



association of the  
luxembourg fund industry

| aifmd



# **the alternative investment fund managers directive**

**Luxembourg implementation**





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## why ... regulate alternative investment fund managers?

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The AIFMD is the outcome of a G20 consensus for closer regulatory oversight of systemic risks emanating from certain players 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 AIFMD 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 AIFMD was finally approved by the EU Parliament on 11 November 2010 after nearly one and a half years of intense negotiations.

Luxembourg has now fully implemented the AIFMD. The AIFM Law is an important step for the ongoing development of the alternative investment fund industry and moreover will reinforce Luxembourg's position as a global investment fund hub.

Although some provisions of the AIFM Law will require clarification from the Luxembourg regulator *Commission de Surveillance du Secteur Financier* (CSSF<sup>1</sup>) more defined rules will apply with respect to, *i.a.*, capital

requirements, specific operational procedures and remuneration.

The AIFM regime also provides for the appointment of additional service providers. In exchange for increased regulatory oversight, a European passport for AIFMs has been introduced for marketing of AIFs to professional investors, ultimately aiming at the phasing out of existing private placement rules.

Going forward, promoters or initiators of AIFs 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 AIFM regime for players 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.

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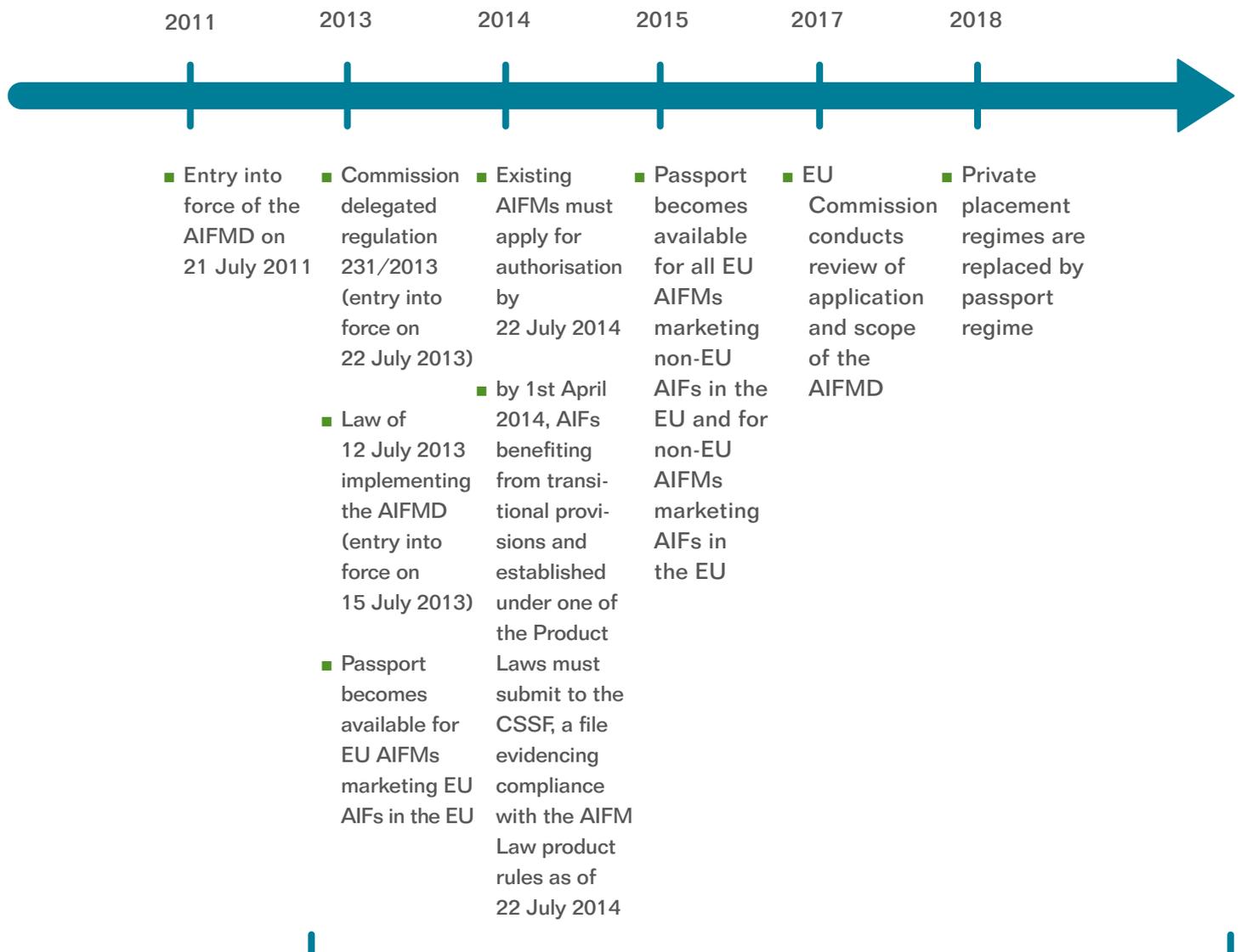
<sup>1</sup> Please note that the CSSF has issued frequently asked questions in this respect. This document will be updated from time to time and may be consulted on the CSSF's website at: [http://www.cssf.lu/fileadmin/files/AIFM/FAQ\\_AIFMD.pdf](http://www.cssf.lu/fileadmin/files/AIFM/FAQ_AIFMD.pdf)

