMA advice)
- 2017
  - EU Commission conducts review of application and scope of the AIFMD
- 2018
  - Private placement regimes to be replaced by the AIFMD passport regime

Private placement regimes for:
- Lux/EU AIFMs marketing non-EU AIFs;
- Non-EU AIFMs marketing AIFs.

Passport for:
- Lux/EU AIFMs marketing EU AIFs.

Co-existence of EU passport and private placement regimes for:
- Lux/EU AIFMs marketing non-EU AIFs;
- Non-EU AIFMs marketing AIFs.

who ... will be subject to the AIFM regime?

All-inclusive scope

The AIFM regime applies to:

- Lux/EU AIFMs managing one or more EU AIFs/non-EU AIFs;
- Non-EU AIFMs managing one or more EU AIFs;
- Non-EU AIFMs marketing AIFs in the EU.

The only scenario which does not fall within the scope of the AIFM regime 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 AIFM regime takes a "one size fits all" approach by encompassing AIFMs of all AIFs which are not covered by the UCITS Directive.

Whereas the AIFM Law directly regulates AIFMs, it indirectly also applies to EU and non-EU AIFs and some of their service providers. In this context, one should keep in mind that the AIFM Law 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."*

Some actors excluded

Certain actors are expressly excluded from the scope of the AIFM Law: these include holding companies, entities which manage pension funds, employee participation or savings schemes, supranational institutions, national central banks, securitisation special purpose entities as well as national, regional and local governments. In addition, the AIFM Law does not apply to family office type arrangements, provided they do not raise external capital.

Sub-threshold AIFMs

Exemptions from the AIFM Law have been expressly provided for sub-threshold AIFMs:

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

Such exempted AIFMs are subject to registration requirements with the CSSF. Exempted AIFMs can also decide to opt-in to the application of the AIFM regime and thereby benefit from the EU marketing passport. Certain EU countries will only allow sub-threshold AIFMs to market if they opt in.

It is important to note that each of the *de minimis* thresholds calculated are at the level of the AIFM, not the level of the AIF. An AIFM managing two AIFs, one with *eg.* EUR 60 million and an AIF with EUR 50 million (with use of leverage), will be required to be authorised as the total assets under management are EUR 110 million.

Determination of the AIFM

The AIFM Law regulates Luxembourg AIFMs. Under certain circumstances, a Luxembourg AIF may be considered as internally managed and hence itself be considered as the AIFM. This can be the case for AIFs whose legal form permits internal management.

The following entities established in Luxembourg may potentially be considered as AIFMs:

- Chapter 15 management companies under the UCI Law;
- Chapter 16 management companies (article 125-1 and article 125-2) under the UCI Law;
- Internally managed UCIs under part II of the UCI Law;
- Internally managed SIFs under the SIF Law;
- Internally managed SICARs under the SICAR Law;
- Any Luxembourg legal entity providing management services to AIFs which is not regulated under any of the Product Laws and any internally managed legal entity qualifying as an AIF, which is not regulated under any of the Product Laws.

It should also be noted that credit institutions cannot combine the status of a credit institution under the 1993 Law and that of an authorised AIFM under the AIFM Law. Furthermore, investment firms cannot combine the status of an investment firm under the 1993 Law with that of an authorised AIFM under the AIFM Law.

Interaction with other EU rules

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

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

Other EU regimes: EuVECA and EuSEF

The EuVECA and EuSEF regulations lay down uniform requirements and conditions for managers of funds that wish to use the designation EuVECA/EUSEF in relation to the marketing of qualifying venture capital/social entrepreneurship funds in the European Union.

They also lay down uniform rules for the marketing of these funds to eligible investors across the EU, for the funds' portfolio composition, for the eligible investment instruments and techniques to be used as well as for the organisation, conduct and transparency of managers that market qualifying venture capital/social entrepreneurship funds across the EU.

Managers wishing to be subject to one of the two regimes have to inform their competent authorities. They will not be authorised but registered and can market eligible funds to professional investors in the EU.

Qualifying venture capital/social entrepreneurship funds must invest at least 70% in eligible undertakings and their aggregate assets under management should remain below EUR 500 million. If this threshold is exceeded, the managers are subject to authorisation under the AIFMD, but may continue to use the designation EuVECA or EuSEF provided certain conditions set by the respective regulation are met.

Registered managers of qualifying venture capital/social entrepreneurship funds may additionally manage UCITS, subject to authorisation under the UCITS Directive.

Grandfathering

The AIFM Law foresees two grandfathering provisions for AIFMs managing closed-ended AIFs:

- If they have not made any additional investments after 22 July 2013, they may continue to manage such AIFs without authorisation under the AIFM Law;
- If their subscription period for investors closed prior to the entry into force of the AIFM Law and if their term expires at the latest in 2016, they may continue to manage such AIFs without authorisation under the AIFM Law but must publish an annual report and, when applicable, comply with the disclosure requirements on the acquisition of portfolio companies.

Who?

- One size fits all approach.
- AIFM regime directly applies to EU and non-EU AIFMs marketing EU AIFs/ non-EU AIFs in the EU.
- AIFM regime indirectly applies to all EU/non-EU AIFs.
- Certain actors are excluded from the AIFM Law.
- AIFM Law applies to internally managed AIFs (considered as AIFMs) and to AIFs appointing an external AIFM.

what ... does the AIFM law regulate?

The AIFM Law principally provides for the authorisation and the operation of Luxembourg AIFMs.

Authorisation of AIFMs

The AIFM license requirements are substantially similar to those which apply to the authorisation of UCITS management companies.

