



The voice of corporate governance
in Luxembourg

AIFS AND AIFMS

A practical guide for directors

Second edition

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Building a better
working world

1. FOREWORD

Dear Directors,

It is our pleasure to introduce the second edition of the Luxembourg Institute of Directors' (ILA's) Practical guide for Directors of AIFs and AIFMs.

The mission of the ILA is to promote the profession of Directors by developing its members into highly qualified, effective and respected Directors.

This Guide aims to provide Directors of Alternative Investment Funds (AIFs) and Alternative Investment Fund Managers (AIFMs) with:

- A roadmap to the role of the Board of Directors in AIF structures covering *inter alia*:
 - The organisational models of AIFs, AIFMs and asset management group/sponsor/initiator
 - The typical roles of a governing body of an AIF or AIFM
 - The key applicable regulatory requirements
 - How the key decision-making processes work
- Insight on 20 common practical questions raised by ILA members on the governance and operation of AIF structures, from the perspective of a Director

The first edition of this Guide was issued following the implementation of the Alternative Investment Fund Managers Directive (AIFMD) by EU Member States in 2013. The AIFMD substantially raised the bar for AIFMs by laying down a more formal and prescriptive regime AIFMs and AIFs impacting organisational models, fund structures, corporate governance practices, internal controls, oversight over service providers, remuneration practices, fund documentation, and many other aspects of operations.

The AIFMD regulatory regime provides some guidance on the role of the governing body of the AIFM and the qualifications expected of its Members. This governing body is primarily responsible for the AIFM, which is required to act honestly, with due skill, care and diligence and fairly in conducting their activities, in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market, and to comply with far reaching regulatory and compliance requirements.

The AIFMD is, however, practically silent on the role of the AIF Board. The strategy and management of an AIF remains the legal responsibility of the AIF Board under most company law regimes in the EU and other provisions of EU Member States. The constitutional document of most AIF currently states that the Board of the AIF is responsible for the structure and operation of the AIF. Investors thus expect that the AIF Board will look after their best interests as investors. Regulators from all over the world will often expect that the AIF Boards will ensure compliance with all applicable laws.

The impact of AIFMD has to be reconciled with the impact of other regulations, such as Dodd-Frank, US Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard, and the European Markets Infrastructure Regulation (EMIR). Regulators, investors and the public may also demand compliance with industry guidelines, codes of conduct and ethics, etc. The financial impact of all of the above will be increase costs to launch and operate AIFs.

From a practical perspective the role of the governing body of the AIF or the AIFM should be considered in the wider contexts of the asset management group/sponsor/initiator, the AIFM, the AIF, delegates and service providers, holding structures and from multiple different perspectives. Directors now have to be part lawyer, auditor, regulatory expert, portfolio and risk manager, operational manager and systems technician, among many other things. However, they should avoid becoming too involved in day-to-day management. The principle of proportionality introduced by AIFMD allows directors to factor the nature, scale and complexity of the business into their decisions affecting AIFs and AIFMs – this principle should be used wisely with a view to building more robust corporate governance processes when size and scale permit.

Whilst sponsors/initiators may expect that the Boards of AIF and AIFM will oversee and ultimately agree with their recommendations and suggestions, Boards members should retain appropriate independence of mind.

When we completed the first edition of the Guide in 2014, we forecast that:

- 1) Luxembourg would play a leading role in the governance of AIFs and AIFMs.

This has indeed turned out to be correct: Luxembourg plays a leading role, particularly in the governance of AIFMs

- 2) It would take a few years to for consensus to be achieved and best practices to emerge.

Reassuringly, almost all the good practices we suggested in 2014 feel even more relevant today than they were then. One of the key challenges remains living up to the good practices on a day to day basis.

This second edition of the Guide nevertheless includes a number of enhancements including:

- Additional guidance on a number of key questions Directors keep asking about the governance of AIFs and AIFMs and applicable regulatory framework
- Explanation of the key requirements on governance of AIFMs implemented by CSSF Circular 18/698
- A summary of how a risk-based approach to anti-money laundering and counter terrorist financing could be implemented under the 4th anti-money laundering Directive

This Guide represents the combined views of members of the ILA Alternatives Taskforce, and not necessarily those of ILA or any of the organisations which the members represent. It is not intended to provide comprehensive guidance to all of the roles or responsibilities of Board Members, and does not represent legal advice.

The Guide is designed to complement other initiatives, such as practical industry guidance and training. Directors are recommended to refer to other Guidance, such as that published by ILA and ALFI, including the ILA Directors FAQ – Luxembourg regulated funds and participate in training initiatives for Directors, such as those organised by ILA.

While the profession of Director has never been so demanding, both technically and in terms of liability, it is also probably as interesting as it has ever been.

We hope that this guide will help guide Boards and their members to perform their duties more effectively in the context of AIFs and AIFMs and in particular to ask good questions.

We would like to thank the members of ILA Alternatives Taskforce, ILA members and others who have contributed to the development of this Guide.



Michael Hornsby



Yann Power

Whilst reasonable care has been taken in compiling this FAQ, ILA and the individual contributors do not accept any responsibility for the completeness or accuracy of its contents, in view of the constant changes in legislation, regulations and practice. Readers should take their own professional advice in order to clarify which laws, regulations and practices apply to their individual circumstances.

2. GLOSSARY OF TERMS

| ABBREVIATION OR TERM | MEANING |
|----------------------------|---|
| 2010 LAW | Law of 17 December 2010 relating to Undertakings for Collective Investment, as amended |
| AIF | Alternative investment fund |
| AIFM | Alternative investment fund manager |
| AIFMD | Alternative Investment Fund Managers Directive Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers, as amended |
| AIFM IMPLEMENTING MEASURES | Commission Delegated Regulation (EU) No 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 |
| AIFM LAW | The Law of 12 July 2013 on Alternative Investment Fund Managers, as amended |
| ALFI | Association of the Luxembourg Fund Industry |
| AML/CFT | Anti-money laundering and counter-terrorist financing |
| AML/CFT LAW | The Law of 10 November 2014 on the fight against money laundering and terrorist financing, as amended |
| CONDUCTING OFFICER | A person who effectively conducts the business of the AIFM – a member of senior management |
| CSSF | The Commission for the Supervision of the Financial Sector – <i>Commission de Surveillance du Secteur Financier</i> |
| CSSF CIRCULAR | Circular CSSF 18/698 of 23 August 2018 on the authorisation and organisation of investment fund managers incorporated under Luxembourg law and laying down specific provisions on the fight against money laundering and terrorist financing applicable to investment fund managers and entities carrying out the activity of registrar agent |
| FCP | Common fund – <i>Fonds commun de placement</i> |
| GOVERNING BODY | The body with ultimate decision-making authority in an AIFM, comprising the supervisory and the managerial functions, or only the managerial function if the two functions are separate. In this Guide, the term Board is used to refer to the governing body. |
| IFM | Investment Fund Manager such as an AIFM or a UCITS Management Company |
| ILA | Luxembourg Institute of Directors – <i>Institut Luxembourgeois des Administrateurs</i> |
| NAV | Net asset value |
| RAIF | Reserved Alternative Investment Fund |
| RAIF LAW | Law of 23 July 2016 on Reserved Alternative Investment Funds |
| SENIOR MANAGEMENT | The senior management of the AIFM, which collectively forms a Management Committee, consisting of Conducting Officers. |
| SA | Public limited company – <i>Société anonyme</i> |
| SÀRL | Private limited company – <i>Société à responsabilité limitée</i> |
| SCA | Partnership limited by shares – <i>Société en commandite par actions</i> |
| SCOSA | Cooperative company organised as a Public limited company – <i>Société cooperative organisée sous forme de société anonyme</i> |
| SCS | Limited partnership – <i>Société en commandite simple</i> |
| SCSP | Special limited partnership – <i>Société en commandite spéciale</i> |
| SE | European Company – <i>Société Européenne</i> |
| SICAR | Investment Company in Risk Capital – <i>Société d'investissement à capital à risque</i> |
| SICAR LAW | Law of 15 June 2004 on Investment Companies in Risk Capital, as amended |
| SICAV | Investment company with variable capital – <i>Société d'investissement à capital variable</i> |
| SIF | Specialised Investment Fund |
| SIF LAW | Law of 13 February 2007 on Specialised Investment Funds, as amended |
| SLA | Service level agreement |
| SUPERVISORY FUNCTION | The relevant persons or body or bodies responsible for the supervision of the AIFM's senior management and for the assessment and periodical review of the adequacy and effectiveness of the risk management process and of the policies, arrangements and procedures put in place to comply with the obligations under the AIFMD |

3. SETTING THE SCENE

This section is designed to enable Directors of AIFs and AIFMs to see their roles in the wider context, from different perspectives. It covers:

- The overall regulatory framework for Luxembourg AIFs and Luxembourg AIFMs
- Key oversight bodies in the AIF context
- Typical roles of governing bodies of AIFs and of AIFMs
- Service providers in an AIF context
- Typical Luxembourg AIF and AIFM models
- Key regulatory requirements applicable to governing bodies of AIFMs
- Internal governance of AIFMs
- Portfolio management, risk management, investment advice and holding structures

3.1. LUXEMBOURG AIFS

Luxembourg AIFs include

- Part II funds subject to the 2010 Law
- Specialised Investment Funds (SIFs)
- Investment Companies in Risk Capital (SICARs)
- Reserved Alternative Investment Funds (RAIFs)
- Other AIFs set up for example as commercial companies

Most Luxembourg AIFs, including AIFs established under the 2010 Law and SIFs, can be set up as either:

- Common funds (FCPs), which are funds in contractual form; they are not legal entities and must appoint a management company established in Luxembourg
- Investment companies (e.g. investment companies with variable capital – SICAVs), which are funds in company form; they are legal entities. Investment companies may be internally managed or may designate a management company.

The following table provides an overall summary of Luxembourg fund regimes from an AIF perspective:

| FUND | UCITS | PART II UCI | SIF | SICAR | RAIF | OTHER AIF |
|-----------------------------------|--|---|--|---|--|---|
| IS IT AN AIF? | X | √ | √ | √ | √ | √ |
| LAW | 2010 Law | 2010 Law | SIF Law | SICAR Law | RAIF Law | 1915 Law |
| BASIC STRUCTURES | | | | | | |
| - COMMON FUND (FCP) | √ | √ | √ | X | √ | X |
| - INVESTMENT COMPANY (E.G. SICAV) | √ | √ | √ | √ | √ | X |
| LEGAL FORMS | FCP SA, SE | FCP SA, SE, Sàrl, SCA, SCS, SCSp, SCoSA | FCP SA, SE, Sàrl, SCA, SCS, SCSp, SCoSA | SA, SE, Sàrl, SCA, SCS, SCSp, SCoSA | FCP SA, SE, Sàrl, SCA, SCS, SCSp, SCoSA | SA, SE, Sàrl, SCA, SCS, SCSp, SCoSA |
| ASSET CLASSES | Eligible transferable securities and liquid assets | Almost any type of asset | Any type of asset | Venture Capital / Private Equity | Any type of asset | Any type of asset |
| PRODUCT SUPERVISION | Standard | Standard | Lighter | Lighter | None | None |
| ELIGIBLE INVESTORS | No restriction | No restriction | Informed investors | Informed investors | Informed investors | No restriction |
| EU PASSPORT | Yes | Yes for professional investors in the EU, if the AIF is managed by an authorised AIFM | | | | |

3.2. LUXEMBOURG AIFMS

3.2.1. REGULATORY FRAMEWORK

The regular business of an AIFM is “managing AIF” which means performing, for one or more AIF, at least the investment management services of:

- Portfolio management
- Risk management

In general, the AIF may be authorised delegate either the portfolio management function or the risk management function, but not both (see also *Sections 3.5: Service providers in an AIF context and 3.9: Portfolio management, risk management and investment advice and holding structures*).

AIFMs may also provide the services of:

- Administration
- Marketing
- Activities related to the assets of AIF¹

AIFM authorisation is required when the sum of the assets under management of all the AIFs managed by the AIFM, or the assets under management of the internally managed AIF, exceed one of the following *de minimis* thresholds:

- €100 million (including leverage)
- €500 million in the case of unleveraged closed-ended AIF in which investors have no right of redemption for a period of at least five years from the date of initial investment in the AIF

Authorised AIFM are subject to extensive and detailed regulatory requirements.

Sub-threshold AIFM are subject to lighter regulatory requirements under the AIFM Law. They may, however, “opt in” – i.e. opt to meet all the requirements of the AIFM Law and request authorisation as an AIFM.

The following table provides an overview of possible scenarios of EU AIF managed by EU AIFM within the context of the AIFMD:

| ENTITY | REGULATORY STATUS | AIFM STATUS | IN SCOPE OF AIFMD? |
|--------|-------------------|--------------------------------------|--------------------|
| AIF | REGULATED | External AIFM | Yes |
| | | Internally managed AIF | |
| | | External sub-threshold AIFM | No ² |
| | | Internally managed sub-threshold AIF | |
| | UNREGULATED | External AIFM | Yes |
| | | Internally managed AIF | |
| | | External sub-threshold AIFM | No ³ |
| | | Internally managed sub-threshold AIF | |
| AIFM | REGULATED | External AIFM | Yes |
| | | External sub-threshold AIFM | No ⁴ |

¹ Such activities include:

- Services necessary to meet the fiduciary duties of the AIFM
- Facilities management
- Real estate administration activities
- Advice to undertakings on capital structure
- Advice to undertakings on industrial strategy and related matters
- Advice and services relating to mergers and the purchase of undertakings
- Other services connected to the management of the AIF and the companies and other assets it has invested in

² Unless the AIFM or internally managed AIF has “opted in” and obtained authorisation as an AIFM.

³ Idem.

⁴ Idem.

Typically, the CSSF authorises Luxembourg AIFM to manage one or more of the following asset classes of AIF:

- Hedge funds
- Private Equity funds
- Real Estate funds
- Fund of funds
- Other types of AIF (e.g. infrastructure, commodities, debt, tangible assets such as art)

When an AIFM wishes to manage AIF of a new asset class, it must submit a request for extension of its authorisation to the CSSF and demonstrate that it has the capacity to manage AIF in the new asset class.

A Luxembourg AIFM may also be authorised as a Luxembourg management company.

The requirement for an AIFM to obtain authorisation as a Luxembourg management company depends on the funds it intends to manage:

- If the AIFM intends to manage Luxembourg common funds (FCPs) directly, authorisation as a management company is required
- If the AIFM only intends to manage investment companies with a General Partner, then authorisation as a management company is not required

Luxembourg management companies include:

- UCITS Management Companies — authorised under Chapter 15 of the 2010 Law to manage UCITS. UCITS management companies may also be authorised to manage AIFs. If the AIFs managed by the management company are above the *de minimis* thresholds, the management company must also be authorised as an AIFM
- Non-UCITS Management Companies — authorised under Chapter 16 of the 2010 Law to manage AIFs. There are two types of Chapter 16 management Companies:
 - Article 125-1 management companies which are not authorised as AIFMs
 - Article 125-2 management companies which also authorised as AIFMs

The following table provides a brief summary of the permitted activities of Luxembourg managers of AIF, including AIFMs and management companies:

BRIEF SUMMARY OF SCOPE OF ACTIVITIES OF LUXEMBOURG MANAGERS OF ALTERNATIVE FUNDS

| | AUTHORISED AIFM | CHAPTER 16 MANAGEMENT COMPANY NOT AUTHORISED AS AN AIFM – “ARTICLE 125-1” | CHAPTER 16 MANAGEMENT COMPANY AUTHORISED AS AN AIFM – “ARTICLE 125-2” | CHAPTER 15 MANAGEMENT COMPANY |
|--|---|---|--|---|
| REGULAR BUSINESS | Managing AIFs | Managing non-UCITS (e.g. Part II UCIs, SIFs and RAIFs) either: <ul style="list-style-type: none"> • Itself as a sub-threshold manager • By delegating the investment management to an authorised AIFM | Managing AIFs | Managing UCITS |
| CAN IT MANAGE AN AIF COMMON FUND (E.G. AN FCP)? | Only if it is also authorised as a management company, i.e. it is either of: <ul style="list-style-type: none"> • A Chapter 15 Management company • A Chapter 16 Management company | Yes, subject to authorisation; must seek AIFM authorisation if the assets of all regulated and unregulated AIFs it manages, taken together, exceed the <i>de minimis</i> thresholds | Yes | Yes, subject to authorisation; must seek AIFM authorisation if the assets of all regulated and unregulated AIFs it manages, taken together, exceed the <i>de minimis</i> thresholds |
| CAN IT MANAGE AN AIF INVESTMENT COMPANY (E.G. A SICAV)? | Yes | Yes, subject to authorisation; must seek AIFM authorisation if the assets of all regulated and unregulated AIFs it manages, taken together, exceed the <i>de minimis</i> thresholds | Yes | Yes, subject to authorisation; must seek AIFM authorisation if the assets of all regulated and unregulated AIFs it manages, taken together, exceed the <i>de minimis</i> thresholds |
| OTHER POSSIBLE ACTIVITIES – MUST NOT BE THE SOLE ACTIVITY | <ul style="list-style-type: none"> • Activities related to the assets of AIF • Discretionary portfolio management • Investment advice | <ul style="list-style-type: none"> • Managing investment vehicles other than AIF | <ul style="list-style-type: none"> • Activities related to the assets of AIF • Discretionary portfolio management • Investment advice | <ul style="list-style-type: none"> • Managing AIFs • Discretionary portfolio management • Investment advice |
| KEY REGULATORY REQUIREMENTS | The provisions of the AIFM Law, the AIFM Implementing measures and the CSSF Circular apply | Certain provisions of the AIFM Law apply (e.g. on reporting to the CSSF) Certain provisions of the CSSF Circular apply | The provisions of the AIFM Law, the AIFM Implementing measures and the CSSF Circular apply | The provisions of the 2010 Law, the UCITS Implementing measures and the CSSF Circular apply; if authorised as an AIFM, AIFM Law and the AIFM Implementing measures also apply |

3.2.2. REQUIREMENTS APPLICABLE TO SHAREHOLDERS

The CSSF requires each prospective shareholder applying to hold a qualified participation in an AIFM to be of good repute and appropriately qualified. The participation must, in principle, be financed from the own funds of the shareholder.

When an AIFM applies to the CSSF for authorisation, the application file must include:

- A detailed organisational chart of the group to which the AIFM belongs
- Detailed information enabling the CSSF to assess the repute and qualifications of the prospective shareholder applying to hold a qualified participation in the AIFM
- Information on how the constitution of the AIFM will be financed

The application file must also include adequate justification regarding the choice of the AIFM structure under Luxembourg Law.

3.2.3. REQUIREMENTS APPLICABLE TO SPONSORS

The CSSF may, at any time, request a letter of sponsorship (*“lettre de patronage”*) of a Luxembourg AIFM. The issuer of this letter, typically of the initiator of the AIFM, undertakes to ensure that the sponsored AIFM respects/complies with the prudential requirements of the applicable law, in particular with regard to capital requirements. The CSSF may request such a letter of sponsorship:

- At the time of the initial authorisation of the AIFM
- At the time of any change in the shareholding of the AIFM
- During the life of the AIFM, when the financial strength of the AIFM and/or the existing shareholder(s) is no longer guaranteed

3.3. KEY OVERSIGHT BODIES IN THE AIF CONTEXT

AIFMs, their service providers, advisors, and AIFs can be configured in many different ways to deal with the specificities of different asset classes, geographies, frequency of trading of assets, and the trend towards investor influence in the oversight of an AIF.

In these different configurations, there can be a range of governance and oversight “bodies” alongside the Boards, which, together, form the fabric of the governance structure.

The key oversight bodies of AIF and their management companies/AIFM may include a combination of the following:

- Board of AIF
- Board of management company
- Board of AIFM
- Board committees:
 - Corporate governance committee
 - Appointment committee

- Investment committee
- Valuation committee
- Audit committee
- Remuneration committee
- Shareholder/Unitholder/Investor Advisory Committee (with or without decision powers)
- Management Committee, composed of Conducting Officers
- Internal control functions:
 - Risk management
 - Compliance and AML/CFT
 - Internal audit
- Boards of delegate portfolio manager, risk manager, other delegates, advisers and service providers
- Boards of holding structures

This Guide focuses primarily on the Boards of AIFs and AIFMs.

3.4. TYPICAL ROLES OF GOVERNING BODIES OF AIFS AND OF AIFMS

This section covers the key roles of governing bodies of AIFs and of AIFMs and/or their management companies.

The separation of the roles between the Board of the AIF and the Board of the AIFM and/or the management company will depend on the organisational model and the type of AIF (common fund or investment company).

The key roles of governing bodies in an AIF context include:

- **Establishing and maintaining the vision, mission and values**
- **Achieving appropriate balance in the composition of the Board:**
 - Skills: ensuring that the Board and committees (e.g., audit, investment, remuneration) has the skills set to understand and critically review the diverse aspects of the business (e.g., representing shareholder, portfolio and risk management, understanding of AIF asset classes and geographical scope, legal, compliance, oversight of delegates and service providers, risks of malpractices)
 - Independence: defining role of independent Directors (e.g., ensuring fair play, objectivity, oversight over implementation processes), ensuring that there is sufficient independence of mind at Board level to question strategy and execution thereof and raise key issues
 - Investor representation: defining the role of investor representatives (e.g., Shareholder/Unitholder/Investor Advisory Committees – See *Section 4: Question 10*), understanding who they represent and managing their output
- **Implementing Board level process:** ensuring that Board oversight is integrated into the processes of the business (e.g., portfolio management, risk management and accounting)
- **Compliance:** ensuring compliance with relevant requirements at all levels (manager, fund, holding structures in each domicile, group)
 - Law and regulatory requirements
 - AIF offering document and constitutional document (fund rules or articles of incorporation/management regulations/limited partnership agreement)
 - Internal policies and procedures
 - Codes of conduct/corporate governance codes*Annex II covers Key oversight responsibilities from a compliance perspective in more detail*
- **Managing conflicts of interest** (e.g., transactions with group entities, other related parties and investors, related party service providers such as administration, transfer agent, distributor, and depository; achieving sufficient independence at Board level in implementing strategy)
- **Due diligence on and ongoing monitoring of delegates and service providers:** ensuring initial and regular due diligence on, and ongoing monitoring of, service providers at all levels (AIFM, AIF, holding structures, underlying assets) is performed
- **Providing delegates with all the information they need to enable them to:**
 - Perform their initial client due diligence
 - Perform their ongoing client monitoring
- **Meeting substance requirements:** meeting regulatory and tax substance requirements (Board, senior management, control, professionals) at all levels (manager, fund and holding structures)
- **Portfolio management:**
 - **Oversight of investment decision-making process:** ensuring flow of information throughout the complete chain of control from advisers to managers through AIF and holding structures to underlying assets in order to ensure appropriate communication and avoid surprises when decisions are made
 - **Execution of decision making:** ensuring that instructions are executed throughout the complete chain of control from managers through AIF and holding structures to underlying assets, in accordance with legal requirements (e.g., transactions are implemented, financial statements are approved by Boards at all levels and communicated)
- **Managing advisers:** efficiently interacting with advisers while ensuring that advice remains separate from decision making
- **Ensuring that the three internal control functions are implemented and effective,** be they internal or delegated:
 - Risk management
 - Compliance
 - Internal audit
- **Ensuring independence of risk management and valuation functions from portfolio management function:** ensuring hierarchical and functional separation of the risk management function from the portfolio management function and that valuation is carried out in an independent manner
- **Ensuring that the valuation function is implemented and effective,** be it internal or external
- **Controlling and monitoring of holding structures,** as well as subsidiaries and branches. See also Annex II on the roles and responsibilities of the governing bodies of holding structures
- **Managing the investor relationship:**
 - Reporting to investors
 - Shareholder/Unitholder/limited partner meetings
 - Investor representation

- **Managing the supervisory authority relationship:**
 - Reporting to supervisory authorities
 - Responding to requests for information from supervisory authorities
 - Updates to applications for authorisation and changes to AIF documentation
- **Managing the asset management group/sponsor/initiator relationship:**
 - Protecting the interests of the sponsor
 - Generating returns for the sponsor/group/shareholder of the AIFM

An addition to the rules of conduct under the AIFMD (see *Section 3.7.3. Rules of conduct*), there are many different references which provide guidance on good governance in general, in the context of investment funds in general, or AIF in particular; some of these are referred to in Annex IV.