### Why?

- More defined regulation of activities in the alternative investment sector and closer oversight of systemic risks.
- Creation of harmonised rules for management and marketing of AIFs in Europe.
- Enhanced transparency for investors and more stringent operational rules.

## when ... will the AIFM regime apply?

### Implementation timeline



#### Private placement regimes for:

- EU AIFMs marketing non-EU AIFs
- Non-EU AIFMs marketing AIFs

#### Passport for:

- EU AIFMs marketing EU AIFs

#### Co-existence of EU passport and private placement regimes for:

- EU AIFMs marketing non-EU AIFs
- Non-EU AIFMs marketing AIFs

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

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### All-inclusive scope

The AIFM regime applies to:

- 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. UCIs governed by Part II of the UCI Law, SIFs governed by the SIF Law if they fulfill the criteria under article 1(39) of the AIFM Law or

SICARs governed by the SICAR Law if they fulfill the criteria under article 1(39) of the AIFM Law are therefore in principle subject to the AIFM regime. The AIFM regime also impacts non-regulated investment vehicles if they are not regulated under the UCI Law, the SIF Law or the SICAR Law but also meet the criteria of article 1(39) of the AIFM Law.

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 players excluded

Certain players are expressly excluded from the scope of the AIFM Law: 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 AIFM Law does not apply to family office type arrangements, provided they do not raise external capital.

### Smaller AIFs exempted

Exemptions from the AIFM Law have been expressly provided for AIFMs managing “smaller” AIFs, i.e.:

- AIFMs managing AIFs which are not leveraged and without redemption rights for a period of 5 years, and with 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 marketing passport.

### Grandfathering

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

- If they do not make 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.

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## Determination of the AIFM

The AIFM Law regulates AIFMs. Under certain circumstances, as the AIF may be considered internally-managed and hence itself be considered

as the AIFM. This can be the case for AIFs whose legal form permits internal management.

## 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.

### 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 players are excluded from the AIFM Law.
- Small AIFs are exempt.
- Grandfathering provisions for closed-ended funds.
- AIFM Law applies to internally managed AIFs (considered as AIFMs) and to AIFs appointing an AIFM.

## what ... does the AIFM law regulate?

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This section summarises the principal requirements defined by the AIFM Law implementing the AIFMD, which has been supplemented with more detailed rules

(*i.e.* delegated acts or implementing acts, as well as regulatory or implementing technical standards adopted for the requirements of the AIFMD) by Level 2.

