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# The Alternative Investment Fund Managers Directive – What Does The Future Hold?

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December 2010



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## 1. INTRODUCTION

On Friday 5 November 2010 Gide Loyrette Nouel LLP London hosted a client seminar on the implications of the incoming Alternative Investment Fund Managers Directive (“the Directive”) which recently reached the final stages of negotiations in the EU. This note is a summary of the presentation given by Lucy Frew.

This Directive was published by the European Commission in its original form in April 2009, and is the EU response to the growing pressure for increased regulation of the alternative investment funds industry in light of the recent economic crisis, the Madoff fraud, political pressure in relation to remuneration in the financial services industry, the Lehman collapse and issues surrounding the liability of custodians.

On 26 October this year, agreement was finally reached between the European Parliament, European Council and European Commission after 18 months of uncertainty and approximately 2000 amendments proposed by MEPs. The agreed form of the Directive, while still posing problems, is far more workable than many of the previous proposals. Nonetheless, this Directive, which aims to introduce a harmonised framework for all alternative investment fund managers (“AIFM”) and alternative investment funds (“AIF”) operating in the EU, will have far reaching effects for the asset management industry for several reasons.

Firstly, it will apply to EU AIFMs, as well as to non-EU AIFMs who manage or market AIFs in the EU. Secondly, the definition of an AIF itself is very broad, including all funds except UCITS so that managers of hedge funds, private equity funds, commodity funds, venture capital funds, real estate funds and investment trusts are all within the scope of the Directive. Although there are provisions for “lighter touch” regulation whereby a smaller AIF need only register with and provide information to its home regulator, such smaller AIFs will not get the benefit of the rights under the Directive, most notably the EU passport. In order to obtain these benefits, they must opt in and comply with all provisions of the Directive.

The European Commission itself estimates that around 30% of hedge fund managers, managing almost 90% of the assets of EU-domiciled hedge funds, will be caught by the Directive, and that it will also apply to almost half the managers of other AIFs including private equity funds.



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## 2. MAIN PROPOSALS

- All AIFMs must be authorised in order to manage one or more AIF;
- AIFMs will be supervised by their home state competent authority;
- Capital requirements of at least EUR 125,000 plus additional own funds or insurance to cover negligence liability risk;
- New conduct of business standards, with systems in place to manage risks, liquidity and conflicts of interest;
- AIFMs to have remuneration policies and practices;
- New procedures for independent valuation of AIF assets;
- Restrictions on the delegation of AIFM functions;
- Restrictions regarding depositaries (for example, who can act as a depositary and increased liability of the depositary);
- Enhanced transparency including the provision of annual reports to regulators and increased disclosure to investors;
- Special provisions regarding managing leveraged AIFs and AIFs which acquire control of non-listed companies and issuers;
- Introduction of an EU passport under which AIFMs can potentially market AIFs across the EU subject to compliance with the Directive and various conditions.
- Imposing conditions to deal with 'the third country issue' i.e. regarding EU AIFMs wishing to manage or market non-EU AIFs in the EU, and non-EU AIFMs, wishing to market EU or non-EU AIFs in the EU.
- Wide powers of inspection and intervention for supervisors, particularly the newly created European Securities and Markets Authority ("ESMA").



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### 3. IMPLEMENTATION TIMETABLE

On 11 November 2010 the European Parliament voted overwhelmingly in favour of the current draft of the proposals. It is anticipated that the text will be published in the Official Journal of the European Union, at which point it becomes a legally binding act, in early 2011. Following this, there will be a two year consultation period overseen by ESMA during which the secondary rules will be formalised, ending with the deadline for transposition of the legislation in Member States in early 2013.

### 4. THIRD COUNTRY ISSUES

The EU passport, which will be available to AIFMs subject to the requirements of the Directive, will allow those AIFMs to market AIFs in Member States other than their home state, giving increased flexibility and certainty. This will initially be available to EU AIFMs and EU AIFs only, with the passport "switched on", in principle, to non-EU AIFMs and non-EU AIFs in early 2015, two years after the transposition date of the Directive. Non-EU AIFMs will be assigned a host Member State (the "Member State of reference") to which their management activities are most closely related, either because they manage AIFs in that Member State, or because they have the most assets under management or investors in that Member State. Throughout this two year transitional period from 2013 to 2015, national regimes will remain in place for EU AIFMs intending to market non-EU AIF without a passport and non-EU AIFMs intending to market AIFs in the EU without a passport. These national private placement regimes are optional for Member States and individual Member States are free to impose additional conditions to those minimum requirements imposed by the Directive. However, it is anticipated that the FSA, as competent authority in the UK, will maintain a sensible and workable regime. In principle, three years after the EU passport has been made available to non-EU AIFMs and non-EU AIFs (so in around 2018), the national private placement regimes will be "switched off". Both the "switching on" of the passport in around 2013 and the "switching off" of national private placement regimes in around 2018 are subject to approval by ESMA. National private placement regimes will not be "switched off" unless the passport is "switched on".

