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Investment Funds 2022

Luxembourg: Law & Practice

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LUXEMBOURG

Law and Practice

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CONTENTS

1. Market Overview p.3
1.1 State of the Market p.3

2. Alternative Investment Funds p.3
2.1 Fund Formation p.3
2.2 Fund Investment p.7
2.3 Regulatory Environment p.8
2.4 Operational Requirements p.10
2.5 Fund Finance p.11
2.6 Tax Regime p.13

3. Retail Funds p.15
3.1 Fund Formation p.15
3.2 Fund Investment p.17
3.3 Regulatory Environment p.17
3.4 Operational Requirements p.19
3.5 Fund Finance p.19
3.6 Tax Regime p.19

4. Legal, Regulatory or Tax Changes p.20
4.1 Recent Developments and Proposals for Reform p.20

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1. MARKET OVERVIEW

1.1 State of the Market

Luxembourg is the world's second-largest fund domicile after the USA, with assets under management of Luxembourg-domiciled funds standing at EUR5,749 billion as at 30 November 2021. Not only is this increase based on the growth of traditional Luxembourg-domiciled undertakings for collective investment in transferable securities (UCITS), but also on the continued strong growth of alternative investment funds (AIFs).

Luxembourg's investment fund industry is a world leader in cross-border fund distribution, as Luxembourg-domiciled investment structures are distributed in over 70 countries worldwide, with a particular focus on Europe, Asia, Latin America and the Middle East. Many Luxembourg funds benefit from the so-called European passport, allowing funds (and their managers) that comply with the UCITS Directive or the Alternative Investment Fund Managers Directive (AIFMD) to be marketed to investors in the European Economic Area (EEA), following a simple notification procedure.

2. ALTERNATIVE INVESTMENT FUNDS

2.1 Fund Formation

2.1.1 Fund Structures

When opting for Luxembourg as domicile for their AIFs, initiators can choose between the following categories of investment vehicles, depending on the nature of the target assets, the type of target investors and the region and manner in which the AIF will be marketed:

- undertakings for collective investment (Part II UCIs), governed by Part II of the law of 17 December 2010, as amended, on undertakings for collective investment (the "UCI Law");
- specialised investment funds (SIFs), governed by the law of 13 February 2007, as amended, on specialised investment funds (the "SIF Law");
- investment companies in risk capital (SICARs), governed by the law of 15 June 2004, as amended, on the investment company in risk capital (the "SICAR Law");
- reserved alternative investment funds (RAIFs), governed by the law of 23 July 2016, as amended, on reserved alternative investment funds (the "RAIF Law"); or
- non-regulated ordinary commercial companies (Soparfis), governed by the law of 10 August 1915, as amended, on commercial companies (the "1915 Law").

Requirements for Luxembourg Investment Vehicles

Part II UCIs, SIFs and SICARs are so-called regulated investment vehicles subject to direct supervision of the *Commission de Surveillance du Secteur Financier* (CSSF) and require prior CSSF approval before they can be set up, which entails a review and approval by the CSSF, notably (without limitation) of:

- drafts of the constitutive documents, offering documents, key service providers agreements (eg, depositary, central administration, management, advisory, audit, global distributor agreements);
- key policies (eg, risk management, conflicts of interest, anti-money laundering policies); and
- certain information on members of the governing body and the manager and/or adviser.

Upon completion of the regulatory review, regulated investment vehicles receive the authorisation to be established and, following their forma-

tion, are registered on an official list maintained by the CSSF.

RAIFs and Soparfis are so-called unregulated investment funds that are not subject to direct supervision of the CSSF and do not require prior CSSF approval. They can be formed as soon as the constitutive documents and arrangements with the required service providers have been finalised.

Part II UCIs – as well as SIFs, SICARs and Soparfis that qualify as AIFs within the meaning of the law of 12 July 2013, as amended, on alternative investment fund managers (the "AIFM Law") – must be managed by an alternative investment fund manager (AIFM) that is authorised or registered (depending on the amount of its assets under management) under the AIFMD.

Authorised AIFMs can opt for any form of commercial company under Luxembourg law, but usually take the form of an SA or a SARL.

The following categories of Luxembourg-domiciled AIFMs do not need to seek CSSF authorisation prior to engaging in the management of a Luxembourg AIF:

- AIFMs that, directly or indirectly through a company with which the AIFM is linked by common management or control or by a substantive direct or indirect holding (an "Affiliate"), manage AIFs that are not leveraged and have no redemption rights for a period of five years, and whose aggregate assets under management do not exceed EUR500 million; and
- AIFMs that, directly or indirectly through an Affiliate, manage AIFs whose assets under management, including any assets acquired through the use of leverage, do not exceed EUR100 million.

Sub-threshold Managers

Luxembourg-domiciled sub-threshold managers do not benefit from the European marketing passport, but must register with the CSSF, disclose the AIFs they manage (and their investment strategies) and regularly report to the CSSF the principal instruments in which they trade and relating investment exposures. However, sub-threshold managers can elect to fully subject themselves to the AIFM Law requirements and opt for any form of commercial company under Luxembourg law, although they usually take the form of a SARL.

Sub-threshold managers not willing to apply for an authorised AIFM licence (eg, smaller private equity or social entrepreneurship managers who would consider the organisational requirements and transparency requirements deriving from the AIFMD as burdensome) may elect to use the European marketing passport regime offered by the European Venture Capital Funds Regulation and the European Social Entrepreneurship Funds Regulation. The rules of both regulations only apply on a voluntary basis, should a fund wish to use the European venture capital fund or European social entrepreneurship fund label.

2.1.2 Common Process for Setting Up Investment Funds

Luxembourg Fund Structures

The formation process of a Luxembourg fund depends on its legal form. Whereas Part II UCIs with variable capital may only take the form of a public limited liability company (SA) or a common fund (FCP), SIFs, SICARs, RAIFs or Soparfis may be structured as a:

- public limited liability company (SA);
- private limited liability company (SARL);
- corporate partnership limited by shares (SCA);
- co-operative company in the form of a public limited liability company (Coop-SA);

- common limited partnership (SCS);
- special limited partnership (SCSp); or
- solely for SIFs and RAIFs, an FCP.