### 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 expressly 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 applying 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 shall be located in Luxembourg.

Authorisation is to be sought (i) 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, or (ii) by the externally appointed AIFM, which may also provide management functions to UCITS and other services listed below.

Authorised AIFMs will be allowed to perform the following internal management 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 inquiries, 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 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 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 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'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.

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 EUR 300,000 while externally appointed AIFMs will have to maintain an initial capital of 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 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 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).

## what ... does the AIFM law regulate?

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### 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.

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### 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 the integrity of the market.

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. This will impact the way side letter arrangements are currently drafted.

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### 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;

- 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.
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### 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). 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. The AIFM Law allows AIFMs to disapply certain provisions of the latter in light of proportionality considerations allowing the adequate consideration of their size, their internal organisation and the nature, scope and complexity of their activities.

The principles laid down in the AIFM Law 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 served as a basis for the implementing guidelines on sound remuneration policies prepared by ESMA to comply with the principles set out in Annex II of the AIFM Law, listing the specific remuneration requirements.

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## 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.

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## 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, *i.a.*, 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.

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## 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.
- Remuneration policies and practices consistent with sound and effective risk management.
- Adequate liquidity and risk management systems.

## what ... does the AIFM law regulate?

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### Valuation

#### Applicable rules for the valuation of assets and NAV calculation

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.

### Publication of the NAV

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 valuation functions?

Valuation may be performed by either:

- An independent (and suitably qualified) external valuer; the AIFM must notify the CSSF of the independent valuer's appointment; 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.

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**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.

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**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.

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**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 strict 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.

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<sup>2</sup>.

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 subdelegation. 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.

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<sup>2</sup> *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 will be subject to the AIFM regime?" under "Determination of AIFM".*

#### Delegation

- Part of each management function may be delegated. No letter-box entity is permitted.
- Sub-delegation is possible.
- Delegation rules similar to UCITS provisions.
- AIFM remains liable in case of delegation.

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## Depositary

### Single depositary rule

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

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### Who may not act as depositary?

Due to the need to separate the safekeeping functions from the management functions and to segregate the investor's assets from those of

the AIFM, an AIFM is not allowed to act as a depositary.

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### 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.

In addition, 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. Such entity is subject to the prior authorisation of the CSSF, which is conditional on the production of evidence of a subscribed and fully paid-up share capital amounting to not less than EUR 500,000. This PFS status is reserved to legal entities and cannot be granted to individuals.

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### 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.

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. Depositary agreements of existing SIFs and SICARs falling within the scope of the AIFM Law will have to be reviewed. Existing corporate UCIs subject to Part II of the UCI Law will also need to amend their depositary agreements in order to provide for 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 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.

## what ... does the AIFM law regulate?

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### Transparency

The AIFM Law ensures increased transparency in 3 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 6 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 the AIF. The content thereof must include, *i.a.*, the investment strategy of the AIF, a description of the delegation of

management functions as applicable and the valuation procedure;

- Disclosure to the CSSF: AIFMs must report, for each AIF, *i.a.*, the markets in which they trade, the risk profile of the AIF, the risk management systems in place, the level of leverage and the liquidity management tools. The CSSF will further clarify the reporting obligations. The CSSF has confirmed that the annual report requirement of the AIFM Law only applies to authorised AIFMs, however the specific rules under Luxembourg Products Laws will continue to apply.
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### 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. Indeed, AIFMs 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 CSSF has a controlling power over these leverage limits and may request such ratio to be adjusted if it deems it unreasonable or likely to contribute to the risk of market disorder.

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### 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 an 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. 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, to its shareholders as well as to the CSSF. Similar disclosure shall be made to the representative(s) of the employees, or where there is none, the employees themselves 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 an SME or a real estate SPV (“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 or where there is none, 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).

