



# Alternative Investment Fund Managers – Luxembourg’s Attractive Features on Substance and Delegation

By Alexandrine Armstrong-Cerfontaine and Jean-Noel Lequeue, SJ Berwin LLP

“Luxembourg is an international financial services center. It is the world leader in investment funds which are legal products and they channel international investments through Luxembourg into Europe.” H.E. Luc Frieden, Minister of Finance, Grand Duchy of Luxembourg

On 24 August 2012, Minister of Finance Luc Frieden filed with Parliament Government Bill N° 6471 (“Bill”) on Alternative Investment Fund Managers, transposing Directive 2011/61/EU (“AIFM Directive”), that was expected to pass into legislature in December 2012. On 4 March 2013, the Chamber of Commerce of Luxembourg approved the terms of the Bill and it is expected that the Bill will be enacted into law shortly, which would make Luxembourg the first mover to implement the Alternative Investment Fund Directive.

Changes to the environment of unregulated or semi-regulated funds (e.g., SIFs, SICARs, etc.) will be profound by requiring, subject to exemption, that they be processed by a management company approved by the Commission de Surveillance du Secteur Financier, the Luxembourg financial sector regulator (“CSSF”). The AIFM Directive could arguably translate into tedious and expensive adaptations for alternative investment funds. On the basis of the terms of the Bill, pragmatism will prevail on the new operational requirements applicable to management companies.

This article aims to clarify the Luxembourg regulatory framework defining substance requirements for management companies, with an insight on changes to be expected and practical steps to be considered by managers to exploit the full potential of the transposition of the AIFM Directive in Luxembourg, where, according to the report of the Association of the Luxembourg Fund Industry published on 29 January 2013, assets of Luxembourg domiciled funds hit €2.383trn at the end of 2012. Changes to the European regulatory framework through the AIFM Directive will have an impact on investors from emerging markets whose investments in Europe are channeled through Luxembourg, traditionally referred to as the Gateway to Europe (marketing passport) and a vast array of emerging market funds, often located there alongside a fund in the United Kingdom.

## What is an AIFM?

According to the Bill, a management company (i.e., an AIFM) is a legal person whose activities are, on a regular basis, portfolio management and/or risk management of one or more alternative investment funds (“AIFs”). The definition of AIF in the Bill is extremely broad and technically includes any fund that would not be regulated by Directive 2009/65/EC of 13 July 2009 of the EU Parliament and of the Council on the coordination of laws, regulations and administrative provisions on undertakings for collective investments in transferable securities. Therefore, the Bill on AIFs and AIFMs remains very close to the terms of Article 4(1) of the AIFM Directive, which defines AIFs as collective investment undertakings, including investment compartments thereof which, (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors and (ii) do not require authorization pursuant to Article 5 of Directive 2009/65/EC and AIFMs as any legal person whose regular business is managing one or more AIFs.

Given the very broad definition of AIFs under the Bill, many fund managers will be caught by the reform. There are limited exclusions, which reflect the terms of the exclusions provided in the Alternative Investment Fund Directive. These include holding companies, supranational institutions, pension funds, securitization special purpose vehicles subject to the conditions set out in the Bill, employee participation schemes, insurance contracts, managers of funds, single investor structures where no investor is an AIF, family offices and managers of small AIFs which do not opt in the AIFM Directive to benefit from its advantages and with assets acquired with leverage lesser than EUR 100 million or assets acquired with no leverage lesser than EUR 500 million.

## No Surprise on Substance

Broadly, Luxembourg domestic law stipulates, as of today's date, that a management company is considered Luxembourg resident if it has its statutory seat or its place of effective management in Luxembourg, which is fairly easy to satisfy. It is impossible to say today with certainty what the detailed requirements for AIFMs in Luxembourg will be for a management company to be approved by the CSSF and to what extent it may delegate its functions to third parties, but it is relatively easy to guess the core principles that will be applied by the CSSF.

A management company will have to seek authorization as an AIFM if it performs either of the two functions (i.e. portfolio management or risk management) for an AIF. The conditions for obtaining and keeping such authorization will be laid down in a circular to be issued by the CSSF after the Bill is passed into legislature. However, from a policy perspective, it is difficult to see why the Luxembourg regulator would adopt a different approach to the requirements it set out for management companies authorized to manage UCITS funds with a European passport. This is because (i) the UCITS Directive and the AIFM Directive are virtually identical when addressing the conditions applicable to management companies to be authorized, (ii) the Bill translates literally the terms of the AIFM Directive on such conditions and (iii) the AIFM Directive expressly provides that management companies which are already authorized under the UCITS regime should not be required, when applying for an AIFM license, to provide information or documents already provided under the UCITS regime.

Consequently, particular attention should be given by CSSF to the AIFM's substance, i.e., its actual physical and economic presence in Luxembourg when designing organizational and operational requirements for AIFMs. Substance requirements applicable to management companies handling UCITS funds ("ManCos") have recently been designed by the Luxembourg regulator to better capture the notion of substance in Regulation 10-04 as detailed in Circular 11/508, replaced and reinforced on 26 October 2012 by Circular 12/546 on the authorization and organization of Luxembourg ManCos. Circular 12/546 will come into force on 1 July 2013 and in terms of substance, the shape of the future of ManCos and AIFMs should very much look the same.