Requirements for Investment Funds

Investment funds taking a corporate form (SA, SARL, SCA or Coop-SA) have to open a blocked bank account with a bank in Luxembourg and have the initial share capital transferred to this bank account, prior to being incorporated before a Luxembourg notary.

Investment funds taking the form of an SCS or SCSp are established under private deed by the mere signature of a partnership agreement by at least one limited and one unlimited partner.

Similarly, an FCP is formed by the mere execution of its management regulations.

The establishment of a RAIF under any of the above-mentioned legal forms requires an additional notarial certification.

Apart from the FCP and the SCSp, all the other legal forms have a legal personality.

The SCSp is the most flexible legal form, which is mainly used by private equity managers eager to structure an investment vehicle by using common law-style partnership concepts.

The FCP is similar to a UK unit trust or a US mutual fund. It is organised as a co-proprietorship whose joint owners are only liable up to the amount they have committed or contributed. The FCP must be managed by a Luxembourg-based management company. Investors in an FCP usually do not have voting rights (except if otherwise provided in the constitutive documents).

Managers willing to list their fund on a stock exchange must opt for an SA or an SCA.

Except for Soparfis and funds formed as FCPs, all investment funds may be organised as an investment company with variable capital (SICAV) or as an investment company with fixed capital (SICAF). While the share capital of a SICAV automatically increases and decreases further to investors' subscriptions and redemptions, variations of share capital in SICAFs require a formal decision and, as the case may be, a notarial deed (which makes SICAFs less attractive, except for an SCS or SCSp). Soparfis may only be organised as SICAFs.

Therefore, when setting up an investment fund under the Soparfi regime, initiators would typically choose the SCS or SCSp as the legal form (in order to achieve flexibility in relation to capital variations).

SCAs, SCSs and SCSps are formed between one or several general partners (GPs) with unlimited liability (and, as the case may be, general management powers) and one or several limited partners (LPs) who participate in any profits and share any losses, generally pro rata with their participation in the partnership and up to the amount of their commitment or contribution, as the case may be.

The SA and SARL may be formed by a single founding shareholder. Whereas all the other legal forms do not impose a maximum number of shareholders, partners or members, a SARL may not have more than 100 members. A SARL would typically be used by fund managers in the context of dedicated funds (eg, family office funds or joint venture funds) as well as master–feeder structures.

The SA and SCA are incorporated before a Luxembourg notary with a minimum share capital of EUR30,000 (or an equivalent amount in any other currency). There is no minimum capital

requirement for an SCS and SCSp. The minimum share capital for a SARL is EUR12,000.

SAs, SARLs, SCAs and Coop-SAs issue shares, whereas SCSs and SCSps may issue units, but can also implement capital account mechanisms that are customary for common law limited partnerships, reflecting an investor's contribution to the partnership adjusted over time to reflect its participation to profits and losses. In this respect, while it is more common to structure liquid funds in the form of an SA or SCA, managers of closed-end funds have a preference for the SCS or SCSp.

Length of Time and Costs for Setting Up Investment Vehicles

The length and costs of the setting-up process will depend, amongst others, on the category of the investment vehicle (regulated or not) and the applicable AIFMD regime (simplified registration regime or full-scope regime).

The authorisation process of a regulated AIF takes, on average, four to six months from the filing of the initial application with the CSSF.

The setting up of an unregulated AIF may take, on average, one to three months.

2.1.3 Limited Liability

Pursuant to Luxembourg law, the liability of an investor (other than a GP) is limited to its subscription or commitment, subject to any contractual arrangements that would increase its liability. The corporate veil may only be pierced in very limited circumstances involving, eg, a mingling of the partners' or shareholders' assets with the entity's assets.

The involvement of LPs of funds formed as an SCA, SCS or SCSp in acts of management towards third parties could potentially put their limited liability at risk, except in a limited number of permitted management acts provided for under Luxembourg law, including:

- the exercise of partners' rights under the constitutive documents;
- any advice given by the LPs to the SCA, SCS or SCSp;
- any supervisory authorisation powers given to LPs under the constitutive documents; and
- the granting of loans-security arrangements to the SCA, SCS or SCSp.

LPs may also act as managers of the relevant partnership and represent it on the basis of a proxy, without losing their limited liability status.

It is not uncommon for investors to obtain a legal opinion confirming their limited liability before investing in a Luxembourg fund.

2.1.4 Disclosure Requirements

For open-end Part II UCIs, a prospectus must be provided containing at least the information indicated in Schedule A of Annex I of the UCI Law, which also requires the essential elements of the prospectus to be kept up to date. Part II UCIs must also provide investors with semi-annual and annual reports.

For SIFs, an offering document must be established. Essential elements of the offering document must be updated only when additional securities or partnership interests are issued to new investors.

For RAIFs, an offering document must be established and include "the information necessary for investors to be able to make an informed judgement of the investment proposed to them and, in particular, the risks attached thereto". Essential elements of the offering document must be updated only when additional securities or partnership interests are issued to new investors.

For unregulated funds, there is no requirement to establish an offering document.

For SIFs, RAIFs and unregulated funds marketed under the AIFMD, investors must be provided with the disclosures required under Article 21 of the AIFM Law before they invest in the fund.

A key information document (KID) containing the information provided for in Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products must be provided to retail investors.

AIFMs are also subject to periodic reporting obligations, including, notably, periodic disclosure to the AIF's investors of the percentage of the AIF's assets that are subject to special arrangements arising from their illiquid nature (eg, side pocket arrangements), any new liquidity management arrangements, the current risk profile of the AIF and the risk management systems employed to manage those risks.