In addition to compliance with the Directive itself, there are certain conditions which must be complied with before marketing by non-EU AIFMs, or of non-EU AIFs, can take place. Which of the conditions need to be met will depend on whether the AIFM, AIF or both, are non-EU. The most stringent of these will apply to non-EU AIFMs marketing a non-EU AIF into the EU, where all four conditions, in addition to the Directive, will need to be met.

The conditions are:

1. Co-operation arrangements for exchange of information between the relevant EU competent authority and the third country supervisory authority.
2. The relevant third country must not be listed as a non-cooperative country/territory by the Financial Action Task Force on anti-money laundering and terrorist financing.
3. The relevant third country in which the AIF is established must have signed a tax information sharing agreement with each of the competent authorities of the AIFM and the competent authorities where the AIF is marketed which fully complies with Article 26 of the OECD Model Tax Convention and ensures effective exchange of information in tax matters.



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4. Non-EU AIFMs wishing to manage or market either EU or non-EU AIFs under the EU passport must have a legal representative established in its host Member State who can be the contact person for investors, ESMA and the competent authorities, and will, along with the AIFM, be jointly responsible for compliance with the Directive.

## 5. OTHER KEY ISSUES

### 5.1 The Role of ESMA

During the initial two year consultation period between publication of the Directive and the deadline for transposition by Member States in around 2013, ESMA will have a key role in determining third country issues. In particular, it will recommend, on the basis of various factors but particularly the level of EU investor access, whether the passport will be activated and whether the private placement regimes will be "switched off". They will also be heavily involved in the negotiation of cooperation agreements and advising supervisory authorities on how to apply the exemption on grounds of incompatibility to non-EU AIFMs who wish to take advantage of this.

ESMA will have powers to intervene in situations where there appears a risk to the integrity of financial markets in addition to its existing emergency powers. Under these they may request that competent authorities prohibit the marketing in the EU of AIFs managed by non-EU AIFMs or non-EU AIFs marketed in the EU by EU AIFMs. They may also impose restrictions on non-EU AIFMs where it is felt that there is an excessive concentration of risk in a specific market on a cross border basis, or where the activities of the non-EU AIFMs could potentially create a counterparty risk to a credit institution or other systemically relevant institution.

### 5.2 Delegated Acts

Delegation and sub-delegation, including of portfolio and risk management, and to third country service providers, will remain possible under the Directive but will be subject to increasingly stringent conditions.

Firstly, and most importantly, the AIFMs will remain liable to the AIF and the investors, despite having delegated particular roles or functions to others. They must therefore ensure that those they choose to carry out the delegated acts are suitable and will comply fully with the Directive. Secondly, before each delegation takes place, the AIFM must notify the home Member State regulator of their intentions. They will not be permitted to delegate to the extent that they become a "letterbox entity" who does not in fact carry out any meaningful activities in relation to the AIF.

The Directive also gives additional powers to the European Commission on matters such as the criteria to be used when assessing whether AIFMs are acting in the best interests of investors, whether conflicts of interest have arisen, the specifications of liquidity management systems to be used, valuation methodologies, and ensuring that the use of delegation does not render an AIFM a "letterbox entity", as discussed above.



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### 5.3 Marketing

The EU passport itself, when activated, will permit authorised AIFMs to market to professional investors only. It will be up to individual Member States to determine whether they will allow marketing activities to be targeted at their retail investors as well. In initial proposals for the Directive, marketing had been defined as "any general offering or placement of units or shares in an AIF to or with investors domiciled in the [EU] regardless of at whose initiative the offer or placement takes place". Now, however, the effects of the marketing provisions have been diluted with the result that reverse solicitation or "passive marketing" no longer falls within the scope of the Directive. Thus investors who want to invest in a specific AIF may do so, as long as they approach the fund themselves. In this way a non-EU AIF may still have many EU investors. Sophisticated and experienced investors will no doubt know where to find AIFs, especially ones which have effectively used active marketing so long as they are permitted to do so.

### 5.4 Acquisition of Non-Listed Companies and Issuers and "Asset Stripping"

When the Directive comes into force, AIFMs will have to fulfil notification requirements when their AIFs acquire shares so as to pass through the 10%, 20%, 30%, 50% and 75% voting right levels of non-listed companies, except where the company involved has fewer than 250 employees and where the annual turnover or balance sheet does not exceed EUR 50 million or EUR 43 million respectively.