More specifically, the AIFM Law states that management companies which are authorised under the UCITS regime should not be required, when applying for authorisation as AIFMs, to provide information or documents already provided when they applied for authorisation under the UCITS regime, on condition 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 the AIFM is to be sought from the CSSF. The head office and registered office of a Luxembourg AIFM must be located in Luxembourg.

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

The functions of an AIFM

Authorised AIFMs will be allowed to perform the following core functions:

- Investment management functions which comprise at least:
  - portfolio management;
  - risk management.
- Other functions which may additionally be provided (only if the investment management functions are provided):
  - administration (i.e. legal and accounting services; customer enquiries; valuation and pricing including tax returns; maintenance of unitholders'/shareholders' register; distribution of income; unit/share issues and redemptions; contract settlements; record keeping);
  - marketing;
  - activities related to the assets of the AIF (such as facilities management).

The CSSF may authorise Luxembourg AIFMs (other than internally managed AIFs) to provide the following additional services (only if the investment 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 UCIs; reception and transmission of orders in relation to one or more financial instruments), only if the management of portfolios of investments is provided.
  MiFID provisions concerning the initial capital endowment and certain organisational requirements apply to the above services of management of portfolios of investments and non-core services.

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

Application requirements for authorisation as an AIFM

- Information on the persons effectively conducting the business of the AIFM: such persons who effectively conduct the business of an AIFM must be of sufficient good repute and sufficiently experienced in relation to the investment strategies pursued by the AIFs they manage.
- Information on the identities of the AIFM's shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings and information on the amounts of those holdings.
- A programme of activities 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 AIFs, to AIFs acquiring control of non-listed companies and issuers, passport conditions, third country 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 AIFs will have to maintain an initial capital of at least EUR 300,000 while externally appointed AIFMs will have to maintain an initial capital of at least EUR 125,000.

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

Furthermore, externally appointed AIFMs will have to maintain additional own funds equal to the higher of:

- One quarter of the AIFM annual overhead costs; and
- 0.02% of the AIF portfolio values in excess of EUR 250 million (capped at EUR 10 million which can be reduced by 50% if such amount is covered by a bank or an insurance guarantee).

Operating conditions

While the AIFM Law has practical implications for certain AIFMs and to a certain extent, the AIFs they manage, many principles enshrined in the AIFM Law are not new and are generally UCITS or MiFID inspired.

General principles

The AIFM Law contains several principle-based rules on general operating conditions. In short, the general operating principles that apply to AIFMs 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 AIFM Law 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 in the integrity of the market.

AIFMs are required to establish and maintain operational three internal control functions: a permanent compliance function, a risk management function and an internal audit function.

AIFMs are required to establish, implement and maintain adequate policies and procedures designed to detect any risk of failure to comply with its obligations under the AIFM Law. They are expected to put in place adequate measures and procedures designed to minimize the risk of a failure to comply with their obligations under the AIFM Law.

In addition, the AIFM Law requires that the AIFM shall treat all investors fairly. Preferential arrangements may still be possible as long as they are disclosed to all investors through the AIF's rules or incorporation documents.

Conflicts of interest

The general requirement to identify and manage conflicts of interest that arise in the course of managing AIFs is not a new concept. However, the AIFM Law requires specifically that:

- Conflicts of interest are identified, notably between the AIFM, its managers/employees and the managed AIF or between the investors of the AIF and another client of the AIFM;
- Organisational and administrative arrangements designed to identify, prevent, manage and monitor conflicts of interest be put in place; and
- Where the above-mentioned arrangements are not sufficient to ensure that the risk 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.

Risk management

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

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

- Due diligence must be conducted when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF;
- The risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio must be properly identified, measured and monitored on an ongoing basis including through the use of appropriate stress testing procedures;
- The risk profile of the AIF must be 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

AIFMs will be required to set a maximum level of leverage and a limit on the reuse of collateral or guarantees that could be granted under a leveraging arrangement taking into account, *inter alia*, the type of AIF, its strategy, the sources of leverage, the relationship with financial services institutions that could pose systemic risk, counterparty exposure and the extent to which the leverage is collateralised.

The AIFM Law defines leverage as "any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash, or transferable securities, or leverage embedded in derivative positions or by any other means."

Leverage will be calculated by using the so-called gross method and the so-called commitment method. The gross method gives the overall exposure of the AIF whereas the commitment method gives insight into the hedging and netting techniques which are used at the level of the AIF.

For private equity AIFs, ESMA has issued guidance to the effect that exposure contained in any financial or legal structure controlled by an AIF is to be included in the calculation of the exposure at the level of the AIF. Where the AIF does not have to bear losses beyond its investment in a financial structure that is used to acquire non-listed companies or issuers, the financial structure should not be considered as having been set up to directly or indirectly increase the exposure at the level of the AIF.

In light of the foregoing, investments which are structured in a way that they do not permit lenders to have recourse at the fund level and the AIF's liability is restricted to the amount of its investment should thus not be treated as leverage of the AIF, as such leverage does not increase the exposure of the AIF.

Liquidity management

Except for AIFMs of unleveraged closed-ended funds, AIFMs 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, AIFMs 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 interest.
- Policies and practices consistent with sound and effective risk management.
- Adequate liquidity and conflict management policies.

Valuation

Applicable rules for the valuation of assets

AIFMs are responsible for the proper valuation of AIF assets as well as the calculation and publication of the NAV.

The AIFM Law sets forth the rules in relation to the valuation function. As valuation standards differ across jurisdictions and asset classes, Level 2 supplements the rules laid down in the AIFM Law and should be read in conjunction with them.

