

ILA

Institut Luxembourgeois
des Administrateurs

AIF AND AIFM

A practical guide for directors

ILA



CONTENTS

| | |
|---|----|
| 1. FOREWORD | 1 |
| 2. INTRODUCTION | 3 |
| 3. GLOSSARY OF TERMS | 4 |
| 4. SETTING THE SCENE | 5 |
| 4.1. THE OVERALL REGULATORY FRAMEWORK | 5 |
| 4.2. PORTFOLIO MANAGEMENT, RISK MANAGEMENT, INVESTMENT ADVICE AND HOLDING STRUCTURES | 6 |
| 4.3. AIFM DIRECTIVE REQUIREMENTS APPLICABLE TO GOVERNING BODIES | 7 |
| 4.4. KEY OVERSIGHT BODIES IN THE AIF CONTEXT | 9 |
| 4.5. TYPICAL ROLES OF GOVERNING BODIES IN AN AIF CONTEXT | 9 |
| 4.6. ILLUSTRATIONS OF TYPICAL LUXEMBOURG AIF AND AIFM MODELS | 11 |
| 4.7. ILLUSTRATIONS OF KEY AIFM DECISION-MAKING PROCESSES | 18 |
| 5. FAQ: KEY OVERSIGHT CHALLENGES FOR BOARD MEMBERS OF AIFMS AND AIFS | 21 |
| BOARD COMPOSITION - SUBSTANCE - DELEGATES AND SERVICE PROVIDERS | |
| INDEPENDENT FUNCTIONS - INTERNAL CONTROL FUNCTIONS - VALUATION - MARKETING | |
| INVESTOR REPRESENTATION - CONFLICTS OF INTEREST - REMUNERATION | |
| MANAGING BOARD PROCESSES - LARGE AIFM - AIF OVERSIGHT OVER THE AIFM | |
| ANNUAL ACCOUNTS - OPERATIONAL COMPLIANCE - INSURANCE & LIABILITY MANAGEMENT | |
| OUT OF SCOPE AIFM AND AIF | |
| | |
| ANNEXES | 42 |
| ANNEX I: BASIC AIF ORGANISATIONAL MODELS | 42 |
| ANNEX II: KEY OVERSIGHT RESPONSIBILITIES FROM A COMPLIANCE PERSPECTIVE | 46 |
| ANNEX III: MAIN ASSET CLASSES OF AIF | 47 |
| ANNEX IV: OVERVIEWS OF SELECTED KEY CORPORATE GOVERNANCE CODES | 48 |

MEMBERS OF THE ALTERNATIVE INVESTMENT TASKFORCE

Chairmen:

Michael Hornsby, Partner, EY
William Jones, Managing Partner, ManagementPlus Group

Members:

Gilles Dusemon, Partner, Arendt & Medernach
Hans-Jürgen Schmitz, Managing Partner, Mangrove Capital Partners and
President of the Executive Committee of Luxembourg Private Equity Association (LPEA)
Johan Terblanche, Partner, Loyens & Loeff
Michael Delano, Partner, PwC
Monique Bachner, Lawyer, Bachner Legal
Paul Guillaume, Managing Partner, ALTRA Partners

Secretary:

Yann Power, EY

1. FOREWORD

The mission of the Luxembourg Institute of Directors (ILA) is to promote the profession of Directors by developing its members into highly qualified, effective and respected Directors. This *practical guide for directors* is intended to help Directors on issues specific to AIFs and AIFMs.

The adoption of the Alternative Investment Fund Managers Directive (AIFMD) and its implementation by EU Member States has triggered an upheaval for EU and non-EU AIF offered to European investors.

The EU has implemented a pan-European regulatory process in a very short timeframe – at least when compared to the development of the UCITS framework which has been evolving for over 25 years.

The bar has been raised substantially for AIFMs. In order to comply with this more formal and prescriptive regime, existing AIFMs and internally managed AIFs have been required to make significant changes to their organisational models and structures, corporate governance practices, remuneration practices, fund documentation, and many other aspects of operations. All parties involved in an AIF structure have to exercise a greater degree of oversight over the AIF and its service providers.

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 subsequent similar regimes), 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.

In the middle of this regulatory and operational maelstrom are the Boards of Directors of AIFs (or equivalent governing bodies) and the Boards of Directors of AIFMs.

While AIFMD is 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 AIFs 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.

AIFMD 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.

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

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.

Directors remain subject to the three classic deficiencies in corporate governance – not enough time, information or resources – but are expected by everyone to navigate successfully increasingly complicated regulatory and operational waters.

However, it is important to note, particularly in the context of AIFMD, that directors are not compliance officers or day-to-day managers. The principle of proportionality introduced by AIFMD allows directors to factor size and scale into their decisions affecting AIFs and AIFMs – this principle should be used wisely but with a view to building more robust corporate governance processes when size and scale permit.

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

Luxembourg is positioned to play a leading role in the governance of AIFs and AIFMs. This Guide is designed to complement other initiatives, such as practical industry guidance and training.

ILA's Alternative Investment Taskforce has prepared this guide to provide:

- A roadmap for the role of the Board of Directors and its positioning in AIF structures
- Answers to 20 common practical questions raised by ILA members on the governance of AIF structures from the perspective of a Director. We hope that these answers will help guide Boards and their members in the execution of their oversight responsibilities and their efforts to meet the requirements of AIFMD.

As AIFMD represents a paradigm shift in the governance and oversight of AIF structures, it will no doubt take a few years for consensus to be achieved and best practices to emerge.

ILA and its Alternative Investment Taskforce hope that this Guide will represent a helpful step forward in the process of developing best practices on the governance of AIFs and AIFMs, and help Directors perform their duties more effectively, particularly in the context of AIFMD.

We would like to express our thanks to the Taskforce, ILA members and others who have contributed to the development of this Guide.



William Jones



Michael Hornsby

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. INTRODUCTION

This Guide on the governance of Alternative Investment Fund Managers (AIFMs) and Alternative Investment Funds (AIFs) has been developed by The Alternative Investment Committee of the Luxembourg Institute of Directors (the *Institut Luxembourgeois d'Administrateurs* – ILA).

The guide is organized as follows:

NAVIGATING THIS GUIDE

| KEY QUESTIONS OF BOARD MEMBERS | SECTION REFERENCE IN THIS GUIDE |
|---|---|
| ROADMAP FOR THE ROLE OF THE BOARD OF DIRECTORS AND ITS POSITIONING IN AIF STRUCTURES | |
| WHAT ARE THE TYPICAL ROLES OF A GOVERNING BODY OF AN AIFM OR AIF? | Section 4.5. <i>Typical roles of governing bodies in an AIF context</i> provides a practical perspective on the different types of governing body and their roles. |
| WHAT ARE APPLICABLE REGULATORY REQUIREMENTS? | Section 4.1. <i>The overall regulatory framework</i> , Section 4.2. <i>Portfolio management, risk management, investment advice and holding structures</i> and Section 4.3. <i>AIFM Directive requirements applicable to governing bodies</i> provide a perspective on where the governing body fits within the regulatory framework and the responsibilities of the governing body. Annex II provides an overview of requirements which may be applicable, and key oversight responsibilities, in relation to AIFs and AIFMs, portfolio managers and investment advisers and holding vehicles. |
| WHAT CORPORATE GOVERNANCE CODES APPLY? | Corporate governance codes may generally be applied on a voluntary basis. The responsibility of a governing body for compliance with a corporate governance code is covered in Annex II. Selected key corporate governance codes are outlined in Annex IV. |
| HOW CAN I OBTAIN A CLEAR UNDERSTANDING OF THE ORGANISATIONAL MODEL OF THE AIF, AIFM AND ASSET MANAGEMENT GROUP/SPONSOR/INITIATOR? | Three practical illustrations of AIF and AIFM models are laid out in Section 4.6. <i>Illustrations of typical Luxembourg AIF and AIFM models</i> . Annex I illustrates more basic AIF organisational models. |
| HOW DO THE KEY DECISION-MAKING PROCESSES WORK? | Illustrations of the key portfolio management and risk management processes are provided in Section 4.7. <i>Illustrations of key AIFM decision-making processes</i> . |
| WHAT ASSET CLASSES DOES THIS GUIDE COVER? | The guidance is relevant to both frequently traded and non-frequently traded asset classes of alternative investment funds. Annex III covers the main asset classes of frequently and non-frequently traded AIFs. |
| PRACTICAL ANSWERS TO TYPICAL KEY QUESTIONS | |
| WHAT ARE THE TYPICAL KEY QUESTIONS I SHOULD MASTER AS A BOARD MEMBER? | Chapter 5 entitled <i>FAQ: Key oversight challenges for Board Members of AIFMs and AIFs</i> provides practical answers to 20 key questions asked by Board Members of AIFMs and AIFs. |

This guidance represents the combined views of the members of The Alternative Investment Committee, and not necessarily those of ILA or any of the organisations which the members represent. It is not intended to provide an exhaustive view of all of the roles or responsibilities of Board Members, and does not represent legal advice.

Directors are also recommended to refer to other Guidance published by ILA, including the *Directors FAQ – Luxembourg regulated funds*.

