

# Using a Luxembourg Host AIFM and the Investment Process

**Since 2013, Alternative Fund Sponsors wishing to market their funds into Europe have had to navigate the Alternative Investment Fund Managers Directive ("AIFMD"). In recent times, fund sponsors are getting more familiar with AIFMD, and the optionality of using a Host AIFM to provide a robust regulatory framework without spending upfront time and expense in getting their own AIFM licence.**

It has been the case from the outset that institutional investors around Europe have accepted this model, and indeed it has been no bar to fundraising, whilst providing a solution for those investors (usually German pension funds and insurance companies) who prefer to operate in an AIFMD compliant fund structure rather than an offshore structure. However, AIFMD remains a complex piece of regulation and non-EU Fund Sponsors in particular are not used to handing over the reins to a third party service provider, who is by law bound to look after the best interest of investors.

Nevertheless, we have recently seen an uptick in interest in Host AIFM services in Luxembourg from those non-EU Fund Sponsors looking to market to the large pool of institutional capital found in Europe. US and Asian fund managers are reviewing this option again when they need (i) to speak to investors in jurisdictions with unworkable national private placement regime (such as Spain, Italy and France), (ii) and to set up a fully AIFMD compliant parallel vehicle to accommodate the specific requirements of, inter alia, German institutional investors. A Host AIFM solution is a quick and cost efficient way to achieve their commercial objectives, rather than to go through the process of setting up an AIFM themselves in Luxembourg, especially in light of the detailed infrastructure and personnel requirements as outlined by the CSSF in Circular 18/698 released in August 2018.

There are many advantages to appointing a Host AIFM, but the perceived loss of control in the investment making-decision process is often the largest concern of fund managers. Ultimately, there is another party involved. The fund counsel and the Host AIFM therefore should explain what is required at the outset. The typical questions usually concern:

- The allocation of responsibilities between the General Partner ("GP") and the AIFM. It is important to be aware of the market practices as there is no clear guidance in the relevant regulations.
- The difference between the advisory model and the delegated management model. The latter is now the preferred route to minimise the Host AIFM involvement in a decision-making process, subject to the fund sponsor's regulated status in their home jurisdiction.

## Allocation of the powers between the General Partner and the Host AIFM

Today in Luxembourg, most of the investment funds which are fully AIFMD compliant are established as an unregulated limited partnership managed by a GP which in turn needs to appoint a full scope AIFM ("Alternative Investment Fund Manager"). AIFMD is practically silent on the role of GP. Under the Luxembourg Company Law, the strategy and management of a fund remains the legal responsibility of the board of the GP.

This being said, the AIFMD defines AIFMs as any "legal person whose regular business is managing one or more AIFs". "Managing AIFs" is then defined as "performing at least investment management functions for one or more AIFs" (the investment management functions being portfolio management and risk management).

Even if there is no single definition of portfolio management in the relevant regulations, it usually involves the process of selecting, acquiring, managing and disposing of the assets of the AIF.

Keeping this in mind, it is therefore crucial that the fund documentation is properly reviewed to avoid confusion, and to clearly differentiate the allocation of functions between the GP and the AIFM. The constitutional documents of most AIFs usually states that the GP shall have all rights and powers with respect to the AIF that may be vested in the GP under the corporate law, subject to any limitations specifically set in the AIFM agreement and provided that the GP shall not do anything or exercise any powers which constitutes a regulated activity under the AIFM regulation.

In practice, it means that anything related to the investment approval is within the AIFM scope, i.e. the approval of the investment itself, CAPEX budgets if any (in the case of real assets) and follow on investments (in case of private equity and venture capital). There are differing views on whether financing (including the hedging policy)

is allocated to the AIFM but the prudent view to take is that the financing assumptions should always be taken into account when approving an investment, obviously subject to the GP reserved matters.

The role of the GP will be limited to the coordination of the capital pursuant to investment approvals of the AIFM. The execution of the transaction documents usually takes place at the level of special purpose vehicles ("SPVs") in accordance with the legal and tax requirements of the jurisdictions where those SPVs have been established.