Whilst the AIFM Law primarily focuses on the establishment and the consistent application of the relevant valuation procedures, Level 2 lays down in detail the main features of such valuation policies and procedures, including the use of models to value AIF assets, the values generated for individual assets, the calculation of the NAV per unit or share, the provision of professional guarantees by external valuers and the frequency of valuations.

Frequency

The valuation procedures used must ensure that the assets are valued on the occasion of each issue or subscription or redemption or cancellation of units or shares. Such valuation must occur at least once a year. In addition, AIFMs should ensure that the number of units or shares in issue is subject to regular verification, at least as often as the unit or share price is calculated.

In the event that the AIFM manages open-ended AIFs, such valuations and calculations must also be carried out at a frequency which is both appropriate to the assets held by the AIF and its issuance and redemption frequency.

With respect to closed-ended AIFs, valuations and calculations must be carried out in case of an increase or decrease in the capital of the relevant AIF and whenever there is evidence that the last determined value is no longer fair or proper.

Transparency obligations

AIFMs must make available for each of the EU AIFs they manage and for each of the AIFs they market in the EU:

- A description of the AIF's valuation procedure and of the pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets;
- The latest net asset value of the AIF or the latest market price of the unit or share of the AIF.

Who can perform the valuation function?

Valuation may be performed by either:

- An independent (and suitably qualified) external valuer; the independent valuer's appointment has to be formalised by a written contract and must be notified to the CSSF; or
- The AIFM itself, but the CSSF has the authority to require any 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 and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.

When performing the valuation functions itself, the AIFM must ensure that the valuation function is independent from the portfolio management function. Appropriate measures must be taken to mitigate conflicts of interest.

Proper valuation of AIF assets

The valuation policies and procedures should describe the obligations, roles and responsibilities pertaining to all parties involved in the valuation. This includes external valuers, if applicable, and should be done in a sound, transparent, comprehensive and appropriately documented manner which covers all material aspects of the valuation process and valuation procedures and controls in respect of the relevant AIF. AIFMs must ensure a consistent application of their policies and procedures and a periodic review thereof.

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 the type of assets).
- Independent external valuation or by the AIFM (subject to conditions).
- The AIFM remains liable for the valuation of the AIF's assets.

Delegation of AIFM functions

AIFMs may, subject to limitations and requirements, delegate the two core functions (i.e. portfolio management and risk management, except that both functions may not be delegated in full at the same time) 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 AIFM regime in this regard are to a large extent carried over from the UCITS Directive.

Indeed, certain rules specified by the CSSF apply by analogy. The principles laid down in section 7 of CSSF Circular 12/546 which specify the delegation rules with respect to Chapter 15 management companies and self-managed UCITS under the Law of 2010 apply to Luxembourg AIFMs delegating investment management functions.

AIFMs 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 portfolio management or 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 country. This means that a Luxembourg AIFM will be able to partly delegate portfolio and risk management functions to an investment manager who does not qualify as an AIFM*.

AIFMs shall at all times remain responsible for the proper performance of their functions and compliance with the rules set out in the AIFM Law. 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. AIFMs 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's investors.

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

Delegation

- Part of each core investment management function may be delegated.
- Sub-delegation is possible.
- Delegation rules similar to UCITS provisions.
- AIFM remains liable in case of delegation.

Depositary

Single depositary rule

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

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 AIFMD (*i.e.* until 2017), allow the depositary (which must be an EU credit institution) to 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.

Luxembourg permits the depositary to be an entity which carries out depositary functions as part of its professional or business activities in the case of certain AIFs which (i) have no redemption rights exercisable during a period of five years from the date of the initial investment; 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 law of 5 April 1993 on the financial sector has been amended to create a new category of professional of the financial sector PFS, *i.e.*, the professional depositary of assets other than financial instruments ("PDAOFI").

Prime brokers

A prime broker may be appointed as a depositary if *inter alia* 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.

When a prime broker has been appointed, it is subject to reporting obligations towards the depositary which shall enable the latter to have a comprehensive overview of all assets and cash held by the prime broker for the AIF.

Core duties of the depositary

Most of the requirements of the AIFM Law are UCITS inspired and thus familiar to initiators and promoters of regulated investment funds. However, some of the core functions have been adapted and/or clarified:

- Monitoring of cash flows: 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 AIFM Law 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-date 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.

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 AIFM Law. 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 wishes 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 AIFM Law 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 AIFM Law states that the depositary is 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.
  The circumstances under which a financial instrument is deemed to be lost have been further clarified in Level 2 and shall be ascertained irrespective of whether it results from fraud, negligence or other intentional or non-intentional behavior. The exemption from liability enabling the depositary to escape from the duty to return lost financial instruments is subject to a narrow definition of the *force majeure* event.
- 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 AIFM Law 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. Such contractual discharge shall be justified by an objective reason, whose application is framed by strict conditions.

Depositary

- Single depositary per AIF.
- AIFMs cannot act as depositaries.
- Only limited eligible entities may act as depositaries.
- 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 obligations

The AIFM Law ensures increased transparency in three different ways:

- The AIFM established in Luxembourg must prepare an annual report for each of the AIFs it manages or markets in the EU. This report must be completed within six months following the end of the financial year of the relevant AIF;
- Disclosure to investors: certain information must be disclosed to investors before they invest in an AIF. The content thereof must include, *inter alia*, the investment strategy of the AIF, the types of assets which the AIF may invest in, and the techniques it may employ, a description of the delegation of management functions as applicable and the valuation procedure;
- Disclosure to the CSSF: AIFMs must report, for each AIF, *inter alia*, the markets in which it trades, the risk profile of the AIF, the risk management systems in place, the level of leverage and the liquidity management tools being used. The CSSF has confirmed that the annual report requirement of the AIFM Law only applies to authorised AIFMs, however the specific rules under Luxembourg Product Laws will continue to apply.