3. GLOSSARY OF TERMS

| ABBREVIATION OR TERM | MEANING |
|----------------------|---|
| AIF | Alternative investment fund |
| AIFM | Alternative investment fund manager |
| AIFMD | Alternative Investment Fund Managers Directive |
| AIFM LAW | The Law of 12 July 2013 on Alternative Investment Fund Managers |
| AML/CFT | Anti-money laundering and counter-terrorist financing |
| CONDUCTING OFFICER | A person who effectively conducts the business of the AIFM – a member of senior management |
| FCP | Common fund – <i>Fonds commun de placement</i> |
| NAV | Net Asset Value |
| 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. |
| SENIOR MANAGEMENT | The senior management of the AIFM, which may take the form of a management committee, consisting of conducting officers. The conducting officers may also be members of the governing body, but do not have to be. |
| SICAV | Investment company with variable capital – <i>Société d'investissement à capital variable</i> |
| SIF | Specialized Investment Fund |
| SIF LAW | Law of 13 February 2007 on Specialized Investment Funds |
| 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 |

4. SETTING THE SCENE

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

- The overall regulatory framework for AIFMs, delegated portfolio management and risk management functions, investment advisers, and holding companies
- Key regulatory requirements: AIFMD requirements applicable to governing bodies
- Key oversight bodies in the AIF context
- The role: typical roles of governing bodies in an AIF context
- Typical Luxembourg AIF and AIFM models
- Key AIFM decision-making processes: portfolio management and risk management

4.1. THE OVERALL REGULATORY FRAMEWORK

The following table provides an overview of possible scenarios of an EU AIF managed by an 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 smaller AIFM | No ¹ |
| | | Internally managed smaller AIF | |
| | UNREGULATED | External AIFM | Yes |
| | | Internally managed AIF | |
| | | External smaller AIFM | No ² |
| | | Internally managed smaller AIF | |
| AIFM | REGULATED | External AIFM | Yes |
| | UNREGULATED | External smaller AIFM | No |

The following table provides a brief summary of the permitted activities of AIFM and non-UCITS management companies:

BRIEF SUMMARY OF SCOPE OF ACTIVITIES OF MANAGEMENT ENTITIES

| | AUTHORIZED AIFM | CHAPTER 16 MANAGEMENT COMPANY (NOT AUTHORIZED AS AN AIFM) |
|----------------------------------|--|--|
| REGULAR BUSINESS | Managing alternative investment funds (AIF) Managing AIF means performing, for one or more AIF, at least the investment management services of: <ul style="list-style-type: none"> • Portfolio management • Risk management AIFM may also provide the services of: <ul style="list-style-type: none"> • Administration • Marketing • Activities related to the assets of AIF³ | Managing non-UCITS (e.g. SIFs and Part II UCIs) |
| OTHER POSSIBLE ACTIVITIES | <ul style="list-style-type: none"> • Activities related to the assets of AIF • Discretionary portfolio management • Investment advice | Managing investment vehicles other than AIF |

¹ If (a) the assets under management of the AIFM, or the internally managed AIF, are below the AIFMD *de minimis* thresholds above which it is in scope of AIFMD (€100 million or €500 million in the case of an unleveraged closed-ended AIF), and (b) has not opted to be authorized as an AIFM, certain provisions of the AIFMD nevertheless apply.

² Idem.

³ 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

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

The central role of the AIFM is performing, for one or more AIFs, the investment management services of portfolio management and 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 5: *FAQ: Key oversight questions for Board Members of AIF and AIFM* Questions 2 and 3). The portfolio manager or, where the portfolio management function has not been delegated, the AIFM, may also appoint one or more investment advisers.

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

This subsection briefly outlines the regulatory framework for these different roles. Annex II covers the applicable requirements and key responsibilities in more detail.

4.2.1. PORTFOLIO MANAGEMENT AND RISK 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.

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.

The portfolio management and risk management processes are illustrated in Section 4.7. The relationship between the portfolio management function and the risk management function is covered in Section 5: *FAQ: Key oversight questions for Board Members of AIF and AIFM* Questions 4 and risk management oversight is covered in Question 5.

When an AIFM delegates its investment management functions of portfolio management or risk management functions, the delegates must be undertakings which are authorized 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 authorized or registered for the purpose of asset management and subject to supervision: AIFMs, UCITS management companies, investment firms authorized under MiFID to perform portfolio management, credit institutions which are authorized to perform portfolio management, and third country entities authorized 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.

4.2.2. INVESTMENT ADVICE

The portfolio manager or, where the portfolio management function has not been delegated, the AIFM or internally managed AIF, may appoint one or more investment advisers.

The investment adviser advises the portfolio manager, the AIFM or internally managed AIF itself, 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 investment recommendations.

The investment adviser generally has 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. authorized 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
- AIFMs

4.2.3. 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 AIFs or other co-investors.

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

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

4.3. AIFM DIRECTIVE REQUIREMENTS APPLICABLE TO GOVERNING BODIES

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

- Rules of conduct
- Qualifications of the governing body
- Roles of the governing body

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

This subsection summarises the AIFMD requirements.

4.3.1. 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 constitutional document.

An AIFM which is authorized 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.

4.3.2. QUALIFICATIONS OF THE GOVERNING BODY

Supervisory authorities generally put a lot of emphasis on the capacity and competencies of Directors during the regulatory approval process.

The minimum qualifications of the governing bodies of AIFMs, as laid down in the regulations, include the following:

MINIMUM QUALIFICATIONS OF GOVERNING BODIES OF AIFM

| | |
|---|---|
| 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 | The Members of the governing body must commit sufficient time to properly perform their functions in relation to the AIFM, and must therefore limit the number of other professional engagements and mandates accordingly. |
| REPUTATION⁴, INTEGRITY AND INDEPENDENCE | Each Member of the governing body must act with honesty, integrity and independence of mind. |
| TRAINING | The AIFM must devote adequate resources to the induction and training of Members of the governing body. |

⁴ 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 authorization procedure, unless there is evidence to the contrary.

4.3.3. ROLES OF THE GOVERNING BODY

The roles of the governing bodies of 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. 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>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>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.⁵</p> |

⁵ CSSF Circular 10/437

4.4. KEY OVERSIGHT BODIES IN THE AIF CONTEXT

AIFMs, their advisors and AIFs can be configured in many different ways to deal with the specificities of different asset classes, geographies, frequently or infrequently traded 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)
- Senior management/ Management Committee
- Internal control functions:
 - Risk management
 - Compliance
 - Internal audit
- Boards of delegate portfolio manager, risk manager, other delegates, advisers and service providers
- Boards of holding structures

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

4.5. TYPICAL ROLES OF GOVERNING BODIES IN AN AIF CONTEXT

Alongside the specific requirements applicable to the Boards of Directors in AIF structures, there are a wide range of topics to which the Board should attend.

There are many different references which provide guidance on good governance in general, in the context of investment funds in general, or AIFs in particular; some of these are referred to in Annex IV.

In practice, the key roles of governing bodies in AIF structures 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) have the skills sets to understand and critically review the diverse aspects of the business (e.g. representing shareholders, 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 of 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 5, 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 administration)
- **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 administrator, 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:** initial due diligence on and ongoing monitoring of service providers at all levels (AIFM, AIF, holding structures, underlying assets) including:
 - Delegates including, where relevant:
 - AIFM
 - Management company
 - Portfolio manager
 - Asset/property manager
 - Risk management service provider
 - Central administrator/transfer agent
 - Valuer
 - Distributor
 - Advisors such as:
 - Investment advisers
 - Consultants
 - Other service providers such as:
 - Depositary
 - Auditor
 - Lawyer
 - Tax adviser/tax compliance service provider

See also Annex II on the roles and responsibilities of the governing bodies of delegated portfolio managers and risk managers and investment advisers.
- **Providing delegates with all 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)
- **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
- **Managing advisers:** efficiently interacting with advisers while ensuring that advice remains separate from decision making
- **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 authorization and changes to AIF documentation
- **Managing the asset management group/sponsor/initiator relationship:**
 - Protecting the interests of the sponsor
 - Generating returns for the group shareholder

4.6. 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 or asset management group/sponsor/initiator formalizes and maintains illustrations of the AIF structures, covering, *inter alia*:

- The internal organisation of the AIFM
- The relationship with group entities and third parties, covering, *inter alia*, responsibility for the due diligence, appointment, and ongoing monitoring, of:
 - Delegates, such as portfolio managers and administrator
 - Other service providers, such as depositary, auditor and legal advisers
- The holding structures of the AIF

This section illustrates three typical Luxembourg AIF structures:

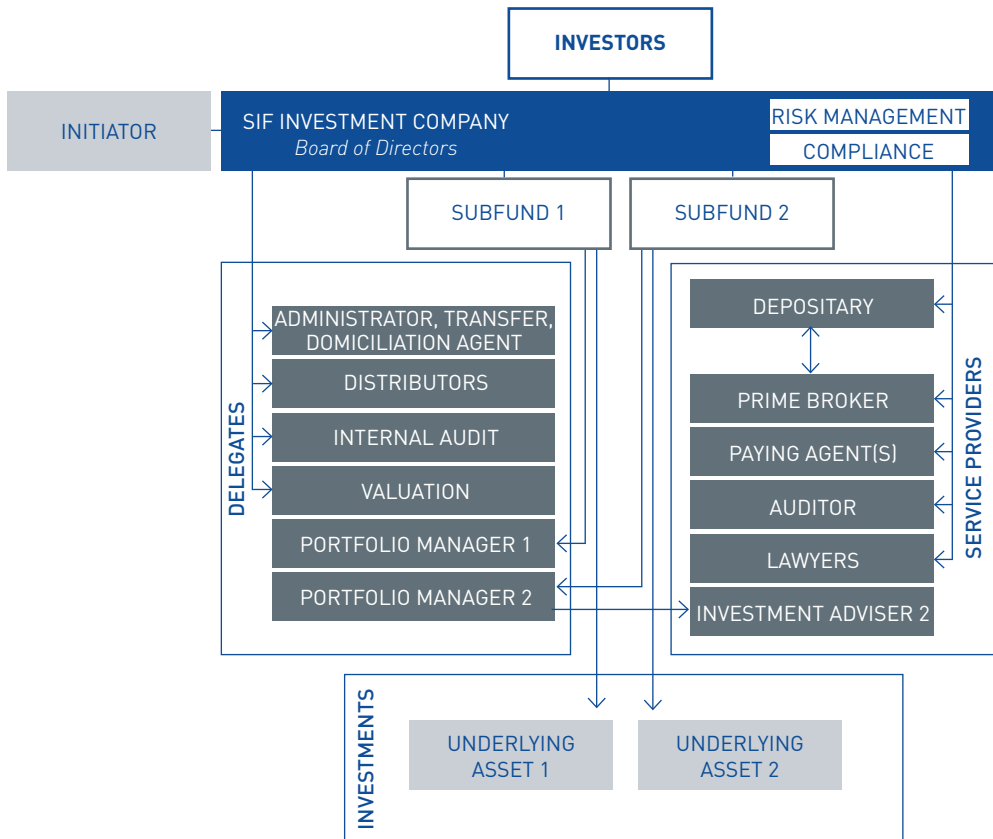
- Internally-managed AIF – a Specialized Investment Fund (SIF)
- Group AIFM with multiple AIF in a single asset class
- Independent external AIFM

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

4.6.1. ILLUSTRATION 1. INTERNALLY-MANAGED AIF – SIF

| SUMMARY | |
|----------------------------|--|
| TYPES OF AIF | A SIF investment company, typically a SICAV or a common or special limited partnership |
| MANAGEMENT | An internally managed AIF |
| TYPICAL UTILIZATION | One asset class, typically a multiple sub-fund (compartment) structure investing in financial assets (such as a hedge fund) |
| 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 internal audit function and external valuer), and service providers • One responsible for risk management, compliance, valuation, and all other AIFM functions |
| RISK MANAGEMENT | Risk manager is a conducting officer |
| COMPLIANCE | Compliance officer insourced from a third party which makes a 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 | The AIFM is a standalone internally managed AIF |
| 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 an investment adviser |
| INTERNAL CONTROL FUNCTIONS | The internally managed 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 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. |

SCHEMATIC OF INTERNALLY-MANAGED AIF-SIF⁶



Source: EY

⁶ This schematic shows a different level of granularity as regards the relationship between the AIF, the AIFM and service providers than the following illustrations.