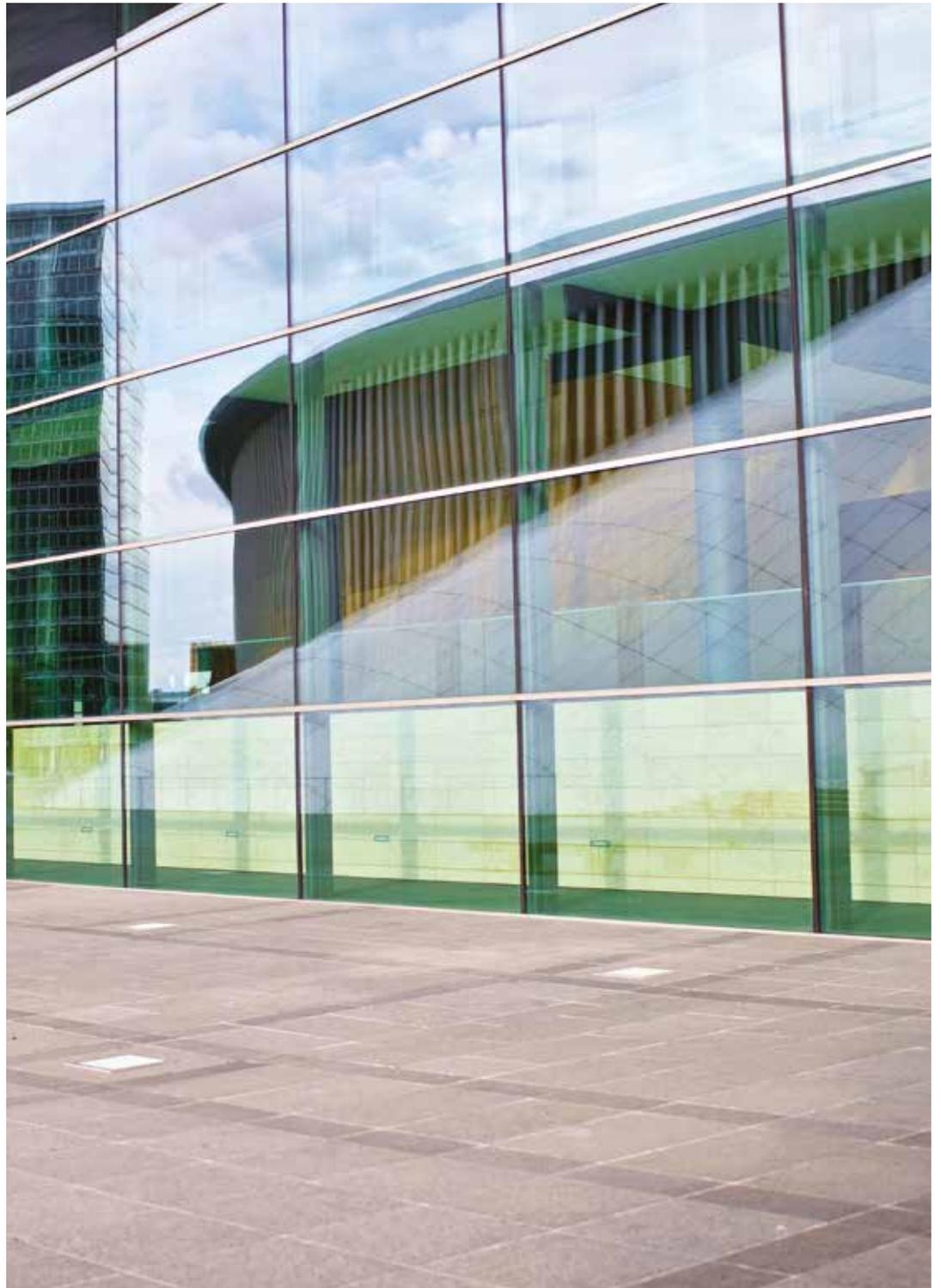
Finally, “asset stripping” is limited by the provisions of the AIFM Law which require the AIFM to use its best efforts to prevent redemptions, capital reductions and certain distributions during a period of 2 years following the acquisition of control of the portfolio company.

