



May 2026

Q&A for US fund managers establishing a Luxembourg in-house AIFM

US fund managers (**USFM**) show an increased appetite for using their own EU-based licensed entity to manage their European private (parallel) funds. Under EU regulations, such entity is referred to as an ‘authorized alternative investment fund manager’ (**AIFM**).

This Q&A provides concise and practical answers to the key questions that USFM typically raise with us. This Q&A uses the term "**In-House AIFM**" for a Luxembourg AIFM that is controlled by the USFM and "**Host AIFM**" for a Luxembourg third-party AIFM.

1. Why should we establish an In-House AIFM if we can also hire the services of a Host AIFM?

USFM usually prefer to manage their European funds through an AIFM established in the EU because this provides access to an EU marketing passport, which facilitates the distribution of their European funds across the EU. The services of a Host AIFM can be hired for this purpose. The Host AIFM is responsible for portfolio and risk management, but the portfolio management (buy-and-sell decisions) is typically delegated to the USFM by the Host AIFM. Alternatively, the USFM acts as adviser to the Host AIFM. The Host AIFM is required to conduct oversight of the USFM in its capacity as delegated portfolio manager. USFM sometimes view this as a model where they pay a third party for oversight of their own US organization in exchange for obtaining an EU marketing passport.

Although the Host AIFM model is tried and tested and is enshrined in Luxembourg law, large USFM often choose to launch their own In-House AIFM to avoid interference by a Host AIFM in their fund marketing and deal processes. While a Host AIFM is bound by confidentiality, confidentiality concerns can also still be a reason to move from a Host AIFM to an In-House AIFM. Confidentiality concerns originate from the fact that Host AIFMs often also act for the USFM's (US) peers and therefore have insight into the deal processes of both the USFM and its peers, which entails a risk of accidental disclosure. In some cases, the driver to launch an In-House AIFM also comes from investor preferences or is driven by EU tax substance preference, especially when the USFM has one or more funds with a European investment strategy. Finally, another consideration for some USFM is that their In-House AIFM can serve as an additional source of earnings, for example by generating fees in addition to the usual management fee or fees from the management of funds sponsored by third parties.

2. What is cost break-even point an in-house AIFM and a host AIFM in terms of European assets under management (AUM)?

Cost aspects are a consideration when USFM decide whether to launch an In-House AIFM. Generally, the cost of managing European funds through a Host AIFM becomes comparable to the cost of operating an In-House AIFM once the assets under management (AUM) in European funds reaches EUR 5-6 billion. If the USFM already has an existing presence in Luxembourg (such as office space and certain qualified personnel), the cost break-even point is typically around EUR 2–3 billion of European AUM as the incremental cost of the In-House AIFM is lower in such cases. As noted in question 1 above, costs are certainly not the only factor in deciding whether to establish an In-House AIFM. See question 15 below regarding the question of who bears the costs of an In-House AIFM.

3. Does an In-House AIFM require physical footprint in Luxembourg?

Yes, an In-House AIFM requires a genuine physical presence in Luxembourg. The In-House AIFM must have office premises in Luxembourg that are *exclusively* available to its staff, along with dedicated office and IT infrastructure. Additionally, the In-House AIFM must employ a team that is experienced and qualified to perform its core functions. The approval process for an In-House AIFM, which is conducted by the Luxembourg regulator (**CSSF**), puts much focus on the robustness of the organization. The In-House AIFM must be robust enough to function on a stand-alone basis, be part of the value chain and function as a genuine decision-making hub especially when it comes to portfolio management, risk management, and valuation. The overarching idea is that the In-House AIFM's organization should be structured in a way that assures the CSSF there will be no future functionality issues.

4. What are the Luxembourg personnel requirements of an In-House AIFM?

There is no fixed framework, but it is generally accepted that all relevant AIFM functions require appropriate staffing to ensure that conflicts of interest are avoided. For example, officers involved in portfolio management (risk takers) cannot simultaneously be responsible for risk management. Typically, an In-House AIFM requires at least 5-8 full-time employees (**FTEs**). The employees should in principle be professionally based in Luxembourg (cross-border workers meet this test).