Fair treatment of investors

The AIFM Law requires that AIFMs should treat all investors fairly. Where there is any preferential treatment of an investor, this should be disclosed in the AIF's constitutive documents. Level 2 states that any preferential treatment given by an AIFM to one or more investors should not result in other investors in the AIF being put at an overall material disadvantage.

Furthermore, the AIFM is required to act honestly, fairly and with the due skill, care and diligence in conducting its activities and comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of the AIF or the investors of the AIF.

Leveraged AIF

AIFMs are required to set a leverage ratio for each AIF they manage and this ratio must be complied with at all times. AIFMs that use leverage for investment purposes are subject to additional disclosure requirements. AIFMs are periodically required to 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 that 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 CSSF has a controlling power over such leverage limits and may request the ratio to be adjusted if it deems it unreasonable or likely to contribute to the risk of market disorder.

Portfolio company disclosures

The AIFM Law imposes reporting obligations when an AIF acquires, individually or jointly, a substantial stake in a non-listed company, other than a SME or a real estate SPV. The acquisition thresholds are set at 10%, 20%, 30%, 50% and 75% of the voting rights of the portfolio company.

Therefore, if an AIF reaches any of these thresholds when acquiring a non-listed company, the AIFM shall, as soon as possible, but not later than 10 working days after the date on which the AIF has reached, exceeded or fallen below the relevant threshold or has acquired control over the non-listed company, notify this information to the portfolio company itself, to its shareholders as well as to the CSSF. Similar disclosure shall be made to the employee representative(s), or where there is/are none, directly to the employees of the portfolio company.

Similar notification obligations are imposed on AIFMs when the relevant AIF acquires, individually or jointly, control of a non-listed company, other than a SME or a real estate SPV.

"Control" is to be understood as the holding of more than 50% of the voting rights of the non-listed company.

In such circumstances, 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, but not later than 10 working days after the date on which the AIF has reached, exceeded or fallen below the relevant threshold or has acquired control of the portfolio company itself, its shareholders, the representative of its employees or where there is none, directly to the employees themselves as well as to the CSSF. 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 AIFM Law which require the AIFM to use its best efforts to prevent redemptions, capital reductions and certain distributions during a period of two years following the acquisition or control of the portfolio company.

Transparency

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

Remuneration

In order to address the potentially detrimental effects of poorly designed remuneration structures on the sound management of risks and control of risk-taking behaviour by individuals, AIFMs must establish and maintain remuneration policies and practices in line with the risk profiles of the AIFs they manage for those categories of staff whose professional activities have a material impact on the aforementioned risk profiles (*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).

The remuneration provisions in the AIFMD are based on those included within the CRD. The CRD provisions apply to banks and investment firms. The stated intention behind those provisions is to ensure that pay for senior staff – in particular bonuses and other variable remuneration aligns the interests of those staff with the bank's interests. Many of the principles have been transposed into the AIFMD with little change. This means that it may not be simple for fund managers to apply the rules in a way which is consistent.

ESMA was tasked in this regard to provide guidelines on remuneration principles and has issued its guidance in July 2013. The guidelines apply to the national regulators on a comply or explain basis and directly to AIFMs. The CSSF is in the process of issuing guidelines to more fully explain its interpretation of the ESMA guidelines.

Of particular interest will be the rules relating to delegates of the AIFM, particularly when such delegates are not based within the EU. ESMA has confirmed that where the delegate is subject to CRD rules and qualifies as identified staff, such entities are subject to regulatory requirements on remuneration that are equally as effective as those applicable under AIFMD.

In ESMA's opinion, AIFMs cannot choose to exclude portfolio managers from the scope of identified staff for the purpose of the remuneration guidelines purely because they are bound by investment limits set out by law and/or internal risk limits set out in the investment restrictions of the AIF. However it should be noted that the AIFMD does not expressly provide for an application of the remuneration policies to delegates of AIFMs.

In particular, AIFMs will need to include aggregate information on remuneration (split into fixed and variable components and, where relevant, amounts paid by the AIF) in the annual report as part of the transparency requirements of the AIFM Law. AIFMs may disapply certain provisions of the latter in light of proportionality considerations including but not limited to the adequate consideration of their size, their internal organisation and the nature, scope and complexity of their activities.

Remuneration

- AIFMs must establish and maintain remuneration policies and practices in line with the risk profiles of the AIFs they manage.
- AIFMs may be able to disapply certain provisions in light of proportionality considerations such as size, internal organisation, the nature, scope and complexity of their activities.

Reporting

Luxembourg established AIFMs are informed of the effective date of their status as authorised AIFM or as registered AIFM by the CSSF. This date is to be taken into consideration for the determination of applicable reporting obligations.

Authorised AIFMs have to ensure that an annual report based on the elements described in Article 20(2) of the AIFM Law is made available in respect of all those AIFs where the AIFM's authorisation date is prior to the end of the relevant AIF's financial year. It should be noted that Article 20(2) only applies to authorised AIFMs notwithstanding any specific rules under the Product Laws applicable to a given Luxembourg established AIF.

According to Article 105 of Level 2, the report on activities for the financial year shall include at least an overview of investment activities during the year or period, and an overview of the AIF's portfolio at year-end or period-end. It should provide an overview of AIF performance over the year or period and inform about material changes as listed in Article 23 of the AIFMD.

For the presentation of the annual report Luxembourg established AIFMs should comply with the requirements under scheme B of the UCI Law (for part II funds) and on the annex of the SIF Law as well as Article 104 of Level 2.