In this context, it is necessary to agree and document the operating model in advance. It will enable all parties involved in the investment process to work together to approve and execute all the transactions on a timely basis. It can also be very convenient to work with a service provider that can offer a "one-stop shop" solution, i.e. Host AIFM, administration and depositary services. This model allows the service provider to fully coordinate the investment approval process, particularly in respect of the Host AIFM and the GP (usually administered by the service provider).

## Advisory vs Delegated Portfolio Management

When a Fund Sponsor appoints a Host AIFM, the investment management process can be managed applying either the advisory model or the delegated model. The Fund Sponsor will be involved in the investment process by acting as a portfolio manager (delegated model) or as an investment adviser (advisory model).

### Delegated model

Under the delegated model, the portfolio manager makes all the investment decisions, and the Host AIFM then carries out oversight of the portfolio management activities and undertakes the risk management function.

In funds with illiquid strategies which are investing in non-fungible assets, the investment decision and risk management considerations are necessarily intertwined, with both qualitative and quantitative risk factors needing to be considered (unlike hedge fund AIFs where the risk management is mostly a quantitative check on investment limits). What happens in practice is that the investment paper prepared by the portfolio manager is also reviewed by the AIFM for risk management. Under AIFMD, the AIFM can only delegate either the portfolio management or risk management functions, but not both. However, the commerciality of the decision will be decided by the portfolio manager and the AIFM will note the risks of the transaction.

The AIFM's liability towards the AIF and its investors will not be affected by the fact that the AIFM has delegated functions to a third party, therefore it is imperative that the AIFM understands from the outset the portfolio manager's internal investment process and has done the requisite due diligence required under AIFMD. Consequently, a delegated portfolio manager must also comply with the requirements of AIFMD, the portfolio manager will have additional obligations and requirements to handle including regular reporting to the AIFM.

### Requirement for a portfolio management licence

To act as the portfolio manager, the entity must be authorised or registered to provide asset management services, and subject to supervision in its home state, or, where that condition cannot be met, prior approval by the Commission de Surveillance du Secteur Financier ("CSSF") will be required before taking up the portfolio manager role.

The following entities are deemed to be authorised or registered for the purpose of asset management and subject to supervision: UCITS management companies, investment firms authorised under MiFID to perform portfolio management, and 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 portfolio manager must be ensured. This cooperation is usually evidenced by a Memorandum of Understanding ("MoU"). A list of all MoUs entered by the CSSF with foreign regulators is available on the CSSF website.

### Compliance with the European Securities and Markets Authority ("ESMA") Remuneration guidelines

The AIFMD provides that each AIFM must have remuneration policies and practices for prescribed categories of staff. When portfolio management is delegated, the ESMA Remuneration Guidelines require that the delegate should be subject to regulatory requirements on remuneration that are

equally as effective as those applicable under the Remuneration Guidelines. There are also disclosures to be made usually in the annual accounts of the fund.

### Host AIFM supervision of the portfolio manager

It is crucial for the Host AIFM to ensure that all investment decisions on behalf of the fund are carried out in compliance with the objectives, the investment strategy, the risk profile and the risk limits of the fund. In practice, the AIFM would, having satisfied itself of the infrastructure, professionalism and commercial acumen of the portfolio manager, leave the decision-making process to the portfolio manager and only intervene and raise any questions if really necessary, and on a timely basis. Relying on the commercial acumen of the portfolio manager, it is expected that if the AIFM raises any issues, it is mostly for clarification on an investment or ensuring regularity with market practice and compliance with the investment restrictions and laws in the process of transacting. Furthermore, the portfolio manager will provide to the Host AIFM all information concerning the investments to enable the Host AIFM to fulfil its duties in relation to risk management and liquidation management.

### Conflict of interest

The AIFMD precludes delegation in circumstances where it conflicts with the interests of the AIFM or investors of the relevant AIF. This may be applicable if the delegate itself is controlled by an investor in the relevant AIF, or the delegate is likely to have a financial or other incentive to favour the interest of another client over the interests of the AIF or the investors in the AIF. The Host AIFM would usually declare in the AIFM agreement that it may act for other funds with the same strategy and will only consider transactions which are proposed by the appointed portfolio manager.