All fund managers are further required to comply with the new European disclosure requirements with respect to ESG criteria, both at the level of the asset management firm and at fund level, irrespective of whether such funds have an ESG focus.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

In the context of AIFs, the predominant types of investors located in Luxembourg are institutional investors, including other investment funds. However, Luxembourg-based family offices play an increasing role in structuring their investments through Luxembourg fund platforms.

2.2.2 Legal Structures Used by Fund Managers

When choosing a regulatory regime, the main considerations are the type of:

- the target investors; and
- the target assets.

Target Investors

Part II UCIs are open to retail investors in Luxembourg, but benefit from the European passport under the AIFMD only with respect to professional investors.

SIFs, SICARs and RAIFs are reserved for well-informed investors and can be freely marketed by their AIFMs to professional investors in other member states of the EEA using the so-called European passport under the AIFMD. "Professional investors" is slightly more restrictive than "well-informed investors" as it includes institutional investors, professional "per se" investors and "opt in" professionals as further described in Annex II of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (MiFID II).

A Soparfi that qualifies as an AIF is, in principle, reserved to professional investors and may be freely marketed by its authorised AIFM to professional investors within the EEA through the European passport, under the AIFMD.

Target Assets

When choosing the regulatory regime, it is also important to consider which one would best suit the proposed investment strategy (see below for investment limitations).

Other Considerations

Another feature that is, in practice, taken into consideration in the choice of the regulatory regime is the umbrella form.

SIFs, SICARs and RAIFs may be set up as umbrella funds with different sub-funds, where each sub-fund corresponds to a distinct portfolio of assets and liabilities of the fund, and which segregation is recognised under their respective governing laws. Sub-funds may have different investment strategies or may be closed ended or open ended within the same umbrella fund. Under certain conditions, cross-investments between sub-funds are allowed.

Soparfis, on the other hand, may not be structured as an umbrella fund.

2.2.3 Restrictions on Investors

SIFs, SICARs and RAIFs are reserved to well-informed investors. Well-informed investors are institutional investors, professional investors or any other investor that:

- has confirmed in writing that it adheres to the status of a well-informed investor; and
- either invests a minimum of EUR125,000 in the fund or has obtained an assessment certifying its expertise, experience and knowledge in adequately appraising an investment in the fund, made by a credit institution within the meaning of Directive 2013/36/EU, an investment firm within the meaning of Directive 2014/65/EU, a management company within the meaning of Directive 2009/65/EC, or, in respect of a RAIF, an AIFM.

Directors (*dirigeants*) and other persons who are involved in the management of the fund do not need to qualify as "well informed" in order to invest in the fund.

AIFs can be freely marketed by their AIFMs to professional investors as defined under MiFID II in other member states of the EEA using the AIFMD European passport.

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Part II UCIs may, in principle, invest in all types of assets but are subject to certain diversification requirements and borrowing restrictions, depending on the target assets; eg, maximum 20% in securities issued by one issuer, maximum 20% in one real estate property, maximum leverage of 300% of the net asset value (NAV), maximum 50% of the value of a property.

SIFs are the most flexible regulated investment vehicles in Luxembourg as there are no restrictions on eligible assets but only certain risk-spreading requirements. A SIF may not invest more than 30% of its assets or commitments in securities of the same type issued by the same issuer (save for certain exceptions), short sales may not result in the SIF holding a short position in securities of the same type issued by the same issuer representing more than 30% of its assets and when using financial derivative instruments, the SIF must ensure, via appropriate diversification of the underlying assets, a similar level of risk-spreading. However, the CSSF accepts, based on specificities of certain strategies and upon appropriate justification, the granting of derogations from these rules and, in practice, ramp-up and ramp-down periods may be provided for in the fund's documentation.

A SICAR is the appropriate regulatory regime for investment vehicles whose object is to invest their assets in securities representing "risk capital", being defined under the SICAR Law as: "the direct or indirect contribution of assets to entities in view of their launch, development or listing on a stock exchange." There are no restrictions on the types of assets that may be held by a SICAR provided they qualify as risk capital (which, in practice, encompasses a high risk and intention to develop the target entities). The CSSF assesses on a case-by-case basis compliance

of a proposed investment policy with the SICAR Law. A SICAR is not subject to diversification requirements.

RAIFs are, in principle, subject to the same regime as SIFs (no asset-type restrictions but a 30% risk-spreading requirement), save that RAIFs investing solely in risk capital (as defined above) do not need to spread their investment risk.

Soparfis are not subject to any asset eligibility restrictions or risk diversification requirements. However, managers of Soparfis qualifying as AIFs will be subject to certain AIFM Law requirements, such as on asset-stripping, which rules also apply to Part II UCIs, RAIFs, and SIFs qualifying as AIFs.

2.3.2 Requirements for Non-local Service Providers

The central administration of a Luxembourg AIF must be situated in Luxembourg.

The depositary and the auditor of a regulated AIF and of an AIF managed by an authorised AIFM must also have their registered office in Luxembourg.

Managers/directors of regulated AIFs must be authorised by the CSSF. In practice, the Luxembourg-based management of regulated AIFs appoints an investment adviser or delegates the portfolio management to entities located outside Luxembourg. The CSSF will only authorise the delegation of the portfolio management if the portfolio manager is regulated and subject to equivalent supervision by another supervisory authority.

2.3.3 Local Regulatory Requirements for Non-local Managers

Luxembourg law applies when the fund, or the manager, or both, are established in Luxembourg, and when investors to whom a fund is marketed are domiciled in Luxembourg.

Following harmonised regulator-to-regulator notification regimes, an authorised manager under the AIFMD in any other EEA member state benefits from a European passport for the purpose of managing, pre-marketing and/or marketing a Luxembourg fund on a cross-border basis.

When management of a regulated fund is delegated to a non-Luxembourg EU manager, prior CSSF approval is required. The same will apply to unregulated funds once the AIFMD third-country passport under Article 38 of the AIFM Law is made available to non-EU AIFMs.