The CSSF does not require information to be reported on a more frequent basis than foreseen in Level 2. The frequency and reporting periods are outlined in the table below:

Frequency	Reporting period start date(s)	Reporting period end date(s)	Deadline for transmission for AIF that are not fund of funds	Deadline for transmission for AIF that are fund of funds
Quarterly	01/01/yyyy 01/04/yyyy 01/07/yyyy 01/10/yyyy	31/03/yyyy 30/06/yyyy 30/09/yyyy 31/12/yyyy	30/04/yyyy 31/07/yyyy 31/10/yyyy 31/01/(yyyy+1)	15/05/yyyy 15/08/yyyy 15/11/yyyy 15/02/(yyyy+1)
Half-yearly	01/01/yyyy 01/07/yyyy	30/06/yyyy 31/12/yyyy	31/07/yyyy 31/01/(yyyy+1)	15/08/yyyy 15/02/(yyyy+1)
Annually	01/01/yyyy	31/12/yyyy	31/01/(yyyy+1)	31/01/(yyyy+1)

The reporting requirements also apply to non-EU AIFMs during the period before the introduction of the passport for non-EU AIFMs. When a non-EU AIFM is marketing AIFs to professional investors in Luxembourg and in other Member States of the EU, the reporting to the CSSF under the requirements of Article 24(1), (2) and (4) of the AIFMD should only cover the data for those AIFs which are being marketed in Luxembourg.

Additionally, a non-EU AIFM that manages or markets a feeder AIF (whether EU or non-EU) in Luxembourg will also have to report to the CSSF under the aforementioned requirements, even if the non-EU master AIF is not marketed in the EU. This case applies only when the non-EU AIFM manages both the feeder AIF and the non-EU master AIF.

Non-EU AIFMs shall in principle take the date of the information form provided to the CSSF for the marketing in Luxembourg under Article 45 of the AIFM Law as the start date for their reporting requirements to the CSSF.
The reporting frequency and the reporting periods for non-EU AIFMs are the same as those applicable to Luxembourg AIFMs.
Further, non-EU AIFMs should continue to report to the CSSF after the marketing period has ended unless they confirm that no investors in the jurisdiction of the authority concerned are invested in the AIF.

Finally, Article 110 of Level 2 requires the AIFM to provide the following information when reporting to the competent authorities:

- The main instruments in which it is trading, including a break-down of financial instruments and other assets, including the AIF's investment strategies and their geographical and sectoral investment focus;
- The markets of which it is a member or where it actively trades;
- The diversification of the AIF's portfolio, including, but not limited to, its principal exposures and most important concentrations.

Reporting

- Authorised AIFMs have to ensure that an annual report based on the elements described in Article 20(2) of the AIFM Law is made available and should provide an overview of investment activities during the year or period.
- The reporting to the CSSF under the requirements of Article 24(1), (2) and (4) AIFMD should only cover the data for those AIFs which are being marketed in Luxembourg.
- Reporting requirements also apply to non-EU AIFMs during the period before the introduction of the passport.

Marketing

The marketing of an AIF is understood to be any direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages, to or with investors domiciled or with a registered office in the European Economic Area (EEA). Since there is no guidance at the European level on the concept of marketing, the position can vary from one regulator to another.

In Luxembourg, marketing takes place when the AIF, the AIFM or an intermediary on their behalf seeks to raise capital by actively making units or shares of an AIF available for sale to a potential investor.

The marketing activity must take place in Luxembourg in order to qualify as marketing in Luxembourg, however, distance marketing - when the investors are domiciled or have their registered office in Luxembourg - also qualifies as marketing in Luxembourg.

Considering the above, the following activities do not qualify as marketing in Luxembourg and consequently the AIFM Law requirements do not apply when:

- Providing draft documents to a prospective investor (a document is considered a draft when it cannot be used to formally subscribe or commit in the AIF);
- Investments made in the context of a discretionary mandate of individual investment portfolios;
- Proposal of investments in the context of an investment advisory agreement;
- Investments made in the context of collective portfolio management of an UCI or an AIF;
- Investments made at the initiative of investors without any solicitation made by the AIF or its AIFM (so-called “reverse solicitation”).

Provided that the activity undertaken constitutes - and can be qualified - as a marketing activity in the EEA, various scenarios are possible for AIFs to be marketed. The scenarios are dependent on the country of origin of the AIFM/AIF and on the type of investors targeted. Each scenario is depicted hereafter, ranging from the AIFM marketing passport to the national private placement regimes.

Summary of the marketing regimes applicable to AIFs in the EEA

Regulatory context	Type of investors targeted	Country of distribution	Regime applicable	Scenario
EEA authorised AIFM managing an EEA AIF	Professional investors	EEA countries	Marketing passport (article 32 of the AIFMD)	1
	Retail investors		National Private Placement Regime (article 43 of the AIFMD)	4
EEA authorised AIFM managing a non-EEA AIF	Professional investors	EEA countries	National Private Placement regime (article 36 of the AIFMD)	2
	Retail investors		National Private Placement regime (article 43 of the AIFMD)	4
EEA authorised AIFM managing an EEA feeder AIF with a non-EEA master AIF	Professional investors	EEA countries	National Private Placement Regime (article 36 of the AIFMD)	2
	Retail investors		National Private Placement Regime (article 43 of the AIFMD)	4
EEA registered AIFM managing an AIF (EEA/non-EEA)	Professional investors	EEA countries	National Private Placement regime	5
	Retail investors		National Private Placement Regime (article 43 of the AIFMD)	4
Non-EEA authorised/ registered AIFM managing an AIF (EEA/non-EEA)	Professional investors	EEA countries	National Private Placement Regime (article 42 of the AIFMD)	3
	Retail investors		National Private Placement Regime (article 43 of the AIFMD)	4
EuVECA/EuSEF	Qualified investors*	EEA countries	EuVECA/EuSEF passport	6

*Qualified investors: Professional investors (MiFID) + investors with minimum commitment of EUR 100,000

Scenario 1: Passport for EEA AIFMs marketing EEA AIFs in the EEA to professional investors

Authorised EEA AIFMs can benefit from a marketing passport, allowing them to market EEA AIFs to professional investors in the EEA through the direct or indirect offering or placement at the initiative (or on behalf) of the AIFM. Such marketing across the EEA is subject to a notification procedure between the home country regulator of the AIFM and the regulator of the EEA Member State where the AIF is to be marketed.