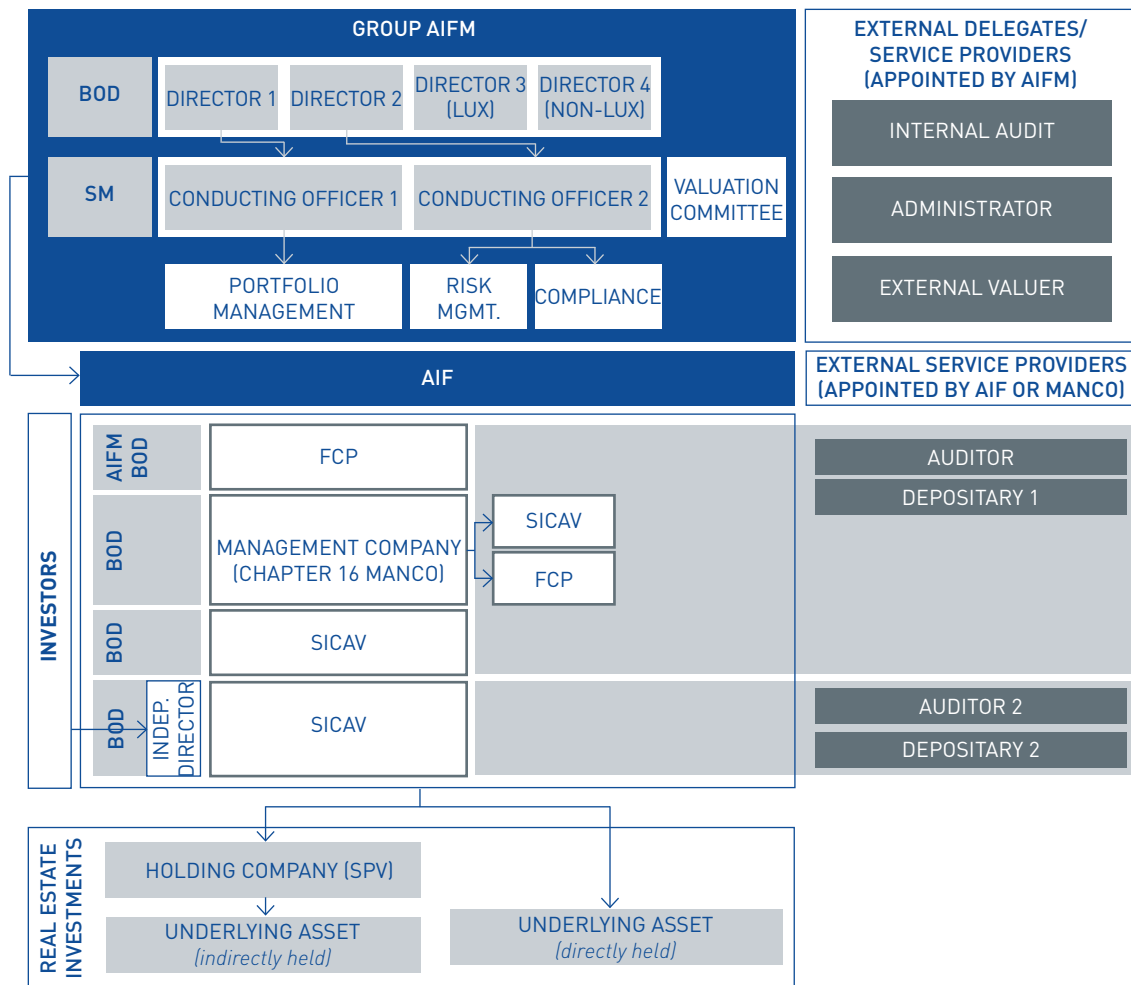
4.6.2. ILLUSTRATION 2: GROUP AIFM WITH MULTIPLE AIF IN A SINGLE ASSET CLASS

| 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 ⁷). |
| MANAGEMENT | Externally managed AIF by a group AIFM. |
| TYPICAL UTILIZATION | One illiquid asset class (such as real estate or private equity). |
| AIFM INTERNAL ORGANISATION | |
| ROLE | IMPLEMENTATION |
| BOARD OF DIRECTORS | Four Board Members: <ul style="list-style-type: none"> • The Board Members who are also conducting officers (senior managers) • One Board Member from the Board of the largest AIF managed by the AIFM • One Group Board Member |
| SENIOR MANAGEMENT | Two conducting officers: <ul style="list-style-type: none"> • One responsible for the oversight of portfolio management • One responsible for the oversight of risk management, valuation, and all the other AIFM functions, and the oversight of delegates 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 specialized third party investment advisers, including advisers specialized 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 valuers. |
| 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 |

⁷ This Club Deal is not a joint venture.

| SERVICE PROVIDER ROLES | |
|------------------------|--|
| SERVICE PROVIDER | IMPLEMENTATION |
| AUDITOR | <p>The same independent auditor has been appointed for the AIFM, and all AIFs, except the "Club deal" AIF, which has appointed a different independent auditor.</p> <p>The independent auditors have been appointed by:</p> <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 | <p>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.</p> |

GROUP AIFM WITH MULTIPLE AIF IN A SINGLE ASSET CLASS⁸



Source: EY

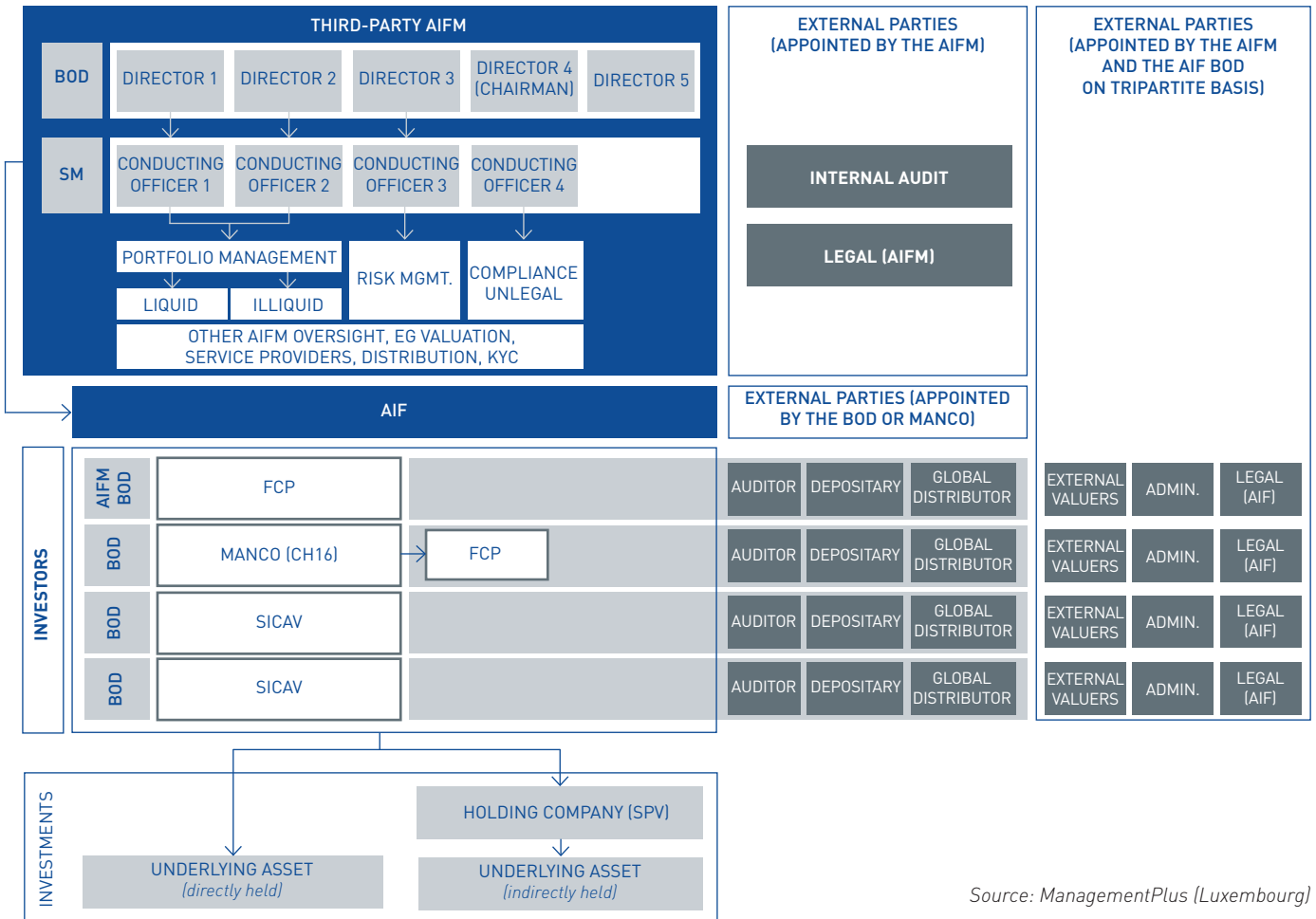
⁸ This schematic shows a different level of granularity as regards the relationship between the AIF, AIFM and service providers than the previous illustration.