Usually, at least 3 or 4 of the FTEs handle the key day-to-day functions of the In-House AIFM at a senior level and are referred to as 'conducting officers' (**Conducting Officers**). The Conducting Officers are typically already employed by the entity applying for authorization at the time the In-House AIFM application is submitted to the CSSF. However, if the designated employees are employed by a group entity, the CSSF does not require immediate transfer and is comfortable with these employees being reassigned to the In-House AIFM once the authorization is granted. Good repute and experience requirements apply to the Conducting Officers.

USFM usually adopt a ramp-up approach when organizing an In-House AIFM. As such, they often start with the minimum number of FTE that is required for purposes of the CSSF authorization and gradually expand as additional strategies and AUM are added to the In-House AIFM. During the license application process, the CSSF requires the In-House AIFM to clearly demonstrate how its staffing plan will accommodate and scale with future growth. We usually see that the In-House AIFM team grows beyond 8-10 FTE when AUM volume through European funds reaches EUR 4-5 billion and several strategies (e.g. credit, buy out and fund of funds) are under management.

5. What is the exact role of Conducting Officers?

The Conducting Officers assume responsibility for portfolio management, valuation, risk management and compliance. Each Conducting Officer is assigned responsibility for one of these functions and may in addition assume certain other compatible functions.

Especially for USFM, it is key to emphasize that the EU concept of portfolio management refers to the investment decision-making process, particularly the buy-and-sell decisions. It does not extend to the operational management of the underlying assets. Accordingly, the Conducting Officer responsible for portfolio management is not required to oversee the day-to-day operations of the acquired assets.

The Conducting Officers are embedded in the relevant processes for which they have responsibility and cannot be bypassed. For example, if a valuation is determined by a USFM and such valuation also impacts a European fund managed by the In-House AIFM, that valuation must be reviewed and vetted by the responsible Conducting Officer.

6. What is the typical profile of the Conducting Officers?

The Conducting Officer for portfolio management usually has transactional, fund product design and distribution experience. The Conducting Officer for valuation usually has an economic or finance background and had ample exposure to fund administration and accounting processes. The Conducting Officer for risk management usually has a financial/econometrics background. The Conducting Officer for compliance usually has a strong regulatory background.

Conducting Officers are generally expected to have at least 6-8 years of relevant professional experience. It is typically required that at least two Conducting Officers - out of the minimum of three or four - are employed on a full-time basis by the AIFM, with their professional address located in Luxembourg.

USFM often seek to repurpose existing Luxembourg employees (for example those responsible for the USFM's Luxembourg special purpose vehicles) for In-House AIFM roles.

These employees typically have a background in accounting, law, or tax. Those profiles are usually not fit for Conducting Officers, but those employees can assume other In-House AIFM roles of a back-office nature. They can do so for instance on a part-time basis, under so-called global employment contracts. Under this type of arrangement, the employee is effectively employed by multiple entities within the same group, allowing their services to be allocated across those entities in a structured and compliant manner.

7. Is it easy to find the required profiles in the Luxembourg market?

Finding the required profiles in the Luxembourg market can be particularly challenging for smaller (US)FM, while large and well-known (US)FM generally do not have issues sourcing the right people. Conducting Officers are usually recruited from Host AIFMs, other In-House AIFMs and financial institutions. In some cases, they already had the title of Conducting Officer, while in other cases they have familiarized themselves with the relevant functions but did not yet hold the title of Conducting Officer.

Luxembourg offers attractive personal income tax regimes for individuals becoming tax resident in Luxembourg. The carried interest, inpatient and profit-sharing bonus tax regimes have significantly increased the country's appeal for such individuals. It is common to see senior professionals recruited from abroad, such as Amsterdam, London, and Paris, to staff In-House AIFMs.

As noted in question 6 above, if the USFM has existing employees in Luxembourg, they can assume certain In-House AIFM roles (possibly on a part-time basis).