It should be noted that Luxembourg domiciled regulated AIFs managed by Luxembourg AIFMs are automatically authorised for marketing in Luxembourg to investors as defined in the applicable Product Laws.

Scenario 2: EEA AIFMs marketing non-EEA AIFs in the EEA (or EEA feeder AIF with a non-EEA Master AIF) to professional investors

As of today (and since July 2013)

Since the entry into force of the AIFMD, EEA AIFMs wishing to market non-EEA AIFs (or EEA feeder AIFs with a non-EEA Master AIF) in the EEA must be in compliance with the national private placement regime pursuant to article 36 of the AIFMD. EEA AIFMs must meet all the requirements of the AIFM regime except for the provisions on depositaries. However, in this respect, one or more entities must be appointed to perform some of the depository functions and the identity of such entities must be communicated to the supervisory authority of the country where the non-EEA AIF will be marketed.

Furthermore, a cooperation agreement for the purpose of systemic risk oversight must exist between the relevant Home Member State of the AIFM and the non-EEA AIF's competent authorities. Finally, the relevant third country must not be listed on the FATF blacklist.

In addition to the above, EEA AIFMs must comply with specific local requirements imposed by the competent Supervisory Authority, if any. Such requirements have to be assessed on a country-by-country basis.

In Luxembourg, the marketing of a non-EEA AIF by an EEA AIFM is possible, pursuant to a simple notification to the CSSF. There is no need for an acknowledgment of receipt, nor an authorisation from the CSSF. Marketing can start in Luxembourg as from the date of notification.

In the future

In the future, the passport regime should be available to authorised EEA AIFMs marketing non-EEA AIFs to professional investors in the EEA. The timetable initially announced foresaw that upon issuance of a positive advice from ESMA on the application of the marketing passport, the European Commission will issue a delegated act allowing non-EEA AIFs to be marketed in the EEA on the basis of the marketing passport regime (pursuant to article 35 of the AIFMD).

The above-mentioned marketing passport implies that the EEA AIFM fully complies with the AIFM regime and completes a notification procedure. In addition, appropriate cooperation agreements for the efficient exchange of information will need to exist between the non-EEA competent authorities of the AIF and the EEA home Member State of the AIFM and also with the competent authority of the country of distribution of the AIF on tax matters. Furthermore, the third country of the non-EU AIF must not be listed on the FATF blacklist.

Scenario 3: Non-EEA AIFMs marketing AIFs in the EEA to professional investors

As of today (and since July 2013)

Since July 2013, according to article 42 of the AIFMD, non-EEA AIFMs may, if transposed into national law, market AIFs under the country's national private placement regime if available.

Such AIFMs must however comply with the transparency requirements including the reporting obligations to the competent authorities, as well as, if applicable, the requirements regarding AIFMs managing AIFs which acquire controlof non-listed companies and issuers. Additionally, cooperation agreements for the purpose of systemic risk oversight must be agreed between the relevant EEA and non-EEA competent authorities. The country of the non-EEA AIFM/AIF must not be listed on the FATF blacklist.

In addition to the above, non-EEA AIFMs must comply with specific local requirements imposed by the competent supervisory authority, if any. The requirements have to be assessed on a country-by-country basis but can be as important as the necessity to comply with the depositary requirements.

In Luxembourg, non-EEA AIFM wishing to market an AIF it manages to professional investors, must go through a notification to the CSSF. The non-EEA AIFM can commence its marketing activity once it has notified the CSSF (*i.e.* it does not have to wait for approval).

The non-EU AIFM managing a Luxembourg AIF or marketing a non-EU AIF into Luxembourg will have to comply with the AIFM Law, except if a provision of the latter 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 *inter alia* the regulatory purpose of the local law to which the non-EU AIFM and/or non-EU AIF offers a similar level of protection.

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

Non-EU AIFMs intending to manage EU AIFs without marketing them in the EU shall also need to obtain an authorisation from their Member State of Reference.

The authorisation by the Member State of Reference shall be subject to a number of additional conditions, such as the country of establishment 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 the effective exchange of information in tax matters between the 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 will be available towards the end of 2015 subject to a notification procedure.

In the event that the non-EU AIFM wishes to market non-EU AIFs 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 be placed 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 will be marketed.

Scenario 4: Marketing of AIFs in the EEA to retail investors

AIFMs wishing to market AIFs in the EEA to non-professional investors may be able to do so pursuant to article 43 of the AIFMD. This is subject to specific requirements imposed by the regulator of the targeted country of distribution. The Member States may indeed impose stricter requirements than the ones applicable to the marketing to professional investors. Member States may even not allow a marketing of foreign AIF to retail investors in their country.

However, Member States may not impose stricter requirements than the ones applicable to domestic AIFs sold to retail investors.

Throughout most of the EEA, the main criteria applicable in this scenario are the appointment of a local agent, who takes care of payments to investors, the principle of reciprocity between the foreign AIFs and an AIF established in the country where it is intended to sell the AIF to retail investors and the translations of the AIFs documents into local language. Usually, authorising an AIF to be sold to retail investors implies a deep involvement of the local regulator.