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## 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.



### 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 an AIF it manages, to or with investors domiciled or with a registered office in the EU. Investments made at the initiative of professional investors are therefore not covered by the AIFM Law (so-called “reverse solicitation”). They may thus continue to invest on their own initiative in AIFs.

Subject to compliance with domestic private placement rules, marketing to retail investors in Luxembourg is permitted provided that the AIF

is subject to permanent supervision by either the CSSF or the supervisory authority of the Home Member State or a third country considered to provide an equivalent standard of supervision as that applied by the CSSF. For non-regulated Luxembourg AIFs, the marketing in Luxembourg is limited to professional investors.

The various scenarios outlined below explain the functioning of the passport regime introduced by the AIFM Law and the Luxembourg private placement rules, which will continue to apply or co-exist, as well as the timing in relation thereto.

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#### Scenario 1: Passport for EU AIFMs marketing EU AIFs in the EU as from 2013

Authorised EU AIFMs may benefit from a passport for marketing EU AIFs to professional investors in the EU as of 22 July 2013. Such marketing across the EU will be subject to a notification procedure between the regulator of the EU Member State of establishment of the AIFM and the EU Member State being marketed into.

As a result, authorised EU AIFMs will no longer be able to market EU AIFs to professional investors in the EU via a private placement regime, although AIFMs existing at the date of implementation into national law may benefit from transitional relief and continue marketing under the existing private placement regime of the relevant Member State until 22 July 2014.

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#### Scenario 2: EU AIFMs marketing non-EU AIFs in the EU

##### Passport regime as from 2015

The passport regime will be available to authorised EU AIFMs marketing non-EU AIFs to professional investors in the EU as of 2015. Authorised EU AIFMs intending to market a non-EU AIF in the EU via the passport will have to fully comply with the AIFM regime and a notification procedure. In addition, appropriate cooperation agreements for the efficient exchange of information, including in tax matters, will need to exist between the EU and non-EU competent authorities and between the third country of the non-EU AIF and the Member State of the AIFM. Furthermore, the third country of the non-EU AIF must not be placed on the FATF blacklist.

##### Private placement regime between 2013 and 2018

Between 2013 and 2015, non-EU AIFs which are managed by EU AIFMs may continue to be marketed under the national private placement regimes (on a country-by-country basis), as the passport will become available from 2015 only.

During the transitional period of 3 years (*i.e.* from 2015-2018), the passport regime will co-exist with the private placement regime. Thereafter, the private placement regime is expected to be replaced entirely by the passport regime.

EU AIFMs marketing non-EU AIFs in the EU under private placement rules must comply with 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 AIFM. Furthermore, a cooperation agreement for the purpose of systemic risk oversight must exist between the relevant Home Member State and the non-EU AIF's competent authorities. Finally, the relevant third country must not be placed on the FATF blacklist.

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### Scenario 3: Non-EU AIFMs marketing AIFs in the EU

#### Authorisation requirements and passport regime for marketing EU AIFs/non-EU AIFs in the EU as from 2015

Non-EU AIFMs intending to market EU or non-EU AIFs in the EU via the passport regime must be authorised under the AIFMD by their Member State of reference, which is determined in accordance with criteria such as the Home Member State of the AIF managed by the non-EU AIFM, or the Member State where most of the AIFs managed by the AIFM are established or the Member State where the largest amount of assets is being managed.

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 i.a. the regulatory purpose of the local law to which 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.* 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 as from 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.

#### Private placement regime between 2013 and 2018

Between 2013 and 2015, according to article 45 of the AIFM Law non-EU AIFMs may continue to market AIFs under the private placement regimes (on a country-by-country basis). For a transitional period of 3 years (*i.e.* from 2015-2018), the private placement regime for non-EU AIFMs will co-exist with the passport regime. Thereafter, it is intended to replace the private placement regime entirely with the passport regime.