4.6.3. 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 UTILIZATION | Both liquid and illiquid asset classes, such as equities, bonds, hedge funds, private equity and real estate funds. |
| AIFM INTERNAL ORGANISATION | |
| ROLE | IMPLEMENTATION |
| BOARD OF DIRECTORS | Five Board members: <ul style="list-style-type: none"> • Three Board Members who are also conducting officers of the AIFM • Two 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 <p>The conducting officers committee jointly oversees valuation, delegates and service providers, and all other AIFM functions.</p> |
| 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 | |
| SERVICE PROVIDER | IMPLEMENTATION |
| AIFM | The independent corporate governance group has created a single third-party AIFM entity in Luxembourg to manage all of its client AIF structures: <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 common fund management company, so the governing body of the AIFM will have direct responsibility for the new common fund AIFs |
| PORTFOLIO MANAGEMENT | 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>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: source opportunities, perform due diligence, recommend transactions, negotiate financing terms and provide day-to-day asset (property) management services.</p> <p>The investment adviser may be in the client group or may be appointed on a third-party basis.</p> |
| RISK MANAGEMENT | 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. |
| 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 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. |

SERVICE PROVIDER ROLES

| SERVICE PROVIDER | IMPLEMENTATION |
|------------------|--|
| VALUATION | 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. |
| DISTRIBUTION | 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. |
| DEPOSITARY | 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. The depositaries and paying agents have been appointed by: <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 | The independent auditors for each AIF have been appointed by: <ul style="list-style-type: none"> • For the investment companies, the Board of the AIF or the general meeting of shareholders • For existing common funds, the common fund management company • For the new directly managed common funds, the AIFM itself |
| LAWYERS | 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. |



Source: ManagementPlus (Luxembourg)

4.7. ILLUSTRATIONS OF KEY AIFM DECISION-MAKING PROCESSES

As the AIFM's core functions are portfolio management and risk management, it is important that Directors understand how these functions are configured in the organisation in order to be effective in their oversight of the functions.

This subsection includes typical workflows related to these entities to try to illustrate how they work in practice. As discussed in more detail in the FAQ section, although some functions need to remain segregated from each other, it is critical that there is a significant amount of interaction between them, particularly when considering new deals in non-frequently traded assets (See Section 5, Question 4). Further, there must be appropriate interaction between the adviser, the AIFM and the AIF Boards throughout a deal process. These bodies need to strike the right balance between relying on each other and maintaining healthy and independent scepticism.

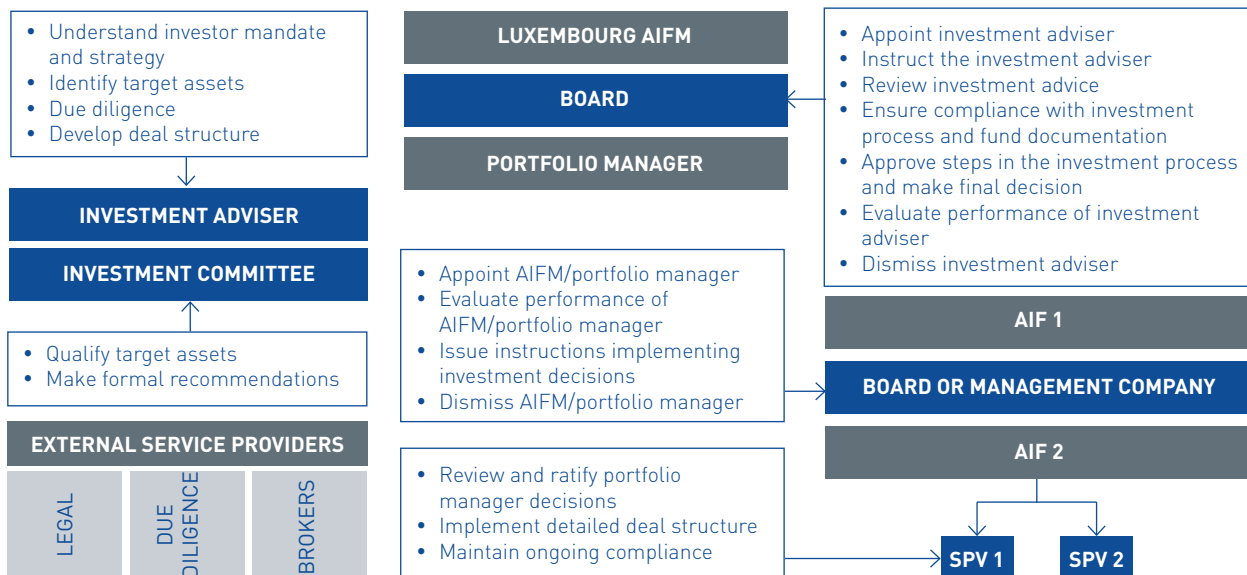
Many alternative workflows are possible; the model will depend on factors such as the organizational model of the AIF and AIFM, the nature of the business of the AIFM, the portfolio manager and the investment adviser, and the asset class.

4.7.1. PORTFOLIO MANAGEMENT

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

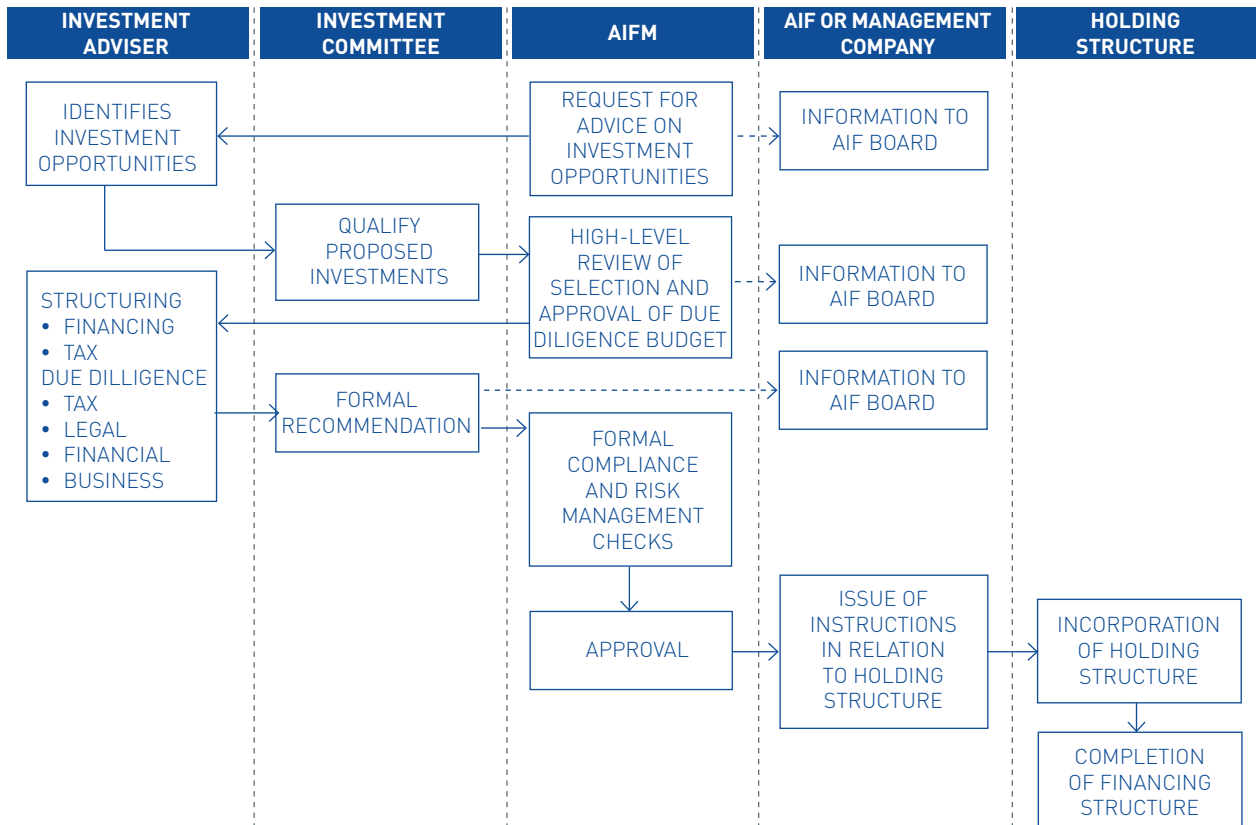
ILLUSTRATION OF AIF PORTFOLIO MANAGEMENT FROM A FUNCTIONAL PERSPECTIVE



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 5, Question 4.

4.7.2. RISK MANAGEMENT

An AIFM is required to:

- 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
- 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

Risk management is typically a cyclical process, managed by the risk management function and overseen by the senior management, and ultimately the Board. A possible model is illustrated below:



Source: EY

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 4.3.3.

5. 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 an AIFM managing an AIF or an internally managed AIF which are subject to the AIFMD. The final question in this section focuses on out-of-scope or sub-threshold AIFs and AIFMs.

Neither the questions nor the answers aim to be comprehensive. 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:

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

5.1. 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 AIFMs and AIFs 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 collective 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 specific areas of responsibility to Board Members, or committees
- Ensuring that each Board Member has sufficient time to dedicate to his function (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)

5.2. SUBSTANCE

2. How should Boards of AIFMs or internally managed AIFs 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 ongoing 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 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 every 3 to 6 months)
- Ensuring that major decisions are taken in Luxembourg
- Ensuring/recommending 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
- 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

5.3. DELEGATES AND SERVICE PROVIDERS

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

- Portfolio managers
- Investment advisers
- Other delegates
- 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 due diligence is performed on delegates (such as the portfolio manager, distributor or external valuer), advisers (such as the investment adviser) and other service providers (such as the depositary), and should review that due diligence. Due diligence should be performed on all delegates, be they group entities or third parties independent of the group.

There are two key elements to the due diligence role:

- Initial due diligence
- Ongoing monitoring

Both initial and ongoing due diligence should be documented. The due diligence process may include face to face meetings between the Board Members 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.

Industry associations such as AIMA, INREV and EVCA provide guidance on due diligence regarding 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 should 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.

INITIAL 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 authorization 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

ONGOING MONITORING

AIFMs should perform ongoing monitoring 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.

From an ongoing compliance perspective, 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 receive these reports at a frequency which is appropriate to the activities of the AIF, and at least annually.

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

5.4. 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. |

5.5. 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 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 system
- 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 and maintain operational three internal control functions: 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.

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. Risk management is covered in Questions 4 and 5.

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

While AIFMs may establish their own internal audit functions, in practice, internal audit is often performed by a group internal audit function or a third party.

5.6. 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

5.7. 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 and/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)⁹ 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 Directive¹⁰
- Consumer protection rules
- Information to be disclosed in the prospectus

If the AIFM conducts marketing itself, then it is responsible for complying with the applicable marketing requirements. If the AIF or its management company conducts 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 formalized in a marketing policy. In practice, the marketing policy is often determined 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 marketing activities 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 Markets in Financial Instruments Directive (MiFID), Directive 2004/39/EC, as amended.

¹⁰ Directive 2002/65/EC concerning the distance marketing of consumer financial services.

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 AIFMs and AIFs – 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 implement appropriate AML/CFT policies, procedures and controls, which are tailored to their specific situation.

