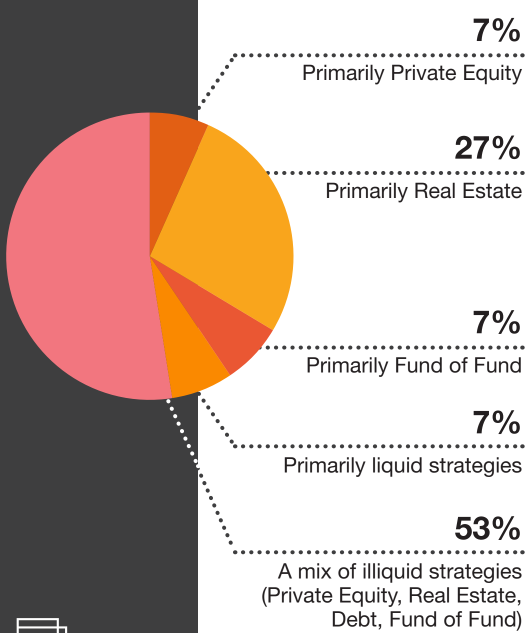
# Alternatives Hub: AIFMs How to do business in today's environment

While the entry into force of the Alternative Investment Fund Managers Directive (AIFMD) has without a doubt revolutionised the European landscape for AIFs and their service providers, numerous external forces have since considerably re-shaped the operating models of AIFMs and service providers. Indeed, a combination of regulatory requirements such as CSSF circular 18/698 from August 2018, global initiatives like the OECD/G20 Inclusive Framework of base erosion and profit shifting (BEPS), political events like Brexit or the rise of technological and digital initiatives have played their part into how European and global alternatives asset managers are doing business in today's environment.

In this context, PwC has invited representatives from 16 Luxembourg-based AIFMs, comprised of a combination of Group-AIFMs (around 60%) and third-party Fund Managers (around 40%) to join the PWC Alternatives Hub, a series of collaborative roundtable event and revise current trends, challenges and best practices in relation to the following three key pillars:

- Regulatory developments (CSSF 18/698) and their impact on operations;
- Tax substance requirements and how to reconcile them with regulatory requirements;
- Scalability and means of achieving it.

Our Luxembourg-based AIFMS representatives service Alternatives asset classes as follows:




The aim was collecting market insights, facilitating exchange amongst peers around key challenges and opportunities as well as initiating discussions to revisit best practices in terms of efficiency, substance, automation and every other way operations are evolving.

Discussions with participants confirmed that they proactively managed arising changes in the regulatory and tax landscape. Indeed, market players were able to effectively complete most required adjustments to their operating model well ahead of their actual enforcement dates due to the early start of internal projects or did not even require any major changes given that they were already largely following best practices in place prior to their enforcement.

Nevertheless, reconciling these substance requirements from a regulatory and tax perspective while remaining operationally efficient remains an important challenge for AIFMs. As they embark further on their journey toward scalability, achieving synergies in the allocation of resources and infrastructures will become an important success factor, along with digital adoption and innovation.

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# External forces reshaping Operating Models

While external forces such as Brexit and a new tax environment have accelerated the growth of the Luxembourg market, participants suggested that neither of the two events had a disruptive impact on the operating model in Luxembourg, referring to them as evolutionary and well anticipated rather than reactive. The same can be said about the enforcement of circular 18/698. Since the legislator made their plans quite clear from the start, market participants found themselves in a position where they could prepare their BEPS- and Brexit-projects very well ahead of the actual event. When the legislation eventually entered into force, it only shaped the contours on what had already been in the process of being transformed.