Luxembourg law requires that the foreign AIF is subject to a permanent supervision performed by a supervisory authority in order to ensure the protection of investors and to provide investors guarantees of protection at least equivalent to those provided by the laws in Luxembourg (governing AIFs authorised to be marketed to retail investors in Luxembourg).

Luxembourg regulated AIFs are automatically allowed to be sold to retail investors if and as defined by their Product Law. Non-regulated AIFs can only be offered to professional investors.

Scenario 5: EEA registered AIFMs marketing AIFs in the EEA to professional investors

EEA Registered AIFMs as defined by article 3(2) of the AIFMD do not benefit from the marketing passport pursuant to article 32 of the AIFMD.

Therefore, EEA registered AIFMs wishing to market an AIF in the EEA need to comply with the local requirements applicable in the targeted countries of distribution. In the absence of any official regulations in that respect, some Member States have adopted an approach which only allows the marketing of AIFs by registered AIFMs in the EEA by "opting-in" to the AIFMD and therefore using the marketing passport.

In Luxembourg, private placement is available for registered AIFMs.

Scenario 6: EuVECA/ EuSEF products sold in the EEA

AIFMs managing qualifying EuVECA/EuSEF products can market their funds in the EEA using the marketing passport offered by EuVECA/EuSEF regulations, *i.e.* without any local law gold plating.

Also, unlike the AIFMD, they can sell their products not only to investors who are or elect to be treated as professional clients but also to investors that are willing to invest at least EUR 100,000 and have confirmed in writing that they are aware of the risks associated with their investment.

Tax aspects

General overview

Although the AIFMD is silent on tax aspects, the Luxembourg AIFM Law introduces specific provisions addressing the modernisation of the Luxembourg partnership regimes, the tax status of foreign AIFs managed in Luxembourg, the carried interest paid to certain Luxembourg managers as well as the VAT applicable.

Luxembourg limited partnerships

The implementation of the AIFMD provided a further opportunity to position Luxembourg as the leading European alternative investment funds centre. The Luxembourg legislator thus modernised the Luxembourg partnership regimes in 2013. The modernisation involved a complete overhaul of the existing CLP regime, the so-called *société en commandite simple* and the creation of an entirely new limited partnership regime, namely the *société en commandite spéciale* or SLP. The essential difference between the CLP and the SLP is that the SLP does not have a legal personality distinct from its limited partners making it similar to the English limited partnership, while the CLP is comparable to Scottish limited partnerships and has a legal personality of its own. Structuring flexibility and tax transparency are the main features of CLPs and SLPs.

Tax treatment of AIF set up as Luxembourg limited partnerships

In order to provide legal certainty on the treatment of income derived by CLPs or SLPs, the Luxembourg tax authority issued Circular Letter L.I.R n° 14/4 (the "Circular") on 9 January 2015.

For Luxembourg tax purposes, CLPs and SLPs are tax transparent entities, and thus not subject to Luxembourg corporate income tax or net worth tax at the entity level. Instead, their partners are treated as carrying out, individually, the activities of the SCS or SCSp. However, their profits may be subject to the municipal business tax (*impôt commercial communal*) if the SCS/SCSp carries out a business activity or if their general partner is a limited company and owns 5% or more of their interests.

The Circular clarifies the situation in which CLPs/SLPs could be subject to MBT.

First and foremost, it guarantees that non-regulated AIFs set up as CLPs and SLPs are never subject to MBT if their general partner holds less than 5% of the partnership interests. In this respect, the Circular highlights the fact that activities performed by a Luxembourg AIF established in the form of a Limited Partnership are not of a commercial nature.

Secondly, it confirms that regulated and foreign funds *i.e.* foreign AIFs, part II SICAVs, SIFs or SICARs with a CLP/SLP legal form are never subject to MBT.

Finally, the Circular provides guidance on the interpretation of the business activity criteria as set out under parliamentary briefing documents as well as German and Luxembourg case law.

No Luxembourg income tax for foreign AIFs managed in Luxembourg

As a general rule in international tax law, a company is tax resident (and thus subject to tax) in the country where it has its statutory seat or where it is effectively managed, the latter criterion prevailing in case of dual residency. The management of an alternative investment fund by an AIFM resident in another state may thus trigger adverse tax consequences for the AIF or its investors.

The AIFM Law expressly states that AIFs established outside Luxembourg but having their place of effective management or central administration in Luxembourg are expressly exempt from Luxembourg taxation (*i.e.* corporate income tax, municipal business tax and net worth tax). This statutory rule ensures the absence of Luxembourg tax exposure for foreign AIFs managed by Luxembourg resident alternative investment fund managers.

Attractive taxation of carried interest received by Luxembourg managers

A specific tax regime is introduced under certain conditions for carried interest received by Luxembourg individuals who are employed by managers or a management company of an AIF. Such carried interest, granted in accordance with the AIFM Law, is taxed as miscellaneous income at 1/4 of the standard progressive income tax rates (*i.e.* a maximum tax rate of 10.90% in 2014).

This favourable tax rate is subject to the following conditions:

- The employee moved his or her tax residency to Luxembourg in the course of the first year following the entry into force of the AIFM (*i.e.* 2013) or in any of the five following years;
- He or she was not previously taxable in Luxembourg during the five tax years preceding 2013;
- No advance of carried interest has been paid to the employee;
- Initial capital contributions have been fully repaid to investors prior to carried interest payment.

According to the AIFM Law, this tax treatment is currently applicable for a period of 11 years (*i.e.* until the end of the 10th tax year following the year in which the employee took up in Luxembourg the position entitling him or her to the carried interest).