8. How to design the In-House AIFM's board?

An In-House AIFM generally requires a minimum of 3 board members, the majority of whom must usually have their professional address in Luxembourg. Board members may also hold a Conducting Officer function within the In-House AIFM, but it must be ensured that it does not give rise to any conflicts of interest and less than 50% of the board members may hold a Conducting Officer function. Sourcing suitable board members is generally not problematic.

9. What are the minimum equity requirements for an In-House AIFM?

The In-House AIFM must in any event have minimum capital of EUR 125,000. If the AUM exceeds EUR 250 million, additional capital must be available in the form of non-speculative liquid assets. The required additional capital equals two basis points (**bps**) of the AUM in excess of EUR 250 million. The sum of the minimum capital plus any required additional capital is capped at EUR 10 million but can never be less than 25% of the In-House AIFM's fixed annual overhead costs. By way of illustration and ignoring overhead costs, for AUM of EUR 5 billion, the minimum capital plus additional capital equals EUR 1,075,000.

Separately, the In-house AIFM must also maintain additional own funds equalling by default 1bps of AUM or take out appropriate professional indemnity insurance to cover claims for negligent performance. If the In-House AIFM opts for insurance coverage the policy should cover at least 70 bps of AUM per claim, with a maximum of 90 bps of AUM for aggregate claims over the years. In our experience, most in-house AIFMs prefer to rely on their own additional funds rather than insurance as insurance is costly. These additional own funds must also be available in non-speculative liquid assets. By way of illustration, for AUM of EUR 5 billion, the default additional own funds requirement of 1 bps amounts to EUR 500,000.

Finally, the In-House AIFM must be able to demonstrate how it will maintain its required own funds through profitable business operations and how it will increase the own funds as its AUM grows.

10. Are there any qualification requirements for the In-House AIFM's shareholder?

Yes, there are, but these are generally not problematic to navigate for sizable USFM. The CSSF requires full and continuous understanding and transparency over the shareholder structure. The shareholder of the In-House AIFM must be able to demonstrate that it can ensure that the In-House AIFM meets both the initial and the ongoing (as AUM grows) capital requirements of the In-House AIFM by deploying its capital which must be kept available in non-speculative liquid assets.

11. What is the timeline for launching an In-House AIFM?

The preparation to file for the license application typically takes 6 months and the approval process with the CSSF typically requires 9 to 12 months. Therefore, an overall timeline of 15-18 months should be expected for launching an In-House AIFM.

After the file is submitted, it is customary to organize an in-person meeting with the CSSF, with the USFM in attendance. The purpose of this meeting is to discuss the plans and identify potential hurdles. It is common for the CSSF to already have reviewed the application file and even posed some initial questions before this meeting.

The actual timeline is largely determined by the responsiveness of the CSSF, which generally corresponds to that of the USFM and its legal advisers. As a result, the USFM and its counsel have significant influence over the pace of the process.

12. What are the core elements of the application file?

The CSSF's core focus is whether the headcount of the In-House AIFM matches its business needs in terms of both size and quality. Other key focus points are the business plan, the growth and delegation of functions plan, and how the Luxembourg organization and headcount align with these plans.

The CSSF aims to avoid thinly staffed and inexperienced In-House AIFMs, as these would create a heavy oversight burden for the CSSF. This focus also serves to protect Luxembourg's reputation as investment management hub. The CSSF requires robust and up-to-date policies and procedures to ensure that the In-House AIFM's internal governance and operations comply with applicable regulatory requirements and mandatory principles. For example, appropriate policies covering compliance, AML/CFT, delegation, risk management, valuation, and remuneration must be established and properly implemented.

13. What are the permitted activities of an In-House AIFM?

An In-House AIFM is permitted to manage private funds and special purpose vehicles controlled by such funds. An In-House AIFM is permitted to manage different investment strategies, provided that such strategies are approved by the CSSF through a license extension process. In this context, the CSSF's assessment will focus on the matters outlined in question 4 above (Luxembourg personnel requirements) in relation to the relevant strategy. If the In-House AIFM manages credit funds, the CSSF may require that its license also covers the underlying entity (i.e., an In-House AIFM managing a credit fund lending to private companies may have to hold a private equity license too).