On the trends best describing the evolution of their operating model over the past three years, our survey respondents said:

**44%**

Leveraging group resources to promote scalability and operational alignment

**38%**

Increasing substance without any material change to the operating model

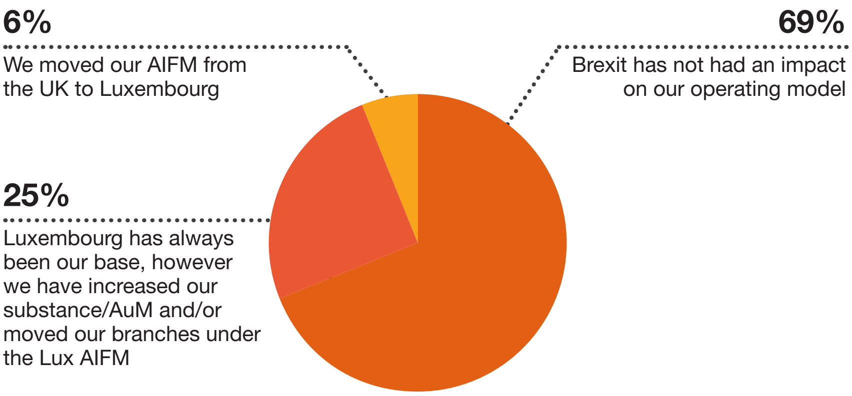
**13%**

Insourcing value-adding operations

**6%**

Outsourcing of additional functions to third parties

On the influence of Brexit on this evolution, attendees responded:



# CSSF Circular 18/698

Circular 18/698, which was published in August 2018, provided market participants with (i) a view on internal governance, e.g. setting new minimum standard staffing requirements within an AIFM; (ii) additional guidance on certain operational aspects of the AIFM, in particular delegation oversight obligations, which the CSSF tends to monitor more and more closely, (iii) additional clarifications on AML/CFT and KYC requirements.

Whilst the circular certainly required some adjustments to the internal governance and to the execution of operational day-to-day activities, there was clear consensus from participants at the Alternatives Hub event that compliance with Anti-Money-Laundering (AML) and Counter-Terrorist-Financing (CFT) requirements, both on (i) the investor - "Know-Your-Customer (KYC)"/and (ii) the transaction - "Know-Your-Investment (KYI)" side, is a key priority and will continue to require additional guidance in its practical application.

> *"When it comes to AML/KYI checks, the commercial aspects matter less than the impact any failures may have on the reputation of the company."*

### AML/KYC - Investors

When it comes to the investor side, participants felt that market practice was already relatively clear and well-known prior to the entry into force of the CSSF Circular. Nonetheless, the clarity of the circular was perceived as a welcome addition that AIFMs could leverage to further push the education of the Client Relationship Management (CRM), onboarding and distribution teams within the Group as well as their distribution networks. Indeed, participants pointed out that client-facing teams often push back on extensive requirements for identification documentation, arguing that they are a blocker for sales as well as upset investors, and fail to fully understand the importance of as well as the increase in investor protection. This is especially the case for teams and investors in countries, where AML/KYC-related standards are lower than in Luxembourg.

Over time and with increasing pressure especially from the CSSF, more and more companies action on fast and thorough implementation of imposed requirements and there is even a trend in which global asset managers align their AML/KYC standard to the country imposing the strictest obligations. One participant stated that *"The Luxembourg circular was instrumental in changing how the Group approaches AML KYC globally"*. Two additional participants echoed this sentiment, one of which emphasised that they did this across the US and Asia.

### AML/KYI - Transactions

Whilst on the investor side, market practice was already relatively well-known and clear, discussions with participants highlighted that market standards are yet to be set on performing appropriate checks on investments and transactions.

Actually, the above described commercial difficulties tend to be even more prevalent in the deal making process. With deal teams located in jurisdictions with potentially lighter AML/KYC obligations and primarily focused on the timely and successful execution of the deals, AML/KYC is often limited to an administrative burden that Fund Managers struggle to justify.

The lack of regulatory guidance and market standards tend to exacerbate this issue and may lead to different interpretations and approaches, as evidenced by the discussions.

Such divergences could be observed in the real estate industry, as players were discussing whether to extend requirements for documentation and checks to each individual tenant or follow a risk-based approach, which the majority adopt today. With this regard, there was consensus in the room that more guidance is required from the regulator on specific requirements for each asset in terms of the types and number of documents to be requested as well as how AML/KYI analyses should be documented.

Having market standards set by larger firms is equally important, as evidenced by the following example: One larger in-house AIFM stated to have complete identification documentation and background checks as conditions precedent in the closing documents. It is felt on the market that *“bigger asset managers are paving the way in imposing AML KYI as a conditions precedent for deals”*. The more stringent big players become in their approach, the easier it is for smaller players to follow and reinforce their specific AML/KYI requirements on their counterparties. Having market standards set by larger firms is especially important for third-party AIFMs, who face an even bigger challenge on imposing strict identification obligations on their counterparts and their clients, whilst remaining competitive.