Non-EU AIFMs marketing AIFs in the EU under private placement rules must comply with the transparency requirements and the reporting obligations under the AIFM regime, as well as, if applicable, the requirements regarding AIFMs managing AIFs 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 country of the non-EU AIFM must not be placed on the FATF blacklist.

## what ... does the AIFM law regulate?

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### Summary of marketing scenarios

Scenario 1



2013

Passport for marketing in the EU to professional investors

Scenario 2



2013 - 2015

Private placement per EU Member State rules

2015

EU AIFM passport for marketing in the EU to professional investors

2015 - 2018

Private placement as per EU Member State rules and EU marketing passport will co-exist

Scenario 3



2013 - 2015

Private placement as per EU Member State rules

2015

Non-EU AIFM passport for marketing in the EU to professional investors

2015 - 2018

Private placement as per EU Member State rules and EU marketing passport will co-exist<sup>3</sup>

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<sup>3</sup> From 2015, non-EU AIFMs intending to manage EU AIFs shall require CSSF authorisation when Luxembourg is the Member State of reference.

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## AIFM and Taxes

### General overview

Although the AIFMD is silent on tax aspects, the AIFM Law introduces specific provisions addressing the tax status of foreign alternative

investment funds (AIFs) managed in Luxembourg, the carried interest paid to certain Luxembourg managers and VAT.

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### 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.

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### 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 2013).

- 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.

This favourable tax rate is subject to the following conditions:

- The employee moved his or her tax residency to Luxembourg in the course of 2013 or in any of the five following years;

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

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### 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.

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### 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.

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## what ... does the AIFM law regulate?

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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.

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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.

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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 that regard, the Luxembourg VAT authorities issued, on 7 November 2013,

a circular (No 723ter) clarifying that risk management functions are forming 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).

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Impacts 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.

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VAT optimisation and reduction of costs

VAT is usually considered a show stopper 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.

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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.

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## **glossary of terms**

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<b>AIF(s)</b>	Alternative Investment Fund(s)
<b>AIFM(s)</b>	Alternative Investment Fund Manager(s)
<b>AIFM Law</b>	Law of 12 July 2013 on Alternative Investment Fund Managers
<b>AIFMD</b>	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
<b>CSSF</b>	<i>Commission de Surveillance du Secteur Financier</i>
<b>Directive 2006/48/EC</b>	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)
<b>Directive 2006/73/EC</b>	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
<b>ESMA</b>	European Securities and Markets Authority
<b>EU</b>	European Union
<b>EU AIFM</b>	Means any AIFM which has its registered office in a Member State of the European Union
<b>FATF</b>	Financial Action Task Force
<b>Home Member State of an AIF</b>	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
<b>Home Member State of an AIFM</b>	Means the Member State in which the AIFM has its registered office
<b>Level 2</b>	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
<b>Member State</b>	Member State of the European Union
<b>Member State of reference</b>	Means the Member State of reference for a Non-EU AIFM
<b>MiFID</b>	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

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<b>NAV</b>	Net Asset Value
<b>Product(s) Law(s)</b>	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)
<b>Professional investor</b>	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
<b>Prospectus Directive</b>	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
<b>Retail investor</b>	An investor who is not a professional investor
<b>SICAR</b>	<i>Société d'Investissement en Capital à Risque</i> (investment company in risk capital)
<b>SICAR Law</b>	Law of 15 June 2004 on investment companies in risk capital (SICAR), as amended
<b>SIF</b>	Specialised investment fund
<b>SIF Law</b>	Law of 13 February 2007 on specialised investment funds (SIF), as amended
<b>SME</b>	Small and medium sized enterprise
<b>SPV</b>	Special Purpose Vehicle
<b>UCI</b>	Undertaking for collective investment
<b>UCI Law</b>	Law of 17 December 2010 on undertakings for collective investment (UCI) as amended
<b>UCITS</b>	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)
<b>UCITS Directive</b>	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
<b>VAT</b>	Value Added Tax

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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 1,300 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](http://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  
directive : Luxembourg implementation**