Furthermore, where an AIF acquires 50% or more of the voting rights in a non-listed company or issuer, the AIFM involved will be required to disclose to the board and employee representatives what their intentions are for the business going forward and whether there are likely to be any repercussions in terms of employment. They must also include supplemental disclosures on the controlled company within the annual reports of the AIF holding the voting rights. This information must be readily available to both investors and the employee representatives of the relevant controlled company.

These requirements, introduced as a response to a perceived growing distrust of the way private equity and hedge funds do business, will have a significant impact on funds and have caused great concern in the sector that it will now be necessary to disclose more highly sensitive information.

Other proposals are aimed at preventing "asset stripping" by funds of their non-listed investee companies/issuers for two years after their acquisition of control, by preventing AIFMs themselves from facilitating, and requiring them to use their "best efforts" to prevent, any "distribution, capital reduction, share redemption and/or acquisition of own shares by the company...".

### 5.5 Depositaries

Under the Directive, the AIFM must ensure that there is a single depositary established for each AIF it manages. The depositary will be responsible for monitoring cash flows and the safekeeping of assets, but may delegate and sub-delegate these roles where it can be shown objectively that this is both justifiable and that their chosen sub-delegate is suitable.

There are stringent restrictions on who can act as a depositary. Only an investment firm, credit institution or entity as permitted under the UCITS Directive may be a depositary. A depositary selected must also be in the same Member State as the AIF itself. In relation to non-EU AIFs only, the depositary may be a credit institution or other entity of the same nature, and may be in the third country of the AIF if prudential regulation and supervision of that third country is equivalent to that under EU law. Alternatively, the depositary should be based in the home Member State or Member State of reference of the AIFM.



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Originally, proposals for the Directive meant that depositaries would be subject to unlimited liability for losses suffered by the AIFM, AIF and investors. This would have been unacceptable to many institutions currently performing this function and might have led to those currently performing this role for AIFs refusing to do so in future. However, these provisions have been altered and are now, while still posing serious issues, at least more realistic in their apportioning of potential liability.

A sub-custodian may take on the liability subject to strict due diligence and other conditions, and only where the AIFM can demonstrate that there is an objective reason for such delegation. The Directive distinguishes between the loss of financial instruments held in custody, and any other losses. In relation to financial instruments lost by a third party, the depositary will remain liable unless it has contractually transferred liability for that loss to that third party, rendering the latter directly liable to the AIF or its investors, in which case the depositary can discharge itself of liability if it can prove it has duly performed its due diligence duties and met other specific requirements for delegation. In relation to the loss of other assets in its custody the depositary will be liable unless it "can prove that loss is result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite its reasonable efforts". Finally, in relation to any other losses, the depositary will only be liable in the case of intent or negligence.

It remains to be seen which entities will be willing and able to act as AIFMD depositary providers, and what the costs will be. It will also be necessary to work out how they may work in practice with, for example, multi-prime broker arrangements.

## 5.6 Prime Brokers

While the agreed version of the Directive recognises that AIFs use prime brokers, it specifies that these prime brokers should not also be appointed as the depositary for that AIF unless it has functionally and hierarchically separated the performance of these two functions and any potential conflict of interest properly identified, managed and disclosed to the investors of the AIF. As prime brokers are regarded as essentially acting as counterparties to the AIF, it is considered that they will not be able to act in the best interests of that AIF as is required of the depositary role.

## 5.7 Valuation

AIFMs will be required to implement an independent valuation of the net asset value of the AIFs they manage at least once a year. This may be carried out either by an independent valuer, or by the AIFM itself, provided this is done in a way that is "functionally independent" of portfolio management. Either way, the AIFM will be ultimately responsible for ensuring a proper valuation.

## 5.8 Leverage

AIFMs will also be responsible for setting leverage limits for each AIF under management, and must at all times be able to demonstrate both that the limits set are reasonable, and that they are in compliance with them. The competent authorities of the home Member State of the AIFM have the power to impose their own limits where they feel that the stability and integrity of the financial system may be threatened by the AIFM's activities. ESMA too may also determine that an AIFM's leverage is too high, and in this case they may issue competent authorities with advice specifying what remedial action should be taken to combat any potential risks.



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## 5.9 Securitisation and Short Selling

The European Commission is planning to adopt conditions which must be complied with before an AIFM is permitted to invest in securities on an AIF's behalf. Firstly, the originator, the sponsor, or the original lender must retain an economic interest in the securities of not less than 5%, and, secondly, qualitative requirements must be met by AIFMs who invest in these securities.