Participants further noted that while commercial aspects may be intimidating, *“the commercial aspects matter less than the impact any failures may have on the reputation of the company”*.

# Brexit

Brexit had quite some impact on operating models but rather at first announcement in 2016 than at the actual event, most players had already established a fully on-shore EU-model by the time Brexit actually came into force. There was full consensus around the table that, in order to continue accessing capital from EU investors, the place to launch future funds will be Luxembourg. With a lot of marketing and capital raising activities are still being performed out of the UK, Fund distribution remains one of the hottest Brexit topics of the financial industry.

### ▶ Distribution

Cross-border marketing and distribution of collective investments will continue to be in the spotlight, with the new directive “Directive (EU) 2019/1160 of the European Parliament and of the Council” (the “New Directive”), which was published in July 2019, with some elements having already taken affect and the majority to enter into force on 2 August 2021.

Whilst the Directive introduces new obligations around the use of marketing materials, as well as a specific notification regarding the discontinuation of marketing of an AIF in a host member state, the most noteworthy change certainly concerns the regulation of pre-marketing activities[1], including:

- Pre-notification requirement of the EU AIFM to its home regulator within two weeks of commencing pre-marketing activities;
- Subscriptions received within an 18 months window following the commencement of pre-marketing, will trigger the requirement to notify the AIF to the host regulators.
- Documents presented to potential professional investors need to include specific disclaimers and should not:
  a. permit investors to commit to acquiring units or shares of a particular AIF;
  b. amount to subscription forms or similar documents, in draft or final form; or
  c. amount to final forms of constitutional documents, prospectus or offering documents, of an AIF that has not yet been established.

About 18 months before the directive is to take full effect, participants around the table were already well aware of new upcoming obligations, however most had not started any gap analysis projects - a sentiment shared by PwC’s Global Fund Distribution team, who confirmed that the market has not yet put the directive, and these important changes, on top of their agendas.

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[1] Defined as “the direct or indirect provision of information or communication on investment strategies or investment ideas to potential investors resident in the EU in order to test their interest in a fund which is not yet established, or which is established but not yet notified for marketing in the respective member state”

In summary, “external forces” like circular 18/698 and Brexit have formalised and finalised what had already been underway in terms of relocating to Luxembourg and increasing local regulatory substance. Most players around the table were fairly mature and had already shifted the centre of their operations from London to Luxembourg, with front-office functions remaining the exception.

Substance has not only been a key topic for AIFMs but also required a lot of attention all the way down to the investment structure due to additional requirements caused by the OECD/G20 Inclusive Framework of base erosion and profit shifting (BEPS).

### ▶ BEPS

BEPS may have significant implications on fund structuring as assets managers must ensure that the latter does not inadvertently create tax issues such as hybrid mismatches.

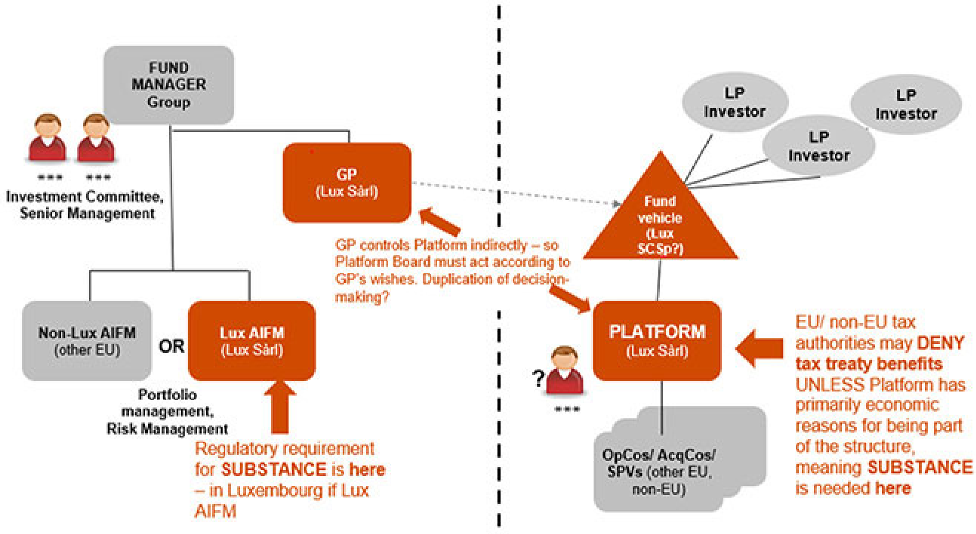
While the robustness of the operating model in Luxembourg has been improved primarily for regulatory reasons it can help the Special Purpose Vehicles (SPV) held by the AIF to benefit from double tax treaties and tax directives.