Common themes include:

- Acting honestly, fairly and with integrity
- Acting in the best interests of investors
- Transparency in disclosures to investors
- Maintaining confidentiality

3.5. SERVICE PROVIDERS IN AN AIF CONTEXT

A distinction is usually made between:

- Delegates, which perform a function on behalf of the AIF or the AIFM. The Board of the AIF or of the AIFM remains ultimately responsible for the work performed by delegates. Delegates may include:
 - Portfolio managers
 - Asset/property managers
 - Delegate risk management service provider
 - Central administrators/transfer agents
 - Valuers
 - Distributors
- Other service providers, some of which may be required and others which may be appointed should the Board of the AIF or of the AIFM so choose, such as investment advisors.
 - Other service providers which are required generally include:
 - The depositaries of the AIFs
 - The auditors of the AIF and of the AIFM
 - Other service providers which are not required may include:
 - Investment advisers
 - Risk management support service providers
 - Consultants
 - Lawyers
 - Tax adviser/tax compliance service provider

The responsibilities for the appointment of service providers depend on the type of AIF and the model.

Where the AIF is an investment company, there are two possible scenarios:

- 1) The AIF is externally managed; the Board of the AIF or General Partner appoints an AIFM/Management Company and the other service providers. The AIFM/Management Company may in turn delegate certain functions to specialist service providers
- 2) The AIF is internally managed AIF: the Board of the AIF or General Partner appoints all delegates and other service providers

Where the AIF is a common fund, it must be managed by a Management Company. Again there are two possible scenarios:

- 1) The Management Company is also the AIFM: the Management Company/AIFM appoints all delegates and other service providers
- 2) The Management Company appoints an external AIFM and the other service providers. The AIFM may in turn delegate certain functions to specialist service providers

See also:

- *Section 3.6: Illustrations of typical Luxembourg AIF and AIFM models*
- *Section 3.8: Portfolio management, risk management and investment advice and holding structures*
- *Section 4.3. Delegates and service providers*
- *Annex II Section II.2: Portfolio managers and investment advisers*

3.6. ILLUSTRATIONS OF TYPICAL LUXEMBOURG AIF AND AIFM MODELS

Board Members should fully understand the AIF structures and their roles and duties therein. In practice, Board Members should ensure that the AIFM formalises and maintains organisational charts, covering, *inter alia*:

- The internal organisation of the AIFM
- The relationship with group and third party service providers including:
 - Delegates
 - Other service providers
- The holding structures of the AIF
- The structure of the group, illustrating the holding structure of the AIFM

This subsection illustrates three typical Luxembourg AIF structures:

- Internally-managed AIF – a Specialised Investment Fund (SIF). Typically, this model is used in sub-threshold structures where the investors do not require AIFMD compliance. When the AIF reaches the AIFMD threshold in terms of assets under management, in general, an external AIFM is set up or appointed. An external AIFM benefits from the flexibility to manage more than one AIF whereas an internally managed AIF does not.

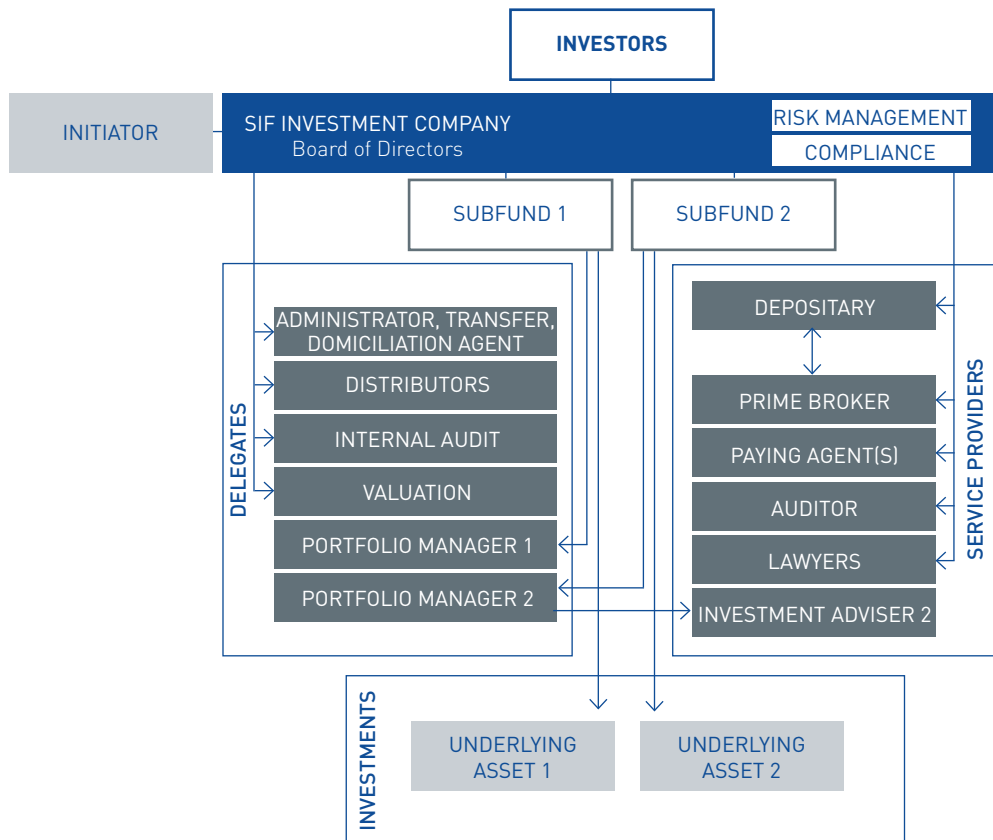
- Group AIFM with multiple AIF in a single asset class. Typically, this model is used by groups specialised in one asset class, such as real estate or private equity; the model enables the group to set up multiple AIF structures often of different types in order to meet the needs of investors.
- Independent external AIFM. Typically, this “third party” AIFM model is used by groups which wish to create an AIF but do not wish to invest in setting up an authorised AIFM. The third party AIFM takes responsibility for most of the regulatory compliance. The group may play multiple roles in such a structure – for example:
 - Group representatives may be appointed to the Board of the AIF
 - Group entities may take on the roles of delegate portfolio manager (i.e. a delegate with responsibility for portfolio management) and/or investment adviser
 - Group entities may be appointed to distribute the AIF

Many other organisational models and structures are possible. A selection of basic schematics can be found in Annex I.

3.6.1. ILLUSTRATION 1. INTERNALLY MANAGED AIF – SIF

| SUMMARY | |
|---------------------|---|
| TYPES OF AIF | A SIF investment company, typically a SICAV or a common fund or special limited partnership |
| MANAGEMENT | An internally managed AIF |
| TYPICAL UTILISATION | One asset class, typically a multiple sub-fund (compartment) structure investing in financial assets (such as a hedge fund) |

SCHEMATIC OF INTERNALLY MANAGED AIF-SIF⁵



Source: EY

⁵ This schematic shows a greater level of granularity as regards the relationship between the AIF, AIFM and service providers than the following illustrations.

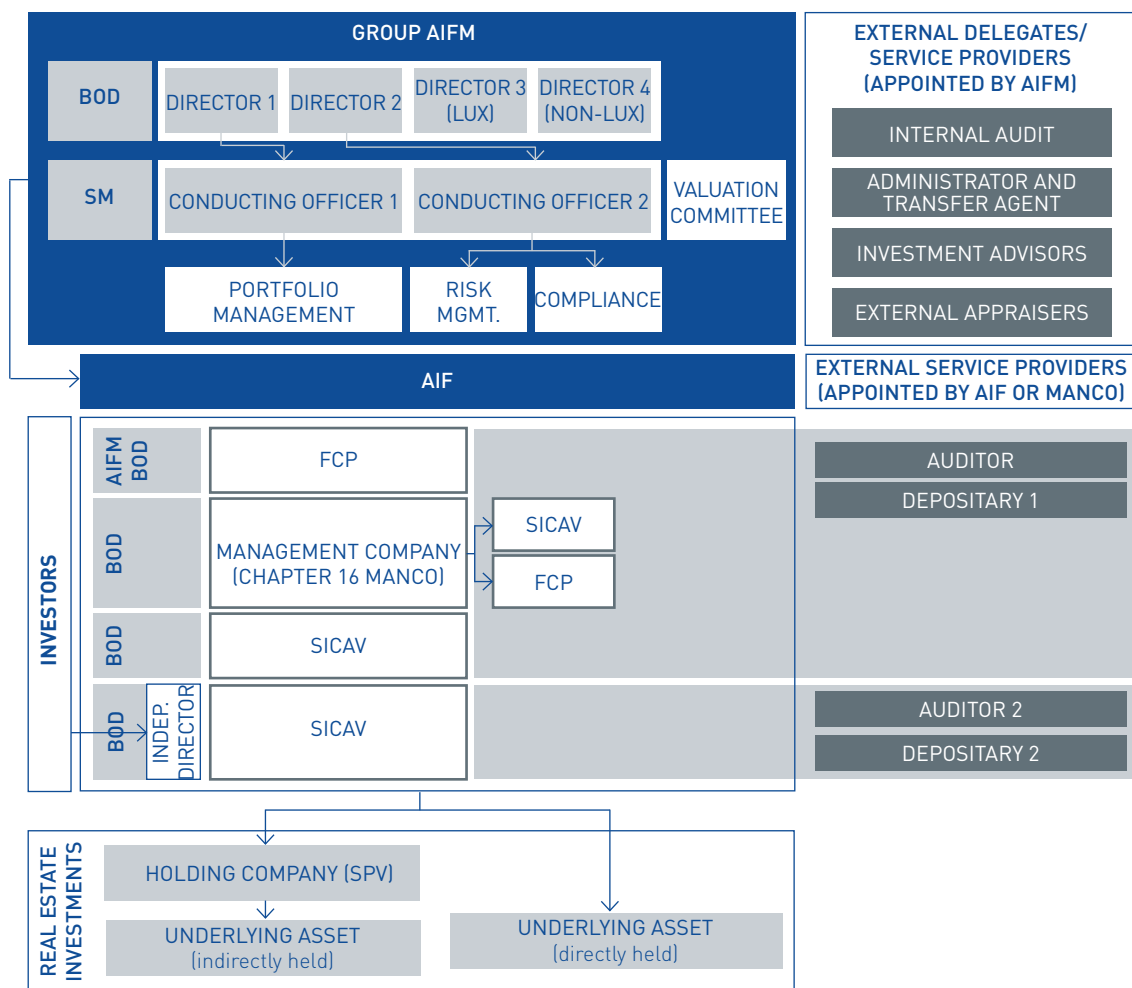
| AIFM INTERNAL ORGANISATION | |
|----------------------------|--|
| ROLE | IMPLEMENTATION |
| BOARD OF DIRECTORS | Three Board Members from the group |
| SENIOR MANAGEMENT | Two conducting officers (senior managers): <ul style="list-style-type: none"> • One responsible for the oversight of portfolio management, and the oversight of delegates (apart from external valuer), and service providers • One responsible for risk management, compliance, valuation, and all the other AIFM functions |
| RISK MANAGEMENT | The Risk manager is a conducting officer |
| COMPLIANCE | The Compliance officer insourced from a third party which makes the compliance officer available |
| INTERNAL AUDIT | The internal audit function outsourced to a third party |
| VALUATION | Valuation is overseen by a conducting officer; this involves, <i>inter alia</i> , overseeing the implementation of the valuation policies, approving valuation methodologies and overseeing the valuation process of the third party service providers (in this case, an administrator and an external valuer) |
| EMPLOYEES | No other employees |

| SERVICE PROVIDER ROLES | |
|----------------------------|--|
| SERVICE PROVIDER | IMPLEMENTATION |
| AIFM | Internally managed AIF; no external AIFM |
| PORTFOLIO MANAGEMENT | Portfolio management of each sub-fund is outsourced to different third party portfolio managers: <ul style="list-style-type: none"> • Portfolio manager 1 manages the assets without advice • Portfolio manager 2 seeks the advice of investment adviser 2 |
| INTERNAL CONTROL FUNCTIONS | The internally managed AIF: <ul style="list-style-type: none"> • Has its own risk management and compliance functions, although only the risk management function is exercised by a member of staff • Has delegated internal audit to a third party |
| ADMINISTRATION | The AIFM has delegated administration to a third party administrator. |
| VALUATION | Pricing services are provided by the administrator. The valuation of OTC derivatives is delegated to an external valuer. |
| DISTRIBUTION | The AIFM has appointed distributors in each country of distribution. |
| DEPOSITARY | A depositary has been appointed by the Board of the internally managed AIF. The depositary is from the same group as the administrator. |
| PRIME BROKER | The prime broker has been appointed by the internally managed AIF through a tripartite agreement between the internally managed AIF, the depositary and the prime broker. |
| PAYING AGENT | The depositary has also been appointed to provide paying agent services through its network. |
| AUDITOR | The independent auditor has been appointed by the Board of the internally managed AIF. |
| LAWYERS | The Board of the internally managed AIF has appointed a legal adviser. |

3.6.2. ILLUSTRATION 2: GROUP AIFM WITH MULTIPLE AIF IN A SINGLE ASSET CLASS

| SUMMARY | |
|---------------------|---|
| TYPES OF AIF | Mix of common funds (FCPs) and investment companies (SICAVs). One of the investment companies has independent directors representing certain investors (the "Club Deal" AIF ⁶). |
| MANAGEMENT | Externally managed AIF by a group AIFM. |
| TYPICAL UTILISATION | One illiquid asset class (such as real estate or private equity). |

GROUP AIFM WITH MULTIPLE AIF IN A SINGLE ASSET CLASS⁷



Source: EY

⁶ This Club Deal is not a joint venture.

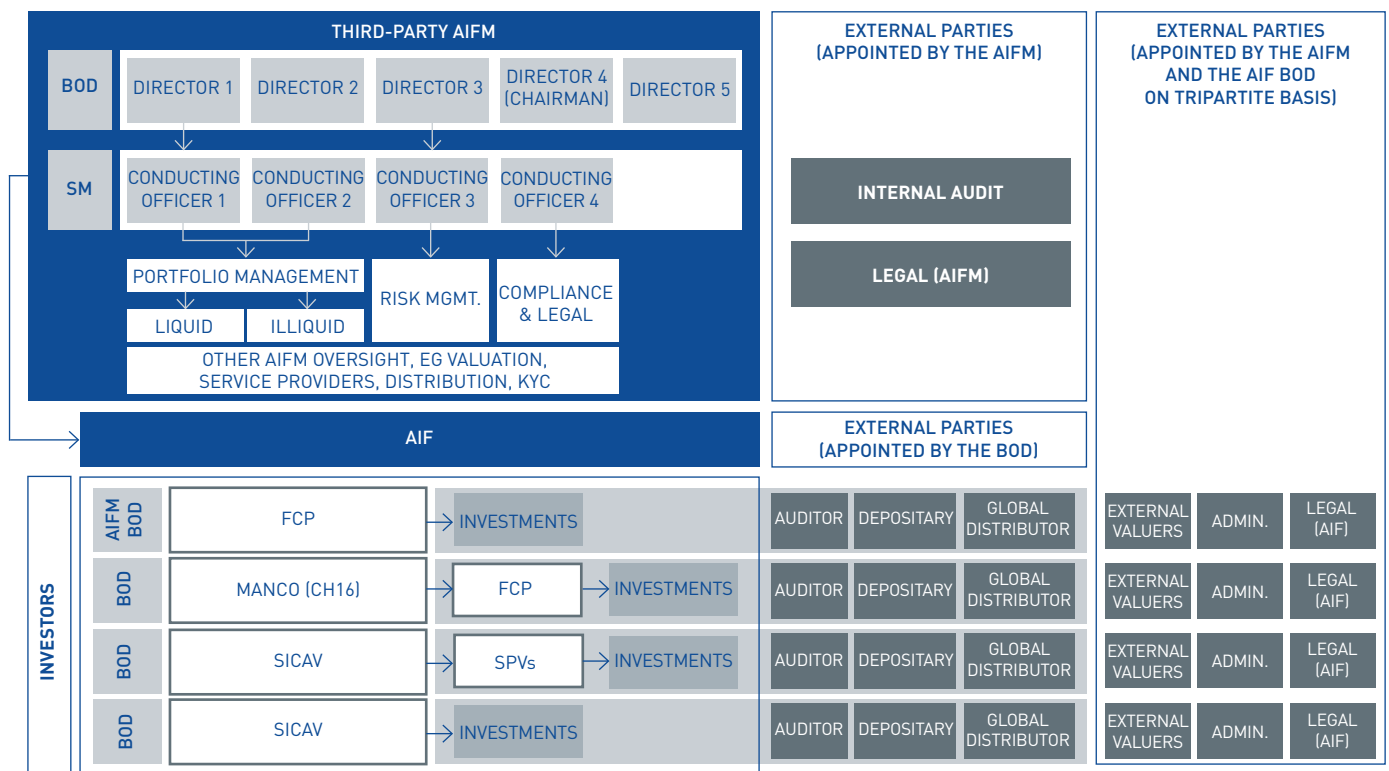
⁷ This schematic shows a lower level of granularity as regards the relationship between the AIF, AIFM and service providers. See Illustration 1 for a greater level of granularity.

| AIFM INTERNAL ORGANISATION | |
|----------------------------|--|
| ROLE | IMPLEMENTATION |
| BOARD OF DIRECTORS | Four Board Members: <ul style="list-style-type: none"> • Two Board Members who are also conducting officers (senior managers) • One Board Member from the Board of the largest AIF managed by the AIFM (Chairman with a casting vote) • One Group Board Member |
| SENIOR MANAGEMENT | Two conducting officers: <ul style="list-style-type: none"> • One responsible for the oversight of portfolio management and internal audit • One responsible for the oversight of risk management, valuation, and all the other AIFM functions, and the oversight of delegates (except internal audit) and service providers |
| RISK MANAGEMENT | One risk manager, a member of staff of the AIFM. |
| COMPLIANCE | One compliance officer, a member of staff of the AIFM. |
| INTERNAL AUDIT | Internal audit function outsourced to Group internal audit. |
| VALUATION | The valuation function consists of a valuation committee; the role involves, <i>inter alia</i> , overseeing the implementation of the valuation policies, approving valuation methodologies and overseeing the valuation process of the third party service providers (in this case, appraisers and NAV calculation by the administrator) |
| EMPLOYEES | Four additional employees |

| SERVICE PROVIDER ROLES | |
|----------------------------|--|
| SERVICE PROVIDER | IMPLEMENTATION |
| AIFM | The group has created a single group AIFM in Luxembourg for all its AIF structures: <ul style="list-style-type: none"> • The Boards of the AIF investment companies have each appointed the AIFM • The Board of the management company of the legacy common funds has appointed the AIFM • The AIFM has created a new common fund directly, so the governing body of the AIFM has ultimate responsibility for the new common fund AIF; there is no external oversight |
| PORTFOLIO MANAGEMENT | The AIFM performs the portfolio management. It has appointed specialised third party investment advisers, including advisers specialised in: <ul style="list-style-type: none"> • European assets • Asian assets |
| INTERNAL CONTROL FUNCTIONS | The AIFM: <ul style="list-style-type: none"> • Has its own risk management and compliance functions • Has outsourced internal audit to a third party |
| ADMINISTRATION | The AIFM has delegated administration to a third party administrator. |
| VALUATION | The appraisal of real estate and other underlying investments is performed by external appraisers and overseen by the valuation committee. |
| DISTRIBUTION | The AIFM performs the distribution/marketing of AIFs itself. |
| DEPOSITARY | The same depositary has been appointed for all the AIFs, except the "Club Deal" AIF, which has appointed a different depositary. The depositaries and paying agents have been appointed by: <ul style="list-style-type: none"> • In the case of the investment companies, the Boards of the AIFs • In the case of the legacy common fund, its management company • In case of the directly managed common fund, the AIFM itself |
| AUDITOR | The same independent auditor has been appointed for the AIFM, and all the AIF, except the "Club deal" AIF, which has appointed a different independent auditor. The independent auditors have been appointed by: <ul style="list-style-type: none"> • In the case of the investment companies, the Boards of the AIFs • In the case of the legacy common fund, its management company • In case of the directly managed common fund, the AIFM itself |
| LAWYERS | The Board of the AIFM has appointed a legal adviser. The legal adviser is used by the AIFM, the management company and the Boards of the AIF investment companies, except the "Club deal" AIF which has appointed a different legal adviser. |

3.6.3. ILLUSTRATION 3: INDEPENDENT EXTERNAL AIFM

| SUMMARY | |
|---------------------|---|
| TYPES OF AIF | Mix of common funds (FCPs) and investment companies (SICAVs). |
| MANAGEMENT | AIFs externally managed by an independent third-party AIFM. |
| TYPICAL UTILISATION | Both liquid and illiquid asset classes, such as equities, bonds, hedge funds, private equity and real estate funds. |



Source: ManagementPlus (Luxembourg)

| AIFM INTERNAL ORGANISATION | |
|----------------------------|--|
| ROLE | IMPLEMENTATION |
| BOARD OF DIRECTORS | Five Board members: <ul style="list-style-type: none"> Two Board Members who are also conducting officers of the AIFM Three Board Members from the AIFM group, including the chairman. |
| SENIOR MANAGEMENT | Four conducting officers: <ul style="list-style-type: none"> One primarily responsible for oversight of portfolio management of illiquid assets (mainly private equity and real estate) One primarily responsible for oversight of portfolio management of liquid assets (equities, bonds, hedge funds) One primarily responsible for oversight of risk management One primarily responsible for compliance The conducting officers committee jointly oversees valuation, delegates and service providers, and all other AIFM functions. |
| RISK MANAGEMENT | One risk manager (employee) |
| COMPLIANCE | One compliance officer (employee) |
| INTERNAL AUDIT | Internal audit outsourced to a third party |
| EMPLOYEES | Four other employees |