## Sound Governance Requirements for Shareholder(s) and Directors of the Management Company

Governance requirements strengthen investor protection and are twofold. It is expected that the shareholders of AIFMs will have to show proof of (i) honesty and integrity

and transparency, as well as (ii) sufficient financial solidity for ensuring the company's long-term equity needs. It is likely that potential conflict of interests will have to be tackled when authorization will be requested from the CSSF.

The board composition and role of its members will be strengthened. Members of the board of directors of the AIFM, for their part, or where a board member is a legal person, its representative, will have to demonstrate appropriate professional experience (in addition to their good reputation) by having already exercised similar activities at a high level of responsibility and autonomy. The appreciation of what, in practice, constitutes a sufficient experience will require evidence that directors have (i) management skills and (ii) knowledge, skills and experience to understand the risks associated to the AIF's activities and the type of assets in which the AIF invests.

Furthermore, the CSSF is expected to seek information from applicants for authorization on effective management. This criterion was set in practice by the CSSF and included in Circular 12/546 for ManCos. The AIFMs will be expected to devote sufficient time to perform their and the number of mandates of their directors, their activities other than as directors and geographical location will be considered by the CSSF.

Regarding the composition of the board of directors, there will have to be at least two directors, even if that is not expressly stated by the CSSF for UCITS. This is because it would be difficult to reconcile the existence of a single director with the conflict of interest rules, which prohibit, in particular, the plurality of office of the same manager with asset management responsibilities and risk control or internal audit and compliance functions.

## Central Administration in Luxembourg

The management company will not be a plain administrative center with an administrative address in Luxembourg and the board will effectively have to manage the fund from Luxembourg with a decision making process and capacity to continuously monitor activities in Luxembourg. Therefore, at least half of the board of directors of the AIFM will be directors residing in Luxembourg or in a location that is close to Luxembourg as the AIFM's directors will have to be able to exert adequate oversight and ensure that there is adequate control over delegated activities. Furthermore, the premises of the management company will be, in addition to the decision-making center, an administrative center, with permanent compliance and risk control functions and include an IT center.

## What about Delegation?

The delegation of functions for the operating parts of the management company is expected to reflect the terms of the AIFM Directive and nothing more, as opposed to other jurisdictions where the standards set out by the AIFM Directive are considered as a minimum core on which to base rules on the decision-making processing and the organizational structure of the AIFM.

The activities of an AIFM include portfolio management and risk management for the fund and these activities can be performed under a delegation arrangement with licensed asset managers or managers with regulatory approval within the EU or, in the case of a non-EU delegate, a delegate with regulatory supervision and co-operation agreements in place with Luxembourg. The activities of an AIFM may go much beyond these two core functions and include a vast array of other functions as provided in Annex 1, and these activities could be delegated as the AIFM may think fit. There is no limitation in Luxembourg to what an AIFM may choose to delegate, provided that delegation does not render the AIFM a “letter-box” entity. The AIFM will have to notify the CSSF in advance of delegation and the CSSF will assess whether delegation exceeds by an excessive margin the investment management functions done by the AIFM itself. This limitation to delegation implies that the CSSF will verify that the AIFM remains responsible for its activities and supervises its delegates. By analogy to ManCos, delegation may relate to AIFM’s basic functions (portfolio management and risk management) both to approved entities and according to strict monitoring and intervention procedures. Delegation may also relate to administrative functions, essentially the company’s accountancy, IT, risk control, compliance and internal audit functions. As for ManCos, AIFMs will have to keep internal managers with the necessary skills for (i) supervising the AIFM’s contractors and (ii) assuming their duties (e.g., for ManCos, audits remain, even if delegated, a duty of an approved director).

## The Shape of AIFMs in Luxembourg

The regulatory framework on the substance of AIFMs based in Luxembourg is expected to adopt a sound and pragmatic approach to delegation in line with the AIFM Directive, both by the full transposition of the European directive into Luxembourg law and the resolute attitude of the Luxembourg regulator on substance. The Luxembourg local accent on flexibility in terms of potential exemptions and delegations to which the industry is used should remain, leaving sufficient headroom for the development of funds and competitiveness of the financial arena. Therefore, it is expected that AIFMs in Luxembourg will be able to optimize business functions and processes, save costs and

use expertise in administration, risk, administration and/or specific markets or investments. The absence of “letter box” test should be satisfied by a Luxembourg AIFM if the decision making centre remains in Luxembourg, i.e., management of the AIFM has the skills and resources to supervise delegated tasks effectively. This flexibility, mixed together with the long lasted and well known appeal of Luxembourg for its funds structures with sharia-compliant instruments, should ensure that Luxembourg remains the platform of choice for investors in the EUA. More generally, the European passport mixed together with the approach in Luxembourg to remain close to the fund industry’s needs mean that the market expects Luxembourg to become a premier location for emerging markets funds managers to structure a European fund.

Now is the time for managers is to identify if delegation would add value to their operations and assess which service providers will be best placed to achieve their goals, as delegates (other than UCITS managers, MiFID discretionary managers, other AIFMs and non-EU managers authorized and supervised falling within the pool of co-operation agreements between Luxembourg and non-EU countries) will have to have an appropriate organizational structure and personnel with the necessary skills and expertise in the relevant functions considered for delegation. ●●

## About the Authors



**Alexandrine Armstrong-Cerfontaine**  
is a Partner at SJ Berwin LLP



**Jean-Noel Lequeue** is a Consultant  
at SJ Berwin LLP

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