## “Adequate” substance

Even though asset managers already have substance in AIFM for regulatory reasons, this does not imply that substance requirements at the level of the investment structure are automatically met from a tax perspective. Indeed, tax authorities are more concerned with the chain of ownership, which the AIFM is not considered to be part of, and therefore analyse substance and governance at the level of the SPVs.

This being said, the main question in today’s tax environment is how to create synergies between substance at fund manager level, which is requested by the regulator, and tax substance requirements in the structure below the fund at SPV level, which is requested by the tax authorities of the jurisdictions where the investments are.

From experience with tax authorities, it is recommendable to base reasoning for substance on both (i) governance, i.e. the reasoning why entities in the structure impact for example decision-making processes; and (ii) cost allocation, i.e. being able to demonstrate a reasonable balance sheet that exhibits activities for each entity. The one key message our tax experts stressed and that was echoed by participants who had previous experiences with questions from tax authorities was around storytelling: What was the thinking behind setting up the fund structure in this way and which role does every entity play within the structure?



*“Headcount does not make substance.”*

# Governance

Governance really matters. In particular, it is crucial to be able to demonstrate to the local tax authorities that the Lux SPVs have been involved at any time in the investment cycle and have the capability in terms of infrastructure, senior directors and members of staff to run its investment activity.

Demonstrating the decision-making power of the SPV when it comes to deciding whether to buy, hold or sell an investment is a key requirement to be able to illustrate substance from a corporate legal perspective. In this context, it is important for representatives of the SPV to be involved from the very start of initiating discussion, doing due diligence, acquisition of investment, monitoring and sales.

For the effective functioning of these related processes and avoidance of duplication of tasks, synergies should be created through close collaboration between the AIFM, who must demonstrate their ability to run a fund, and a board of an SPV, who must demonstrate capacity to run an investment company. Examples of potential means to achieving such synergies include:

- Having board members of the SPV work side by side with the AIFM: This includes the sharing of all information and documentation regarding the investments prior to any decision-making process and Board meetings.
- Establishing a close relationship between the AIFM IC and the Board of the platform; Both the Portfolio Managers and the managers of the SPV can work side by side along the entire value chain of investments from acquisitions to exit.
- Having people from the AIFM sit on the board of the SPVs: Although the most efficient option, resource limitations and mandate restrictions can make it difficult to have the right level of seniority of people on board of the SPVs, especially as volume grows.

With regards to leveraging substance between the AIFM and platform, there was consensus around the table that from a governance perspective, the following factors are more favourable to creating such synergies:

- Resource allocation: In essence, the CSSF does not have any objections if excess levels of staffing within the AIFM is dedicated to managing SPVs. There should be no overlapping regarding the tasks of the two entities, however the same person can be employed by both entities to perform a similar job. While a conducting officer role is a full-time position by definition, they cannot be split across two different entities. If a conducting officer only heads up a single function, e.g. only PM, only RM or only Valuation, they may still be members of the SPV board.
- PM function setup: In case Portfolio Management is delegated to an external Industrial Adviser, the collaboration between the external party, the Board of the SPV and the AIFM, in particular the risk management function is still crucial, as the risk must still be borne by the AIFM.
- Location of the Fund structure: Synergies are achieved more easily when the AIFM and the fund structure are set up in the same jurisdiction.
- AIFM type: It is easier for Group-AIFMs to move and leverage their staff in-house. Third-party AIFMs face more practical challenges and usually state to have less focus on what is happening within the SPVs.