SERVICE PROVIDER ROLES

| ROLE | IMPLEMENTATION |
|----------------------------|---|
| AIFM | <p>The independent corporate governance group has created a single third-party AIFM entity in Luxembourg to manage all of its client AIF structures:</p> <ul style="list-style-type: none"> • The Board of the AIF investment companies will appoint the AIFM • For existing common funds, the common fund management company will appoint the AIFM • The AIFM will create new common funds directly as a management company, so the governing body of the AIFM will have direct responsibility for the new common fund AIFs |
| PORTFOLIO MANAGEMENT | <p>The AIFM delegates portfolio management fully for each liquid AIF and for some illiquid AIFs to specialised portfolio managers who are themselves authorised or registered for the purpose of asset management, either in the client group or on a third-party basis.</p> <p>The AIFM retains fiduciary responsibility, and oversees the portfolio management delegation via a service level agreement (SLA), incident reporting and periodic meetings.</p> <p>The AIFM is the nominated portfolio manager for some illiquid AIFs (e.g., real estate), where investment frequency is limited, but appoints an investment adviser to :</p> <ul style="list-style-type: none"> • Source opportunities • Perform due diligence • Recommend transactions • Negotiate financing terms • Provide day-to-day asset (property) management services <p>The investment adviser may be in the client group or may be appointed on a third-party basis.</p> |
| RISK MANAGEMENT | <p>The AIFM retains oversight of risk management, but may delegate data collection and calculation functions to various third parties, depending on the risk topics and specific sector knowledge required.</p> |
| INTERNAL CONTROL FUNCTIONS | <p>The AIFM:</p> <ul style="list-style-type: none"> • Has its own risk management and compliance functions • Has delegated internal audit to a third party |
| ADMINISTRATION | <p>The Board of Directors of the AIF and the AIFM delegate administration on a tripartite basis to a client group administrator or third party administrator for each AIF, depending on preferences indicated by client groups and on specific capabilities required.</p> |
| VALUATION | <p>The AIFM oversees the valuation process. The Board of Directors of the AIF and the AIFM may delegate valuation on a tripartite basis, using various external valuers and advisers (including the client's valuation committee, etc.) as required for different AIFs.</p> |
| DISTRIBUTION | <p>The Board of Directors of the AIF delegates distribution to a global distributor for each AIF, which usually will be to each client group, who then may appoint further sub-distributors.</p> |
| DEPOSITARY | <p>The Board of Directors of the AIF, with the AIFM's agreement, delegates depositary functions to a single depositary for each AIF, depending on preferences indicated by client groups and on specific capabilities required.</p> <p>The depositaries and paying agents have been appointed by:</p> <ul style="list-style-type: none"> • For the investment companies, the Board of the AIF • For existing common funds, the common fund management company • For the new directly managed common funds, the AIFM itself |
| AUDITOR | <p>The independent auditors for each AIF have been appointed:</p> <ul style="list-style-type: none"> • For the investment companies, by the Board of the AIF or the general meeting of shareholders • For existing common funds, by the common fund management company • For the new directly managed common funds, by the AIFM itself |
| LAWYERS | <p>The AIFM will appoint its own legal adviser with regards to AIFM issues. The Board of Directors of the AIF and the AIFM appoint on a tripartite basis legal advisers proposed by the sponsor of each AIF with regards to AIF issues.</p> |

3.7. REQUIREMENTS APPLICABLE TO GOVERNING BODIES OF AIFMS

The AIFM Directive, the AIFM Law, the relevant Implementing measures and the CSSF Circular, set down key requirements for Members of the governing body, including:

- Composition and qualifications of the governing body
- Roles of the governing body
- Rules of conduct

The AIFMD and the Circular underline some key responsibilities of Boards of Directors of AIFM, but does not lay down in detail what is expected of the Board.

This subsection summarises the key requirements.

3.7.1. COMPOSITION AND QUALIFICATIONS OF THE GOVERNING BODY

The CSSF puts a lot of emphasis on the composition, capacity and competencies of Directors during the regulatory approval process.

The requirements on the composition and qualifications of the governing bodies of AIFMs, as laid down in the regulations, are summarised in the following table:

| MINIMUM QUALIFICATIONS OF GOVERNING BODIES OF AIFM | |
|--|--|
| NUMBER OF MEMBERS | The governing body of the AIFM must be composed of at least three Board Members |
| KNOWLEDGE, SKILLS AND EXPERIENCE | The governing body of the AIFM must possess adequate collective knowledge, skills and experience to be able to understand the AIFM's activities, in particular the main risks involved in those activities and the assets in which the AIF is invested |
| SUFFICIENT TIME AND DEDICATION | <p>The Members of the governing body must commit sufficient time to properly perform their functions in the AIFM, considering the nature, scale and complexity of its activities. They must therefore limit the number of other professional engagements and mandates accordingly. The CSSF Circular clarifies the limits on the number of Board mandates:</p> <ul style="list-style-type: none"> • Each candidate for a position as Member of the Board of Directors/Managers of an AIFM is required to meet the following requirements: <ul style="list-style-type: none"> – The hours devoted to professional commitments must not exceed 1,920 hours per year – The number of mandates in regulated entities and operating companies must not exceed 20 mandates <p>In practice, assuming 48 working weeks per year, this means that the CSSF seems to expect a Board Member to dedicate at least approximately 2 hours per mandate per week to an AIFM Board mandate. The CSSF Circular clarifies that "mandate" means any role as a member of a managing body or governing body or of a supervisory function or of senior management, in regulated or unregulated entities.</p> <ul style="list-style-type: none"> • Where one of the thresholds is exceeded, the Board member must describe the measures in place to ensure that additional mandates receive appropriate time and attention, describe how he organises his workload and detail the support he benefits from • Under certain conditions, some types of mandates may be considered as one: <ul style="list-style-type: none"> – Mandates in underlying SPVs of a UCI – Fund mandates with the same initiator – Group mandates |
| REPUTATION ⁸ , INTEGRITY AND INDEPENDENCE | <p>Each Member of the governing body must act with honesty, integrity and independence of mind. The CSSF Circular clarifies that:</p> <ul style="list-style-type: none"> • The Board of Directors/Managers should not be composed predominately of people who hold an executive position or in the AIFM (Conducting Officers) or other employees of the AIFM (with the exception of staff representatives) • In case of Funds in corporate form, the Board of Directors/Managers of the AIFM and the Board of the UCI should not be composed mainly of the same people • The AIFM must also ensure sufficient independence from the depositary |
| TRAINING | The AIFM must devote adequate resources to the induction and training of Members of the governing body. |
| MEETINGS | The Board must meet on at least a quarterly basis |

3.7.2. ROLES OF THE GOVERNING BODY

The roles of the governing bodies of an AIFM, as laid down in the regulations, include the following:

| ROLES OF GOVERNING BODIES OF AIFM | |
|-----------------------------------|--|
| COMPLIANCE | <p>The governing body, the senior management and, where it exists, the supervisory function, are responsible for the AIFM's compliance with its obligations under the AIFM Directive.</p> <p>Senior management and, where appropriate, its governing body or supervisory function must:</p> <ul style="list-style-type: none"> • Assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations laid down in the AIFM Directive and AIFM Law • Take appropriate measures to address any deficiencies |
| INTERNAL CONTROLS | <p>The governing body or the supervisory function, if any, must receive on a regular basis written reports on matters of compliance, internal audit and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.</p> |
| RISK MANAGEMENT | <p>The risk management function must be represented in the governing body or the supervisory function, where it has been established, at least with the same authority as the portfolio management function. The AIFM's governing body and, where it exists, its supervisory function:</p> <ul style="list-style-type: none"> • Must be notified in a timely manner by the permanent risk management function when it considers the AIF's risk profile inconsistent with the risk limits or sees a material risk that the risk profile will become inconsistent with these limits • Receives regular updates from the permanent risk management function on: <ul style="list-style-type: none"> – The consistency between and compliance with the risk limits and the risk profile of the AIF as disclosed to investors – The adequacy and effectiveness of the risk management process, indicating in particular whether appropriate remedial measures have been or will be taken in the event of any actual or anticipated deficiencies • Reviews the functional and hierarchical separation of the risk management function |
| CONFLICTS OF INTEREST | <p>The governing body of the AIFM and, where it exists, the supervisory function must establish the safeguards against conflicts of interest, regularly review their effectiveness and take timely remedial action to address any deficiencies.</p> |
| REMUNERATION | <p>AIFMD: The Board of the AIFM, in its supervisory function, must adopt and periodically review the general principles of the remuneration policy and is responsible for its implementation.</p> <p>All regulated entities: The Board of Directors must establish the general principles of the remuneration policy and is responsible for its implementation.</p> <p>The Board of Directors must fix the remuneration of the Members of the governing and management bodies.⁹</p> |

⁸ The concept of good repute of members of the Board of Directors or of senior management does not seem to be clarified in the regulations in relation to management entities. However, the Commission Level 2 Delegated Regulation does provide some clarifications with respect to the "good repute" of persons who effectively conduct the business of a delegate. They shall not be deemed of sufficiently good repute if they have any negative records relevant both for the assessment of good repute and for the proper performance of the delegated tasks or if there is other relevant information which affects their good reputation. Such negative records shall include but shall not be limited to criminal offences, judicial proceedings or administrative sanctions relevant for the performance of the delegated tasks. Special attention shall be given to any offences related to financial activities, including but not limited to obligations relating to the prevention of money laundering, dishonesty, fraud or financial crime, bankruptcy or insolvency. Other relevant information shall include information such as that indicating that the person is not trustworthy or honest.

Furthermore, where the delegate is regulated in respect of its professional services within the EU, the persons who conduct the business may be deemed to be of "good repute" when the relevant supervisory authority has reviewed the criterion of "good repute" within the authorisation procedure, unless there is evidence to the contrary.

⁹ CSSF Circular 10/437

3.7.3. RULES OF CONDUCT

AIFMs must at all times:

- Act honestly, with due skill, care and diligence and fairly in conducting their activities
- Act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market
- Have and employ effectively the resources and procedures that are necessary for the proper performance of their business activities
- Take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable, disclose those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated
- Comply with all regulatory requirements applicable to the conduct of their business activities so as to promote the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market
- Treat all AIF investors fairly

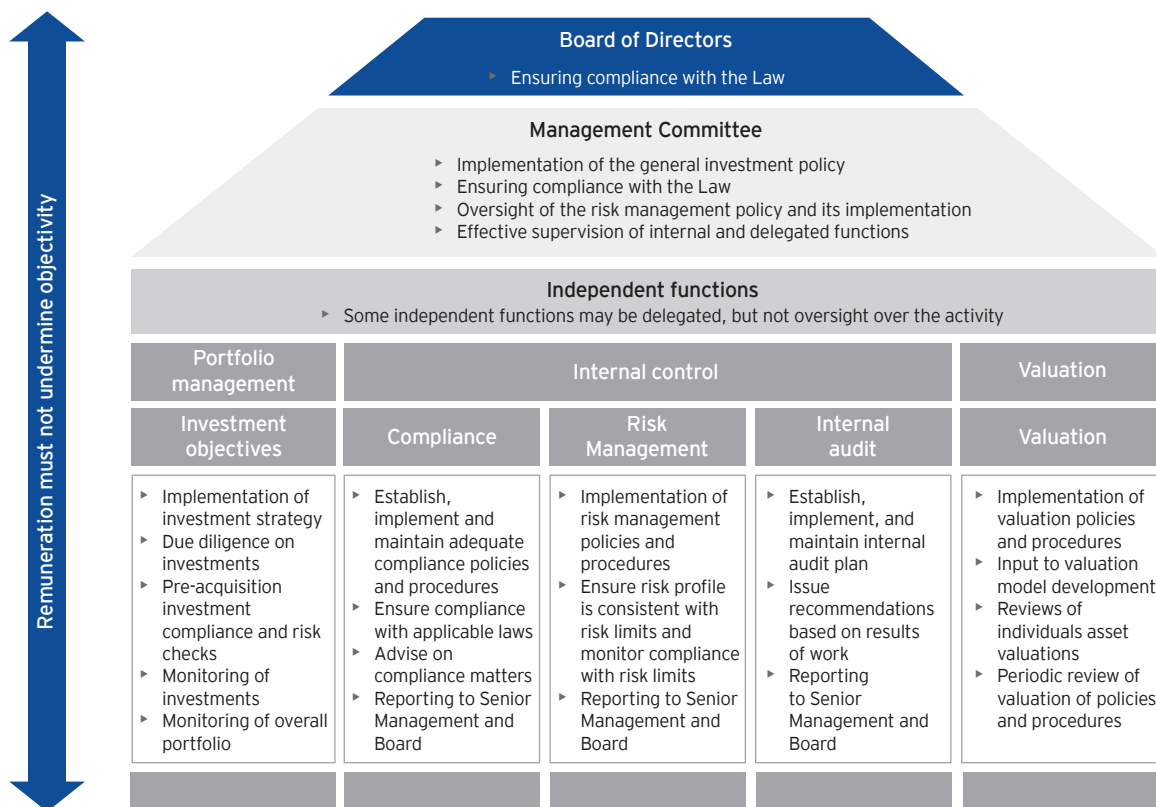
No investor in an AIF can obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF's management regulations or instruments of incorporation.

An AIFM which is authorised to provide discretionary portfolio management services is not permitted to invest all or part of the client's portfolio in units or shares of the AIFs it manages, unless it receives prior general approval from the client.

In relation to conflicts of interest impacting individual Board Members, each Board Member is required to disclose any other mandates they have outside of the AIFM to the Board of Directors/Managers of the AIFM.

3.8. INTERNAL GOVERNANCE OF AIFMS

The following illustrates the overall governance structure of an AIFM, including the independent functions:



3.8.1. SENIOR MANAGEMENT/MANAGEMENT COMMITTEE

The Members of Senior Management (“Conducting Officers”) effectively conduct the business of the AIFM on a day-to-day business.

Each AIFM is required, in principle, to employ in Luxembourg a minimum of two Conducting Officers each devoting one full-time equivalent (“FTE”) to their work in the AIFM:

- The Conducting Officers should be bound by an employment contract with the AIFM
- The CSSF may, however, accept that one or more Conducting Officers is/are made available by or seconded from another company provided that there is an agreement precisely defining their rights and obligations and, where appropriate, who they report to

The requirements on the conducting persons depends on the assets under management of the AIFM:

| REQUIREMENTS ON CONDUCTING PERSONS DEPENDANT ON ASSETS UNDER MANAGEMENT | | |
|---|---|---|
| | AIFMS WITH < €1.5BN OF ASSETS UNDER MANAGEMENT | AIFMS WITH > €1.5BN OF ASSETS UNDER MANAGEMENT |
| LIMITS TO HOLDING EXECUTIVE POSITIONS IN OTHER IFMS | The Conducting Officers may not hold more than two executive positions in IFMs. | The two legally required Conducting Officers may not hold any other Conducting Officer mandate in another IFM. |
| PERMANENCE IN LUXEMBOURG | In principle the Conducting Officers must be permanently available in Luxembourg. However, the CSSF may accept that only one of the two legally required Conducting Officers is permanently available in Luxembourg, subject to certain conditions. | If the AIFM has only two Conducting Officers, then these two Conducting Officers must be permanently available in Luxembourg. The CSSF may accept that additional Conducting Officers are not permanently available in Luxembourg, and/or spend less than one FTE on their role, subject to certain conditions. |
| ADDITIONAL CONDUCTING OFFICERS | The CSSF may accept that additional Conducting Officers spend less than one FTE on their role, subject to certain conditions. | The CSSF may accept that additional Conducting Officers spend less than one FTE on their role, subject to certain conditions. |

Any conflicts arising from organisation of the Conducting Officers must be identified; the AIFM must strive to avoid conflicts of interest in the organisation of the Conducting Officers.

Conducting Officers should have appropriate support for the performance of their daily tasks provided by qualified staff, which should be sufficient in number and work in Luxembourg for the performance of the daily tasks. The staff employed, if any, within one or several branches of the AIFM may be taken into account.

Responsibility for the oversight of each of the key functions of the AIFM must be allocated to one of the Conducting Officers including:

- Investment management
- Risk management
- Fund Administration
- Marketing
- Compliance
- Internal audit
- AML/CFT
- Complaints handling
- Valuation
- IT
- Accounting

The allocation of tasks between Conducting Officers must be organised so as to avoid conflicts of interest.

The Conducting Officers must work in close collaboration in the execution of their tasks. They must be in contact with each other on a regular basis.

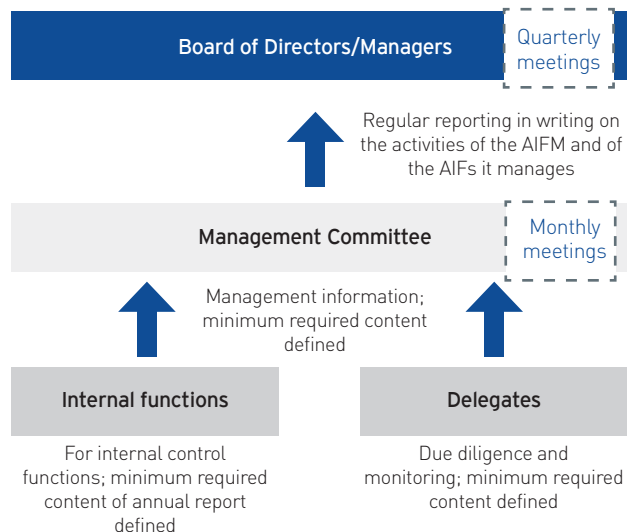
The Conducting Officers form, collectively, a Management Committee.

Conducting Officers must hold periodic Management Committee meetings in Luxembourg:

- The frequency must be appropriate to the size and the structure of the AIFM and the nature, scale and complexity of its activities, but at least monthly
- An analysis of 'management information' must be presented and discussed at the Management Committee meetings held at least on a monthly basis in Luxembourg
- The activities of the AIFM and the UCIs it manages should be reviewed
- The Management Committee meetings must be recorded in writing (minutes), in particular documenting the decisions and actions taken by the AIFM

The Circular defines the minimum content of the 'management information', which includes information from internal functions, delegates and other service providers. The minimum content of the annual reports of the internal control functions and the due diligence and monitoring of delegates is defined in the Circular.

The Management Committee must regularly inform the Board of Directors/Managers, in writing, regarding the activities and the AIFM and the UCI it manages.

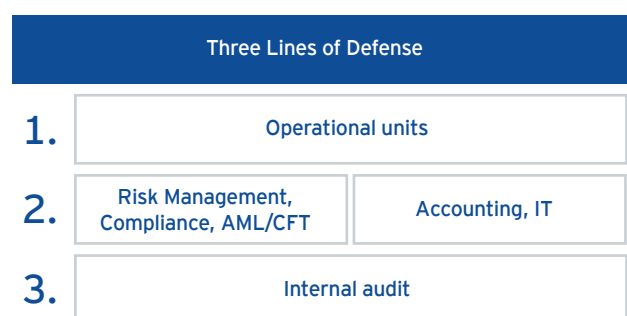


Source: mebs

3.8.2. THREE LINES OF DEFENCE

The AIFM must set up an internal governance framework in accordance to the "three lines of defence" model.

1. Operational units
2. Risk management, compliance, AML/CFT, IT and accounting function
3. Internal audit function



Source: mebs

The following diagram illustrates the incompatibilities between functions in an AIFM:

| | | | | | | | | | |
|------------------------------|--------------------|--------------------|----------------------|---------------------------|---------------------------|------------------------|------------------------------|-----------|--|
| Conducting Officer | YES ^{4,6} | | | | | | | | |
| Portfolio Management | YES ⁶ | YES ⁵ | | | | | | | |
| Head of Risk Management | YES ^{2,6} | YES ^{2,5} | NO | | | | | | |
| Head of Compliance | YES ^{2,6} | YES ² | NO | YES | | | | | |
| Head of Internal Audit | YES ^{3,6} | YES ³ | NO | NO | NO | | | | |
| AML/CFT Officer ¹ | YES ^{1,6} | YES ² | NO | YES | YES ¹ | NO | | | |
| Valuation | YES ⁶ | YES | NO | Generally NO ⁷ | Generally NO ⁷ | NO | Generally NO ⁷ | | |
| Accounting | YES ⁶ | YES | Generally NO | Generally NO ⁷ | Generally NO ⁷ | NO | Generally NO ⁷ | YES | |
| | Board | Conducting Officer | Portfolio Management | Head of Risk Management | Head of Compliance | Head of Internal Audit | AML/CFT Officer ¹ | Valuation | |

1. Under the responsibility of the Compliance Officer.
2. This role is incompatible with Internal Audit. A Board member must also be a Conducting Officer to assume this role. The Conducting Officer responsible for overseeing Risk Management and/or Compliance may not be the Head of Internal Audit, nor be responsible for overseeing Internal Audit.
3. This role is incompatible with Risk Management, Compliance Officer and AML/CFT. A Board member must also be a Conducting Officer to assume this role. The Conducting Officer responsible for overseeing Internal Audit may not be the Head of Risk Management and/or the Head of Compliance, nor be responsible for overseeing Risk Management and/or Compliance.
4. Conducting Officers must not be in a majority on the Board of the IFM.
5. The Conducting Officer responsible of Portfolio Management may not combine this role with Risk Management and may not be responsible for overseeing Risk Management (functional and hierarchical separation).
6. The Board members of the IFM should not be in a majority in the Board of the UCI.
7. Generally, the control functions should be independent of the functions which they control

Source: mebs

3.8.3. INTERNAL CONTROL FUNCTIONS

An AIFM is required put in place the following internal control functions:

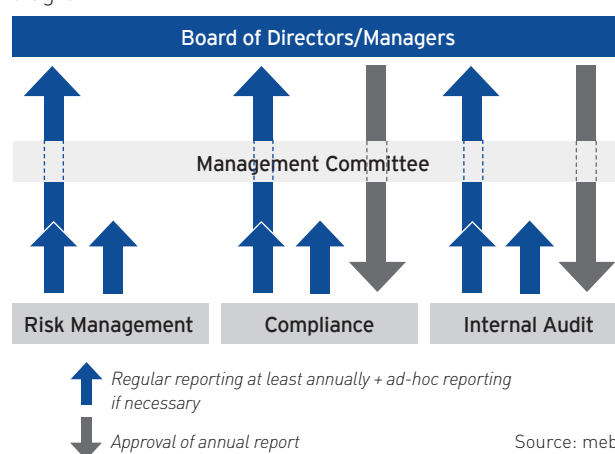
- Risk management
- Compliance
- Internal audit

The principle of proportionality does not permit an AIFM not to have one of the internal control functions.