A notification to the CSSF is required prior to any pre-marketing or marketing of a foreign or Luxembourg AIF by a non-EU manager to Luxembourg investors.

2.3.4 Regulatory Approval Process

The authorisation process of a regulated AIF takes, on average, four to eight months from the filing of the initial application with the CSSF.

2.3.5 Rules Concerning Marketing of Alternative Funds

Any provision of information or communication, direct or indirect, on investment strategies or ideas by an EU manager or on its behalf by a regulated third party, to potential Luxembourg-domiciled professional investors in order to test their interest in a not-yet-established AIF, or in an established, but not yet notified for marketing AIF, and which in each case does not amount to an offer or placement to the potential investors to invest in the units or shares of that AIF, requires a prior notification to the CSSF.

Any direct or indirect offering or placement at the initiative of a manager or on its behalf by a

regulated third party of units or shares of a fund it manages with Luxembourg-domiciled investors requires a prior notification to the CSSF.

Specific rules with respect to de-notification of AIFs have recently been transposed into Luxembourg law and must be complied with to discontinue the marketing of shares or interests in AIFs. It must be noted that following a de-notification in a jurisdiction, an AIFM is not allowed to market interests in AIFs with a similar investment strategy within a period of 36 months after the de-notification.

Investment firms not qualifying as a manager under the UCI Law or the AIFM Law must request prior CSSF authorisation under the Financial Sector Law to distribute units or shares of funds in Luxembourg.

2.3.6 Marketing of Alternative Funds

Part II UCIs are open to retail investors in Luxembourg but benefit from the AIFMD European passport only with respect to professional investors as defined under MiFID II.

SIFs, SICARs and RAIFs are reserved for well-informed investors and can be freely marketed by their AIFMs to professional investors as defined under MiFID II in other member states of the EEA using the AIFMD European passport.

A Soparfi that qualifies as an AIF is, in principle, reserved to professional investors as defined under MiFID II and can be freely marketed by their AIFMs to professional investors in other member states of the EEA using the AIFMD European passport.

Foreign AIFs may only be marketed to retail investors in Luxembourg if they comply with the rules laid down in CSSF Regulation 15-03.

2.3.7 Investor Protection Rules

SIFs, SICARs and RAIFs are reserved to well-informed investors (see above).

Managers and funds subject to CSSF supervision are required to have a complaint management policy and file a yearly summary report with the CSSF, which acts as an out-of-court complaint resolution body.

Regulated funds (Part II UCIs, SIFs and SICARs), RAIFs and Soparfis that qualify as AIFs and are managed by a Luxembourg AIFM must file an audited annual report with the CSSF. In addition, regulated funds must file monthly financial information with the CSSF, and Part II UCIs must file an additional unaudited semi-annual report.

2.3.8 Approach of the Regulator

Over the past years, the CSSF entered an active digitalisation phase through the creation and development of special dropboxes and eDesk portals, aiming at modernising its supervisory mission.

The CSSF regularly issues regulatory guidance. It also performs on-site visits and issues warnings to entities that may not meet the expected standards. In certain cases, face-to face meetings with the regulator may be organised.

2.4 Operational Requirements

Part II UCIs are subject to investment limitations, SIFs and RAIFs to diversification requirements and SICARs to asset restrictions (see above).

Part II UCI, SIFs, SICARs, RAIFs and unregulated AIFs managed by authorised AIFMs must appoint a depositary whose assets must be segregated from the fund's assets. Soparfis managed by a sub-threshold AIFM are not required to appoint a depositary.

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Authorised AIFMs must comply with the risk, borrowing restrictions, valuation and pricing of the assets held by the AIFs and transparency requirements set out in the AIFM Law or the AIFMD, as applicable.

Luxembourg entities must further comply with anti-money laundering (AML) and counter-terrorist financing (CTF) Luxembourg laws, regulations and CSSF circulars.

Issuers whose securities are admitted to trading on the Luxembourg regulated market within the meaning of MiFID II are subject to the obligations of various EU directives that have been implemented under Luxembourg law, in particular:

- the Prospectus Regulation and the related Commission Delegated Regulation (EU) No 2019/980 of 14 March 2019, as amended;
- Directive 2004/109/EC of the European Parliament and of the Council dated 15 December 2005 on the harmonisation of transparency requirements, as amended (the "Transparency Directive"), implemented by the Luxembourg Law of 11 January 2008, as amended (the "Transparency Law"); and
- Regulation (EU) No 596/2014 on market abuse, as amended.

Short-selling restrictions are set out in CSSF Circular 07/309 in respect of SIFs and CSSF Circular 02/80 in respect of Part II UCIs.

2.5 Fund Finance

Provisions of the AIFM Law

While non-regulated Soparfis, SICARs, SIFs and RAIFs are not subject to any legally imposed leverage limits, to the extent those vehicles qualify as AIFs and are considered as leveraged, the provisions of the AIFM Law may, nevertheless, need to be considered.

Based on the AIFM Law, leverage is defined as any method by which the AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities, leverage embedded in derivative positions, or by any other means. In respect of private equity and venture capital funds, leverage existing at the level of a portfolio company is not intended to be included when referring to those financial or legal structures, to the extent the AIF does not have to bear potential losses beyond its investment.

The European Commission has clarified that borrowing arrangements entered into by an AIF that are temporary in nature and fully covered by capital commitments by investors are excluded from the leverage calculations.

It is important to note that leverage may affect whether an AIF must appoint an authorised AIFM (see **2.1.1 Fund Structures**).

The AIFM Law also requires AIFMs to set a maximum level of leverage that they may employ on behalf of each AIF they manage, as well as the extent of the right to reuse collateral, or guarantees that could be granted under the leverage arrangement. In addition, for each AIF they manage that is not an unleveraged closed-end AIF, AIFMs must employ an appropriate liquidity management system and adopt procedures that enable them to monitor the AIF's liquidity risk, and ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations. AIFMs must regularly conduct stress tests, under normal and exceptional liquidity conditions, that enable them to assess the AIF's liquidity risk, and monitor that risk accordingly.