Not only from a governance but also from a cost allocation standpoint, in-house AIFMs face fewer challenges in staying connected than third-party AIFMs. Depending on client needs, a third-party AIFM may also offer additional SPV resource at an additional cost.

Looking specifically at the "platform" (pictured above) in Luxembourg owned by the fund vehicle, to the question which one of the following best describes your current situation when it comes to investment decision making? attendees responded:

**19%**

Considerable involvement of senior decision makers in the Luxembourg platform in the review of and recommendation on investment decisions by the "platform" company

**44%**

Reasonable involvement (at times more / at times less) of senior decision makers in the Luxembourg platform in the review and recommendation of investment decisions

**6%**

Limited involvement of senior decision makers in the Luxembourg platform in the review and recommendation of investment decisions

**31%**

Minimal presence and involvement of senior decision makers in the Luxembourg platform - the Board of the "platform" essentially "rubber-stamps" decisions already made elsewhere

To the question which one of the following best describes your current situation when it comes to monitoring the performance of the investments made and the strategic supervision of their business activity? Respondents said:

**27%**

Considerable involvement by the "platform" company, i.e. acting as the main party responsible for monitoring and supervising investments

**47%**

Reasonably involved, but does not act as the main party

**20%**

Limited involvement after initial investment decision, merely covered as formal Board routine agenda items

**7%**

Minimal presence and involvement

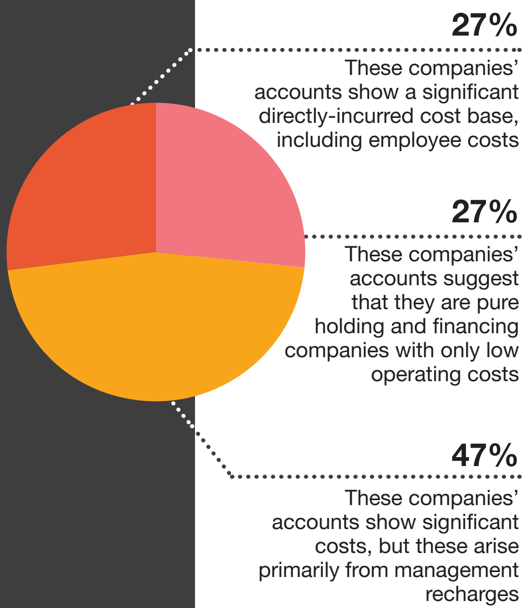
# Infrastructure - Administration and associated cost

In addition to appropriate governance needed to satisfy tax authorities and the CSSF, substance also refers to the whole infrastructural set-up of an investment company required to properly administer those entities and evidencing this by means of cost allocation and the reflection thereof on the financials. The AIFM often acts as a ServiceCo, so costs can be shared across the structure.

Global employment contracts are another popular way to manage resource sharing, as employees can be put on the payroll of any entity that needs additional substance and it limits the large administrative burden of having to put employees on multiple payrolls separately. However, this approach also brings a number of limitations. In this regard, it is usually recommended that employees do not have more than 10 employers, so the maximum number of entities to benefit from this headcount is 10. In Luxembourg, a payroll software or service provider is needed to simplify filing and payment obligations with the authorities.

A less significant balance sheet position compared to human resources is rental cost and other cost. In some countries, tax authorities consider rental cost in their reviews, while others deem this position less critical. While each structure is different, there is a trend on the market to set the platform or TopCo as the core tenant and recharging the rent to the SPVs, considering VAT cost if SPVs do not have the exclusive use of the office space. In practice however it is very difficult to make all SPVs part of the same rental agreement.