The main purpose of internal control functions is to verify compliance with all internal policies and procedures that fall within their scope, to periodically assess their adequacy, its strategies, activities and risks, the legal and applicable regulatory requirements, and directly report on these matters to the Conducting Officers and the Board. They provide advice and guidance to the Conducting Officers and the Board of Directors/Managers deemed useful for improving the central administration and internal governance of the AIFM.

The internal control functions must report regularly to Senior Management and the Board. The Board must approve the annual reports of the Compliance and the

Internal audit functions, as illustrated in the following diagram:



Source: mebs

The annual reports of each internal control function must be submitted to the CSSF.

The role of an Internal control function may not be held by a Member of the Board, unless he/she is also a Conducting Officer of the AIFM responsible for that function.

AIFMs may, in general, be permitted to delegate the performance of one or more Internal control functions, subject to CSSF prior authorisation.

3.8.4. CENTRAL ADMINISTRATION

The Circular defines the concept of Central Administration for all Luxembourg AIFMs.

The AIFM is required to have, *inter alia*, the following elements in Luxembourg:

- Its own staff, sufficient in number to execute decisions
- Its own systems, i.e. having procedures and technical and IT infrastructure
- Its own internal control functions
- An accounting function
- Its own premises. Access to AIFM premises must be secured and limited to AIFM staff
- Its own procedures
- Its own anti-money laundering and counter terrorist financing (AML/CFT) mechanism
- Documentation relating to its operations and those carried out by its delegates

3.8.5. HUMAN RESOURCES

Each AIFM must employ at their Luxembourg headquarters at least three full-time equivalents (FTEs) (including Conducting Officers and/or non-executive staff) dedicated to key functions.

The size of the teams working on key functions must be adapted according to the nature, scale and complexity of the activities of the AIFM.

In principle, the staff must be employed by the AIFM.

However, the CSSF may grant a derogation and authorise one or more of the conducting persons and/or members of staff to be made available on secondment by a group entity or a third party company. In this case, the secondment contract is subject to CSSF prior approval.

3.9. PORTFOLIO MANAGEMENT, RISK MANAGEMENT AND INVESTMENT ADVICE AND HOLDING STRUCTURES

The central role of the AIFM is performing, for one or more AIF, the investment management services of:

- Portfolio management
- Risk management

The AIFM may partially or wholly delegate these functions provided that it does not delegate substantially more of these functions than it performs itself.

This subsection includes typical workflows of the portfolio management and risk management functions to try to illustrate how they work in practice. Many alternative workflows are possible; the model will depend on factors such as the organisational model of the AIF and AIFM, the nature of the business of the AIFM, portfolio manager and investment adviser, and the asset class.

Where the AIFM performs the portfolio management function itself, it may appoint one or more investment advisers. Where the AIFM has delegated the portfolio management function to a portfolio manager, the delegate portfolio manager may also appoint one or more investment advisers.

There must be appropriate interaction between the portfolio manager, the investment adviser and the AIFM and the AIF Boards throughout a deal process. These bodies strike the right balance between relying on each other and maintaining healthy and independent scepticism.

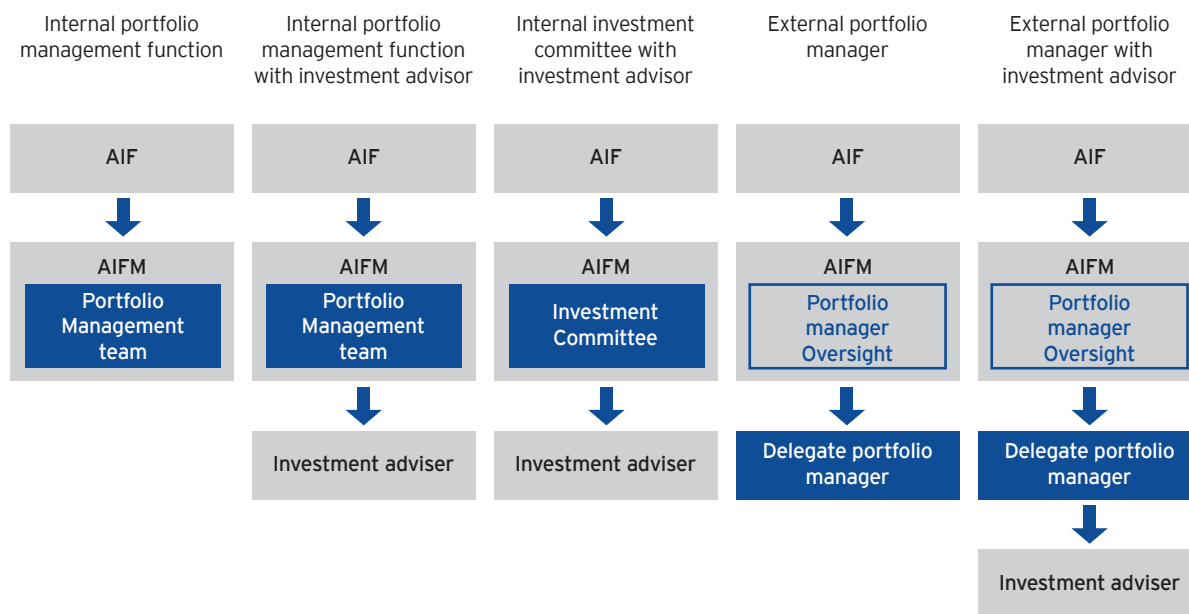
The assets of the AIF are typically held through holding structures (often referred to as special purpose vehicles).

It is important that Directors understand the key framework for these functions and how these functions are configured in the organisation in order to be effective in their oversight of the functions.

Annex II covers the applicable requirements and key responsibilities in more detail.

3.9.1. PORTFOLIO MANAGEMENT MODELS

The following diagram illustrates some of the possible portfolio management models of an AIFM:



3.9.2. WHAT IS PORTFOLIO MANAGEMENT?

Portfolio management involves the process of selecting, acquiring, managing and disposing of the assets of the AIF, or one or more of its compartments.

There is no single definition of portfolio management in the relevant regulation.

The scope of portfolio management in the context of AIFs depends on a number of factors such as the organisational model of the portfolio management function, the asset class, the type of preparatory work performed by the investment advisor, and the types of controls which are performed post investment.

3.9.3. INVESTMENT COMMITTEE

AIFMs which establish an Investment Committee, should ensure, *inter alia*, that:

- The Committee Members collectively has the necessary professional experience and qualifications, in particular with regard to strategies being managed
- The Committee is composed of (but not necessarily exclusively) Conducting Officers and staff of the AIFM permanently based in Luxembourg or who have their domicile in a place that allows them to travel, in principle, to Luxembourg every day; it is recommended that the Conducting Officer in charge of the portfolio management function is part of the Investment Committee
- Where the investment advisor sits on the Investment committee, the adviser's role is, in principle limited to an advisory role

3.9.4. WHAT IS RISK MANAGEMENT?

AIFM are required to implement an adequate risk management system in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF's investment strategy and to which each AIF is or may be exposed.

AIFMs are required to:

- Ensure that the risk profile of the AIF corresponds to the objectives of the AIF as laid down in the AIF's constitutional document, and/or offering documents
- Establish and implement quantitative or qualitative risk limits, or both, for each AIF it manages, taking into account all relevant risks. The risk limits define the risk appetite of the AIF, and ensure compliance with the risk profile
- Implement an adequate risk management system in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF's investment strategy and to which each AIF is or may be exposed. The risk management system should be reviewed at an appropriate frequency and at least once a year and updated where necessary

3.9.5. DELEGATION OF PORTFOLIO MANAGEMENT OR RISK MANAGEMENT

The portfolio management and risk management functions may be internal to the AIFM, or delegated in part or in whole, provided that the AIFM continues to effectively supervise the delegated functions, and the delegation requirements are met (see *Section 4: Section 4.3. Delegates and service providers: Questions 2 and 3*).

When an AIFM delegates its investment management functions of portfolio management or risk management, the delegates must be undertakings which are authorised or registered for the purpose of asset management and subject to supervision or, where that condition cannot be met, only subject to prior approval by the AIFM's competent authority.

The following entities are deemed to be authorised or registered for the purpose of asset management and subject to supervision:

- AIFM
- UCITS management companies
- Investment firms authorised under MiFID to perform portfolio management
- Credit institutions which are authorised to perform portfolio management
- Third country entities authorised or registered for the purpose of asset management and effectively supervised by a competent authority in those countries

Where the delegate is a third-country undertaking, cooperation between the CSSF and the supervisory authority of the undertaking must be ensured.

Any change of delegate is subject to CSSF prior approval.

3.9.6. INVESTMENT ADVICE

The investment adviser advises the AIFM, the internally managed AIF or the delegate portfolio manager, with respect to the investment, divestment and reinvestment of the assets of the AIF. Investment advisers do not make decisions or intervene in any other way in the implementation of the advice; their activity is limited to sourcing opportunities, conducting due diligence and providing recommendations.

The investment adviser should have specialist knowledge and experience in the area of investment of the AIF (e.g., sectors, asset classes, geographical region), and often has experience in advising AIFs with similar characteristics.

Investment advisers may be regulated (i.e., authorised and supervised) or unregulated. However, EU investment advisers, including Luxembourg investment advisers, which provide advice to third parties in respect of one or more transactions relating to financial instruments, must be regulated.

Luxembourg regulated entities which can provide investment advice can be:

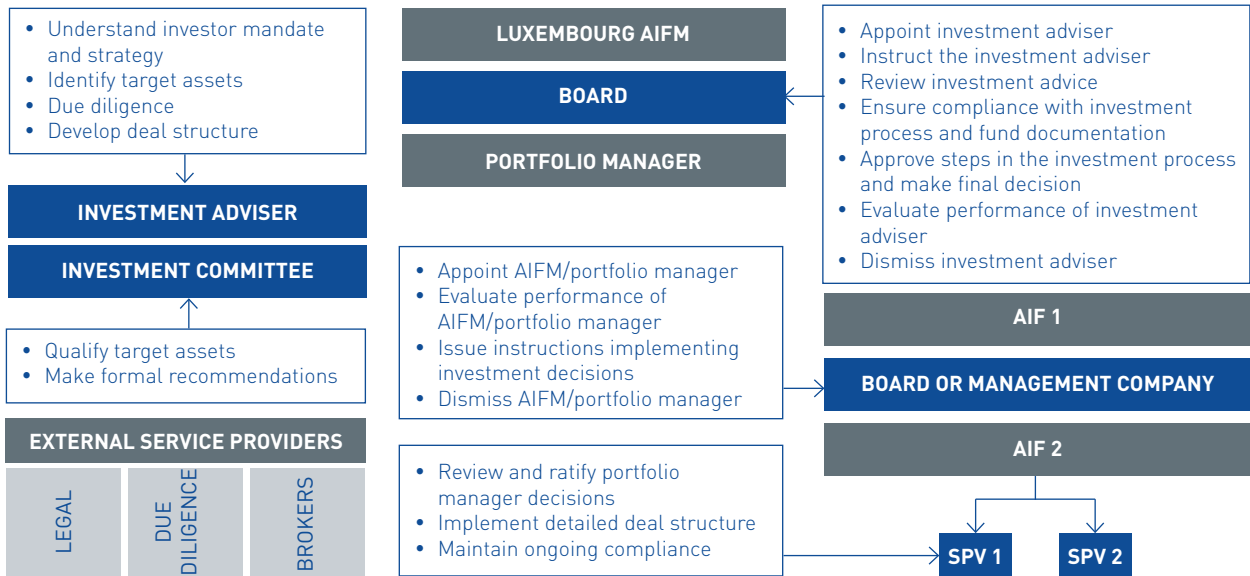
- Investment firms:
 - Investment advisers
 - Commission agents
 - Private portfolio managers
 - Professionals acting for their own account
- Credit institutions
- Management companies
- AIFM

3.9.7. ILLUSTRATIONS OF THE PORTFOLIO MANAGEMENT FUNCTION

The following diagram illustrates a possible model for the allocation of roles and responsibilities in the portfolio management process between the Board of the AIF or management company, the Board of the AIFM or portfolio manager, the investment advisor, the investment committee and the Boards of the holding structures (SPVs). It covers the complete portfolio management process:

- Appointment of the AIFM or portfolio manager and investment adviser
- The investment decision process
- The evaluation of the performance of the AIFM/portfolio manager and investment adviser
- The dismissal of the AIFM/portfolio manager and investment adviser

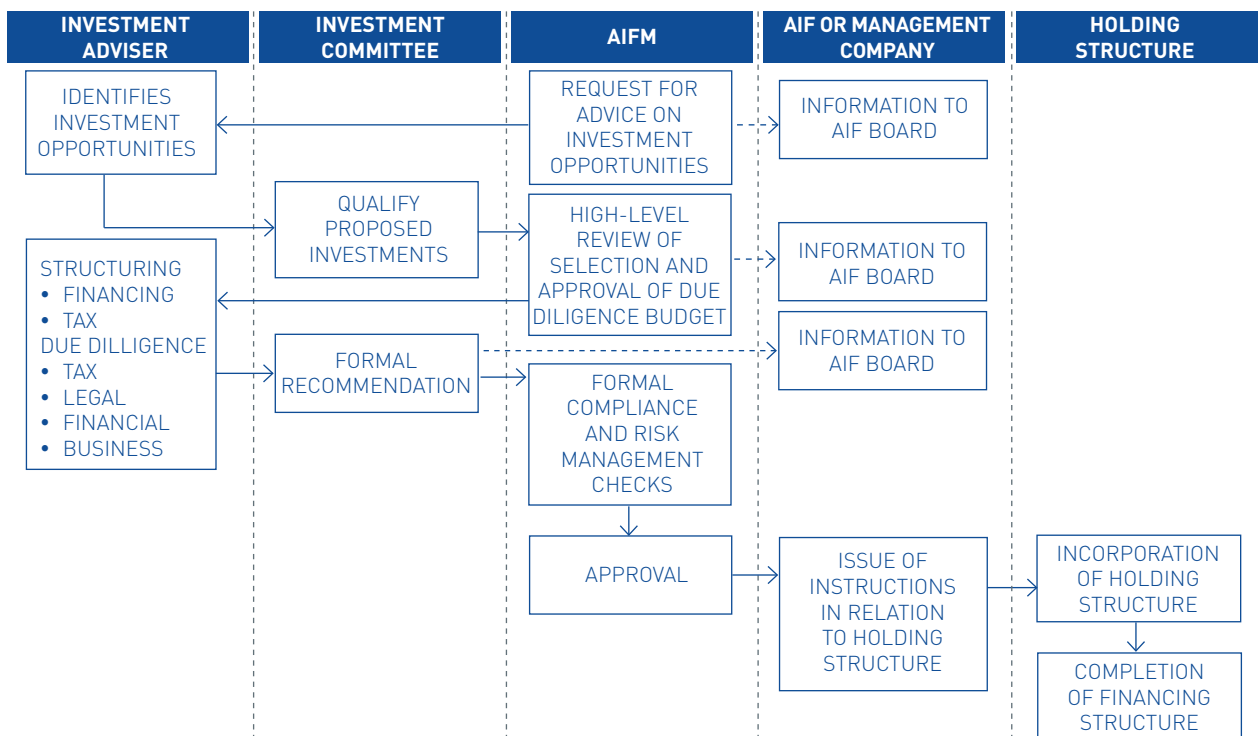
ILLUSTRATION OF AIF PORTFOLIO MANAGEMENT FROM A FUNCTIONAL PERSPECTIVE



Source: EY

The following diagram illustrates a possible model for the process of making investment decisions and transactions:

ILLUSTRATION OF AIF INVESTMENT DECISION AND TRANSACTION PROCESS



Source: EY

AIFMs are required to perform appropriate due diligence with respect to the portfolio management activity. The due diligence requirements are covered in Section 4: Question 4.

3.9.8. ILLUSTRATION OF RISK MANAGEMENT FUNCTION

Risk management is typically a cyclical process, managed by the risk management function and overseen by the senior management, and ultimately the Board. It is illustrated below as a wheel:



The risk management function must be represented in the governing body or the supervisory function, where it has been established, at least with the same authority as the portfolio management function. The risk management responsibilities of the governing body of an AIFM are outlined in *Section 3.7.2*.

3.9.1. RELATIONSHIP BETWEEN PORTFOLIO MANAGEMENT AND RISK MANAGEMENT

The portfolio management function and the risk management function must be functionally and hierarchically separate but in practice their approach must nevertheless be coordinated, particularly when considering new deals in non-frequently traded assets. (see *Section 4*: Question 4 on relationship between the portfolio management function and the risk management function and Question 5 on Risk management oversight).

3.9.2. HOLDING/SPECIAL PURPOSE VEHICLES

Alternative assets are often held through holding vehicles, typically holding companies (often referred to as special purpose vehicles - "SPVs"). Typically, Luxembourg holding companies will be referred to as SOPARFIs (*sociétés de participations financières*).

Such holding vehicles may be owned either exclusively by the AIF or its AIFM on its behalf, or as joint ventures, for example with other AIF or other co-investors.

Typically, holding vehicles are used in AIF structures to hold assets such as:

- Real estate in real estate AIF
- Unlisted companies in private equity AIF

4. FAQ: KEY OVERSIGHT CHALLENGES FOR BOARD MEMBERS OF AIFMS AND AIFS

This Chapter aims to provide practical answers to some of the typical questions asked by Board Members of AIFMs or AIFs. Most of the responses are written from the perspective of AIFM or internally managed AIF which are subject to the AIFMD. The final question in this section focuses on out-of-scope or sub-threshold AIF and AIFM.

Neither the questions nor the answers aim to be complete. There are many good alternative answers to the questions herein and many other good questions which Board Members should ask. Our aim is to provide a starting point for Boards, in terms of some of the key questions to be asking and possible responses.

The key topics covered from a Board Member's perspective in this Chapter are:

| QUESTION | TOPIC | SUBJECT OF QUESTION |
|----------|---------------------------------------|---|
| 1 | BOARD COMPOSITION | Achieving appropriate Board composition |
| 2 | SUBSTANCE | Meeting substance requirements |
| 3 | DELEGATES AND OTHER SERVICE PROVIDERS | Oversight over delegates and other service providers |
| 4 | INDEPENDENT FUNCTIONS | Independence of portfolio management, risk management, and valuation functions |
| 5 | INTERNAL CONTROL FUNCTIONS | Board oversight of risk and liquidity management functions |
| 6 | | Board oversight over, and relationship with, internal controls |
| 7 | VALUATION | Handling controversy on valuation methodologies or results |
| 8 | MARKETING | Oversight over marketing and distribution |
| 9 | | Oversight over anti-money laundering and counter-terrorist financing (AML/CFT) controls |
| 10 | INVESTOR REPRESENTATION | Approaches to investor representation |
| 11 | CONFLICTS OF INTEREST | Deal allocation to a particular AIF |
| 12 | | Typical conflicts of interest, and their mitigation |
| 13 | REMUNERATION | Oversight over remuneration policies, and their implementation |
| 14 | MANAGING BOARD PROCESS | Implementing Board level processes to manage complexity of oversight responsibilities |
| 15 | LARGE AIFM | Organisation and oversight of large, multiple asset class and geographic sector AIFM |
| 16 | AIF OVERSIGHT OVER THE AIFM | Oversight by the Board of the AIF or management company over an AIFM which it has appointed |
| 17 | ANNUAL ACCOUNTS | Representation by the AIFM to the Board of the AIF when appraising reports and accounts |
| 18 | OPERATIONAL COMPLIANCE | Approaching the specific compliance obligations under AIFMD |
| 19 | INSURANCE AND LIABILITY MANAGEMENT | Managing personal exposure |
| 20 | OUT-OF-SCOPE AIFM AND AIF | Oversight responsibilities in relation to out-of-scope or sub-threshold AIF and AIFM |

4.1. BOARD COMPOSITION

1. How do Boards overseeing the various activities of AIF structures achieve an appropriate balance of resources and competencies to adequately perform their tasks?

Boards of AIFM and AIF can achieve an appropriate balance of resources and competencies to adequately perform their tasks by:

- Defining the competences needed in the overall composition of the Board, including:
 - Asset class
 - Asset management
 - Risk management
 - Legal
 - Compliance
 - Financial, accounting and tax
 - Distribution
 - Operations
- Ensuring that Board Members, considered as a collegiate body, have the knowledge, skills and experience matching the competencies required
- Ensuring that each Board Member has a standing and sufficient independence of mind appropriate to act in the best interests of the AIF, and not any individual interests (such as those of an investor or the initiator)
- Ensuring that conflicts of interest, including those involving Board Members, are properly identified, prevented, managed and monitored, and where

appropriate disclosed (see Question 12) and that appropriate policies exist and procedures are implemented when a Board Member faces a conflict of interest (e.g., the Board Member does not participate in decisions where there is a conflict of interest)

- Appointing a Chairman who will ensure that an appropriate balance is achieved between collaboration between Board Members and independence to challenge the *status quo*
- Assigning areas of responsibility to Board Members, or committees
- Ensuring that each Board Member has sufficient time to dedicate to his function (in addition to the CSSF Circular, see, for example, ILA guidance entitled *A Guide for accepting company director mandates*)
- Training Members of the Board: internal and external training, induction training and continuous professional training
- Performing periodic Board evaluations
- Periodically reviewing Board composition, needs and functioning, especially as the activities of the AIFM and the AIF it manages evolve over time (e.g., new AIF, new asset classes or geographic areas, other mandates)

4.2. SUBSTANCE

2. How should Boards of AIFM or internally managed AIF approach the monitoring of their level of substance relative to legal and tax requirements and practices? How do they avoid becoming a letter box entity?