Subject to obtaining the necessary top-up permissions, an In-House AIFM can also manage separate accounts, provide investment advice, act as a third-party portfolio manager, and perform credit servicing activities. The In-House AIFM can also domicile special purpose entities controlled by the Luxembourg funds under its management. However, we do observe that in-house Luxembourg service companies for SPVs and In-House AIFMs are typically separate legal entities with separate IT infrastructure, although they often share the same office premises (but with *segregated* office space exclusively accessible for the In-House AIFM team).

14. What are the key transition considerations when switching from a Host AIFM to an In-House AIFM?

In most cases, the transition from Host AIFM to In-House AIFM will require amendments to the fund documentation. In addition, the agreement with the Host AIFM will need to be terminated and other service provider agreements may need to be reviewed and updated, as appropriate, to reflect the appointment of the In-House AIFM. The analysis must be carried out on a case-by-case basis.

Limited partner consent is typically not required to switch from a Host AIFM to an In-House AIFM. Notification to the limited partners is generally sufficient.

The final step consists of notifying the CSSF of the transition. This requires coordinated notifications from the Host AIFM and the In-House AIFM to ensure a seamless transition, particularly to avoid any disruption to existing arrangements, including marketing activities.

The transition is typically implemented as a phased, step-by-step process. The USFM may decide that the In-House AIFM will assume certain functions at a later stage and continue to rely on the Host AIFM for those functions during the interim period. The USFM may also decide that the In-House AIFM will only manage new funds and will thus not take over the management of the funds already launched and managed by the Host AIFM. Alternatively, the USFM may decide that the In-House AIFM will only manage funds having certain strategies while leaving the management of others with the Host AIFM.

15. Who bears the costs incurred by the In-House AIFM?

The answer depends ultimately on the fund expenses clause in the fund documents. The fee charged by a Host AIFM is typically classified as a fund expense and is therefore borne by the investors. Fund documents are often not clear about whether the costs of an In-House AIFM should be paid out of the fund management fee (and thus borne by the USFM) or can be charged as a fund expense to the fund(s) managed by the In-House AIFM. This point should be carefully discussed and clarified with the relevant fund(s)' investor base. Even if the launch of the In-House AIFM will only take place in the distant future, it's advisable to draft the fund expense clauses for new funds with the anticipated launch of the In-House AIFM in mind.

16. Does the entire fund management fee flow through the In-House AIFM?

USFM usually prefer splitting the fund management fee, whereby the In-House AIFM only receives the amount needed to cover its costs plus a markup and the remainder is paid directly to the USFM by the fund. Running the entire

management fee through the In-House AIFM on a back-to-back basis is generally not favoured by USFM and may create additional vulnerabilities from a Luxembourg tax perspective.

17. What about the CSSF's continuing oversight function?

The CSSF is responsible for continuing oversight, which usually focuses on topical matters such as AML, valuation and remuneration. The CSSF oversight team operates independently from its authorization team, and they do not necessarily share the same views.

Oversight is performed on an ad-hoc basis, with the CSSF randomly selecting In-House AIFMs. However, certain triggering events, such as the departure of a Conducting Officer, can initiate an on-site inspection. We have seen the CSSF announcing on-site visits about a week in advance. Prior to the visit, the CSSF generally requests certain documents, including agreements and board minutes. During an on-site visit, the CSSF may interview Conducting Officers, board members and staff separately. To prepare for these visits, In-House AIFMs may ask their Luxembourg counsel to conduct annual health checks or to conduct a mock inspection.

Conducting Officers have a strong interest in ensuring that CSSF inspections produce favourable outcomes, as their professional reputation with the CSSF is at stake. In-House AIFMs that are not adequately organized or robust from a governance and operational perspective may face difficulties in attracting and recruiting suitably qualified Conducting Officers.

If you have further questions on this topic, feel free to contact one of our colleagues below.

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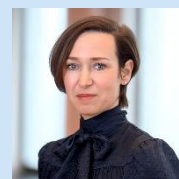
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