We asked a final question related to the pictured structure to respondents - how is the position evidenced and reflected in the "platform" companies in terms of the structure and types of the costs and expenditure they incur, the staff that they employ, and the premises and equipment that they have? Attendees responded:




**There are different models and strategies to achieve satisfactory tax substance and manage cost efficiently. Substance should show on the staff list, balance sheet and most definitely in the governance setup.**

**Key success factor is a good mix of all aspects and most importantly, the story you can tell about your respective operating model in Luxembourg: Who makes the decisions? What is the purpose for each of the entities in the fund structure? This story should be documented during the fund structuring phase and stored, as local tax authorities can challenge fund managers at any time including at liquidation, which usually happens 5-10 years after the structure had been set up.**

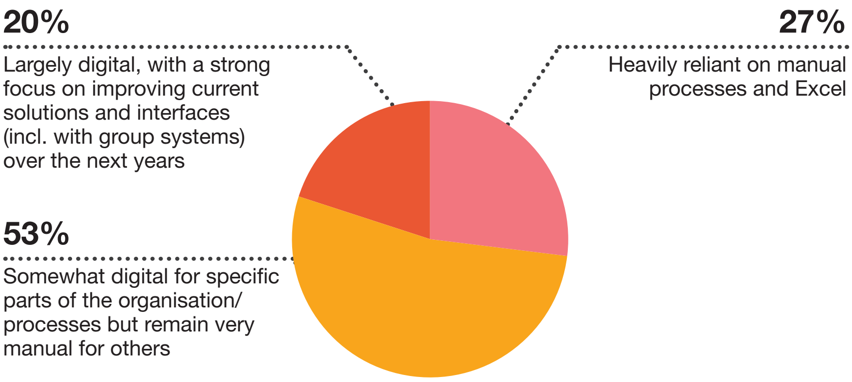
**Substance is a key consideration for the design and implementation of governance and operations and can be especially challenging to reconcile with cost efficiency. In order to remain competitive, players are also shifting their strategic focus to scalability, with digitalisation being high on everyone's agenda.**

# Strategy and Scalability

Looking 5-10 years ahead from a strategic angle: Where is the market heading and what is shaping the strategic focus? One key statement that all participants agreed to was that *"We want to double our capital but not our people"*.

With no exception, all participants agreed that digitalisation and a well-integrated, consistent IT landscape was the way towards achieving this goal in the long-run. Discussions quickly switched to the current status of digitalisation and how players are coping with growth and managing high volumes with the technical capabilities they have today.

Level of digitalitsation of our attendees' operations:




One technically highly advanced player advised based on good experiences that *"It is a good idea to lock your IT people in a room and see what happens"*, while most participants responded that they were moving to more digital solutions. A clear statement echoed by all players was that the need for IT was evident but the solutions not yet always clear.

While fund managers used to buy individual point-to-point solutions, they are now aiming for end-to-end solutions, as the different systems in their often-fragmented IT landscape do not always correspond to each other well. The one common response and solid answer from everyone was that, no matter which systems they bought or how technically advanced they are, Excel is still something that is frequently used in some way, shape or form.

High cost for IT is still a topic holding back some players from redesigning their digital landscape but also the heavily regulated environment in which themselves and moreover their service providers operate. Compliance testing is a significant administrative, resource-intensive and long-term process, which often must be completed not only within the own organisation but also at service provider level.

The question of digitalisation goes back to the question about data management. One participant asked the question: "How can I get all my data points on all my devices at all times from anywhere in the world?" In order to answer this question, you first of all need to know what those data points are and where they are stored. Data management is as big a topic as digitalisation itself, as it really builds the basis for all tools and software. Data management happens internally but also in coordination with service providers, with whom data is exchanged on a daily basis.

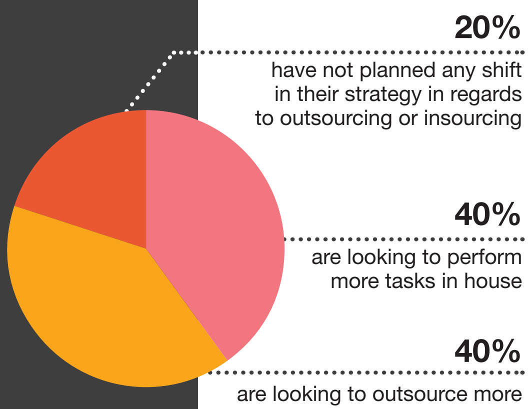
Apart from service providers, information and data flows also happen between the AIFM and the investors of the AIFs they manage. The feedback on how this information flow is currently handled varied from emails to a dedicated and secure investor portal. Nobody currently performs data feeds to investors but there was consensus that this is probably the preferred solution going forward, as cyber threat is increasing, and emails are not considered the most secure way to communicate. In general, investor demands are different and since fund managers operate in an investor-driven industry, those demands must be catered for.