From a regulatory perspective, an AIFM cannot delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter box entity. This may arise in any of the following situations:

- The AIFM no longer retains the necessary expertise and resources to effectively supervise the delegated tasks and manage the risks associated with the delegation
- The AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions
- The AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice
- The AIFM delegates the performance of investment management functions (portfolio management and risk management) to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself

There are a number of practical measures which can be taken to avoid becoming a letter box entity and to maintain adequate substance. These include:

- Ensuring that the AIFM is adequately staffed (including, where relevant, secondments or transfers from affiliates)

- Formalizing the roles and responsibilities within the AIFM through:
 - Establishing, implementing and maintaining decision-making procedures and an organisational structure which specifies reporting lines and allocates functions and responsibilities clearly and in a documented manner
 - Ensuring that the staff are aware of the procedures to be followed for the proper discharge of their responsibilities
 - Establishing, implementing and maintaining adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the AIFM
 - Establishing, implementing and maintaining effective internal reporting and communication of information at all relevant levels of the AIFM and effective information flows with any third party involved
- Monitoring and, on a regular basis, evaluating the adequacy and effectiveness of their systems, internal control mechanisms and arrangements, and taking appropriate measures to address any deficiencies
- Initial and regular due diligence on delegates (see Question 3)

- Formalizing the roles and responsibilities of delegates (such as the portfolio manager), advisers (such as the investment adviser) and service providers (such as the depositary), through contractual arrangements
- Monitoring the performance of the delegated activities
- Ensuring that all formal communication respects the general organisational arrangements of the AIFM and the contractual arrangements
- Holding shareholders' meetings in Luxembourg at least once a year
- Ensuring that at least the quarterly Board of Directors meetings take place in Luxembourg
- Ensuring that the meetings of senior management (which is responsible for conducting the day to day business of the AIFM) take place in Luxembourg

- Ensuring that formal meetings of senior management take place on a regular basis (at least monthly)
- Ensuring that major decisions are taken in Luxembourg
- Ensuring that at least one member of senior management is a Luxembourg resident, or resident in a location where they are able, in principle, to come to Luxembourg on a daily basis (see *Section 3.8.1 Senior Management/ Management Committee*)
- Ensuring that there is a fully functional office in Luxembourg where records are kept
- Ensuring that the AIFM has direct control of its own IT system
- Recommending that the AIF and/or AIFM should use a Luxembourg domain name (".lu") for their website and email addresses

4.3. DELEGATES AND SERVICE PROVIDERS

3. How should Boards of AIFM and AIF approach the selection, appointment and monitoring of:

a. Portfolio managers

b. Investment advisers

c. Other delegates

d. Other service providers

The AIFMD lays down detailed requirements in relation to delegation. These include, *inter alia*:

- The AIFM must be able to justify its entire delegation structure on objective reasons
- The AIFM's liability towards the AIF and its investors is not affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation
- The delegation must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors
- The AIFM must be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question, that it was selected with all due care and that the AIFM is in a position to monitor effectively at any time the delegated activity, to give at any time further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interest of investors
- The delegate must have sufficient resources and employ sufficient personnel with the skills, knowledge and expertise necessary for the proper discharge of the tasks delegated to it and have an appropriate organisational structure supporting the performance of the delegated tasks
- The persons who effectively conduct the business of the delegate must be of sufficiently good repute
- Persons who effectively conduct the activities delegated by the AIFM must have sufficient experience, appropriate theoretical knowledge and appropriate practical experience in the relevant functions
- The AIFM must ensure that the delegate carries out the delegated functions effectively and in compliance with applicable law and regulatory requirements
- The AIFM must ensure that the delegate discloses to the AIFM any development that may have a material impact on the delegate's ability to carry out the delegated functions effectively

The Board of the AIFM (or in some cases, of the AIF), should therefore ensure that the AIFM performs:

- Initial and regular due diligence on delegates and other service providers
- Ongoing monitoring of delegates and other service providers

Due diligence and ongoing monitoring should be performed on:

- Delegates (such as the portfolio manager, distributor or external valuer)
- Advisers (such as the investment adviser)
- Other service providers (such as the depositary), and should review that due diligence

Due diligence should be performed on all delegates and service providers, be they group entities or third parties independent of the group.

AIFMs should adopt a risk-based approach to due diligence and ongoing monitoring.

Both due diligence and monitoring should be documented.

The AIFMD, the Implementing Regulation and the CSSF Circular lay down requirements to be met on the due diligence and monitoring to be performed by AIFM on their service providers. The CSSF Circular specifies, *inter alia*, the minimum list of topics which must be covered in the due diligence and monitoring, including general topics and topics for specific types of delegate, such as portfolio managers.

Industry associations such as the Association of the

Luxembourg Fund Industry (ALFI), the Alternative Investment Management Association (AIMA), the European Association for Investors in Non-Listed Real Estate Vehicles (INREV) and Invest Europe provide guidance on due diligence on the selection and ongoing monitoring of portfolio managers, investment advisers, delegates and service providers.

An AIF should perform initial and ongoing due diligence on the AIFM which it has appointed, which should, *inter alia* cover delegation arrangements. The AIF will therefore request all the relevant information from the AIFM; this is covered in Question 16.

Due diligence should also be performed on clients. The AIFM should perform initial and ongoing due diligence on its clients – initiators and promoters of the AIF they manage and the AIF themselves. The Board of the AIFM should ensure that such due diligence is performed. Furthermore, as clients of service providers, AIFM and Boards of AIF should also expect that service providers will perform initial and ongoing due diligence on them.

DUE DILIGENCE

Before appointing any service provider, the Board of the AIFM and/or of the AIF should ensure that initial due diligence is performed, in line with the requirements of the AIFMD and carefully review this due diligence. The initial due diligence should, *inter alia*, assess the ability of the proposed service provider to perform the tasks to be delegated to it, and, where relevant, its ability to comply with the relevant legal requirements.

One of the key indicators for AIFMs will be whether the service provider has the appropriate authorisation and is subject to supervision by the relevant supervisory authorities (such as the CSSF), and/or relevant registration or certification and/or confirmation of adherence to the relevant professional standards.

Typical other factors which AIFMs may consider may include:

- Scope of activities and experience of the service provider in the relevant field
 - The ability of the service provider to serve the specific types of the AIF which the AIFM is managing (experience of the asset classes, geographic regions, etc.)
 - Knowledge, skills, experience and reputation of the Board, senior management and key staff
 - Organisation of the service provider, including human and technical infrastructure, and risk management, compliance and internal audit functions and control arrangements
 - Any sub-delegation arrangements, including the ability of the delegate to perform adequate due diligence and ongoing monitoring of the sub-delegate
 - Any service organisation controls reports, such as ISAE 3402
 - Shareholder composition
- The ability of the service provider to meet the applicable

requirements and/or good practice standards

- Any values statement or code of conduct, and how it is implemented in practice

AIFMs should perform regular reviews of the due diligence to assess whether the service provider continues to have the ability to perform the tasks which have been delegated to it and, where relevant, to comply with AIFM requirements.

AIFMs should ensure that the service provider regularly provides it with updates to the information already provided. In the case of key changes, such as changes at the level of the Board, senior management and key staff, or to the sub-delegation arrangements, this information should be provided to the AIFM, where possible, on an *ex-ante* basis and if not when they are implemented. Less critical changes, such as non-key modifications to the scope of activities, changes to the organisation of the service provider, human and technical infrastructure, shareholders or values statement may be provided on an *ex-post* basis.

The due diligence process may include due diligence questionnaires, face to face meetings between the AIFM and the service provider, communication by mail, email or telephone and independent diligence and checks; Boards may also consider inviting service providers to answer questions of Board Members at Board meetings.

ONGOING MONITORING

The service provider should provide the AIFM or AIF with one or more reports including key indicators of its performance. The key indicators of performance will be specific to the type of service provider in question, typically covering, for example:

- Breakdown of activities performed on behalf of the AIFM or AIF
- Assessment of performance against expectations
- Information on activities performed by sub-delegates
- Compliance with deadlines
- Operational risk events, such as human errors and technical failures
- Number of complaints, their nature, and how they have been handled

In each case, the report should also cover remedial action to correct any deficiencies identified in the current or previous reports.

The AIFM should ensure that it receives these reports at a frequency which is appropriate to the activities of the AIF and reviews them carefully. It should follow up on any deficiencies detected. The content of these reports will be part of the management information discussed at the Management Committee meetings.

DUE DILIGENCE IN PRACTICE

In practice, one of the AIFM's key roles under the AIFMD is to conduct due diligence on the AIF's principal service providers, independently of whether the Board of the AIF or the AIFM appoints the service provider.

The main questions relate to how and where shall the due diligence review be conducted and the scope of the review. In analysing these questions, the principle of proportionality should be taken into account.

A well-resourced AIFM will be able to send staff to conduct site visits at the service provider's offices, but a small AIFM may not be able to afford site visits. To the extent that due diligence is conducted through site visits, these should take place at least annually. It is crucial not to just follow a check-list approach to due diligence – questions asked to the service providers should be probing and relevant to the context of the AIF.

To the extent that due diligence is carried out remotely, typically by phone or video conference, the AIFM could make up for the lack of a meeting in person by having semi-annual reviews and requiring the service providers to deliver detailed presentations or make "deep-dives" into specific aspects of their services.

Whether or not due diligence is conducted in person or remotely, regular monitoring calls should be added to the due diligence schedule to address specific issues that arise during the operation of the AIF.

Finally, the results of any due diligence review should be recorded in a written, filed report with any outstanding issues or action points being resolved as appropriate. This report should be made available to the Board of Directors (or equivalent governing body) of the AIF.

The ultimate objective of due diligence by an AIFM is to uncover and address structural, operational and regulatory issues affecting an AIF. In its most extreme form, due diligence can act as a deterrent to, and even uncover, instances of fraud. While Directors are not responsible for the management or day-to-day operations of an AIF, their responsibility for the governance of an AIF/AIFM includes mitigating and combatting the risks such as:

- Fraud: reference is made to ILA's *Fraud and its Governance – a Practical Guide* for Directors for a framework for Directors to analyse and detect the possibility of fraud
- Money laundering and terrorist financing: see Question 9

4.4. INDEPENDENT FUNCTIONS

4. How does the Board of an AIFM ensure the ongoing independence of the risk management and valuation functions from the portfolio management?

INDEPENDENT RISK AND VALUATION FUNCTIONS...

AIFMs are required to ensure that:

- The risk management is functionally and hierarchically separate from the portfolio management function
- An internal valuation function is functionally independent from the portfolio management function

Many AIFMs are challenged to implement these requirements in practice, particularly when these functions are within the AIFM, or one of the functions is delegated to a related party.

A number of measures can be taken including:

- Ensuring that there is functional and hierarchical separation of the risk management function and the valuation function from the portfolio management function all the way up to the level of the governing body, and that this separation is reviewed by the governing body
- Ensuring that the risk management and valuation functions report to a different senior manager from the portfolio management function
- Ensuring that, if the portfolio management function is represented in the Board, the risk management function is represented with equal weight

- Ensuring that the heads of these independent functions are of sufficient stature and independence of mind
- Ensuring that these independent functions have documented job descriptions
- Ensuring that these independent functions operate according to documented policies and procedures
- Ensuring that persons engaged in portfolio management tasks are not engaged in potentially conflicting tasks, such as controlling tasks, and that persons engaged in risk management tasks are not engaged in potentially conflicting tasks, such as operating tasks
- Ensuring that these independent functions have sufficient resources to perform their activities, including backup resources
- Ensuring that these independent functions are remunerated in accordance with the achievement of their objectives linked to that function and independently from the performance of the operating units
- Inviting the heads of these independent functions to report directly to the Board of Directors of the AIFM on a regular basis, and periodically to the Boards of the AIF it manages

In practice, appropriate functional and hierarchical separation of the risk management function and the valuation function from the portfolio management function will depend on a number of factors such as:

- The organisational model - e.g., whether the function is internal to the AIFM or delegated
- The nature, scale and complexity of the business of the AIFM
- The number of staff

The CSSF may allow AIFMs to derogate from the obligation to functionally and hierarchically separate the risk management function from the portfolio management function in accordance with the principle of proportionality. The AIFM must, in any case, be able to demonstrate that specific safeguards against conflicts of interest allow for the independent performance of risk management activities and that the risk management process satisfies the requirements of the AIFM and is consistently effective.

...COLLABORATING WITH THE PORTFOLIO MANAGEMENT FUNCTION

The independence of the risk management function and the valuation function from the portfolio management function does not imply that they should not work together. On the contrary, both the risk management and valuation functions should often work together closely with the portfolio manager in order to:

- Understand the portfolio management process and decisions
- Obtain the data needed to perform the risk and valuation functions
- Coordinate the due diligence process

Collaboration between the portfolio manager and risk manager is, for instance, required during the investment due diligence process. In particular, investment decisions of non-frequently traded funds, such as private equity and real estate, will generally have a material impact on the risk profile of the AIF; once the decision to invest is taken, given the illiquid nature of these asset classes, the options open to change the risk profile of the AIF may be limited.

AIFMs are required to establish, implement and apply written policies and procedures on due diligence and implement effective arrangements for ensuring that investment decisions on behalf of the AIFs are carried out in compliance with the objectives, the investment strategy, the risk profile and, where applicable, the risk limits of the AIF. These policies and procedures on due diligence must be regularly reviewed and updated.

AIFM must ensure that the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured, managed and monitored on an ongoing basis, including, where appropriate, through the use of appropriate stress testing procedures.

When investing in assets of limited liquidity and where such investment is preceded by a negotiation phase, AIFMs are required to:

- Set out and regularly update a business plan consistent with the duration of the AIF and market conditions
- Seek and select possible transactions consistent with the business plan
- Assess the selected transactions in consideration of opportunities, if any, and overall related risks, all relevant legal, tax-related, financial or other value affecting factors, human and material resources, and strategies, including exit strategies
- Perform due diligence activities related to the transactions prior to arranging execution
- Monitor the performance of the AIF with respect to the business plan

Typically, the timing of the risk management controls, and thus the nature of the relationship between the risk manager and the portfolio manager, will depend on the type of assets:

| ASSET TYPE | COLLABORATION BETWEEN PORTFOLIO AND RISK MANAGER | TIMING OF RISK CONTROLS | RATIONALITY |
|-----------------|--|---|--|
| LIQUID ASSETS | The portfolio manager may, or may not, provide data on the investment to the risk manager. | The risk controls will typically only be carried out on an <i>ex-post</i> basis. | Breaches of risk limits may often be corrected relatively quickly through transactions on the assets of the portfolio. |
| ILLIQUID ASSETS | There should be significant collaboration between the risk manager and the portfolio manager before the execution of the transaction, as well as after the fact. | The risk controls will typically be performed on an <i>ex-ante</i> basis, as well as an <i>ex-post</i> basis. | It may be difficult and costly to unwind positions to correct breaches of risk limits. |

4.5. INTERNAL CONTROL FUNCTIONS

5. How do Boards of AIFMs oversee the risk and liquidity management function within an AIFM, and how does the Board of an AIF get comfortable with the quality of this risk management process from their perspective?

AIFMs are required to implement an adequate risk management system in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF's investment strategy and to which each AIF is or may be exposed.

Risk management systems comprise the relevant elements of the organisational structure of the AIFM, with a central role for a permanent risk management function, policies and procedures related to the management of risk relevant to each AIF's investment strategy, and arrangements, processes and techniques related to risk measurement and management employed by the AIFM in relation to each AIF it manages.

The risk management system should be reviewed at an appropriate frequency and at least once a year and updated where necessary.

In implementing the risk management system, the AIFM will appoint one senior manager with specific responsibility for overseeing the risk management function, who may rely on a risk manager and external resources to conduct the risk management function, including data collection and analysis. The risk management function should report to the Board of the AIFM on a regular basis; in practice, the reports of the risk management function should also be regularly provided to the Board of the AIF (e.g., at regular Board meetings).

The Board of the AIFM should be able to assess and, if necessary, challenge the risk management team on all key aspects of the risk management system. These include:

- Ensuring that the risk profile of the AIF corresponds to the objectives of the AIF as laid down in the AIF's constitutional document (fund rules or articles of incorporation/management regulations/limited partnership agreement), and/or offering document (e.g., prospectus, private placement memorandum, issuing document)
- Establishing and implementing quantitative or qualitative risk limits, or both, for each AIF it manages, taking into account all relevant risks. The risk limits define the risk profile of the AIF, and ensure measurability of the actual risk against the risk profile

- Establishing, implementing and maintaining an adequate and documented risk management policy which:
 - Identifies all the relevant risks to which the AIFs it manages is or may be exposed (see also Question 4)
 - Describes the procedures necessary to enable the AIFM to assess, for each AIF it manages, the exposure of the AIF to each risk which may be material
- Ensuring that risks are assessed in relation to each investment
- Implementing a risk management function which should:
 - Be functionally and hierarchically separate from the operating units portfolio management (see Question 4)
 - Implement the risk management policies
 - Ensure that the risk profile disclosure to investors is consistent with the risk limits
 - Monitor compliance with the risk limits
 - Provide regular updates to the Board on compliance with the risk limits and the adequacy and effectiveness of the risk management process
 - Provide regular updates to senior management on the current levels of risk and any foreseeable or actual breaches of risk limits
- Appropriately testing the risk management system by conducting periodic back-tests in order to review the continued validity of risk measurement arrangements which include model-based forecasts and estimates
- Assessing the impact of changes in market conditions that may adversely impact the AIF by conducting appropriate periodic stress tests and scenario analyses, including extreme scenarios
- Providing the CSSF with a description of the risk management process
- Regularly disclosing information on the risk profile of the AIF both to the investors in the AIF and the CSSF

In evaluating the effectiveness of the risk management system, the Board will wish to ensure that, while all types of risk to which the AIF is or could be exposed are identified and measured, the key focus is on the typical types of risks inherent in AIF in question:

| RISK CATEGORY | HEDGE FUNDS | PRIVATE EQUITY FUNDS | REAL ESTATE FUNDS |
|-------------------------------------|---|--|---|
| MARKET RISK | <ul style="list-style-type: none"> Securities prices Leverage FX exposures Large volume trading | <ul style="list-style-type: none"> Exit strategies (e.g. IPO) Leverage | <ul style="list-style-type: none"> Real estate & rental prices Investment and leverage risk Vacancy Project development |
| CREDIT RISK | <ul style="list-style-type: none"> Creditworthiness (ratings) of counterparties Concentration risk | <ul style="list-style-type: none"> Ownership of the economic risk associated with a leveraged buy out | <ul style="list-style-type: none"> Tenant concentration risk |
| COUNTERPARTY RISK | <ul style="list-style-type: none"> Prime brokers Derivatives dealers Lending, trading, cash management Depository | <ul style="list-style-type: none"> Investor risk Lenders | <ul style="list-style-type: none"> Investor risk Leaseholder Lenders Address non-payment risk |
| INTEREST RATE RISK | <ul style="list-style-type: none"> Market interest risk modelling | <ul style="list-style-type: none"> Hedging to floating interest rates | <ul style="list-style-type: none"> Hedging to floating interest rates |
| LIQUIDITY RISK | <ul style="list-style-type: none"> Cash management Redemption risk | <ul style="list-style-type: none"> Fund raising Redemption risk | <ul style="list-style-type: none"> Fund raising Redemption risk Covenant & refinancing risk |
| OPERATIONAL RISK AND STRATEGIC RISK | <ul style="list-style-type: none"> Model risks IT & arbitrage algorithm processing Market abuse Reputational risk | <ul style="list-style-type: none"> Due-diligence Tax & legal risk Market abuse Reputational risk | <ul style="list-style-type: none"> Due-diligence Tax & legal risk Reporting risk Reputational risk |

6. How should Boards of AIFM and internally managed AIF approach their oversight responsibilities over internal controls and their relationship with the internal control environment?

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

The governing body must receive on a frequent basis, and at least annually, written reports on matters of compliance, risk management and internal audit indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.

The CSSF Circular lays down the minimum content of the annual reports of the Compliance and Internal audit functions of an AIFM. The governing body of the AIFM must approve these reports.

AIFMs should promote an internal culture of control and of risk management which aims to ensure that all members of staff actively participate in the detection, declaration and control of risks incurred.

See also *Section 3.8. Internal governance of AIFMs*.

COMPLIANCE

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 Law, and the related risks. AIFMs must put in place adequate measures and procedures designed to minimize the risk of failure to comply with its obligations under the Law.

AIFMs are required to establish and maintain a permanent and effective compliance function, responsible for:

- Monitoring of adequacy and effectiveness of measures, policies and procedures put in place to detect risk of failure by the AIFM to comply with its obligations under the Law, as well as the related risks, and the actions taken to address any deficiencies in the AIFM's compliance with its obligations
- Advising and assisting relevant persons responsible for carrying out services and activities on matters of compliance with the Law

INTERNAL AUDIT

AIFMs are required to establish and maintain an internal audit function, where this is appropriate in view of the nature, scale and complexity of the business as well as the nature and range of collective portfolio management activities undertaken.

The internal audit function is responsible for:

- Establishing, implementing and maintaining an internal audit plan to examine and evaluate the adequacy of the AIFM's systems, internal control mechanisms and arrangements
- Issuing recommendations based on the work carried out
- Verifying compliance with the recommendations issued
- Issuing internal audit reports, at least annually

4.6. VALUATION

7. How should disagreements or controversies about valuation methodologies or results between depositaries, AIFMs and AIFs be avoided?

AIFMs are required to establish, maintain, implement and review, for each AIF they manage, written policies and procedures that ensure a sound, transparent, comprehensive and appropriately documented valuation process. The AIFM must ensure that fair, appropriate and transparent valuation methodologies are consistently applied to each AIF it manages.

The valuation policies and procedures must cover, *inter alia*:

- Valuation methodologies, including inputs, selection criteria for pricing and market data sources and the main features of valuation models
- The obligations, roles and responsibilities of all parties involved in the valuation process, including the senior management of the AIFM

The AIFM, and ultimately its Board, is responsible for the proper valuation of the AIF assets, the calculation of the net asset value (NAV) and the publication of the NAV.

The valuation function must be an independent function. It can be either performed by:

- The AIFM itself, provided that the valuation task is functionally independent from the portfolio management and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employees is prevented. The AIFM may have its valuation procedures and/or valuations verified by an external valuer or, where appropriate, an auditor. Third party appraisers are commonly used, for example, to determine the fair value of property of a real estate AIF.
- An external valuer subject to mandatory professional registration, independent from the AIF and the AIFM. In this case, the valuation policies and procedures must:
 - Set out a process for the exchange of information between the AIFM and the external valuer to ensure that all necessary information required for the purpose of performing the valuation task is provided
 - Ensure that the AIFM conducts initial and periodic due diligence on third parties that are appointed to perform valuation services.

In order to meet its responsibilities, the AIFM will always exercise oversight over the valuation function. The valuation function may, for example, be overseen by a conducting officer and/or a valuation committee.

If a model is used to value the assets of an AIF, the model and its main features must be explained and justified in the valuation policies and procedures. The reason for the choice of the model, the underlying data, the assumptions used in the model and the rationale for using them, and the limitations of the model-based valuation must be appropriately documented.

The valuation policies and procedures must ensure that, before being used, a model is validated by a person with sufficient expertise who has not been involved in the process of building that model. The model must be submitted to senior management of the AIFM for approval before it may be adopted and used.

The valuation policies and procedures must set out a review process for the individual values of assets, where a material risk of an inappropriate valuation exists, including in the following cases:

- The valuation is based on prices only available from a single counterparty or broker source
- The valuation is based on illiquid exchange prices
- The valuation is influenced by parties related to the AIFM
- The valuation is influenced by other entities that may have a financial interest in the AIF's performance
- The valuation is based on prices supplied by the counterparty who originated an instrument, in particular where the originator is also financing the AIF's position in the instrument
- The valuation is influenced by one or more individuals within the AIFM, such as the portfolio manager

The valuation policy should be submitted to the competent authorities.

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, must be disclosed to investors before they invest.

A key challenge for the valuation function of AIFMs relates to "hard to value" assets. Assets may be hard to value due to their unique characteristics, or lack of comparable market data.