The AIFM concerned must provide investors with disclosures in respect of the AIF in which they intend to invest, including:

- a description of the circumstances in which the AIF may use leverage;
- the types and sources of leverage permitted and the associated risks;
- any restrictions on the use of leverage and any collateral and asset reuse arrangements; and
- the maximum level of leverage that the AIFM is entitled to employ on behalf of the AIF.

In addition, AIFMs managing EU AIFs employing leverage or marketing AIFs employing leverage in the EU must disclose to the investors, on a regular basis, for each AIF:

- any changes to the maximum level of leverage that the AIFM may employ on behalf of the AIF, plus any right to the reuse of collateral or any guarantee granted under the leveraging arrangement; and
- the total amount of leverage employed by that AIF.

In addition to the disclosures to be made, AIFMs must also provide the competent authorities of their home member state with information in respect of the AIFs they manage. In this context, AIFs employing leverage on a substantial basis must make available information on the overall level of leverage employed by each AIF they manage, the breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, as well as the extent to which the AIF's assets have been reused under leveraging arrangements. Such information includes the identity of the five largest sources of borrowed cash or securities and the amounts of leverage received from each of those sources. For non-EU AIFMs, the reporting obligations referred to in this paragraph are limited to EU AIFs that they manage and non-EU AIFs that they market in the EU.

Fund Finance Arrangements

The fund finance arrangements most used by Luxembourg funds are capital call financings (which do not constitute leverage if temporary in nature; see above). These arrangements are typically secured by the investors' unfunded capital commitments and are subject to a borrowing base determined by the value of the investors' commitments satisfying certain eligibility criteria.

Typically, the security package is comprised of a pledge by the fund of its rights under the unfunded investors' commitments and the claims against the investors in relation thereto, as well as of a pledge over the bank account dedicated to the investors' contributions.

It is usual for lenders to require security interests granted by a fund to be notified to the investors, in order to ensure that investors act in accordance with the security taker's instructions and pay the unfunded commitments to the pledged account upon enforcement of the security interest. Notices may be served to the investors by different means (registered letters, emails, electronic communications, etc). Alternatively, notices may be included in the financial reports or published on an investor portal.

In order for the lenders to be comfortable that, upon the enforcement of the security interest, investors would not challenge their payment obligations in respect of their commitments, lenders would generally request that investors waive any defences, right of retention or set-off and counterclaim they may have in respect of the pledged claims and any applicable transferability restrictions.

With a view to pre-empting any difficulties in respect of the above, fund documentation (nota-

bly, the partnership agreements) would now usually include "bankable" financing provisions, such as:

- the investors' acceptance of the possibility for the fund and its GP to borrow and pledge the unfunded capital commitments;
- the security taker's right to initiate and enforce capital calls;
- investors' waivers of set-off and defences to funding;
- provisions allowing the security taker to give instructions to the investors upon the occurrence of an event of default;
- subordination of the investors' claims; and
- including the lender in the "non third-party right" provisions to ensure the lender will be able to benefit from the above "bankable" financing provisions.

If the investors' capital commitments are structured as an obligation to subscribe for interests or shares, a specific undertaking of the investors to fund their capital commitments, notwithstanding the impossibility of the fund to issue such units or shares (notably in the case of bankruptcy or suspension of the NAV calculation), should also be included in the fund documentation.

Luxembourg funds may also use NAV or asset-backed financing arrangements. These borrowing arrangements are facilities made available to a fund (or an SPV held directly by the fund) with recourse to the portfolio of assets of the fund. The borrowing base is calculated on the NAV of the assets of the fund (being the primary source of repayment). Lenders will analyse the underlying investments as well as cash flows and other distributions that the fund will receive from those investments.

Depending on the investment strategy of the fund, the security package may be composed of pledge over shares, claims, loans and/or bank accounts into which investment proceeds are to be paid with the aim to allow the lender to control the underlying assets or distributions paid on such assets. These financing arrangements constitute leverage and must be included in the leverage calculation of the borrowing AIF.

2.6 Tax Regime

The tax regime applicable to Luxembourg AIFs depends both on the legal form of the fund and whether it is subject to a specific product law.

Unregulated Funds

- A fund organised as an SCS or SCSp is tax transparent for purposes of (and thus not subject to) corporate income tax (CIT) and net wealth tax (NWT). An SCS or SCSp may, however, be subject to municipal business tax (MBT) at a rate of 6.75% (the rate applicable in Luxembourg City in 2021) on its profits if it carries out a business activity or is deemed to carry on a business activity. A SCS or SCSp that acts as a "classic" fund should not conduct a business activity. If the SCS or SCSp qualifies as an AIF within the meaning of the AIFM Law, it is deemed not to carry on a business. An SCS or SCSp, even if it qualifies as an AIF, is still subject to MBT if its GP is a Luxembourg capital company holding at least 5% of interests in the partnership or a foreign capital company with a Luxembourg permanent establishment through which it holds at least 5% of interests in the partnership.
- A fund organised as a corporate entity is subject to the ordinary corporate taxation regime; ie, subject to (i) CIT and MBT on its worldwide profits (subject to certain exemptions) at a consolidated rate of 24.94% (the rate for 2022 for companies resident in Luxembourg City) and (ii) NWT on the fair market value of its worldwide net assets (again, subject to certain exemptions) at a rate of 0.5% for the first EUR500 million of net assets and 0.05%

for the tranche of net assets exceeding EUR500 million. A minimum NWT applies.

Regulated Funds

- A SIF is exempt from CIT, MBT and NWT (even if organised as a corporate entity) but is subject to subscription tax at an annual rate of 0.01% on its NAV (the tax is computed and payable quarterly). A RAIF, by default, adopts the tax regime of the SIF. Certain exemptions from subscription tax exist.
- A SICAR organised as a corporate entity is formally fully subject to tax but benefits from a specific exemption on income and gains from risk capital securities. In addition, it is exempt from NWT, except for the minimum NWT. A RAIF investing in risk capital may elect to be taxed as a SICAR. In Luxembourg, vehicles with the SICAR regime have traditionally been considered to qualify for the benefit of EU directives and double tax treaties. Foreign tax authorities may, however, take a different stance, in particular following the Court of Justice of the EU's judgments in the so-called Danish cases.