Moving away from data and digitalisation as growth drivers, Group AIFMs stated that leveraging from resources, expertise and technology available within the Group has been a key part of their growth to-date, spanning across multiple functions, mainly HR, Finance and IT.

*“With growth, there comes change and there is a balancing act to be performed between the two.”*

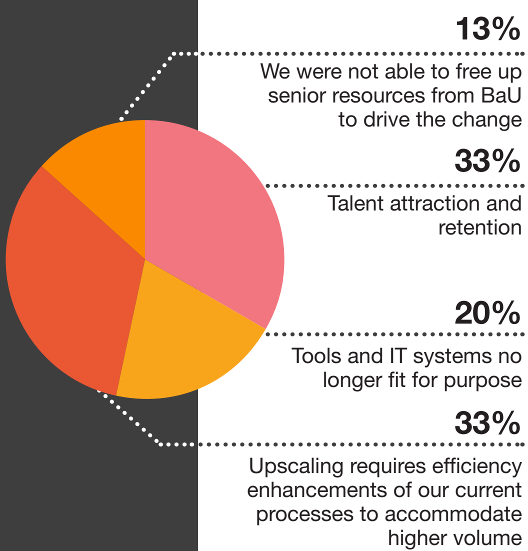
Referring back to the substance part of the discussions and the aim to satisfy both corporate and fund manager substance, another balancing act must be mastered between the **level of insourcing vs. outsourcing**. On the one hand, it makes sense to outsource low value-adding, high volume tasks while on the other hand, you also need a sufficient number of people within your own organisation to ensure appropriate staffing levels.

Further feedback from participants on this topic was that investors are most often highly in favour of outsourcing low value-add tasks.




Almost half of the participants stated that a lack of resources was an obstacle when trying to further scale operations. In a booming financial industry in the EU’s central fund hub, talent attraction and retention can be a real challenge.

We asked attendees what were the main challenges they had experienced as part of their growth and they responded:




The overall feedback to this section from participants was that there is a clear trend towards enhancing data management and increasing digitalisation levels, as *“we are on the run-up to the digital era, we will all have to jump on it eventually”* but that since this is a long-term process, the focus is on coping with volumes within means available today.

# Conclusion

The operating model of AIFMs has considerably evolved since the inception of the AIFMD, in part due to the maturing of the alternatives market but also due to external forces, including additional regulatory requirements, a new tax environment and political events like Brexit, further accelerating these developments. While none of the forces were found to have significantly disrupted the way asset managers operate, they nevertheless all played an important role in shaping today's environment and how business is done in Luxembourg.

With these developments comes the need for a sound balancing act between the CSSF's regulatory and the tax authorities corporate substance requirements, an exercise which does not become more straight forward as fund structures increase in complexity and substance needs. Although the overarching aim is clearly to achieve this balance in the most operationally efficient and cost-effective way, several approaches for creating senseful synergies between the AIFM and corporate entities have emerged – in part relating to whether the funds are managed by a group or third-party AIFM.

In this regard, there was a clear consensus among participants that they would appreciate further joint guidance from the authorities around how best to balance both requirements.

*“We are on the run-up to the digital era, we will all have to jump on it eventually.”*

Market players increasingly recognise that having a well-structured and integrated set-up that spans not only the operations of the AIFM but reaches down to the fund structure, will be all the more important as fund managers continue to grow in size.

The premise of such rapid and sizeable growth puts scalability high up on everyone's agenda. Although short- to medium-term investments continue to be made with regard to additional resources or process enhancements to deal with the immediate growth in volume while the roadmap towards digitalisation unfolds, all participants agreed that digitalisation is the long-term way forward, right by the statement “We are on the run-up to the digital era, we will all have to jump on it eventually.”

## Outlook

With new regulations and directives coming out, such as the new directive on marketing and AIFMD II, we are still not at end of the road in terms of changes, operational and scalability challenges. New topics like the EU Green Action plan are around the corner and do not only affect AIFMs but also their service providers to ensure that the Luxembourg fund industry does not get bored.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