This includes performing customer due diligence, or ensuring that customer due diligence is duly performed. The customer due diligence must be adapted to the client AML/CFT risks:

- Identification of the client – i.e. the investor (potential shareholder or unitholder) – generally referred to in AML/CFT terms as the “beneficial owner”
- Verification of the client identity

The customer due diligence may be performed by:

- The AIFM or AIF itself
- A third party, such as the entities which are part of a financial group. Third parties may be:
 - An entity which introduces the client
 - A delegate of the AIFM or AIF which performs the AML/CFT risk assessment

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 and ongoing due diligence 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
- Client transactions in order to identify potentially suspicious transactions
- Third parties acting on their behalf
- Related stakeholders (including directors, shareholders, and proxies)

AIFM and internally managed AIF are required to:

- Appoint an officer responsible for AML/CFT
- Keep adequate records of AML/CFT documentation for a required period of time
- Establish a written AML/CFT risk analysis report
- Take 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 officer will be responsible for implementing adequate and appropriate AML/CFT policies and procedures, reporting, record keeping, internal control, risk assessment, risk management, and communication in order to meet the AML/CFT obligations.

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

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) Recommendations. 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.

5.8. 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, usually the largest investors in the AIF.

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. 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.

5.9. 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

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 have to ensure 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) |

| TYPICAL CONFLICT OF INTEREST | TYPICAL MITIGATING FACTORS |
|---|---|
| The AIF challenges the portfolio management decisions of the AIFM or its manager ⁷ | <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 4.7.1. illustrates a 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 |
| Two different AIFs 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 AIFs 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 AIFs 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 AIFs, requiring different decisions to be taken for the different AIFs. 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. |

¹¹ Where there is a divergence of views between the AIFM and the AIF, this may or may not be a conflict of interest situation.

5.10. 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?

AIFMs, and internally managed AIFs, 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 the AIF it manages including:

- Senior management
- Risk takers, including those taking investment decisions
- 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.

AIFMs 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 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, 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 not create significant issues for the AIFM Board. The remuneration of the Board of the AIFM will often be fixed, plus variable compensation in some circumstances. 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 equivalency 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 may be tricky. Naturally, portfolio managers will try to determine ways in which to minimize 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.

5.11. 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 formalized 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).

5.12. LARGE AIFM

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, these AIFMs will typically have a more sophisticated organisational model. The Board may, as a consequence, play less of a role in monitoring the activities of the AIFM, which are 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.

5.13. 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 authorization 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 provide the Board of the AIF with an overview of its application for authorization to the supervisory authorities (generally the CSSF), and/or a summary of its handbook describing its organisational structure, policies and procedures, to assist the Board of the AIF in its assessment of the ability of the AIFM to comply with 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 are both are newly set-up.

5.14. 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 AIFs and AIFMs with other service providers such as management companies, fund administrators, portfolio managers, etc.

5.15. 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 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 authorized 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 an 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, the depositary, the AIF and the 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:

- AIFMs managing leveraged AIF
- AIFMs which acquire major holdings in a non-listed company, and additional requirements for those which control non-listed companies
- AIFMs which exercise control over an issuer whose shares are admitted to trading on a regulated market
- AIFMs managing AIFs which invest in securitization positions
- AIFMs managing AIFs 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 AIFs, 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.

5.16. 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 (regulatory capital)
- 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 the 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 interests 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 the AIFM, and engaging the investment manager and other service providers
- Ensuring that he/she is familiar with the regulatory environment in which the AIF and/or the 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 may need 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 minimize 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 formalized 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 the 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 the 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.

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 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 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.

5.17. OUT OF SCOPE AIFM AND AIF

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 AIFs 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 formalized 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 AIFs managed by an authorised AIFM, standards are set to increase overall. Directors of sub-threshold AIFs may find useful guidance in this paper.

ANNEXES

ANNEX I: BASIC AIF ORGANISATIONAL MODELS

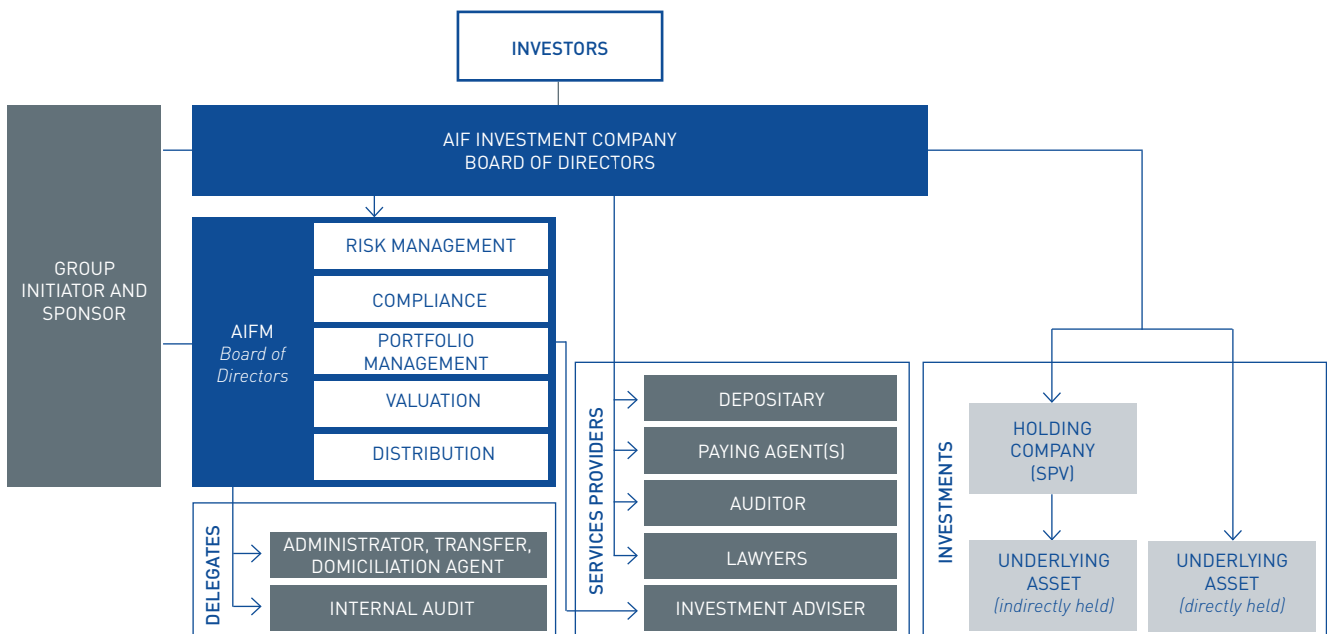
This Annex provides illustrative examples of the organisation of non-frequently traded AIF.

I.1. EXTERNALLY MANAGED AIF

ILLUSTRATION 1

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

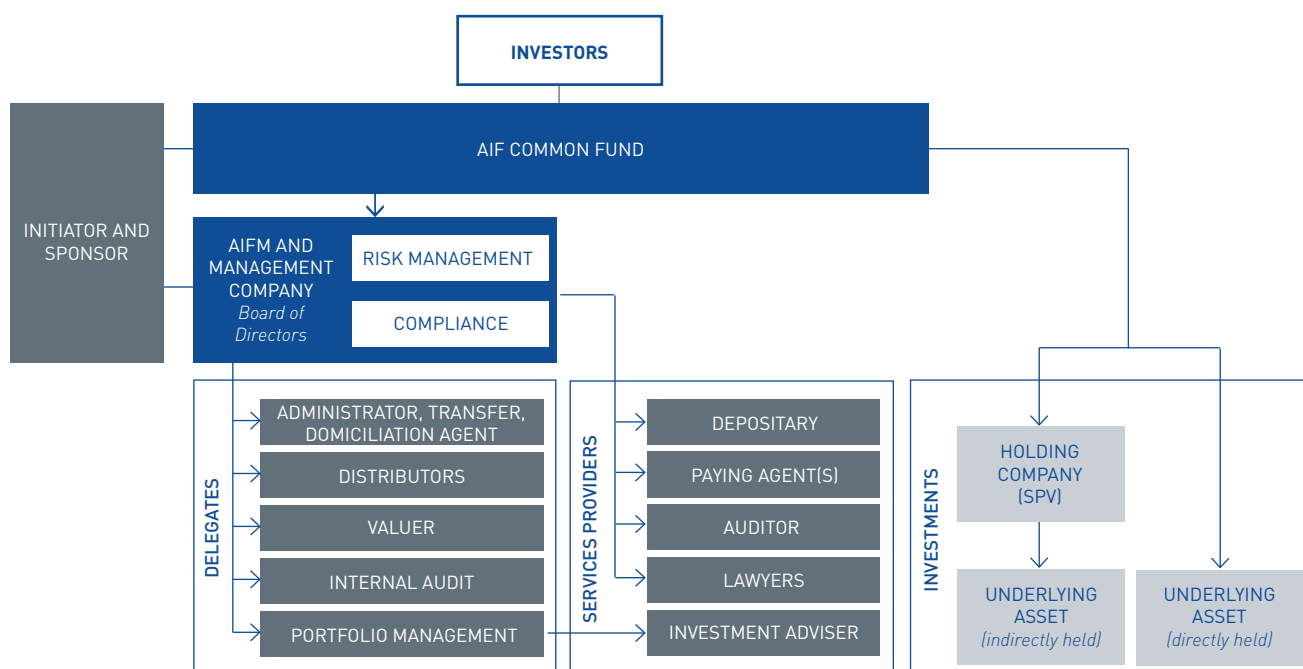
| ROLE | IMPLEMENTATION |
|----------------------------|---|
| AIFM | The Board of the AIF investment company has appointed an external AIFM from the same financial group. |
| PORTFOLIO MANAGEMENT | The AIFM performs the portfolio management. It has appointed a third party investment adviser. |
| INTERNAL 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