Reverse Hybrid Rules

Importantly for unregulated funds organised as partnerships or other legal forms that allow them to be treated as tax-transparent entities for CIT purposes in Luxembourg, as from tax year 2022, so-called reverse hybrid rules may result in the entity becoming subject to CIT if the following conditions are met:

- one or more non-resident investors see the fund as an opaque entity (ie, not transparent for tax purposes);
- such investors together hold in aggregate at least 50% of interests or voting rights in the fund, or are entitled in aggregate to at least 50% of the profits distributed by the fund; and
- such investors are associated to the fund.

There is an exemption from the reverse hybrid rule for collective investment vehicles: this notion covers UCITS, as well as – according to the commentary to the bill of law implementing the Second Anti-Tax Avoidance Directive (ATAD 2) – Part II UCIs, SIFs, RAIFs and any AIF that meets the following three conditions:

- it is widely held;
- it invests in a diversified portfolio of securities; and
- it is subject to investor protection rules in its country of establishment.

The interpretation of these criteria and their application to regulated funds remain subject to further clarifications.

A key concept to assess association is "acting together": persons that act together are deemed to hold the interests/voting rights/profit entitlement of the entities with which they act together for purposes of assessing the 50% association threshold. Investors are acting together, eg, if they are members of the same family, or if one acts in accordance with the wishes of another. According to the OECD's report on BEPS Action 2, investing in a partnership under a common investment mandate would also suffice to act together.

The Luxembourg legislator considers, however, that investors in an investment fund generally do not have an effective control over the fund's investments. Hence, the law contains a rebuttable presumption that investors that hold less than 10% of interests/profit entitlement in a fund that is a collective investment undertaking raising capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors (this corresponds to the criteria defining an AIF under the AIFMD), do not act together.

Withholding Tax

As regards withholding at source on distributions to investors, the following applies.

- There is no withholding tax on distributions made by funds that are tax transparent for Luxembourg tax purposes.
- Distributions made by funds subject to a specific regulatory regime (SICAR, SIF, RAIF) are not subject to withholding tax.
- Distributions by an unregulated fund taking the form of a corporate entity are, in principle, subject to a 15% withholding tax. A reduction or exemption may apply for qualifying investors.

Capital Gains Taxation

As regards non-resident capital gains taxation, the following applies.

- A gain realised by a non-resident investor on a participation in an unregulated fund taking the form of a corporate entity is taxable under Luxembourg tax law if the participation (i) represents more than 10% of the share capital of the unregulated corporate fund and (ii) has been disposed of within six months of the acquisition. An applicable tax treaty may set aside this rule and allocate the exclusive taxing right to the country of residence of the investor.
- A gain on the disposal of interests in a corporate fund subject to a product law (SIF, RAIF, SICAR) does not give rise to non-resident capital gains taxation.
- A disposal of interests in an unregulated tax-transparent partnership is assimilated, for Luxembourg tax purposes, to a disposal of the underlying partnership net assets (pro rata to the interest held by the non-resident investor in the partnership). Taxation may arise if the taxing rights on the disposal of the underlying partnership assets are allocated to Luxembourg and fall within the scope of non-resident capital gains taxation.

Non-resident investors should not be considered to have a permanent establishment in Luxembourg by mere reason of their investment in a Luxembourg partnership, unless that partnership carries out a business and the investor is seen as co-exploiting the business. Usually, this is not the case, as partnerships that qualify as AIFs are deemed not to carry out a business.

As to resident investors, they are taxed at the applicable income tax rate on proceeds arising from, and gains realised on, their participation/interest in an alternative fund vehicle, subject to special regimes. Amongst these, it is particularly worth mentioning the following.

- For individual resident investors – a 50% exemption applies on dividends paid by certain resident or non-resident capital companies. Moreover, if the investor acts in the context of the management of their private wealth, capital gains on participations are taxable only if (i) the participation has been disposed of within six months of its acquisition, or (ii) the participation exceeds 10% of the share capital of the company.
- For companies – the participation exemption regime results, under certain conditions, in the exemption of dividends from, and capital gains on, a participation in certain Luxembourg and foreign companies.

3. RETAIL FUNDS

3.1 Fund Formation

3.1.1 Fund Structures

When opting for Luxembourg as domicile for their retail funds, initiators can choose between the following categories of regulated funds:

- UCITS, governed by Part I of the UCI Law; and
- Part II UCIs.

Regulated retail funds may be structured as:

- SICAVs (only in the form of an SA or FCP);
- SICAFs; or
- FCPs.

Regulated retail funds can be set up as standalone funds or umbrella funds.

A CSSF Circular 18/698 on authorisation and organisation of Luxembourg investment fund managers has unified the licensing process for UCITS managers and authorised AIFMs. The following key elements are considered by the CSSF when reviewing the application for a UCITS management company (or authorised AIFM licence):

- compliance with organisational requirements (shareholding structure, own funds, team and substance); and
- compliance with operational requirements (internal policies and processes, external control and reporting).

Specific attention will be given to the performance of portfolio management and risk management functions, as well as to the AML procedures. The minimum number of full-time employees who must be located in Luxembourg (or the closer region) is three. Depending on the nature, size and complexity of the firm's activities, the CSSF may allow part-time employees, certain delegation arrangements and outsourcing of certain functions (eg, internal audit). The proposed investment process, risk and liquidity management policies, valuation, conflict of interest, AML and remuneration policies need to be submitted to the CSSF for review. Preparation of the filing may take several weeks or months depending on how quickly the local team is assembled and the required information is gathered. In practice, the CSSF generally takes six to eight months to review a licence application.