The following practical steps can be taken to handle such situations:

- Disclosure: valuation is subjective, and subject to numerous uncertainties. This must be clearly understood by investors and third parties. They should be provided with appropriate disclosures to enable them to understand that such valuation is not precise
- Keep within the acceptable range: a range of valuations may be acceptable for an asset. The AIFM should always ensure that the chosen valuation remains within the acceptable range

It is important to understand that, although the AIFM must apply valuation methodologies consistently to each AIF it manages, valuations of an individual asset may be tailored to, or even only be relevant in, the specific context. In other words, the fair values of an individual asset may vary significantly from one AIF to another. The fair value of an asset held by an AIF which is invested in the asset for the long-term, for example, may be significantly different from the fair value of the same asset in an AIF which intends to exit its position within a short timeframe – a typical case would be shares or units of a closed-ended AIF; the first AIF intends to hold its investment to maturity, and may therefore value the shares or units at NAV whilst the second AIF intends to exit its position within a short period of time via a secondary market transaction, and, therefore a discount should be applied. It is important, therefore, that communications to investors make clear that a valuation of an individual asset must be understood in the specific context.

The Board should therefore:

- Ensure that there is appropriate oversight over the valuation function
- Understand the valuation methodology
- Be comfortable with the underlying assumptions of the methodology

- Approve the valuation methodology, review the methodology and ensure it is adapted at appropriate intervals
- Be able to intervene in case of “hard to value” assets causing controversy, looking at the specific assumptions of the case in question and be able to check the reasonableness of a value
- Be able to intervene in case of manifest error

The depositary is required to ensure that the value of the shares or units is calculated in accordance with the Law and the constitutional document, including:

- Verifying on an on-going basis that appropriate and consistent procedures are established and applied for the valuation of the assets of the AIF in compliance with AIFM Law or AIFM Directive, and its implementing measures, and with the AIF constitutional document
- Ensuring that the valuation policies and procedures are effectively implemented, for example, by the performance of sample checks or by comparing the consistency of the change in the NAV calculation over time with that of a benchmark
- Ensuring that the valuation policies and procedures are periodically reviewed

4.7. MARKETING

8. How does an AIFM monitor the legal compliance of the marketing and distribution strategies and practices of its AIFs?

A number of different models can be implemented for the marketing of AIF. These include:

- Marketing by the AIFM itself
- Marketing by the AIF or its management company; in this case, the AIFM has not been appointed by the AIF, or its management company, to perform the marketing
- Appointment of a global distributor
- Appointment of individual distributors or placement agents on behalf of the AIF

The distribution/marketing model chosen will depend on a number of factors, such as the target investors, their geographical location and the asset class of the AIF.

The marketing requirements to be complied with will depend on the marketing regime:

SUMMARY OF MARKETING REGIMES FOR AIF

| REGULATORY FRAMEWORK | REGION | MARKETING REGIME | INVESTORS |
|---|--------|--|------------------------|
| FULL AIFM REGIME AIF | EU/EEA | EU/EEA “passport” of AIFM | Professional |
| FULL AIFM REGIME AIF | EU/EEA | Member State national retail distribution regimes, if applicable | Retail |
| EUVECA AND EUSEF | EU/EEA | EU/EEA “passport” of AIFM | Qualified |
| SIMPLIFIED AIFM REGISTRATION REGIME AIF | EU/EEA | National private placement regimes (NPPRs) | Professional |
| ANY AIF (FULL AIFM REGIME OR SIMPLIFIED AIFM REGISTRATION REGIME) | EU/EEA | Reverse solicitation | Professional |
| ANY | Non-EU | National requirements | Professional or retail |

National marketing requirements to be complied with may include, for example, requirements on:

- Representative and/or paying agent(s) of the AIF
- Promotion (i.e., public offering), including advertising materials
- Investor solicitation (i.e., communication to a targeted clientele)
- Means of communication (e.g., durable medium (such as paper, CD or DVD), email, website, radio, TV)
- Entities which are eligible to sell shares/interests or units of the AIF (e.g., management companies, credit institutions, investment firms such as investment advisers and distributors)
- Conduct of business rules applicable to entities (e.g., credit institutions, investment firms) selling AIF, and in particular when providing investment services (e.g., investment advice, or the reception and transmission of orders), *inter alia* implementing the Markets in Financial Instruments Directive (MiFID II)¹⁰ requirements
- Rules of conduct applicable to management companies, as well as conduct of business requirements applicable to management companies providing investment services, *inter alia*, implementing MiFID requirements applicable to management companies
- Distance marketing, *inter alia*, implementing the Distance Marketing Directive¹¹
- Consumer protection rules
- Information to be disclosed in the prospectus

If the AIFM performs marketing itself, then it is responsible for complying with the applicable marketing requirements.

If the AIF or its management company performs marketing, then the Board of the AIF or the management company is responsible for complying with the applicable marketing requirements.

If distributors or placement agents are appointed, then they will generally ensure that the applicable marketing rules are complied with. In this case, the AIF and/or AIFM should perform initial and ongoing due diligence on distributors or placement agents.

The marketing arrangements should be formalised in a marketing policy. In practice, the marketing policy is often elaborated by the initiator or asset manager at group level. Where there is a group marketing policy, then the relevant AIF and/or AIFM should be represented in group level marketing committees and have a veto right in relation to any changes to marketing policy affecting the AIF and/or AIFM.

The AIFM should always understand the marketing arrangements for each AIF it manages. It should understand the distribution strategy, be the owner of or be informed of the marketing policy, perform due diligence on the distributors or ensure that appropriate due diligence is performed, and monitor the marketing on an ongoing basis.

In general, the AIFM will provide the compliance infrastructure to the AIF it manages, or their management companies, to ensure that the AIF complies with the applicable marketing requirements (see also Question 14).

9. Who is responsible for anti-money laundering and counter-terrorist financing checks and controls in alternative fund structures and how do Boards oversee this?

Anti-money laundering and counter-terrorist financing (AML/CFT) responsibilities represent a key challenge for Luxembourg AIFM and AIF— both those marketed directly by the AIFM or the AIF itself, and those marketed through distributors or placement agents.

AIFMs and AIFs are required to adopt a risk-based approach to AML/CFT adapted to the nature, scale and complexity of the business.

As an illustration, a risk-based approach could include the following steps:

- Identification of inherent risks
- Setting the risk tolerance
- Creating risk-reduction measures and key controls
- Implementing the risk-based approach
- Review the risk-based approach

AIFMs and AIFs are required to identify, assess, manage and mitigate the risk of money laundering and terrorist financing to which they are exposed taking into account risk factors including those relating to:

- Their customers
- Countries or geographic areas
- Products, services and transactions
- Delivery channels

The risk assessment should cover the risk of money laundering and terrorist financing in relation to:

- The development of new products and business practices, including delivery mechanisms prior to their launch
- The use of new or developing technologies for new and existing products prior to their implementation

¹⁰ Markets in Financial Instruments Directive (MiFID), Directive 2014/65/EU, as amended.

¹¹ Directive 2002/65/EC concerning the distance marketing of consumer financial services.

AIFMs and AIFs are required to perform customer due diligence, or to ensure that customer due diligence is duly performed. The customer due diligence must be adapted to the client AML/CFT risks:

- Identification of the client – including the investor (potential shareholder or unitholder), its beneficial owner and proxies
- Verification of the identity of the client, beneficial owner and proxy applying the defined risk-based approach

The customer due diligence on investors may be performed by:

- The AIFM or the AIF itself
- A third party, such as the entities which are part of a financial group. Third parties may be:
 - A delegate of the AIFM or AIF. In practice, the transfer agent generally performs the customer due diligence on investors on behalf of the AIFM
 - An entity which introduces the client, and makes the documents immediately available upon request

Where the AIFM or internally managed AIF performs the marketing itself, the AIFM or internally managed AIF is required to perform customer due diligence on potential investors. Where a distributor performs the marketing, the AIFM is required to ensure that customer due diligence is duly performed on its behalf. Adequate initial due diligence, regular due diligence and ongoing monitoring must be performed on the distributor, and the AIFM must have access, on request, to all the information collected by the distributor on the investors in order to be able to check the due diligence performed on its behalf.

AIFM, AIF or third parties are required to perform ongoing monitoring of:

- Their book of clients against AML/CFT blacklists, sanction lists and politically exposed person lists
- Client transactions in order to identify potentially suspicious transactions
- Third parties acting on their behalf
- Related stakeholders (including directors, shareholders, and proxies)

AIFMs/AIFs must also perform appropriate AML/CTF due diligence on investments

AIFM and internally managed AIF are required to implement appropriate AML/CFT framework, including internal organisation, delegation arrangements, policies, procedures and controls, which are tailored to their specific situation.

This includes, *inter alia*:

- Appointing an officer responsible for AML/CFT
- Appointing an AML/CFT Compliance Officer at the management level responsible for verifying the compliance with professional requirements
- Keeping adequate records of AML/CFT documentation for a required period of time
- Establishing a written AML/CFT risk analysis report
- Ensuring that the AML/CFT Compliance Officer at the management level issues an annual summary report five months after the year end of the AIFM
- Taking appropriate AML/CFT measures in relation to hiring and training employees
- Integrate AML/CFT review into the tasks of the internal audit function

Typically, the AML/CFT officer will be the compliance officer. The AML/CFT Compliance officer will be responsible for reviewing the adequacy and appropriateness of AML/CFT policies and procedures and their implementation, performing or reviewing the risk assessment, following up on AML/CFT issues, and communication in order to meet their AML/CFT obligations.

Policies, controls and procedures validated by the AML/CFT officer must be approved by the management and by the Board of Directors of the AIFM and of the AIF.

Where the AIFM or internally managed AIF is part of a group, it is required to apply group-wide AML/CFT policies and procedures, including data protection policies and policies and procedures for sharing information within the group for AML/CFT purposes.

Guidance for the Luxembourg fund industry entitled *Practices and Recommendations aimed at reducing the risk of money laundering and terrorist financing in the Luxembourg Fund Industry* was issued in 2006 and updated in July 2013 by the Association of the Luxembourg Fund Industry (ALFI), in association with the Luxembourg Bankers' Association (ABBL), the Association of Luxembourg Compliance Officers (ALCO) and the Association of Professionals in Risk Management, Luxembourg (ALRiM). It provides guidance on a risk-based approach in relation to customer identification and transaction monitoring, in line with international standards, which includes the Financial Action Task Force (FATF) "40 Recommendations" updated in February 2012. It also provides a methodology for assessing the equivalence of legal and regulatory know your customer (KYC) requirements of foreign jurisdictions by comparing them to FATF standards.

4.8. INVESTOR REPRESENTATION

10. How are investors commonly represented in AIF structures and what is the role of such investor representative bodies?

Investors are not necessarily represented in AIF structures. It is the responsibility of the AIFM, and, where relevant the AIF Board or management company, to always act in the best interests of AIFs and their investors.

Investor representation is more common in illiquid asset AIFs, such as private equity and real estate, than liquid asset AIFs, such as hedge funds.

Independent Directors are often appointed as an alternative to, or to complement, other forms of investor representation. Independent Directors can play a key role in ensuring that the AIFM, and the AIF Board, act in the best interests of investors.

Where investors are represented and/or independent Directors are appointed, they are typically represented at the level of the AIF, not the AIFM. The typical investor representation models include:

- A unitholder or shareholder advisory committee
- Investor representatives in AIF Boards or other committees

The challenge with investor representation is to find the right balance. While it may sometimes be appropriate to provide information to investors and consult investors before making key decisions, neither the AIF Board, nor the AIFM must give up the power to take key decisions which fall under their responsibility.

SHAREHOLDER/UNITHOLDER/INVESTOR ADVISORY COMMITTEE

Shareholder/Unitholder/Investor Advisory Committee may be composed of representatives of the investors, or the largest of them only.

The Shareholder/Unitholder/Investor Advisory Committee will generally play an advisory role (as opposed to an executive or decision-making role) or be consulted on certain transactions before they take place.

4.9. CONFLICTS OF INTEREST

11. What governance issues arise in situations where investment advisers/transaction teams allocate investments across a range of AIF or non-AIF vehicles? How might potential fairness issues be addressed?

Such a situation may occur if:

- An investment adviser is appointed to advise more than one AIF of an AIFM
- An external portfolio manager is appointed to manage more than one AIF of an AIFM
- A portfolio manager is appointed to manage several portfolios of the same asset management group

The Committee may also be given pre-approval rights for key events such as:

- Transactions where there is a potential conflict of interest
- The choice of portfolio manager, and any changes thereto
- Any change to the independent valuer or auditor
- Any material change to the constitutional document or issuing document
- Certain types of investment (related party, investment allocations, exceeding "soft" portfolio limits, etc.)

Investor representatives sitting on Advisory Committees will not typically owe a fiduciary duty to act in the best interest of the AIF. Instead, the members will typically represent, and act in, the interests of the investor they represent. The principles should be clearly stated in the constitutional documents of the AIF, or clarified at inception.

INVESTOR REPRESENTATIVES

While all Members of the AIF Board must act in the best interests of investors, investors may be directly represented at the level of the AIF Board, or may opt to be represented by independent Board Members. Board Members representing investors may also be appointed to committees such as an audit committee or corporate governance committee.

Investors may also be represented within the portfolio management process, on investment committees of:

- The AIFM or portfolio manager
- The investment adviser

If investor representatives are appointed to the AIF Board, they have identical responsibilities to other Board Members to act in the best interest of the AIF and of all investors collectively, and cannot only consider the interests of the investors that caused them to be elected.

Where such situations may arise, the AIFM, investment adviser and/or portfolio manager should have policies and procedures for allocation of potential investments between several AIFs, sub-funds, other entities and portfolios.

Such policies and procedures should be designed to avoid or reduce potential conflicts of interest, and ensure fairness and transparency (see also Question 12). The policy document should describe the principles, and the procedures should outline the protocols to be followed in such cases.

Where the AIFM appoints an adviser or an external portfolio manager, the review of this procedure should be part of the due diligence performed by the AIFM; similarly when an investment adviser is appointed by a delegate portfolio manager, the review of this procedure should be part of

the portfolio manager's due diligence on the investment adviser, and the results of the due diligence should be communicated to the AIFM.

Adherence to the policy should be regularly reviewed by the portfolio manager's and AIFM's internal control functions.

Another option is to create one or more investment committees to decide which entity the investment will be allocated to or the *pro rata* allocations among relevant AIF. The rules and procedures on how such committees operate should be documented at inception (see also Question 10).

12. Where do the most common conflicts of interest or disagreements arise in AIF structures, and how can these be avoided or managed?

AIFMs should take all reasonable steps to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors. Where the arrangements made by the management entity to identify, prevent, manage and monitor conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to investors' interests will be prevented, the management entity must disclose the general nature or sources of conflicts of interest to the investors.

In practice, certain conflicts of interest are inherent in many AIF structures, and cannot be avoided. The Boards of the AIFM and AIF will therefore focus on ensuring that there is appropriate mitigation and disclosure of such conflicts of interest.

Typical conflicts of interest arising in AIF structures, and mitigating actions, include the following:

TYPICAL CONFLICTS OF INTEREST AND MITIGATING FACTORS

| TYPICAL CONFLICT OF INTEREST | TYPICAL MITIGATING FACTORS |
|--|--|
| Transactions with related parties such as: <ul style="list-style-type: none"> • Seeding AIFs with related party portfolios • Portfolio transactions with related parties | <ul style="list-style-type: none"> • Disclosure to investors • Use an independent valuer • Pre-approval by a Shareholder/Unitholder/Investor Advisory Committee (see Question 10) |
| A related party portfolio manager, investment adviser or service provider is appointed | <ul style="list-style-type: none"> • Disclosure to investors on the appointment of a related party • Review of arm's length nature of the fees/ transfer pricing arrangements • Transparency on fees • Documented due diligence (see Question 3) • Pre-approval by a Shareholder/Unitholder/Investor Advisory Committee (see Question 10) |
| Related parties play an influential role within AIFM, such as: <ul style="list-style-type: none"> • Service provider represented in Board • Investment adviser represented in portfolio management function or Board | <ul style="list-style-type: none"> • Disclosure to investors on the potential conflicts of interest • Policy on abstention from decisions impacting related party, and documented implementation • Documented due diligence (see Question 3) |
| The AIF challenges the portfolio management decisions of the AIFM or its manager ¹² | <ul style="list-style-type: none"> • Well-documented portfolio management and risk management policies and procedures • Well-documented investment due diligence • Regular communication between the AIFM and/or portfolio manager and the Board of the AIF (the portfolio management process in Section 3.9.7. illustrates a typical possible communication model) • Setting up of a Shareholder/Unitholder/Investor Advisory Committee (see Question 10) |
| A deal could be allocated to several AIF | See Question 11 |

¹² Although there is a divergence of views between the AIFM and the AIF, this may or may not be a conflict of interest situation.

TYPICAL CONFLICTS OF INTEREST AND MITIGATING FACTORS (CONTINUED)

| TYPICAL CONFLICT OF INTEREST | TYPICAL MITIGATING FACTORS |
|---|--|
| Two different AIF managed by the same AIFM, or sub-funds of the same AIF, are invested in the same illiquid asset (such as portfolio company); the interests of the AIF may differ on the most favourable timing for exiting the investment | <ul style="list-style-type: none"> • At the level of the asset: <ul style="list-style-type: none"> – Appropriate voting provisions in governing documents (e.g., qualified majority rules in respect to exit) – Independent appraisal of market situation • At the level of the AIFM/AIF: <ul style="list-style-type: none"> – Clear rules set out in the issuing documents of the respective AIFs (with the aim of setting limits of and/or governing rules for events of cross over investments) – Regular communication between the AIFM and/or portfolio manager and the Board of the respective AIFs – Consultation with the Shareholder/Unitholder/Investor Advisory Committees (see Question 10) – Disclosure to investors on the potential conflicts of interest |
| In the interests of investors and in accordance with the relevant AIF's valuation rules, an asset which is invested by two different AIF managed by the same AIFM, may be valued differently. However, the AIFM is required to implement its valuation policy consistently. How can this be reconciled? (see also Question 7) | <ul style="list-style-type: none"> • The AIF must provide a description of its valuation procedure and pricing methodology for valuing assets, including the methods used in valuing hard-to-value assets • Communication to investors should make clear that: <ul style="list-style-type: none"> – Valuation is subjective, and subject to numerous uncertainties – Valuation of an individual asset must be understood in the specific context of the AIF • The AIFM should ensure that hard to value assets are valued within the acceptable range |
| There are other conflicts between the best interests of different AIF, requiring different decisions to be taken for the different AIF. Such a situation may occur in the exercise of voting rights attached to the assets of the AIF. For example <ul style="list-style-type: none"> • Corporate restructuring of a portfolio company may be in the interests of a long-term AIF, but not in the interests of an AIF which is intending to exit its position in the short term • The payment of a dividend may be in the interest of one AIF, and its investors, but not in the interests of another AIF, for legal or tax reasons | <ul style="list-style-type: none"> • The contract appointing the AIFM or portfolio manager should clearly determine the entity which has the rights to exercise any rights attached to the assets of the AIF. This entity may be the AIFM, the portfolio manager or the AIF itself • The AIFM, the portfolio manager, or the AIF itself must have a policy on the exercise of the rights attached to the assets of the AIF • This policy on the exercise of the rights attached to the assets of the AIF should be followed on an AIF by AIF basis; thus, an AIFM or a portfolio manager may act in one manner on behalf of an AIF, and the opposite on behalf of another AIF |
| Conflicts of interest between groups of investors in an AIF invested in illiquid assets which permit subscriptions and redemptions: <ul style="list-style-type: none"> • Subscribing shares or units and those already in the fund • Redeeming shares or units and those remaining in the fund | <ul style="list-style-type: none"> • Liquidity measures defined in the offering document, such as gates, redemption queues, and swing pricing • Ensuring that the balance of liquidity in the AIF remains stable over the transaction period • Applying discounts, such as secondary market value pricing, for the transactions in the shares or units of exiting investors • Anti-dilution rights, rights of first refusal, etc. |

4.10. REMUNERATION

13. How should Boards of AIFMs exercise their oversight responsibilities over the remuneration of governing and management bodies, and portfolio management? What responsibilities are there, if any, on Boards of AIFs to monitor this?

AIFM, and internally managed AIF, are required to have remuneration policies that:

- Are consistent with, and promote, sound and effective risk management
- Do not encourage risk-taking which is inconsistent with the risk profiles, or constitutional documents of the AIF it manages
- Are in line with the business strategy, objectives, values and interests of the AIFM and the AIF it manages or the investors of such AIF, and includes measures to avoid conflicts of interest

An AIFM's remuneration policies and practices must cover those categories of staff whose professional activities have a material impact on the risk profiles of the AIFM or of the AIF it manages including:

- Senior management
- Risk takers, including those taking investment decisions (the members of the investment management function and/or the delegate portfolio managers)
- Control functions
- Any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers

RESPONSIBILITIES OF BOARD OF AIFMS

The Board of the AIFM must adopt and periodically review the general principles of the remuneration policy, and is responsible for its implementation.

AIFM that are significant in terms of their size or the size of the AIFs they manage, their internal organisation and the nature, the scope and the complexity of their activities, are required to establish a remuneration committee. This requirement only applies to AIFMs which have over €1.25 billion of assets under management and a total of over 50 employees. The remuneration committee is responsible for the preparation of decisions regarding remuneration. It is required to directly oversee the remuneration of the senior officers in the risk management and compliance functions. The remuneration committee must exercise independent judgment. It must be chaired by, and composed of, non-executive Directors.

The implementation of the remuneration policy must, at least annually, be subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the Board in its supervisory function.

RESPONSIBILITIES OF BOARD OF AIFS

The Board of an AIF should, as good practice, review the remuneration policy established by the AIFM.

The Board of the AIF or its management company, is responsible for approving the annual financial statements of the AIF. Those financial statements of AIF must include disclosures on remuneration paid to the staff of the AIFM and to any delegate portfolio managers (see also *Remuneration of the portfolio manager* hereafter), including, *inter alia*:

- The total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries, and, where relevant, carried interest paid by the AIF
- The aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF

REMUNERATION OF GOVERNING AND MANAGEMENT BODIES OF AIFM

In practice, the remuneration of the governing and management bodies should often not create significant issues for the AIFM Board. The remuneration of the Board of the AIFM will often be fixed, plus compensation for participation in AIFM Board meetings. While AIFM senior management may be evaluated on the performance of the AIFM and their performance of their tasks, the variable component should not be too significant compared with the fixed component.

REMUNERATION OF THE PORTFOLIO MANAGER

Boards generally face a greater challenge with the remuneration of the portfolio manager.