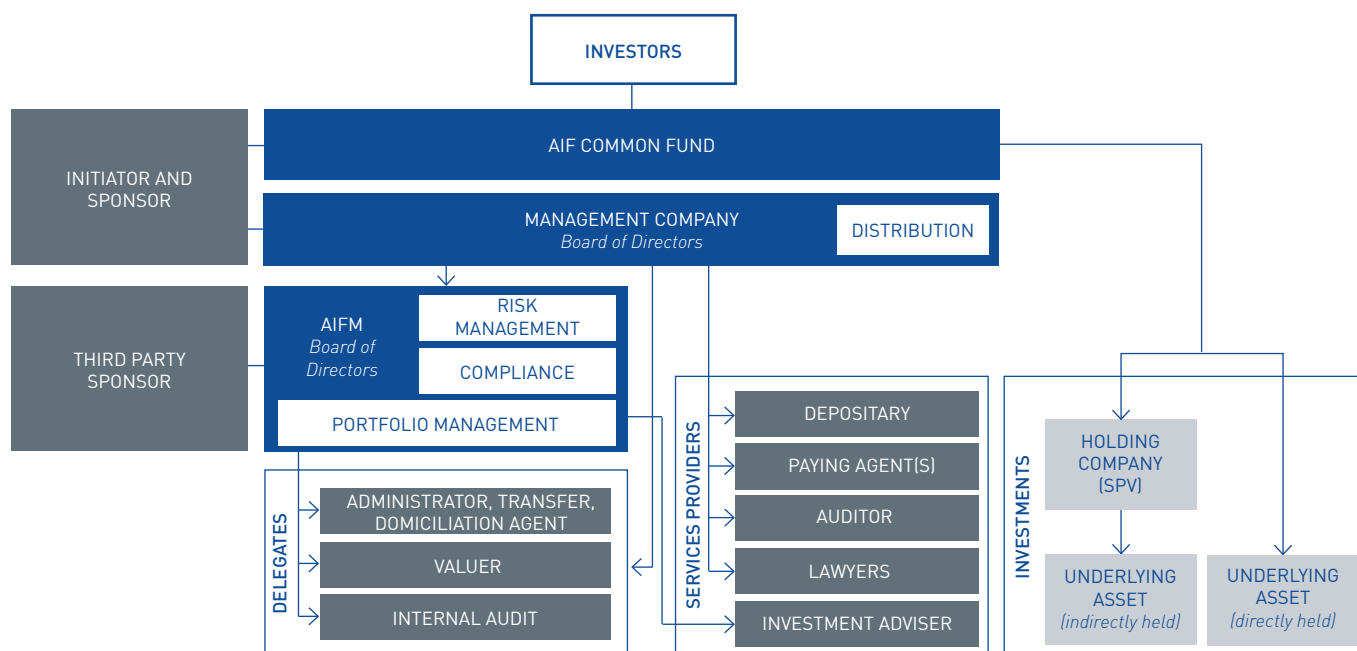
| SUMMARY | |
|----------------------------|---|
| TYPES OF AIF | Common fund |
| MANAGEMENT | Externally managed |
| TYPICAL UTILIZATION | Real estate |
| ROLE | IMPLEMENTATION |
| AIFM | The AIF is created and managed by the AIFM, which is also the management company. |
| PORTFOLIO MANAGEMENT | The 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 UTILIZATION | 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. |

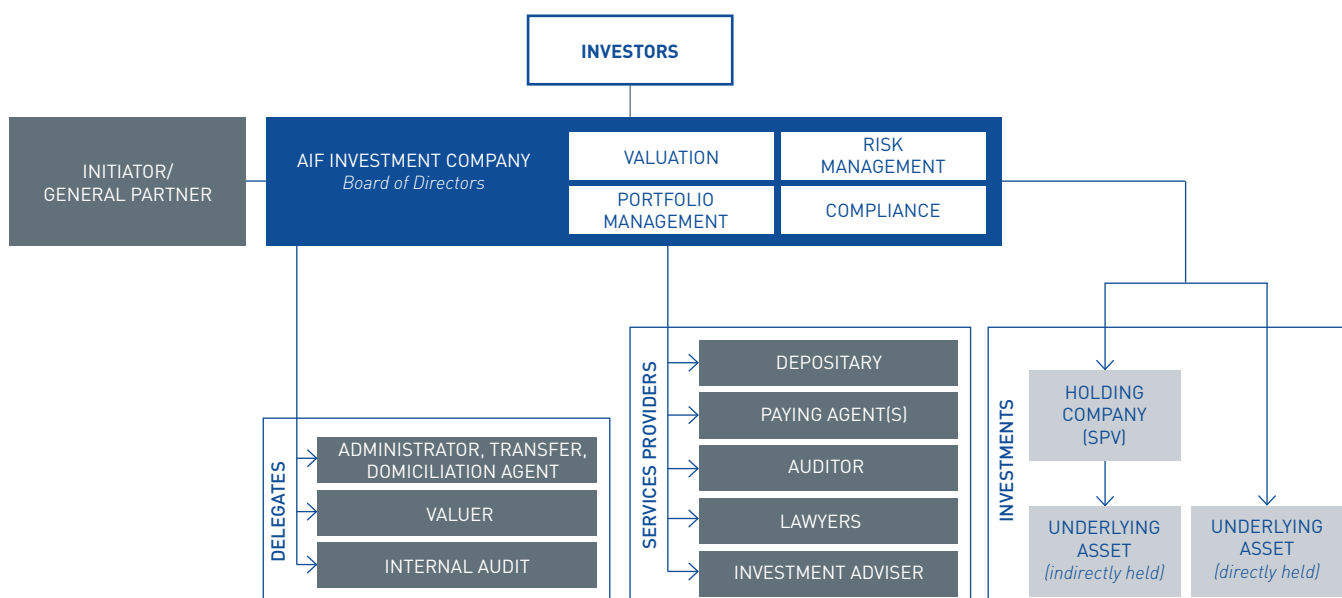


Source: EY

I.2. INTERNALLY MANAGED AIF

ILLUSTRATION 4

| SUMMARY | |
|----------------------------|--|
| TYPE OF AIF | Investment company |
| MANAGEMENT | Internally managed |
| TYPICAL UTILIZATION | 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 Chapter 16 of the 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 (see Annex IV for further information):
 - General investment fund codes of conduct, e.g. ALFI, EFAMA
 - Hedge fund codes of conduct, e.g. AIMA
 - Private Equity codes of conduct, e.g. EVCA
 - Real Estate codes of conduct, e.g. INREV
 - General codes of conduct: e.g., Luxembourg Stock Exchange, OECD
 - Specific standards, such as RICS
 - AIF, AIFM or group voluntary codes of conduct

The key oversight responsibilities of Board Members are outlined in Section 4.5..

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 authorization and changes to AIF documentation
- Asset management group/sponsor relationship:
 - Protecting the interests of the group
 - Generating returns for shareholder

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
 - 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
- Managing underlying assets:
 - Executing decisions of AIF or AIFM, in accordance with legal and regulatory requirements (e.g. transaction decisions, appointment of service providers)
 - Managing and monitoring of underlying assets
 - Reporting to AIF or AIFM on activities

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
- Other frequently traded funds (i.e. fund of funds)
- Multi-asset class

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
- Debt
- Other non-frequently traded funds (i.e. fund of funds)
- Multi-asset class

ANNEX IV: OVERVIEWS OF SELECTED KEY CORPORATE GOVERNANCE CODES

This section summarizes the main principles or topics covered in selected key corporate governance codes in the context of AIF:

- The Organisation for Economic Co-operation and Development – OECD
- Luxembourg Stock Exchange – Bourse
- The European Confederation of Directors Associations – EcoDa
- Association of the Luxembourg Fund Industry – ALFI
- European Fund and Asset Management Association – EFAMA

- Alternative Investment Management Association – AIMA
- European Association for Investors in Non-Listed Real Estate Vehicles – INREV
- European Private Equity and Venture Capital Association – EVCA
- Institutional Limited Partners Association – ILPA

Each code is much more detailed.

| | | |
|------------------------------|---|--|
| ORGANISATION | The Organisation for Economic Co-operation and Development – OECD | www.oecd.org |
| TITLE | OECD Principles of Corporate Governance | |
| EDITION/REVIEW | 2004. A review of the principles was launched in 2014 | |
| SUMMARY OF GUIDELINES | <p>I. ENSURING THE BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.</p> <p>II. THE RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS The corporate governance framework should protect and facilitate the exercise of shareholders' rights.</p> <p>III. THE EQUITABLE TREATMENT OF SHAREHOLDERS The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.</p> <p>IV. THE ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.</p> <p>V. DISCLOSURE AND TRANSPARENCY The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.</p> <p>VI. THE RESPONSIBILITIES OF THE BOARD The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.</p> | |
| ORGANISATION | Luxembourg Stock Exchange – Bourse | www.bourse.lu |
| TITLE | The X Principles of Corporate Governance of the Luxembourg Stock Exchange | |
| EDITION/REVIEW | 3 rd edition, May 2013 | |
| SUMMARY OF GUIDELINES | <p>PRINCIPLE 1 – CORPORATE GOVERNANCE FRAMEWORK The company shall adopt a clear and transparent corporate governance framework for which it shall provide adequate disclosure.</p> <p>PRINCIPLE 2 – THE BOARD OF DIRECTORS' REMIT The Board shall be responsible for the management of the company. As a collective body, it shall act in the corporate interest, and shall serve all the shareholders by ensuring the long-term success of the company.</p> | |

| | |
|--------------------------------|---|
| | <p>PRINCIPLE 3 – COMPOSITION OF THE BOARD OF DIRECTORS AND OF THE SPECIAL COMMITTEES The Board shall be composed of competent, honest, and qualified persons. Their choice shall take account of the specific features of the company. The Board shall establish the special committees necessary for the proper execution of its remit.</p> <p>PRINCIPLE 4 – APPOINTMENT OF DIRECTORS AND EXECUTIVE MANAGERS The company shall establish a formal procedure for the appointment of Directors and Executive Managers.</p> <p>PRINCIPLE 5 – CONFLICTS OF INTEREST AND BUSINESS ETHICS RULES The Directors must show integrity and commitment. Each shall represent the shareholders as a whole, and shall make decisions solely in the company's interest, and independently of any conflict of interest.</p> <p>PRINCIPLE 6 – EVALUATION OF THE PERFORMANCE OF THE BOARD The Board shall assess regularly its operating methods and its relationship with the Executive Management.</p> <p>PRINCIPLE 7 – MANAGEMENT STRUCTURE The Board shall set up an effective structure of executive management. It shall clearly define the assignments and duties of Executive Management and shall delegate the powers required for the proper discharge of these assignments and duties to the latter.</p> <p>PRINCIPLE 8 – REMUNERATION POLICY The company shall secure the services of qualified Directors and Executive Managers by means of a fair remuneration policy that is compatible with the long-term interests of the company.</p> <p>PRINCIPLE 9 – FINANCIAL REPORTING, INTERNAL CONTROL, AND RISK MANAGEMENT The Board shall establish strict rules that are designed to protect the company's interests in the areas of financial reporting, internal control and risk management.</p> <p>PRINCIPLE 10 – SHAREHOLDERS The company shall respect the rights of its shareholders and shall ensure that they receive equal treatment. The company shall establish a policy of active communication with its shareholders.</p> |
| ORGANISATION | The European Confederation of Directors Associations– ecoDa www.ecoda.org |
| TITLE | The 14 Principles of Corporate Governance of the European Unlisted Companies |
| EDITION/REVIEW | First edition, March 2010 |
| SUMMARY OF SELECTED GUIDELINES | <p><i>Corporate governance principles applicable to all unlisted companies</i></p> <p>Principle 1: Shareholders should establish an appropriate constitutional and governance framework for the company.</p> <p>Principle 2: Every company should strive to establish an effective board, which is collectively responsible for the long-term success of the company, including the definition of the corporate strategy. However, an interim step on the road to an effective (and independent) board may be the creation of an advisory board.</p> <p>Principle 3: The size and composition of the board should reflect the scale and complexity of the company's activities.</p> <p>Principle 4: The board should meet sufficiently regularly to discharge its duties, and be supplied in a timely manner with appropriate information.</p> <p>Principle 5: Levels of remuneration should be sufficient to attract, retain, and motivate executives and non-executives of the quality required to run the company successfully.</p> <p>Principle 6: The board is responsible for risk oversight and should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.</p> <p>Principle 7: There should be a dialogue between the board and the shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should not forget that all shareholders have to be treated equally.</p> <p>Principle 8: All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.</p> <p>Principle 9: Family-controlled companies should establish family governance mechanisms that promote coordination and mutual understanding amongst family members, as well as organise the relationship between family governance and corporate governance.</p> |