Luxembourg management companies governed by the UCI Law may take the form of an SA, SARL, SCA, Coop or Coop-SA. They are usually set up as an SA.

3.1.2 Common Process for Setting Up Investment Funds

Regulated retail funds are subject to the direct supervision of the CSSF and require prior CSSF approval before they can be set up.

The CSSF needs to receive for its review and approval, notably (without limitation), drafts of the constitutive documents, offering documents and key service providers agreements (such as depositary, central administration, management, advisory, audit, global distributor agreements), as well as key policies (such as risk management, conflicts of interest, anti-money laundering policies). The CSSF also needs to receive certain information on the members of the governing body and the manager and/or adviser.

The authorisation process of a UCITS takes, on average, six to ten weeks from the filing of the initial application, while the authorisation process of a UCI Part II lasts, on average, two to five months.

The length and costs of the setting-up process will depend, amongst others, on the category of the investment vehicle.

3.1.3 Limited Liability

Please refer to the paragraph relating to the limited liability of LPs in AIFs.

3.1.4 Disclosure Requirements

For UCITS and open-end Part II UCIs, a prospectus must be provided containing at least the

information indicated in Schedule A of Annex I of the UCI Law, which also requires the essential elements of the prospectus to be kept up to date. Part II UCIs must, in addition, deliver a packaged retail investment and insurance products KID to potential investors, whereas a UCITS must provide potential investors with a key investor information document that, amongst others, contains the investment objectives and policy of the fund, risk profile, costs and associated charges, past performance and practical information. Finally, UCITS and Part II UCIs must provide investors with semi-annual and annual reports.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

As at June 2021, assets under management of Luxembourg UCITS represent 36% of the aggregate assets managed by UCITS in the EEA.

Part II UCIs and UCITS can be distributed to all types of investors, such as retail, institutional and professional counterparties.

3.2.2 Legal Structures Used by Fund Managers

Please see **3.2.1 Types of Investors in Retail Funds**.

3.2.3 Restrictions on Investors

Please see **3.2.1 Types of Investors in Retail Funds**.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

UCITS are subject to detailed and complex asset eligibility, liquidity and diversification requirements. They may only invest in transferable securities and other liquid financial instruments authorised by the UCI Law.

Part II UCIs may, in principle, invest in all types of assets but are subject to certain diversification requirements and borrowing restrictions, depending on the target assets.

3.3.2 Requirements for Non-local Service Providers

The central administration, the depositary and the auditor of a regulated retail fund must have their registered office in Luxembourg.

Managers or directors of a regulated retail fund must be authorised by the CSSF.

3.3.3 Local Regulatory Requirements for Non-local Managers

Unless self-managed, a UCITS must be managed by a management company that is authorised under the UCITS Directive (either in Luxembourg or elsewhere in the EEA). A Part II UCI that qualifies as an AIF must be managed by an AIFM that is authorised or registered (depending on its assets under management) under the AIFMD.

When management of a regulated fund is delegated to a non-Luxembourg EU manager, prior CSSF approval is required.

3.3.4 Regulatory Approval Process

The authorisation process of a UCITS takes, on average, six to ten weeks from the filing of the initial application, while the authorisation process of a UCI Part II lasts, on average, four to six months.

3.3.5 Rules Concerning Marketing of Retail Funds

EEA-based UCITS may be freely marketed in Luxembourg, provided that they or their managers have been approved by their national supervisory authority and provided, further, that their local regulator has notified the CSSF of their intention to market their shares in Luxembourg.

As for AIFs, de-notification rules must be complied with to discontinue the marketing of shares or units of UCITS.

Similarly to the AIFMD marketing passport, UCITS benefit from a European marketing passport under the UCITS Directive. The marketing of UCITS outside the EEA is subject to each third country's national regime.

Part II UCIs are open to retail investors in Luxembourg, but benefit from the European passport under the AIFMD only with respect to professional investors. Part II UCIs that intend to target retail investors in other member states must meet specific conditions laid down by the regulatory authorities of the host member states.

Where foreign funds are marketed to Luxembourg-domiciled retail investors, they need to make arrangements in Luxembourg to perform certain tasks (eg, for the process of subscriptions and redemptions, the provision of certain information to investors). They are not required to have a physical presence in Luxembourg or to appoint a third party for the purpose of these tasks. A local paying agent is no longer required.

In the case of an offer of securities issued by a closed-end foreign investment fund (not qualifying as an AIF) to the public in Luxembourg, a prospectus must be published in compliance with Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market (the "Prospectus Regulation") and the law of 16 July 2019 on prospectuses for securities (the "Prospectus Law"). The obligation for closed-end funds to publish a prospectus does not apply to the following categories of offers:

- offers addressed solely to qualified investors;
- offers addressed to fewer than 150 natural or legal persons, other than qualified investors, per EU member state;
- offers of securities whose denomination per unit amounts to at least EUR100,000;
- offers addressed to investors acquiring securities for a total consideration of at least EUR100,000 per investor, for each separate offer;
- offers for which the total consideration in the EU is less than EUR8 million over a period of 12 months where only an information notice shall be published in accordance with the Prospectus Law; or
- any other exempt offers falling within the scope of Article 1(4) of the Prospectus Regulation.

The Prospectus Regulation shall not apply to offers of securities to the public with a total consideration in the EU of less than EUR1 million, which shall be calculated over a period of 12 months.

3.3.6 Marketing of Retail Funds
Part II UCIs and UCITS can be distributed to all types of investors, such as retail, institutional and professional counterparties.

3.3.7 Investor Protection Rules
Managers and funds subject to CSSF supervision are required to have a complaint management policy and file a yearly summary report with the CSSF, which acts as an out-of-court complaint resolution body.

UCITS and Part II UCIs must file with the CSSF an unaudited semi-annual report, an audited annual report and monthly financial information (U1.1) with the CSSF.