When delegating portfolio management or risk management activities, the AIFM should ensure that either of the following criteria are met:

- The entities to which portfolio management or risk management activities have been delegated are subject to regulatory requirements on remuneration that are equally as effective as those applicable under ESMA's guidelines (e.g., EU credit institutions and investment firms). Guidance may be provided by the EU Member State competent authorities as to what constitutes equivalence or which jurisdictions are deemed to have equivalent remuneration regimes.
- Appropriate contractual arrangements are put in place with entities to which portfolio management and/or risk management activities have been delegated in order to ensure that there is no circumvention of the remuneration rules set out in ESMA's guidelines. These contractual arrangements should cover any payments made to the delegates' identified staff as compensation for the performance of portfolio or risk management activities on behalf of the AIFM

In practice, compliance with the remuneration provisions of AIFMD will be tricky. Naturally, portfolio managers will try to determine ways in which to minimise the impact of these remuneration provisions. Some EU Member State competent authorities assume the equivalency of a certain jurisdictions' remuneration provisions. The key for the AIFM is to ensure that at a minimum the type of remuneration structure used by a portfolio or risk manager has been approved or accepted by the national supervisory authority of the jurisdiction in which the portfolio manager or risk manager is based, and the competent authority of the AIFM has been provided with all the information it needs in relation to the remuneration of the delegate.

4.11. MANAGING BOARD PROCESSES

14. With so many specific oversight tasks across a potentially wide range of investment vehicles, what approaches might a Board take to establish effective Board level processes?

Typically, the AIFM will provide the infrastructure not only to the Board of the AIFM itself, but also to the AIF and any underlying holding structures (SPVs) to support all these Boards in the execution and monitoring of their activities.

The AIFM may define the processes and procedures covering both:

- The annual planning of the AIFM, AIF or SPV
- Specific events, such as key transactions

There is a wide range of different models, some of which are more formalised than others, relying on the resources of the AIFM including staff, processes and systems.

Considering the oversight responsibilities of the AIFM, and its role in coordinating the Board processes of the AIF and the SPVs across multiple AIF structures, a well-designed

workflow tool may be appropriate. Such a tool enables both the staff of the AIFM and the Members of each Board to effectively plan their agendas and perform their roles by providing them with:

- An overview of the governance process
- Identification of individual steps or actions in the governance process
- The compliance status of each step, including any breaches and remedial action taken
- Notification when approval is required

Boards should also ensure that they maintain appropriate Board composition and that all Board Members commit sufficient time to their mandate, especially as the activities of the AIFM, and the AIF it manages evolve over time (see also Question 1).

4.12. LARGE AIFMS

15. What are the implications on Board activities of AIFMs managing a large number of AIFs operating with multiple asset classes or across geographically dispersed market sectors?

While the Board of a multiple asset class, multiple geography AIFM must have a wider range of competencies to cover the range of asset classes, most of the competencies required of the Board will be similar to those of a single asset class AIFM. The range of backgrounds of Board Members of a multiple asset class AIFM is generally wider than those of a single asset class fund. Furthermore, the Board Members should generally dedicate more time to their mandate, and therefore will generally hold fewer mandates. The composition of the Board is covered in Question 1.

Because of the complexity of operations, AIFMs will typically have a more sophisticated organisational model. The Board may, as a consequence, play less of a role in the day to day decision making; this decision-making becomes the responsibility of the multiple layers of management.

A matrix structure may be implemented in AIFMs by:

- Function, such as portfolio or risk management
- Asset class, with professionals representing each asset class
- Geographic focus, with professionals representing different geographical areas

All these functions have common policies, procedures and organisational structure.

These functions often also rely on advisers and specialist service providers.

Generally, the AIFM will be split into different divisions representing the asset classes/geographical focus areas.

4.13. AIF OVERSIGHT OVER THE AIFM

16. To what extent should the Board of an AIF (or management company) monitor the activities and level of compliance of its appointed AIFM?

This scenario may typically occur in the following situations:

- An investment company appoints an AIFM (see for example, Illustration 1 of Annex I)
- The management company of a common fund appoints an AIFM (see for example, Illustration 3 of Annex I)

The tasks delegated to the AIFM must include portfolio management and risk management, and will often also include administration and marketing. The AIFM may also, for example, provide support to the Board of the AIF in the performance of its duties.

There are two key elements to the due diligence role:

- Initial due diligence
- Ongoing due diligence

Both initial and ongoing due diligence should be documented.

INITIAL DUE DILIGENCE

Before appointing an AIFM, the Board of the AIF should perform initial due diligence. The initial due diligence should, *inter alia*, assess the ability of the proposed AIFM to perform the tasks to be delegated to it, and its ability to comply with the requirements of the AIFM Directive and the AIFM Law.

One of the key indicators for the Board of the AIF will be authorisation and supervision by the relevant supervisory authorities (such as the CSSF). Typical other factors which the Board of the AIF may consider may include:

- Scope of activities and experience of the AIFM
- Knowledge, skills, experience and reputation of the Board, senior management and key staff, including the portfolio manager and risk manager
- Organisation of the AIFM, including human and technical infrastructure, and risk management, compliance and internal audit functions and control arrangements
- Delegation arrangements, and ability of the AIFM to perform adequate due diligence and ongoing monitoring
- Shareholders
- The ability of the AIFM to meet the applicable requirements and/or good practice standards
- Values statement or code of conduct, and how they are implemented in practice

From a practical perspective, the AIFM could, for example, provide the Board of the AIF with its presentation and/or standard response to due diligence requests describing, *inter alia*, its organisational structure, policies and procedures, due diligence on and oversight over service providers, to assist the Board of the AIF in its assessment of the ability of the AIFM to comply with the requirements of the AIFM requirements.

ONGOING MONITORING

The Board of the AIF should perform ongoing monitoring to assess whether the AIFM continues to have the ability to perform the tasks which have been delegated to it and to comply with AIFM requirements and should assess the performance of the AIFM.

The Board of the AIF should ensure that the AIFM regularly provides it with updates to the information already provided. In the case of key changes from the perspective of the AIF, such as changes at the level of the Board, senior management and key staff such as portfolio manager, or to the delegation arrangements, this information should be provided by the AIFM on an *ex-ante* basis. Less critical changes, such as non-key modifications to the scope of activities, changes to the organisation of the AIFM, human and technical infrastructure, shareholders or values statement may be provided on an *ex-post* basis.

From an ongoing compliance perspective, the AIFM should provide the Board of the AIF with one or more reports covering:

- Risk management, including, *inter alia*, key performance indicators on the compliance with the risk limits and the risk profile of the AIF as disclosed to investors
- Compliance with the regulatory requirements, including in particular key performance indicators on the compliance of the AIF
- Internal audit, *inter alia* providing an evaluation on whether risk management, control, and governance systems are functioning as intended

Typically, each of these reports would be AIF specific.

In each case, the report should also cover remedial action to correct any deficiencies identified in the current or previous reports.

The Board of the AIF should receive these reports at a frequency which is appropriate to the activities of the AIF, and at least annually.

In practice, the due diligence performed by the Board of the AIF over the AIFM will be more challenging to perform where both belong to the same group or both are newly set-up.

4.14. ANNUAL ACCOUNTS

17. What representation does the AIFM need to provide to the AIF Board when appraising reports and accounts?

In connection with the audit of the AIF's financial statements, the auditor typically requests written management representations from the Board of the AIF. The management representation letter covers multiple points and is used by the auditor to support the audit.

Certain representations may relate to tasks which are delegated to the AIFM. In this situation, the Board of the AIF will typically request a "back to back" representation

letter from the AIFM with the relevant points using the same or very similar language as that included in the representation letter requested by the auditor.

This type of "back to back" representation letter is widely used in practice today by Boards of AIF and AIFM with other service providers such as management companies, fund administrators, portfolio managers, etc¹³.

4.15. OPERATIONAL COMPLIANCE

18. How should AIFM and AIF Boards approach their oversight responsibilities towards the specific compliance obligations of the AIFMD?

Operational compliance with the specific compliance obligations of the AIFMD should distinguish between:

- Transitions to a new status, e.g., where an AIFM or AIF enters into the scope of application of the AIFMD, be it because of:
 - One of the thresholds being exceeded
 - Direct opt-in by an AIFM or an internally managed AIF
 - An indirect opt-in via the appointment of an authorised AIFM
- Ongoing compliance once the AIF is managed by an authorised AIFM. In particular the AIF Board needs to be fully aware of the various compliance, reporting and disclosure requirements applicable

TRANSITIONS TO A NEW STATUS

The AIFM or AIF Board should ensure that a list of future oversight responsibilities under AIFMD is drawn up. This should include a review of past actions, operations and arrangements or agreements.

While most opt-ins will be accompanied by changes to the organisational and operational set-up, the AIF Board should ensure that a detailed assessment is made of required remedial actions. This may include a complete review of all the agreements and processes in place.

Depending on the asset class, certain adjustments will be of particular relevance. For example:

- The relationship with the depositary may be of particular relevance for AIF investing in financial instruments. The review of the depositary function may, however, also be of relevance for the illiquid asset classes
- The relationship between the prime broker, depositary, AIF and AIFM will be key for hedge funds

The exercise should be seen as a joint effort between the AIF and the AIFM to be appointed, where applicable.

In each case, interaction with investors, service providers and supervisory authorities should be carefully assessed, monitored and managed.

ASSET CLASS SPECIFIC OVERSIGHT RESPONSIBILITIES

Specific oversight responsibilities may significantly depend on the asset classes that the AIFM manages.

The AIFMD lays down specific compliance obligations for:

- AIFM managing leveraged AIF
- AIFM which acquire major holdings in a non-listed company, and additional requirements for those which control non-listed companies
- AIFM which exercise control over an issuer whose shares are admitted to trading on a regulated market
- AIFM managing AIF which invest in securitisation positions
- AIFM managing AIF using a prime broker, typically hedge funds.

Special reporting, disclosure and/or notification requirements will apply to some of these AIFM. AIF Boards should be duly informed of and involved in such notifications and disclosures in order to permit them to fully assess the situation of their AIFs. The general assumption is that certain disclosure requirements apply primarily to the AIF and only indirectly onto the AIFM. There may thus be certain exposures that AIF Boards should monitor.

In respect of leveraged AIF, AIFMs will have to demonstrate that the leverage limits set by them for each AIF they manage are reasonable and that these limits are complied with at all times. The AIF Boards should be duly informed of these leverage limits and the reasonableness of the limits set by the AIFM or supervisory authorities.

Given that some of the disclosures will have to be included in the reporting to be prepared in respect of the AIF, AIF Boards should be duly informed in advance.

¹³ The IIA Fund Committee has issued a *Management Representation Letter Guide*.

4.16. INSURANCE & LIABILITY MANAGEMENT

19. How do AIFM manage their liability, and Directors manage their personal exposure?

LIABILITY OF AIFM

AIFMD does not specify any insurance requirements for Directors, but does raise the issue in terms of the 'Professional Liability' of the AIFM.

Directors should note that this term is substantially wider than the more common 'Professional Indemnity' insurance typically held by directors and other professionals. It is essentially meant to cover any business risks that the AIFM is exposed to, including, without being limited to:

- Loss of documents evidencing title of assets of the AIF
- Misrepresentations or misleading statements made to the AIF or its investors
- Acts, errors or omissions resulting in a breach of:
 - Legal and regulatory obligations
 - Duty of skill and care towards the AIF and its investors
 - Fiduciary duties
 - Obligations of confidentiality
 - AIF rules or instruments of incorporation
 - Terms of appointment of the AIFM by the AIF
- Failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts
- Improperly carried out valuation of assets or calculation of unit/share prices
- Losses arising from business disruption, system failures, failure of transaction processing or process management

The liability of the AIFM can be covered by

- Additional own funds
- Insurance

The "additional own funds" route

If the AIFM chooses to cover professional liability risks through additional own funds, the level of those additional own funds must at least equal 0.01% of the value of the portfolios of AIFs managed. This can be reduced to a minimum of 0.008% with regulatory consent.

Example:

For an AIFM with assets under management (AuM) of €5 billion, the amount required would be €500,000 (calculated at 0.01% of AuM).

The insurance route

If the AIFM chooses to cover professional liability risks through professional indemnity insurance, the coverage (limit) of the insurance for an individual claim must at least equal 0.7% of the value of the portfolios of AIFs managed, and the coverage (limit) of the insurance for claims in aggregate per year must at least equal 0.9% of the value of the portfolios of AIFs managed. Any agreed excess and significant exclusions will have to be covered by additional own funds.

The cover should have an initial term of no less than one year and shall have a notice period for cancellation by insurers of at least 90 days.

Example:

For an AIFM with assets under management (AuM) of €5 billion, the required professional indemnity policy per-claim limit would need to be €35 million (calculated at 0.7% of AuM), or an aggregate limit of €45 million (calculated at 0.9% of AuM).

DIRECTORS' PERSONAL EXPOSURE

The best way to discharge a director's duties is to do the job properly. At a minimum, this means that the Director should be familiar with the fiduciary duties or other applicable standards under the national law of the jurisdiction in which the AIFM or AIF is established and discharge those duties and apply those standards appropriately. The Director should be familiar with the business of the AIF or AIFM, although there are many Directors who are not portfolio or risk specialists and still perform a good job.

Each Board Member should exercise independent judgment and use reasonable skill and diligence in their role as such and act in the best interest of the relevant entity. This includes, for example:

- Understanding the business of the company
- Exercising "real control", for example by devoting sufficient time and attention to the exercise of the mandate (see also Question 1), including, reading all relevant documents pertaining to the AIF and/or AIFM, and engaging the investment manager and other service providers
- Ensuring that he/she is familiar with the regulatory environment in which the AIF or AIFM operates. In the context of AIFMD, a Director's role requires detailed knowledge of AIFMD, as well as sufficient knowledge of the other regulatory regimes relevant to the AIFM. For example, if an AIF has service providers such as investment advisers based in Singapore, the Director should be at least somewhat familiar with the Singapore licensing regime and the issues that may arise when reconciling Singaporean regulations and AIFMD. In addition, given the extraterritorial reach of the laws of certain other countries, such as the United States, a Director needs to be familiar with laws such as Dodd Frank, FATCA etc.
- Ensuring that regular Board meetings are held as well as *ad hoc* meetings as needed, and attending those meetings
- Ensuring that Board decisions are documented
- Handling all *ad hoc* corporate governance events, such as written resolutions
- Approving audited financial statements etc.
- Consulting with advisers and investors as appropriate
- Ensuring that the entity has professional liability cover

While no one can prevent an investor from suing a director or a regulator from focusing on a Director's actions, a Director can minimise the likelihood that such events would trigger liability, regulatory and reputational ramifications by doing the job properly.

It is important that Board Members conduct due diligence before accepting a mandate, that the mandate is formalised in a contract, and that they consider potential conflicts of interest arising from other activities already performed.

A Director can also manage his/her personal exposure through formal mechanisms such as a mandate agreement (or director services agreement in some jurisdictions), indemnities and insurance.

Having a written mandate is helpful in that it sets expectations between the Director and the AIFM or AIF. For example, a mandate could stipulate terms such as the AIFM will have a pre-determined level of insurance coverage and a minimum of four board meetings annually. The mandate could also include terms agreed with the sponsor of the AIF, as opposed to the AIF or AIFM themselves, such as provision of information, Board composition, additional insurance coverage, additional indemnities, disclaimers of liability etc.. There are no specific requirements of terms to be included in a mandate or to even have a mandate, but it is considered good practice to have one.¹⁴

An AIF often provides indemnities to its Directors which would be satisfied from the assets of the AIF, although in some jurisdictions an AIF may be precluded from providing an indemnity as a matter of law. It is important that the terms of the indemnity are drafted clearly including provisions such as notice to the indemnifier of a claim for indemnity, funding of a claim by the indemnifier, defending a claim, the standard to be applied to a claim for indemnity etc. Most indemnities are drafted in general terms which could result in a claim by a Director not being funded by an indemnifier on a timely basis or even litigation over the indemnity clause itself.

This is precisely why having insurance is the next level of exposure management for a Director.

Insurance is available mainly in two forms – Directors and Officers ("D&O") and professional indemnity ("PI") insurance. Typically, one would see D&O obtained for the fund Directors and PI for the management company directors, but the practice varies according to jurisdiction.

An option to consider is whether to have an individual Director policy, which is more common for example in Luxembourg and the US, an entity specific policy, or a group policy that covers all entities in a fund structure.

Insurance is a very technical industry so covering the scope of D&O and PI terms is beyond the scope of this Guide. However, some key terms to focus on are the policy limit and any excesses, exclusions, named insured parties, reinstatement and most importantly on the specific language relating to what the policy will cover. There is no such thing as a standard insurance policy so terms vary widely among underwriters and brokers. A Director would be wise to actually read and understand his/her insurance coverage so there are no surprises at the back end of a claim.

Many sponsors of funds rely on corporate insurance policies to cover employees who are asked to be Directors of funds sponsored by the employer or an affiliate. These corporate policies tend to have a general liability clause to cover roles carried out by employees at the request of the employer, but it is not always clear whether a particular role will be covered. This potential risk can be covered by obtaining a director specific or entity specific policy.

Some professional Directors have additional insurance coverage over and above any coverage provided by the funds and management companies for whom they act as directors. While this may be considered "over-insurance", it is not always obvious that a fund indemnity or insurance coverage will actually cover the relevant loss or that the underwriter will pay on a timely basis or at all.

4.17. OUT OF SCOPE AIFMS AND AIFS

20. For boards of out-of-scope or sub-threshold AIFMs and AIFs, what are the fundamental differences in their responsibilities or approach to governance responsibilities?

There are no fundamental differences between the responsibilities of the Boards of sub-threshold AIF and sub-threshold management companies, and those of entities compliant with AIFM requirements. However, the regulatory requirements are far less comprehensive; in certain cases, less human and technical resources may be required, a less formalised organisational structure may be implemented, and less detail may be permitted in certain policies and procedures

The SIF and SICAR Laws lay down minimum requirements on conflicts of interest, and the SIF Law also lays down requirements on risk management.

While the bar is set substantially higher for AIF managed by an authorised AIFM, standards are set to increase overall. Directors of sub-threshold AIF may find useful guidance in this paper.

¹⁴ ILA and AIFI have issued an *Example Director Engagement Letter* as part of the specific guidance for the implementation of the ALFI Code of Conduct – see *Guidance on Board Member Letters of Appointment*

ANNEXES

ANNEX I: BASIC AIF ORGANISATIONAL MODELS

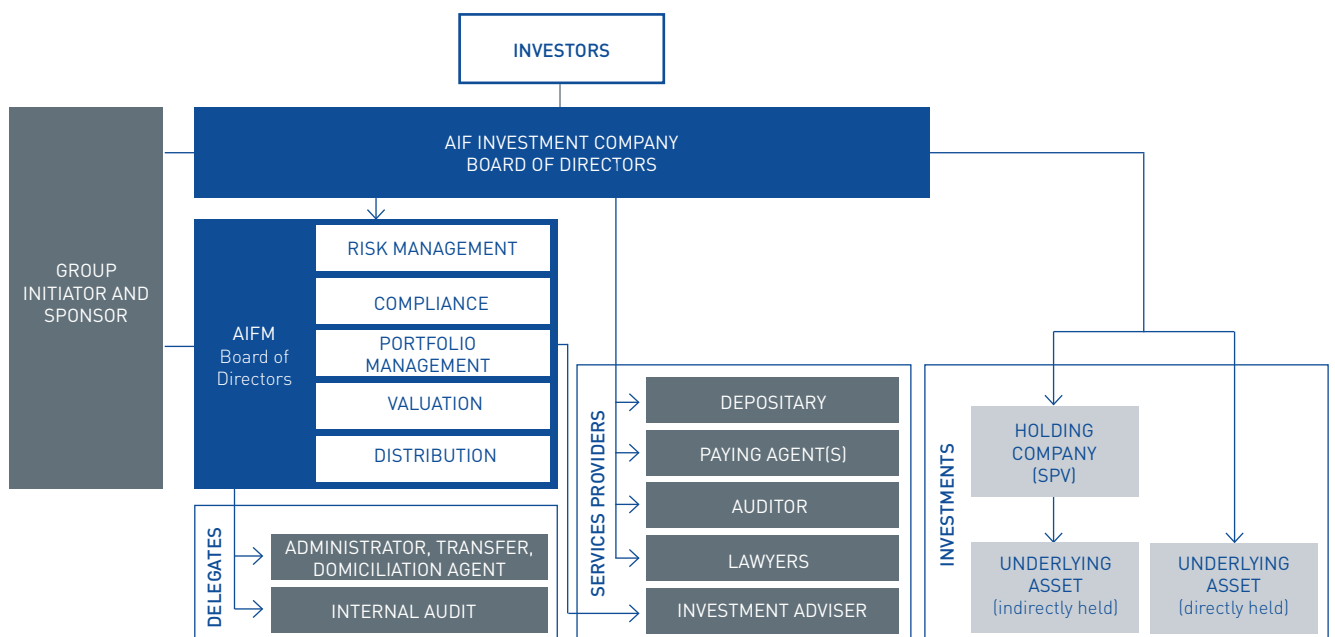
This Annex provides illustrative examples of the organisation of non-frequently traded AIF.