| | | |
|------------------------------|---|---------------|
| ORGANISATION | Association of the Luxembourg Fund Industry – ALFI | www.alfi.lu |
| TITLE | ALFI Code of Conduct for Luxembourg Investment Funds | |
| EDITION/REVIEW | September 2009, revised August 2013 | |
| SUMMARY OF GUIDELINES | <p>I. The Board should ensure that high standards of corporate governance are applied at all times</p> <p>II. The Board should have good professional standing and appropriate experience and use best efforts to ensure that it is collectively competent to fulfill its responsibilities</p> <p>III. The Board should act fairly and independently in the best interests of the investors</p> <p>IV. The Board should act with due care and diligence in the performance of its duties</p> <p>V. The Board should ensure compliance with all applicable laws, regulations and with the fund’s constitutional documents</p> <p>VI. The Board should ensure that investors are properly informed, are fairly and equitably treated, and receive the benefits and services to which they are entitled</p> <p>VII. The Board should ensure that an effective risk management process and appropriate internal controls are in place</p> <p>VIII. The Board should identify and manage fairly and effectively, to the best of its ability, any actual, potential or apparent conflict of interest and ensure appropriate disclosure</p> <p>IX. The Board should ensure that shareholder rights are exercised in a considered way and in the best interests of the fund</p> <p>X. The Board should ensure that the remuneration of the Board members is reasonable and fair and adequately disclosed</p> | |
| ORGANISATION | European Fund and Asset Management Association – EFAMA | www.efama.org |
| TITLE | EFAMA Code of Conduct for the European Investment Management Industry | |
| EDITION/REVIEW | A discussion paper, January 2006 | |
| SUMMARY OF GUIDELINES | <p>1. FIDUCIARY DUTY In its activity of managing a portfolio of assets for investors on a discretionary basis and in the form of funds, the Investment Management Company recognizes and accepts a fiduciary duty to the investor. Therefore the Investment Management Company must always act in the best interest of the investor and in line with the integrity of the markets. All individuals and responsible bodies of an Investment Management Company must be guided by these Principles.</p> <p>2. GOVERNANCE The Board, its members and the senior management of an Investment Management Company shall be accountable that the Investment Management Company acts in the best interest of investors. They shall ensure that investors receive the benefits and services to which they are entitled as a matter of law, in accordance with contracts and prospectuses or in accordance with specific instructions clients may give. All Directors must have a good professional standing and they must be experienced with regard to their assigned function. The Board must collectively be competent to fulfil its responsibilities. All necessary qualifications and resources needed to effectively provide the types of products and services offered must be available. In order to fulfil efficiently its responsibility towards investors and to resolve any conflicts of interests that arise the Board and senior management must act in sufficient autonomy and independence of shareholders, service providers and other related parties. The principles and rules for the governance of the Investment Management Company must provide safeguards that ensure this independence.</p> <p>3. CONFLICTS OF INTEREST The Investment Management Company shall identify areas where the interests of investors may conflict with those of other parties such as the management company, its staff, the service providers, in particular related parties, or other investors. It shall define rules and procedures for such cases to avoid, manage or disclose such conflicts of interest and to assure that the interests of investors are protected and all investors are treated equally.</p> <p>4. ORGANISATION AND PROCEDURES The Investment Management Company shall have the necessary means, resources and expertise to properly carry out its activities and which shall correspond to the business lines and the complexity of financial instruments and portfolio types that are managed. It shall act with due skill, care and diligence to manage its business in a responsible manner, in particular with regard to the protection of the rights and interests of investors. It shall have appropriate written policies, procedures and controls for its operations and apply the “four-eyes” principle. It shall apply an appropriate segregation of business areas and duties (decision making, execution, administration and compliance) and control systems. It shall have an appropriate corporate risk management system.</p> | |

5. COMPLIANCE

The Investment Management Company shall constantly monitor compliance with the Law, regulation and other rules, in particular those that protect the interests of investors and mitigate conflicts of interest.

The compliance function shall be independent from operative functions, be equipped with adequate resources and report regularly to the Board of Directors. Persons conducting the compliance function must have the necessary expertise and authority, as well as full access to all information enabling them to perform their duties.

6. DELEGATION/OUTSOURCING AND SERVICE PROVIDERS

When delegating/outsourcing functions to third parties and carrying out business transactions on behalf of investors or portfolios, the Investment Management Company must have a clearly defined policy with respect to the selection of service providers. It shall monitor the services provided, their quality and price. Particular diligence is required when transactions or delegated functions involve related parties.

The delegation of functions does in no way reduce the responsibility of the Investment Management Company to the investor. It must maintain control over delegated functions and the supervision of risk management.

7. INVESTMENT DECISIONS

When the portfolio management function is delegated to a third party the Investment Management Company shall closely monitor the portfolio and its risk profile to ensure that the outside manager abides by all objectives and policies relevant to the portfolio.

Investment decisions require a high level of diligence. Only portfolio managers with the appropriate professional expertise shall be responsible for taking investment decisions.

They must have sufficient analytical and research capacities at their disposal.

The necessary procedures and techniques to manage the risk profile of each portfolio have to be in place. The risk management process shall be appropriate with regard to investment instruments and techniques and portfolio strategies applied.

Investment decisions shall be in line with the objectives and guidelines that are relevant for the portfolio. Rules and safeguards shall be in place to ensure that the investment policy complies at all times with the portfolio objectives and guidelines.

8. BEST EXECUTION

The Investment Management Company shall set up and implement effective arrangements to achieve the best possible execution of investment decisions, taking into account price, costs, speed, likelihood of execution and settlement, and any other consideration relevant to the execution of the order.

9. BROKER RELATIONS

The Investment Management Company shall select counterparties for trade execution (brokers) according to defined procedures and criteria, taking into account execution capability and – in the case of bundled services – quality of research.

Transaction-related commissions paid to brokers may be used to compensate execution and research or other services that improve the activities of the Investment Management Company to the benefit of investors.

The Investment Management Company should disclose its policy regarding broker relations.

10. ASSET VALUATION

The portfolio must reflect the fair value of the assets. Whenever possible it must be priced according to the "mark to market" principle applying predetermined criteria (e.g. by utilising independent pricing sources or predetermined pricing models)." As a basic rule the valuation of assets must be performed independently from the portfolio management function.

11. CUSTODY OF PORTFOLIO ASSETS

Portfolio assets shall be kept segregated from those of the Investment Management Company.

In the case of a collective investment schemes, a depositary shall hold the assets in custody in the interest of the investors. The depositary must fulfill professional standards and be selected on the basis of the general principle that the Investment Management Company and the depositary are separate entities or sufficiently independent.

12. FUND UNIT TRADING

The Investment Management Company shall establish procedures to discourage frequent unit trading and other practices that may harm the interests of long-term investors.

The Investment Management Company shall disclose its policy with regard to fund unit trading and any potentially remaining risks for long-term investors.

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| | <p>13. SHAREHOLDER AND CREDITOR RIGHTS</p> <p>Investment Management Companies shall use shareholder and creditor rights attached to portfolio holdings in a considered way, in the best interest of investors and to enhance the portfolio value. When making use of shareholder and creditor rights, the Investment Management Company shall support the aim that portfolio companies comply with recognised standards of good corporate governance.</p> <p>Investment Management Companies shall define and document their policy with regard to the use of shareholder and creditor rights, in particular on how to exercise voting rights attached to portfolio company holdings. Particular attention must be given to potential conflicts of interest in the case of related companies. The policies regarding the use of shareholder and creditor rights must be disclosed to investors.</p> <p>14. INVESTOR INFORMATION</p> <p>All information about products and services that is directed to investors or the public must be true, fair and not misleading, in particular with regard to investment objectives and policy, potential returns and risks, and costs to be borne by the investor. If performance data on managed portfolios is published, the Investment Management Company shall comply with recognised standards with regard to calculation methods, periods of reference and the application of benchmarks.</p> <p>All information provided shall in particular comply with the information and disclosure requirements for the types of products and services offered.</p> <p>All information shall be provided in a consistent format to allow comparability across different products and consistency between different types of publications including prospectuses, standard agreements and periodic reports.</p> <p>15. CLIENTS & INTERMEDIARIES</p> <p>Where the Investment Management Company provides advice, it shall obtain information about the customer and provide information in order to ensure the suitability of the advice and the appropriateness of the products for that particular investor.</p> <p>Where Investment Management Companies appoint distributors, they shall have policies and procedures for their selection, use and monitoring.</p> <p>Where such distributors provide advice to the investor, the Investment Management Company shall take reasonable care to ensure that the appointed intermediary obtains all necessary product information and support in order to comply with recognised advice and service standards.</p> |
| ORGANISATION | Alternative Investment Management Association – AIMA www.aima.org |
| TITLE | Guide to Sound Practices for European Hedge Fund Managers |
| EDITION/REVIEW | May 2007 |
| SUMMARY OF GUIDELINES | <p>The Guide to Sound Practices for European Hedge Fund Managers covers:</p> <ol style="list-style-type: none"> 1. Creating and Managing a Hedge Fund Business <ol style="list-style-type: none"> 1.1 Creating a Hedge Fund Management Business 1.2 Managing a Business 1.3 Management and Controls 1.4 Finance 1.5 Compliance 1.6 Employees 2. Investment Process and Portfolio Risk Management <ol style="list-style-type: none"> 2.1 Investment Process 2.2 Portfolio Risk Management 3. Portfolio Administration and Operational Controls <ol style="list-style-type: none"> 3.1 Fund Pre-Launch 3.2 Middle Office 3.3 Trade Procedures 3.4 Reconciliation Procedures 3.5 Portfolio Valuations 3.6 Reporting 3.7 Non-Trading Transactions 3.8 Managing Service Providers 3.9 Information Systems and Business Continuity 4. Raising Capital and Investor Relations <ol style="list-style-type: none"> 4.1 Raising Capital 4.2 On-going Investor Communications 5. Hedge Fund Structure and Organisation <ol style="list-style-type: none"> 5.1 Structure of the Hedge Fund 5.2 Independent Service Providers |