VAT aspects

As regards VAT, the AIFM Law impacts many market players of the non-UCITS industry in Luxembourg and their existing business models, which may need to be reviewed and adapted. New service flows characterise the environment post-AIFMD and new VAT issues have to be managed so as to limit or avoid VAT costs.

VAT exemption

SIFs and SICARs benefit from the VAT exemption applicable to any fund management services supplied to them, irrespective of whether they qualify as AIF and irrespective of whether they are established in Luxembourg or any other EU jurisdiction.

As regards unregulated investment vehicles, a provision has been introduced into the Luxembourg VAT law explicitly extending the scope of VAT exemption to the management of AIFs as they are defined in the AIFM Law.

No EU harmonisation of the notion of fund management services

In theory, VAT is subject to EU harmonisation. There are however many differences, not only in VAT rates, but also in the interpretation (i) of the list of vehicles benefiting from the VAT exemption, and (ii) of the notion of "fund management services". The impacts of these VAT distortions also merit consideration.

Increasing cross-border marketing and management

The AIFM Law provides AIFMs with a "marketing passport" for EU and non-EU AIFs. It also provides AIFMs with a "management passport" allowing these AIFMs to provide their services cross-border to EU and non-EU AIFs. Both passports increase cross-border management activities mainly in the private equity, real estate and hedge fund industries. The VAT treatment applicable to these cross-border management activities may be subject to various and conflicting interpretations, possibly resulting in unexpected taxation within the EU if not properly managed.

New service providers

The AIFM Law introduces new requirements in respect of valuation, liquidity and risk management as well as reporting to investors and regulators. These functions can be delegated under certain conditions by the AIFM to third parties. In this respect, new types of services circulate within the AIFs and the AIFMs and new VAT problematics are emerging.

In this regard, the Luxembourg VAT authorities issued, on 7 November 2013, a circular (No 723ter) clarifying that risk management functions form part of VAT exempt fund management services. This exemption remains applicable in case risk management functions are outsourced to third parties to the extent some specific conditions are fulfilled. It will not apply in case the role of the external supplier would be limited to purely technical functions (*e.g.* provision of the required computer software or supply of computerised calculations).

Impact on the VAT deduction

Depending on the VAT status and the form adopted by the investment schemes as well as the domicile countries involved, VAT on costs may or may not be recovered (at least partially). These VAT costs have to be managed specifically during the lifecycle of the structure.

VAT optimisation and reduction of costs

VAT can be an issue if charged on recurring expenses (*e.g.* on management fees payable by unregulated investment schemes). The invoicing of set-up costs is also mainly subject to VAT and the question of the recovery of that VAT is often material. Designing an investment scheme maximising VAT recovery is a key step in the set-up phase.

Ever growing importance of VAT compliance

The increasing management activities of investment vehicles on a cross-border basis require the fulfilment of VAT compliance obligations. Any mismanagement of these obligations (*e.g.* incorrect invoices, lack of VAT identification number, incorrect reporting of foreign transactions, unclear explanations provided to the tax authorities, etc.) will necessarily lead to unexpected VAT costs or even to double taxation.

glossary of terms

AIF(s)	Alternative Investment Fund(s)
AIFM(s)	Alternative Investment Fund Manager(s)
AIFM Law	Law of 12 July 2013 on Alternative Investment Fund Managers
AIFMD	Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC
CLP	Common Limited Partnership (*société en commandite simple*)
CRD IV	Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC
CSSF	*Commission de Surveillance du Secteur Financier*
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)
Directive 2006/73/EC	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
EEA	European Economic Area including EU Member States as well as Iceland, Liechtenstein and Norway
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
EuSEF Regulation	Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship
EuVECA Regulation	Regulation (EU) 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds
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
Level 2	Delegated Regulation (EU) 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision and any further delegated regulations

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
Product(s) Law(s)	Means the Luxembourg investment fund laws under which regulated AIFs can be established in Luxembourg (Part II of the UCI Law; SICAR Law and SIF Law)
Professional investor	An investor who is considered to be a professional client or may, on request, be treated as a professional client within the meaning of Annex II to Directive 2004/39/EC
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
Retail investor	An investor who is not a professional investor
SICAR	Investment company in risk capital (*Société d'investissement en capital à risque*)
SICAR Law	Law of 15 June 2004 on investment companies in risk capital (SICAR), as amended
SIF	Specialised investment fund
SIF Law	Law of 13 February 2007 on specialised investment funds (SIF), as amended
SME	Small and medium sized enterprise
SPV	Special Purpose Vehicle
UCI	Undertakings for Collective Investment
UCI Law	Law of 17 December 2010 on undertakings for collective investment (UCI) as amended
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
VAT	Value Added Tax

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fund industry

The Association of the Luxembourg Fund Industry (ALFI), the representative body for the Luxembourg investment fund community, was founded in 1988.
Today it represents more than 1,500 Luxembourg-domiciled investment funds, asset management companies and a wide variety of service providers including depositary 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 70 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 organizing 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 economic missions organised by the Luxembourg government around the world and takes an active part in meetings of the global fund industry.

  ALFI is an active member of the European Fund and Asset Management Association, of the European Federation for Retirement, of the International Investment Funds Association and of the Global Impact Investing Network.

For more information,
visit our website at www.alfi.lu
and follow ALFI on

Disclaimer: this brochure does not constitute legal advice and is merely intended to raise awareness of issues relating to the AIFMD and/or the AIFM Law. A&M shall not incur liability of any kind should this document be used as a basis for responding to legal questions.

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the alternative investment fund managers law: a complete guide to the essential aspects