3.3.8 Approach of the Regulator
Please see above.

3.4 Operational Requirements

Please see above for the restrictions on the types of investments.

UCITS and Part II UCIs must appoint a depositary, and the fund's assets must be segregated from the depositary's assets.

Please refer to **2.4 Operational Requirements** for the applicable laws and regulations in respect of market abuse, AML–CTF and transparency.

The short selling of securities is not permitted for UCITS.

3.5 Fund Finance

UCITS

In principle, an investment fund (or a management company acting on behalf of a common fund) cannot borrow. By way of derogation, UCITS may borrow, provided that such borrowing is:

- on a temporary basis (revolving facilities are not allowed) and represents no more than 10% of the assets of the investment fund (or, in the case of a common fund, 10% of the value of the fund); or
- to enable the acquisition of immovable property essential for the direct pursuit of its business and represents, in the case of an investment company, no more than 10% of its assets, it being understood that the aggregate amount of such borrowing may not exceed 15% of the net assets of the investment fund.

The CSSF has clarified that UCITS may borrow (subject to the 10% borrowing limitation):

- to meet redemptions;
- for investment purposes if such borrowing is temporary (ie, it must mature in a reasonable period of time) and must not be permanently part of the investment policy of the UCITS; or
- to anticipate subscriptions, provided that the investor is irrevocably obliged to pay within a short timeframe.

Part II UCIs

A Part II UCI investing in transferable securities may borrow up to 25% of its net assets without any restriction.

A Part II UCI that adopts alternative investment strategies may borrow for investment purposes on a permanent basis from first-class credit institutions that specialise in this type of transaction, provided that in-principle borrowings may not exceed 200% of its net assets.

A Part II UCI investing in real estate may borrow up to 50% of the value of all properties.

Lenders will see their security package limited when dealing with UCITS due to the various restrictions applicable to them. In principle, Part II UCIs (depending on their strategy) offer more flexibility to lenders in that respect.

3.6 Tax Regime

Retail funds (UCIs covered by the law of 17 December 2010) are subject to subscription tax at an annual rate of 0.05% (0.01% in certain circumstances) of their NAV, subject to certain exemptions. There is also a decreasing rate in the event that certain proportions of investments in "environmentally sustainable economic activities" are reached. The tax is payable quarterly. Retail funds are exempt from CIT, MBT and NWT; this also applies to UCIs established outside Luxembourg, but whose place of effective management or place of central administration is in Luxembourg.

UCIs having a corporate form may benefit from certain tax treaties concluded by Luxembourg.

There is no withholding tax on distributions made by retail funds and non-resident investors are not subject to tax in Luxembourg on capital gains realised on units issued by a retail fund.

For resident investors, the ordinary tax rules on the taxation of dividends and capital gains apply.

4. LEGAL, REGULATORY OR TAX CHANGES

4.1 Recent Developments and Proposals for Reform

Pre-marketing activities are now subject to a CSSF notification in accordance with Directive (EU) 2019/1160 regarding cross-border distribution of collective investment undertakings as implemented under Luxembourg law. The CSSF has extended to non-EU AIFMs pre-marketing AIFs into Luxembourg the pre-marketing regime applicable since 2 August 2021 to EU AIFMs in order to create a level playing field between EU AIFMs and non-EU AIFMs.

Circulars CSSF 21/789 and 21/790 introduce a new self-assessment questionnaire (SAQ) to be completed annually by all regulated alternative and retail funds and Luxembourg authorised AIFMs regarding their compliance with the applicable legal and regulatory requirements for financial years ending on or after 31 December 2021 (for authorised AIFMs and self-managed regulated funds) or 30 June 2022 (for externally managed regulated funds). The approved statutory auditors (*réviseurs d'entreprises agréé*) will be required to review annually certain questions of the SAQ and complete a separate report (the "SAQ Report"). The SAQ Report will be required for the financial years ending on or after 31 December 2021 for Luxembourg authorised AIFMs, 30 June 2022 for UCITS and Part II UCIs, and 30 June 2023 for SIFs and SICARs.

From a tax perspective, aside from the potential impact of ATAD and ATAD 2 on underlying special-purpose vehicles/portfolio companies, tax-transparent fund entities need to carefully monitor the impact of the reverse hybrid rules applicable as from 2022. This is especially relevant for AIFs (retail funds are less likely to be affected). Under the reverse hybrid rules, a Luxembourg tax-transparent entity may become subject to CIT on its income not otherwise taxed (in its hands or the hands of another person, in Luxembourg or abroad) where at least 50% of the interests, voting rights and rights to profits are held by associated investors resident in a jurisdiction that sees the entity as opaque. An "acting together" test applies in the context of the association test.

These rules require planning, both in terms of investment structure and additional wording in the legal documentation (limited partnership agreements, private placement memorandums, subscription documents).

Another relevant development is the mandatory disclosure rules under the so-called EU DAC6, which requires intermediaries and, on a subsidiary basis, taxpayers and entities established in the EU to report certain schemes that meet hallmarks deemed indicative of tax avoidance. The reporting obligation started in Luxembourg on 1 January 2021. Only limited guidance is available. In some circumstances, funds, fund managers and/or investors may face certain reporting obligations.

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Loyens & Loeff Luxembourg SARL has an Investment Management team that is part of a fully integrated (tax and legal) firm with home markets in the Benelux and Switzerland, and offices in all major financial centres. The Luxembourg team comprises more than 60 dedicated fund lawyers combining banking and finance, corporate, real estate, regulatory and tax expertise. Investment management is one of the key practice areas of the firm and the team has built substantial experience in the structuring and formation of investment funds. The Investment Management team advises fund managers on the formation of a variety of investment funds and pooling vehicles, including real assets/commodities funds, REITs and PE real estate funds, venture capital and PE/buyout funds covering various sectors, such as infrastructure, biotech/life science, (renewable) energy, IT/information and communications technology, mezzanines, private debt funds, retail investment vehicles and funds of funds (including UCITS).

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