I.1. EXTERNALLY MANAGED AIF

ILLUSTRATION 1

| SUMMARY | |
|---------------------|------------------------------------|
| TYPES OF AIF | Investment company |
| MANAGEMENT | Externally managed by a group AIFM |
| TYPICAL UTILISATION | Private equity |

| ROLE | IMPLEMENTATION |
|----------------------------|---|
| AIFM | The Board of the AIF investment company has appointed an external AIFM from the same financial group. |
| PORTFOLIO MANAGEMENT | The AIFM performs the portfolio management. It has appointed a third party investment adviser. |
| INTERNAL CONTROL FUNCTIONS | The AIFM: <ul style="list-style-type: none"> • Has its own risk management and compliance functions • Has delegated internal audit to a third party |
| ADMINISTRATION | The AIFM has delegated administration to a third party administrator. |
| VALUATION | The AIFM performs the valuation itself. The valuation procedures, and certain valuations, are reviewed by the external auditor. |
| DISTRIBUTION | The AIFM performs the distribution itself. |
| DEPOSITARY | The Board of the AIF has appointed a depositary and paying agent. |
| AUDITOR | The Board of the AIF has appointed an external auditor. |
| LAWYERS | The Board of the AIF has a legal adviser. |

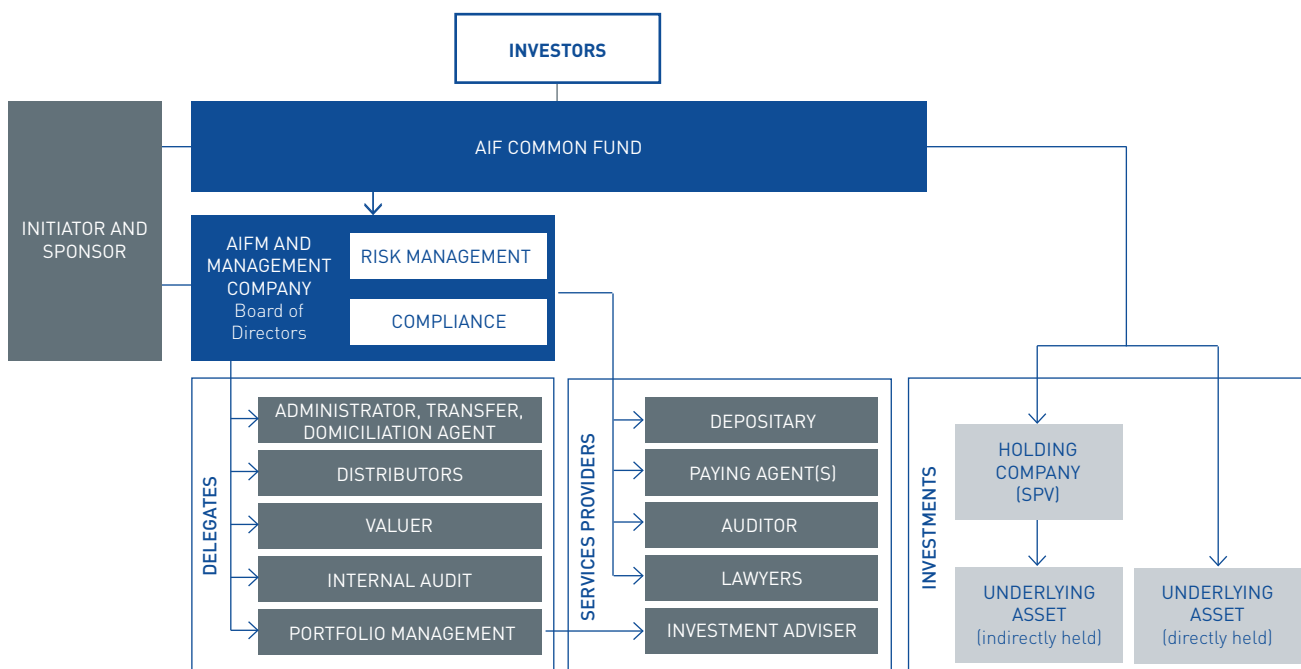


Source: EY

ILLUSTRATION 2

| SUMMARY | |
|---------------------|--------------------|
| TYPES OF AIF | Common fund |
| MANAGEMENT | Externally managed |
| TYPICAL UTILISATION | Real estate |

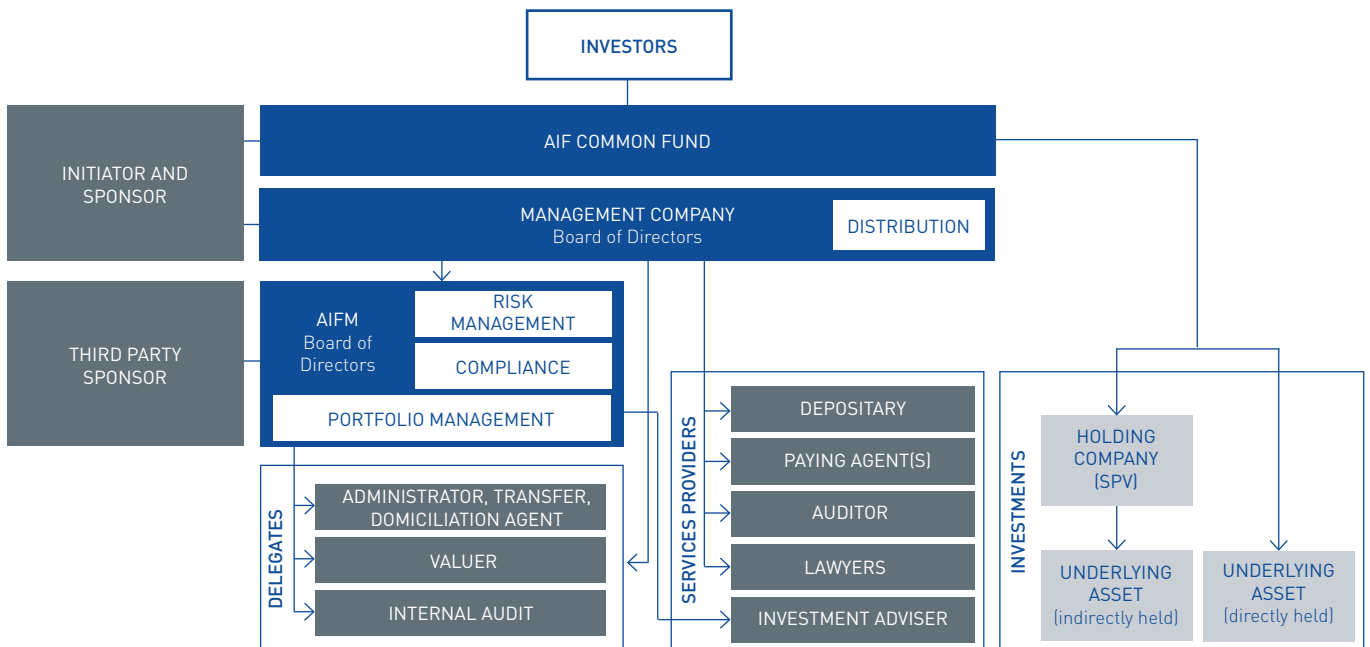
| ROLE | IMPLEMENTATION |
|----------------------------|---|
| AIFM | The AIF is created and managed by the AIFM, which is also the management company. |
| PORTFOLIO MANAGEMENT | The AIFM delegates portfolio management. The portfolio manager has appointed a third party investment adviser. |
| INTERNAL CONTROL FUNCTIONS | The AIFM: <ul style="list-style-type: none"> • Has its own risk management and compliance functions • Has delegated internal audit to a third party |
| ADMINISTRATION | The AIFM has delegated administration to a third party administrator. |
| VALUATION | The AIFM has appointed an external valuer. |
| DISTRIBUTION | The AIFM has appointed a third party distributor. |
| DEPOSITARY | The AIFM has appointed a depositary. |
| AUDITOR | The AIFM has appointed an external auditor. |
| LAWYERS | The AIFM has a legal adviser. |



Source: EY

ILLUSTRATION 3

| SUMMARY | |
|----------------------------|--|
| TYPE OF AIF | Common fund |
| MANAGEMENT | Externally managed The AIF is managed by a management company from the financial group which has appointed an independent third party AIFM |
| TYPICAL UTILISATION | Real estate |
| ROLE | IMPLEMENTATION |
| AIFM | The management company has appointed an independent third party AIFM to perform portfolio management and risk management. |
| PORTFOLIO MANAGEMENT | The AIFM performs the portfolio management. It has appointed a third party investment adviser. |
| INTERNAL CONTROL FUNCTIONS | The AIFM: <ul style="list-style-type: none"> • Has its own risk management and compliance functions • Has delegated internal audit to a third party |
| ADMINISTRATION | The management company has delegated administration to a third party administrator. |
| VALUATION | The AIFM has appointed an external valuer. |
| DISTRIBUTION | The management company performs the distribution itself, keeping control of distribution within the financial group. |
| DEPOSITARY | The management company has appointed a depositary and paying agent. |
| AUDITOR | The management company has appointed an external auditor. |
| LAWYERS | The management company has a legal adviser. |



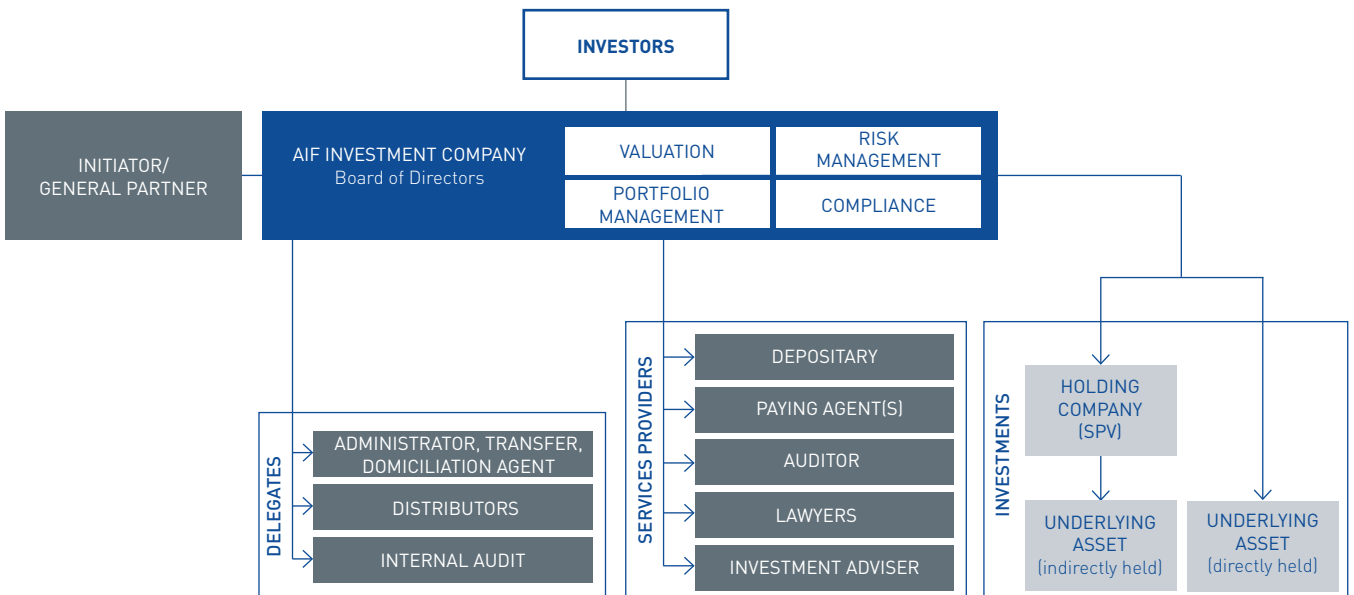
Source: EY

I.2. INTERNALLY MANAGED AIF

ILLUSTRATION 4

| SUMMARY | |
|---------------------|--------------------|
| TYPE OF AIF | Investment company |
| MANAGEMENT | Internally managed |
| TYPICAL UTILISATION | Private equity |

| ROLE | IMPLEMENTATION |
|----------------------------|--|
| AIFM | AIF investment company is internally managed. |
| PORTFOLIO MANAGEMENT | The Board of the AIF performs the portfolio management. It has appointed a third party investment adviser. |
| INTERNAL CONTROL FUNCTIONS | The AIF: <ul style="list-style-type: none"> • Has its own risk management and compliance functions • Has delegated internal audit to a third party |
| ADMINISTRATION | The AIF has delegated administration to a third party administrator. |
| VALUATION | The AIF performs the valuation itself. The valuation procedures, and certain valuations, are reviewed by the external auditor. |
| DISTRIBUTION | The AIF has delegated distribution to a third party distributor. |
| DEPOSITARY | The AIF has appointed a depositary and paying agent. |
| AUDITOR | The AIF has appointed an external auditor. |
| LAWYERS | The AIF has a legal adviser. |



Source: EY

ANNEX II: KEY OVERSIGHT RESPONSIBILITIES FROM A COMPLIANCE PERSPECTIVE

This Annex outlines the key oversight responsibilities for Board Members in the context of AIF at the levels of:

- AIF and AIFM
- Portfolio managers and investment advisers
- Holding vehicles

II.1. AIF AND AIFM

The key compliance responsibilities of Boards of AIF and AIFM include, *inter alia*:

- Legal and regulatory requirements (Level 2 implementing measures and Level 3 Circulars and guidelines):
 - AIFM requirements including AIFM Directive and AIFM Law
 - Management company requirements, such as Chapter 15 or 16 of 2010 Law
 - Laws applicable to AIF (e.g., SIF Law, SICAR Law, 2010 Law, EuVECA or EuSEF Regulations)
 - Corporate Law (e.g., 1915 Law)
 - Markets in Financial Instruments Directive (MiFID) requirements (e.g., sales practices)
 - Anti-money laundering and counter terrorist financing (AML/CFT) requirements
 - Anti-bribery and corruption requirements (e.g., UK Bribery Act or US Foreign Corrupt Practices Act)
 - Tax Law (e.g., Luxembourg Income Tax, Municipal Business Tax Law, Net Wealth Tax, Value Added Tax Law as well as specific investment fund related tax provisions, and foreign tax law)
 - Accounting requirements (e.g., financial reporting, submission to Trade Register, holding shareholder meetings, completing tax returns)
 - Listing requirements and stock exchange rules (where relevant)
- AIF offering document and constitutional document (fund rules or articles of incorporation/management regulations/limited partnership agreement)
- Internal policies and procedures
- Codes of conduct.

The chosen code(s) of conduct may depend on factors such as the asset class. Common codes of conduct include:

- General investment fund codes of conduct, e.g. the Association of the Luxembourg Fund Industry (ALFI)
- Hedge fund codes of conduct, e.g. Alternative Investment Management Association (AIMA)
- Private Equity codes of conduct, e.g. Invest Europe
- Real Estate codes of conduct, e.g. European Association for Investors in Non-Listed Real Estate Vehicles (INREV)

- General codes of conduct: e.g. Luxembourg Stock Exchange, Organisation for Economic Co-operation and Development (OECD)
- Specific standards, such as The Royal Institution of Chartered Surveyors (RICS)

(see *Annex IV: Selected key corporate governance codes* for further information)

The Group, AIFM and AIF may also voluntarily adopt their own codes of conduct

The key oversight responsibilities of Board Members are outlined in *Setting the scene: Typical roles of governing bodies in an AIF context*.

II.2. PORTFOLIO MANAGERS AND INVESTMENT ADVISERS

The key responsibilities of the Boards of AIF and AIFM in relation to the oversight of portfolio managers and investment advisers may include:

- Compliance with:
 - Legal and regulatory requirements (Level 2 implementing measures and Level 3 Circulars and guidelines):
 - Banking, investment firm, management company or AIFM Law
 - MiFID requirements, where the portfolio includes one or more financial instruments
 - Corporate Law (e.g., 1915 Law)
 - Anti-bribery and corruption requirements (e.g., UK Bribery Act or US Foreign Corrupt Practices Act)
 - Tax Law (e.g., Luxembourg Income Tax, Municipal Business Tax Law, Net Wealth Tax and Value Added Tax Law)
 - Accounting requirements (e.g., financial reporting, submission to Trade Register, holding shareholder/unitholder/limited partner meetings)
 - Contract with AIF, AIFM or portfolio manager, and, where relevant, the essential elements of AIF offering document and constitutional document
 - Internal policies and procedures
 - Codes of conduct. Common codes of conduct include:
 - ABBL
 - Luxembourg Stock Exchange
 - Group voluntary codes of conduct
- Due diligence on and ongoing monitoring of:
 - Advisers such as:
 - Investment advisers and sub-advisers
 - Consultants
 - Other service providers such as:
 - Auditor
 - Lawyer
 - Tax adviser/tax compliance service provider

- Providing the AIFM or portfolio manager with all the information it needs to enable it to:
 - Perform its initial due diligence
 - Perform ongoing monitoring
 - Take and execute investment decisions in a timely fashion
 - Controlling and monitoring of subsidiaries and branches
 - Supervisory authority relationship:
 - Reporting to supervisory authorities
 - Responding to requests for information from supervisory authorities
 - Updates to applications for authorisation and changes to AIF documentation
 - Asset management group/sponsor relationship:
 - Protecting the interests of the group
 - Generating returns for shareholder
- Anti-bribery and corruption requirements (e.g., UK Bribery Act or US Foreign Corrupt Practices Act)
 - Tax Law (e.g., Luxembourg Income Tax, Municipal Business Tax Law, Net Wealth Tax and Value Added Tax Law)
 - Accountability requirements (e.g., financial reporting, submission to Trade Register, holding shareholder meetings)
- Due diligence on and ongoing monitoring of:
 - Delegates such as:
 - Asset managers
 - Advisers such as:
 - Consultants
 - Other service providers such as:
 - Auditor
 - Lawyer
 - Tax adviser/tax compliance service provider

III.3. HOLDING VEHICLES

The oversight responsibilities of the Boards of AIF and AIFM in relation to the oversight of holding structures may include:

- Compliance with:
 - Legal and regulatory requirements:
 - Company Law (e.g., 1915 Law)
 - Anti-money laundering and counter terrorist financing (AML/CFT) requirements

ANNEX III: MAIN ASSET CLASSES OF AIF

III.1. FREQUENTLY TRADED AIF

Frequently traded asset classes include the following:

- Listed equity
- Bonds
- Money market instruments
- Other collective investment undertakings (i.e., funds of funds)
- Financial derivative instruments
- Cash and deposits

Frequently traded asset class AIF may also use techniques and instruments such as:

- Repurchase and reverse repurchase agreements (repos and reverse repos)
- Securities lending and borrowing
- Sale with right of repurchase agreements
- Currency hedging transactions
- Investment in transferable securities embedding derivatives

III.2. NON-FREQUENTLY TRADED AIF

Non-frequently traded asset classes include the following:

- Private equity
- Microfinance
- Real estate
- Infrastructure (e.g., public infrastructure, energy generation)
- Physical (natural resources, transportation, commodities, collectibles such as luxury goods and vehicles)
- Intellectual assets (such as patents and libraries of intellectual property)
- Long-term financial
- Multi-asset class
- Debt
- Other non-frequently traded funds (i.e., fund of funds)

ANNEX IV: OVERVIEWS OF SELECTED KEY CORPORATE GOVERNANCE CODES

This section lists selected key corporate governance codes in the context of AIF.

| | |
|---------------------|--|
| TITLE | G20/OECD Principles of Corporate Governance |
| LINK | http://www.oecd.org/corporate/principles-corporate-governance.htm |
| ORGANISATION | G20/Organisation for Economic Co-operation and Development – OECD |
| OECD SUMMARY | Originally developed by the OECD in 1999, then updated in 2004, the 2015 revision of the Principles of Corporate Governance addresses these and other emerging issues that are increasingly relevant. Building on the expertise and experience of policy makers, regulators, business and other stakeholders from around the world, the Principles provide an indispensable and globally recognised benchmark for assessing and improving corporate governance. The Principles have been adopted as one of the Financial Stability Board’s key standards for sound financial systems, and have been used by the World Bank Group in more than 60 country reviews worldwide. They also serve as the basis for the guidelines on corporate governance of banks issued by the Basel Committee on Banking Supervision. |

| | |
|--|---|
| TITLE | The X Principles of Corporate Governance of the Luxembourg Stock Exchange |
| LINK | https://www.bourse.lu/corporate-governance |
| ORGANISATION | Luxembourg Stock Exchange – Bourse de Luxembourg |
| LUXEMBOURG STOCK EXCHANGE SUMMARY | <p>The X Principles of Corporate Governance of the Luxembourg Stock Exchange (hereinafter “the X Principles”) are based on existing Luxembourg legislation regarding commercial companies, and specifically on the financial regulations that are applicable to companies listed on the Stock Exchange. The rules and recommendations adopted at the European level, and the legislation regarding governance in neighbouring countries, have also been taken into account.</p> <p>The X Principles include three series of rules:</p> <ul style="list-style-type: none"> • The actual mandatory (“compliance”) Principles: Their scope is sufficiently broad for all companies to be able to adhere to them, regardless of their specific features. All Luxembourg companies whose shares are admitted for trading on a regulated market operated by the Luxembourg Stock Exchange (hereinafter, the “target companies”) must therefore apply them without exception. • The “comply or explain” Recommendations (that is to say, those which are mandatory save in exceptional justified circumstances): The Recommendations (some of which are detailed in the Appendices to the X Principles) describe the proper application of the principles. • The Guidelines, which are indicative but not binding |

| | |
|---------------------|--|
| TITLE | ALFI Code of Conduct |
| LINK | http://www.alfi.lu/about-alfi/fund-governance-alfi-code-conduct |
| ORGANISATION | Association of the Luxembourg Fund Industry – ALFI |
| ALFI SUMMARY | The ALFI Code of Conduct provides boards of directors with a framework of high level principles and best practice recommendations for the governance of Luxembourg investment funds and management companies. Originally published in 2009, the second and latest version of the ALFI Code of Conduct was issued in June 2013. The trust of investors is key to the continuing successful development of the investment fund industry. ALFI strives to raise awareness of the leadership role that boards of directors have in promoting good ethical behavior, integrity and professionalism throughout the sector. |

| | |
|---------------------|---|
| TITLE | Guide to Sound Practices for European Hedge Fund Managers |
| LINK | https://www.aima.org/sound-practices/guides-to-sound-practices.html |
| ORGANISATION | Alternative Investment Management Association – AIMA |
| AIMA SUMMARY | The Guide considers various practical aspects of establishing and managing a hedge fund business in Europe and suggests corresponding sound practices. It is a 'must have' for any individuals or companies thinking of establishing a hedge fund business. |

| | |
|----------------------|---|
| TITLE | INREV Guidelines |
| LINK | https://www.inrev.org/guidelines/ |
| ORGANISATION | European Association for Investors in Non-Listed Real Estate Vehicles – INREV |
| INREV SUMMARY | The INREV Guidelines are for non-listed real estate investors and fund managers. They include best practices of investor reporting, corporate governance structures, valuation and liquidity. |

| | |
|------------------------------|---|
| TITLE | The Invest Europe Handbook of Professional Standards |
| LINK | https://www.investeurope.eu/about-us/professional-standards/professional-standards-handbook/ |
| ORGANISATION | Invest Europe |
| INVEST EUROPE SUMMARY | <p>The Handbook brings together the key elements of governance, transparency and accountability that are expected of industry participants. It provides accessible, practical and clear guidance on the principles that should govern professional conduct and the relationships between all those engaged in the industry, with a particular focus on the relationship between those operating the funds (referred to as General Partners or GPs) and their investors (referred to as Limited Partners or LPs), and between GPs and portfolio companies, whilst taking into account the importance of the role the industry plays in society at large.</p> <p>Updated on a regular basis, it focuses on the relationship between private equity managers and their investors and between managers and the companies they back.</p> |

| | |
|----------------------|--|
| TITLE | ILPA Principles |
| LINK | https://ilpa.org/ilpa-principles/ |
| ORGANISATION | Institutional Limited Partners Association – ILPA |
| ILPA OVERVIEW | <p>The ILPA's Private Equity Principles were developed to encourage discussions between Limited Partners and General Partners regarding fund partnerships in private equity.</p> <p>The ILPA three guiding principles are:</p> <ul style="list-style-type: none"> • Alignment of Interest • Governance • Transparency <p>The three guiding principles form the essence of an effective partnership beneficial to all parties, and are intended as a base level of recommended best practices. The Private Equity Principles have been well received by the industry, and help promote its long-term health.</p> |

ILA Mission Statement

The mission of ILA is to promote the profession of Directors by developing its members into highly qualified, effective and respected Directors.

In parallel, we promote best practices in Luxembourg in the field of Corporate Governance of companies and institutions by actively engaging with those institutions in charge of introducing, applying and overseeing Corporate Governance rules and practices.

We achieve this through high quality training, forum discussions, research, publications and conferences. ILA aims to be the premier interlocutor in Luxembourg on issues affecting Directors.