Regarding short selling the Directive is silent. Previous proposals would have effectively prevented naked short selling by requiring AIFMs to have prior arrangements to borrow in place, along with requiring disclosure of short provisions to the regulator. These provisions have now been removed and it is anticipated that the issue will be dealt with under separate forthcoming European Commission legislation.

## 5.10 Remuneration

ESMA has been given the role of establishing "sound remuneration policies" for application across the AIFM sector and ensuring that these are consistent with remuneration policies in the wider financial services sector, to prevent individuals pursuing short term profits at the risk of long term gains. AIFMs must therefore have remuneration policies and practices that are "consistent with sound and effective risk management" covering all staff who have a "material impact on the risk profiles" of the AIFs under management. These policies should be appropriate to the size, internal organisation and scope, nature and complexity of the activities of the AIFM.

The remuneration wording in AIFMD is very similar to that in CRD 3, where the proportionality principle has been interpreted very positively by FSA with regards to its application to hedge fund managers. However, it is not yet clear whether the proportionality provisions in AIFMD can be interpreted by the FSA in a similar manner given that, unlike CRD 3 which applies to a broad range of firms, its specific focus is the investment fund industry.

## 6. IMPACT OF THE DIRECTIVE

This Directive will have a significant impact on the asset management industry, imposing as it does a heavy compliance burden in terms of time and cost. However, the current version of the text is less onerous than the original proposals, in that the most damaging provisions have been removed, leaving the text relatively workable.

Despite the fact that the national private placement regimes will remain in place until at least 2018, AIFs and AIFMs should start to consider now what the Directive means for their businesses; whether they should relocate or to how they will comply. For example, some private equity funds may choose to relocate outside the scope of the Directive to meet the needs of their investors, who may prefer a less onerous disclosure regime for their target company. Other investors may welcome, and indeed require, the more stringent regulation imposed by the Directive in the wake of the economic crisis. Ultimately, larger managers will be able to finance, and make a strategic virtue of, compliance with the AIFMD. UCITS have gained the benefit of brand recognition outside Europe and the same benefit may be achieved for AIFMD funds. Some AIFMs will wish to benefit from the passport opportunities offered by the Directive. It is certainly possible to see the potential benefits of a passport as opposed to 27 separate national private placement regimes especially as a number of EU states currently have none. Many AIFs are currently targeted only to investors in a limited number of Member States but this could change if a passport was available.



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It remains to be seen the route that will be taken by the majority of affected funds, but anecdotal evidence so far seems to suggest that few funds will relocate completely and that many may opt instead to set up parallel funds, seeking to keep regulatory compliance costs lower where possible. A number of AIFMs are exploring the extent to which their strategy may work within a regulated UCITS or “Newcits” structure. It may be that the Directive could mean broadly equivalent costs of compliance to costs of compliance for a UCITS.

There will also be challenges for other parties: the newly created ESMA will have a wide range of tasks requiring a great deal of resources, including facilitating and determining the content of cooperation agreements between regulators, and depositaries will face difficult decisions regarding their increased liability under the Directive. ESMA will need to recruit heavily and hit the ground running in order to be effective.

The Directive is a framework directive (Level 1). This means that the agreed legislation contains legal principles which are expected to be supplemented with more detailed rules (Level 2) to be adopted by the European Commission with the assistance of ESMA. The way this works is that the European Commission issues a mandate to ESMA to produce technical advice, which ESMA will consult on and provide. The European Commission will then draft Level 2 implementing measures (based on the technical advice) and submits them for discussion to the European Securities Committee (composed of Member State ministry and supervisory representatives). Following negotiations in the Committee and discussions with the European Parliament, the European Commission will adopt the final Level 2 measures. Structured industry input will be expected all throughout the process of development and negotiation of the Level 2 measures.

It is anticipated that ESMA will be consulting widely over the next two years, and it is therefore key that representatives of the investment fund industry are proactive in making their views known and maintaining political pressure so that the EU and particularly UK fund management industries remain competitive.

While AIFMs should start to consider now what the Directive means for their businesses, until details become clearer as the Level 2 process is progressed, it is probably too early to make any significant decisions such as relocation, or to do much more than contingency planning. Moreover, while there is no doubt of the significance of the Directive for the investment management industry, fulfilling the needs of investors, rather than regulation, is likely to remain AIFMs’ key consideration.

Gide Loyrette Nouel LLP intends to play an active role providing input in relation to the detailed rule-making process (known as Level 2). Lucy Frew would be happy to discuss with individual firms and can be contacted at [lfrew@gide.com](mailto:lfrew@gide.com) or on + 44(0)20 7382 5523.

This publication is intended to highlight certain issues. It is not intended to be comprehensive or to provide legal advice.