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|------------------------------|--|---------------|
| ORGANISATION | European Association for Investors in Non-Listed Real Estate Vehicles – INREV | www.inrev.org |
| TITLE | The Principles of Corporate Governance | |
| EDITION/REVIEW | Revised INREV Guidelines 2014, White Paper | |
| SUMMARY OF GUIDELINES | <p>COMPLIANCE WITH THE LAW P.1 The investment vehicle and its manager should always comply with the relevant legislation and regulations applicable in the jurisdiction in which it is established.</p> <p>COMPLIANCE WITH CONSTITUTIONAL TERMS P.2 The vehicle’s constitutional terms should clearly articulate the key corporate governance principles which should always be applied.</p> <p>SKILL, CARE, DILIGENCE AND INTEGRITY P.3 Investors, investor representatives, non-executive officers and managers respectively should manage the protection of investors’ interests and their investments, with due skill, care, diligence and integrity, and should ensure adequate levels of human, financial and operational resources.</p> <p>ACCOUNTABILITY P.4 Managers, non-executive officers, investor representatives and investors, and those they have delegated to, should always be accountable for their actions.</p> <p>TRANSPARENCY P.5 All relevant information relating to the vehicle should be communicated in a way which is clear, fair, complete, timely and not misleading.</p> <p>ACTING IN INVESTORS’ INTERESTS, INCLUDING ALIGNMENT OF INTERESTS AND CONFLICTS OF INTEREST P.6 Vehicles should be run in the interests of all investors. Where they arise, conflicts of interest should be managed fairly between investors, vehicles and managers; the alignment of interests between investors and managers can reduce the risk of such conflicts.</p> <p>CONFIDENTIALITY P.7 Information regarding vehicles and investors’ interests in vehicles which is not publicly available should always be treated confidentially.</p> <p>FUND DOCUMENTATION P.8 Fund documentation should be clear and precise and cover, among other items: <ul style="list-style-type: none"> • The commercial design of the fund • The corporate governance framework, including secondary market transaction considerations, the valuation and reporting framework and exit rules </p> <p>REPORTING P.9 Annual and interim reporting should be consistent, transparent and provide meaningful information to investors.</p> <p>P.10 The manager’s report should contain information relevant to gaining an understanding of the overall performance of the fund and factors that may affect performance in the future.</p> <p>PROPERTY VALUATION P.11 Property valuations should be accurate, consistently, independently determined in compliance with regulations and transparently reported to investors.</p> <p>INREV NAV P.12 INREV NAV should reflect a more accurate economic value of the investment (units) based on the fair value of the underlying assets and liabilities, as at the balance sheet date, as adjusted for the spreading of costs that will benefit different generations of investors, than the NAV based on generally accepted accounting principles.</p> <p>FEE METRICS P.13 Fund fees and other costs should be consistently categorised and presented to enable investors and managers to compare fee and cost structures between non-listed real estate funds. To enable fairer comparisons of fund fees and expenses between funds, the fund should present a total expense ratio (TER), which expresses consistently categorised annual operating costs borne by a fund over one year, as a proportion of weighted average fund assets. A REER should also be calculated and presented to capture property-specific costs. There should be clear disclosure of all the fees charged by the fund manager and the activity to which they relate. Where a single fee is charged to cover a variety of activities, the constituent elements will need to be identified and disclosed annually.</p> | |

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| | <p>LIQUIDITY</p> <p>P.14 The fund documentation should clearly explain the liquidity rights of the investor. The manner in which equity is subscribed to and redeemed from a fund has a material impact on the interests of new and existing investors. Overseeing the establishment of a fair liquidity mechanism and the disclosure of it to investors should be one of the objectives of a fund's corporate governance activities. In some jurisdictions and fund structures the mechanism is prescribed by legislation or government regulations. In these cases, full disclosure of the rights, obligations and process should still be considered best practice to ensure the fund is suitable for the investor.</p> <p>P.15 The terms and pricing of a new equity issue should be fair to both new and existing investors. Where this is not possible and a conflict of interest exists, the manager should fully explain the issues and impact on the respective investors' interests.</p> <p>P.16 Investors should, where possible, have the right to transfer their interests in non-listed real estate funds without unreasonable restrictions as long as it does not prejudice the manager or other investors.</p> <p>P.17 Constitutional documents should provide a clear legal and regulatory framework as to how such secondary transfers should be conducted.</p> <p>P.18 Confidentiality arrangements over fund documentation should not, where possible, prevent the development of secondary market transactions.</p> <p>P.19 Potential new investors should have access, subject to signing a standard non-disclosure agreement and with the consent of existing investors, to the same information as existing investors with respect to the fund's constitution, activities and performance. Additional information may be provided, subject to consent, but is not required by these guidelines.</p> <p>Additional information may include, though not as a compulsory requirement:</p> <ul style="list-style-type: none"> • Investors' register (number of investors, largest investors, investors managed by the manager or external investors and etc.) • Unit issue/redemption disclosures (typically disclosed in the fund financial statements) • Any further financial disclosures, forecasts, property portfolio details, valuation information, not required by these guidelines <p>Confidentiality agreements may be appropriate for additional information and the manager should be entitled to restrict access to such detailed information if the manager believes that its release to the third party could be prejudicial to the interests of the fund and all of its investors.</p> <p>INREV DATA DELIVERY</p> <p>P.20 The fund manager should provide information requested by INREV in the context of industry data analysis and performance measurement.</p> |
| ORGANISATION | European Private Equity and Venture Capital Association – EVCA www.evca.eu |
| TITLE | Code of Conduct |
| EDITION/REVIEW | October 2008 |
| SUMMARY OF GUIDELINES | <p>1 Act with integrity</p> <p>2 Keep your promises</p> <p>3 Disclose conflicts of interest</p> <p>4 Act in fairness</p> <p>5 Maintain confidentiality</p> <p>6 Do no harm to the Industry</p> <p>EVCA's Q&A cover the following topics:</p> <p>Fund formation</p> <ul style="list-style-type: none"> • Early stage planning • LPs and marketing • Structuring <p>Fundraising</p> <ul style="list-style-type: none"> • The Fundraising process • The Fundraising Team • Target LPs • Origin of capital • LPs • Structure of the offer: terms of investment |

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| Structure of the documents |
| Terms in the Fund documents |
| Presentations to LPs |
| Responsible investing |
| Track records |
| Forecasts |
| Time period for Fundraising |
| Investing |
| Due diligence |
| Costs |
| Approach to responsible investment |
| Investment decision |
| Structuring investments |
| Responsibilities to other shareholders in the same or other classes of shares and to bondholders |
| Investment Agreement |
| GP's consent to Portfolio Company actions and board appointments |
| The Portfolio Company's corporate strategy |
| Co-operation with co-investors and syndicate partners |
| Co-investment and parallel investment by the GP and its executives |
| Co-investment and parallel investments by LPs and other third parties |
| Divestment planning |
| Management of an investment |
| Investment monitoring |
| Environmental factors |
| Social factors |
| Governance factors |
| Board participation |
| Exercise of GP consents |
| Exercise of influence on responsible investment factors |
| Responsibilities in relation to other stakeholders |
| Follow-on investments |
| Underperforming investments |
| Disposal of an investment |
| Implementation of divestment planning |
| Responsibility for divestment decision-making |
| Warranties and indemnities |
| Cash vs. shares/earn-outs on realisation |
| Sale of a Portfolio Company between Funds managed by the same GP |
| Managing quoted investments |
| Distributions |
| Distribution provisions |
| Timing of Distributions |
| LP relations |
| Reporting obligations to LPs |
| Transparency to LPs |
| LP relations generally |
| LP conflicts of interest |
| LP Advisory Committee |
| Keyman Provisions |
| Secondaries |
| Overview |
| Secondary Transactions |

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| | <ul style="list-style-type: none"> Winding up of a Fund <ul style="list-style-type: none"> Liquidation Fund documents Management of multiple Funds <ul style="list-style-type: none"> Conflicts of interest Establishment of new Funds GP's internal organisation <ul style="list-style-type: none"> Management are responsible for establishing the control environment Management are responsible for establishing procedures for risk assessment Management are responsible for control activities Human resources Incentivisation Financial resources Segregation of Fund assets Procedures and organisation Internal reviews and control Management are responsible for the organisation's information and information systems and for communications within and outside the organisation External communication Market Transparency – EVCA Research and Data External assistance Considerations relating to monitoring of governance – GP governance Appendix – Code of Conduct for Placement Agents |
| ORGANISATION | Institutional Limited Partners Association – ILPA www.ilpa.org |
| TITLE | Private Equity Principles |
| EDITION/REVIEW | September 2009, updated January 2011 |
| SUMMARY OF GUIDELINES | <p>ILPA's principles cover the following topics:</p> <ul style="list-style-type: none"> Alignment of Interest <ul style="list-style-type: none"> Carry/Waterfall Management Fee and Expenses Term of Fund General Partner Fee Income Offsets General Partner Commitment Standard for Multiple Product Firms Governance <ul style="list-style-type: none"> Team Investment Strategy Fiduciary Duty Changes to the Fund Responsibilities of the LPAC Transparency <ul style="list-style-type: none"> Management and Other Fees Capital Calls and Distribution Notices Disclosure Related to the General Partner Risk Management Financial Information LP Information |

■ 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, it will promote best practices in Luxembourg in the field of Corporate Governance of companies and institutions by actively engaging with and contributing to those institutions and trade associations charged with the introduction, application and oversight of those Corporate Governance rules and practices. It will achieve this through high quality training, forum discussion, research, publications and conferences.

ILA aims to be not only the premier interlocutor in Luxembourg on issues affecting Directors but also to play an important role at the European level.