### Advisory Model

Under the advisory model, the investment advisor advises the AIFM with respect to the investments and divestments of the fund. The investment advisor would usually still have its own internal investment committee meetings, but it is the investment committee of the AIFM that makes the decisions based on the recommendation of the investment adviser. The investment advisor's activities comprise of sourcing opportunities, conducting due diligence, providing investment recommendations, assisting with carrying out the transactions and assisting with reporting in the management of the investments. Note that the investment committee of the AIFM can possibly include personnel of the investment advisor subject to certain restrictions (i.e. an advisory role without any voting rights).

### Does the fund sponsor need a licence?

Investment advisers may be regulated (i.e. authorised and supervised) or unregulated (albeit under certain conditions). EU investment advisers which provide advice to third parties in respect of one or more transactions relating to financial instruments, must be regulated. Non-EU based investment advisers may have to register with the CSSF unless they are appointed by the Host AIFM and/or fund on a reverse solicitation basis<sup>1)</sup>. This registration requirement recently introduced by the CSSF applies until activation of the third country MiFID passport. The purpose is for the CSSF to assess whether the non-EU adviser is subject to equivalent regulatory requirements in its home jurisdiction prior to authorising any services to Luxembourg based professional clients (such as the Host AIFM and/or the fund).

From one jurisdiction to another, the requirement for permissions and the scope of authorised activities can be significantly different. The fund sponsor may need therefore to seek legal advice from the fund counsel and the Host AIFM.

### How to mitigate the risk of delay?

As mentioned previously, one of the key concerns fund sponsors often have with the Host AIFM model may be the loss of control in the investment decision-making process, and the risk of delay in the execution of the transaction. This is particularly relevant under the advisory model, and even more so when there are many investments (i.e. secondary markets or venture capital). It is therefore crucial for the fund sponsor to discuss and clearly understand how the investment process will work in practice. Under this model, the typical investment approval process consists of three key steps.

First, it is necessary for the Host AIFM to have a clear understanding of the deal pipeline on a regular basis. Sharing, for example, a pipeline report every month is considered good practice, including details of the current stage of each opportunity. Investment papers/details can be batched for approvals.

Then, as the Host AIFM will approve any due diligence budget for new projects, it can also take the opportunity to review the key terms of the investments, and perform a preliminary check against the investment strategy and the investment restrictions. This approval typically takes place between 3-5 days before the start of the due diligence process.

Finally, once the host AIFM has sufficient understanding of the deal, and assuming all the required information has been received from the fund sponsor on a timely basis, then the final approval will take a maximum of 48 hours. Key to timely sign off from the Host AIFM is undoubtedly proper preparation in advance of the deal.

### Is it really difficult to be AIFMD compliant?

Especially under the advisory model, the fund sponsor may feel that the Host AIFM option is an intrusive process. However, we do believe that once it is properly explained and fully understood, it is less onerous than expected and can become a routine process.

The requirements under AIFMD, as supervised by the Host AIFM should also reduce litigation risk for the fund sponsor as there would be proper processes and documents to support all material decisions. The key point is the capacity of the Host AIFM to adapt to the fund sponsor's existing processes, particularly if the fund sponsor is already regulated in another jurisdiction. It is only possible if the Host AIFM team has a very good understanding of the AIFMD and of the relevant market practices.

Under the host AIFM model, the fund sponsor is sharing the Host AIFM platform with multiple funds. It is therefore critical that the Host AIFM that will appear on the fund documentation remains free from legal action or any reputational damage.

This legal and reputational risk is one that the fund sponsor should carefully consider when deciding to appoint a host AIFM, and so it is essential to assess the quality and expertise of the team working for the Host AIFM. Staff selection is important, not only to give the platform substance for effective supervision of the fund sponsor, but also to have an efficient, commercial process for decision making. Anticipation of potential problems is key. A poor quality team can erode the time of deal professionals, given that any sign-off at Host AIFM level is often needed quickly during the deal cycle. In a worst case scenario it could even allow a decision to be made which may lead to litigation at a later date.

Furthermore, the Host AIFM is required to demonstrate its effective supervision over the portfolio management process, this means proper meeting minuting and supporting paperwork collating processes. Any gaps or lack of tracking can cause more risk for the client and the Host AIFM, and as is heavily documented, can even be prejudicial in case of litigation.

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<sup>1)</sup> Refer to CSSF circular 19/716 on the provision in Luxembourg of investment services or performance of investment activities and ancillary services

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