

## AIFM Directive – A new beginning

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After more than a year of intense negotiation and political manoeuvring, the Alternative Investment Fund Managers Directive (the "AIFMD") was finally adopted on 11 November 2010 by a plenary vote in the European Parliament. Through this vote, the Parliament gave its official seal of approval to a draft of the Directive proposed by the EU Council of Ministers, and brought to a close a protracted and unpredictable legislative process. Once the Directive comes into force in June 2011, the deadline for its implementation by EU Member States will be two years later in 2013, at which point various elements of the new framework will be phased in over a staggered timetable. This article provides an overview of the principal provisions of the AIFMD and an appraisal of its implications for the funds sector.

It is important to note that the AIFMD only represents the first step in a legislative process that will effectively continue until the deadline for implementation in 2013. The AIFMD is a so-called "Level 1" framework directive, and is due to be supplemented by a series of more detailed "Level 2" measures determined by the European Commission on the basis of technical advice provided to it by the European Markets and Securities Authority ("ESMA"), and ultimately, by "Level 3" guidance issued by ESMA. Additionally, it is likely that Member States will retain some room for manoeuvre in their implementation of certain provisions of the AIFMD. This means that at present, the new regime is still very much under construction.

### Scope

The AIFMD applies a basic catch-all approach to alternative investment fund managers ("AIFM") that engage in EU-related management or marketing activities, subject to specific exemptions. An AIFM is defined as any legal person whose regular business is managing one or more alternative investment funds ("AIF"), with an AIF being defined as a non-UCITS collective investment undertaking of any legal form which raises 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. Subject to applicable exemptions, the Directive applies to all of the following AIFM:

- all EU AIFM managing EU AIF or non-EU AIF, irrespective of whether they are marketed in the European Union or not;
- non-EU AIFM managing EU AIF, irrespective of whether they are marketed in the European Union or not; and
- non-EU AIFM marketing EU AIF or non-EU AIF within the European Union.

Many of the exemptions proposed in the course of the legislative process have made it into the final version of the AIFMD, with managers of pension funds, supranational institutions, central banks, governmental bodies, employee participation or savings schemes, securitisation special purpose entities, insurance contracts and intra-group arrangements outside the scope of the Directive. AIFM which manage AIF with a cumulative value of less than €100 million, or €500 million if the AIF are unleveraged and subject to a minimum five-year lock-in period, are automatically subject to a light-touch regime (consisting only in mandatory registration and reporting) but can voluntarily opt in to the full Directive regime (for example, if they wish to obtain the benefit of passporting – see below).

Additionally, the AIFMD exempts listed or non-private-equity holding companies which operate long-term business strategies through their subsidiaries or associated companies (thus potentially benefiting certain listed, self-managed investment trusts), and significantly, it also excludes from its scope "joint ventures" and managers of "investment undertakings (such as family office vehicles) which invest the private wealth of investors without raising external capital". These structures are not further defined but may well be the object of additional European guidance – or may simply remain open to individual interpretation by Member States – as the implementation process unfolds.

### Authorisation

AIFM (whether EU AIFM or non-EU AIFM) that are within the scope of the Directive are generally required to obtain authorisation in order to carry on their management or marketing activities. However, non-EU AIFM that wish to market AIF in a Member State under a local private placement regime will not require authorisation for this purpose (although they will need to comply with certain Directive requirements, as explained below). The AIFMD also contains grandfathering clauses under which AIFM managing closed-ended AIF which will not make additional investments following the effective date of the AIFMD (in mid- 2013), or which are closed to further subscriptions and will expire in mid-2016 at the latest, will not require authorisation to manage those AIF.

In order to be granted authorisation from its home Member State (or, in the case of a non-EU AIFM, from its “Member State of reference”), an AIFM will need to submit information on various aspects of its activities (including its structure, constitution, managers, shareholders, investment strategy and remuneration policy), and importantly, provide evidence of its ability to comply with the Directive, its capital adequacy, the reputability and experience of its management and the prudence of its shareholders.

Given the pending dismantlement of the FSA and reform of the regulatory institutional landscape in the UK, it is not yet clear which UK authority will have principal responsibility for authorising AIFM, whether the Bank of England’s new Prudential Regulatory Authority (PRA) or the Consumer Protection and Markets Agency (CPMA).

## Capital and own funds

AIFM are subject to capital requirements starting at €125,000 for external AIFM and €300,000 for internally managed funds. AIFM managing portfolios exceeding €250 million must provide an additional amount of own funds corresponding to 0.02% of the excess amount, subject to an overall cap of €10 million for initial capital and own funds. Member States may allow AIFM to provide up to 50% of the additional amount of own funds in the form of a guarantee from a bank or insurance undertaking. Additionally, AIFM are required to have additional own funds or professional indemnity insurance to cover potential professional liability risks.

## Organisational and conduct-of-business principles

AIFM are required to apply due skill, care and diligence, to act in the best interests of investors, and to identify and seek to avoid conflicts of interest. They are also required to separate the functions of risk management from operating units (including portfolio management), implement risk management systems and comply with specified due diligence standards when investing on behalf of AIF. For each AIF it manages (except for unleveraged, closed-ended AIF), an AIFM must employ a liquidity management and monitoring system, conduct regular stress tests, and ensure that the liquidity profile of an AIF matches its redemption policy.

## Valuation

The valuation provisions in the AIFMD defer to the valuation principles of the law of the jurisdiction in which the AIF is registered and to those contained in the AIF rules or instruments of incorporation. Certain additional obligations (e.g. applicable valuation procedures, frequency of valuations for open-ended funds) are due to be laid down by the European Commission in additional implementing measures following formal adoption of the AIFMD.

Valuation may be carried out by the AIFM or by an external valuer, provided that it is carried out independently from the AIF and from the portfolio management function. A depositary appointed for the AIF can act as its external valuer if it can separate its respective depositary and valuation functions. For open-ended AIF, valuation must be carried out at a frequency that is appropriate to relevant asset classes and to the redemption frequency. In the case of closed-ended AIF, additional valuations are required whenever the AIF increases or decreases its capital.

## Disclosure and reporting

For each EU AIF it manages and each AIF it markets in the European Union, an AIFM is required to prepare an annual report which must be provided to the competent authorities as a matter of course and to investors on request. This must be prepared by an EU auditor and contain, at the very least, information on the AIF’s balance sheet or statement of assets and liabilities, the AIFM’s activities, changes in information to be disclosed to investors, and remuneration for the financial year paid by the AIFM.

An AIFM must also, for each EU AIF it manages and each AIF it markets in the European Union, provide investors with minimum mandatory pre-investment information from the AIF’s investment strategy and objectives to its liquidity risk management arrangements and leverage levels.

AIFM must also regularly report information to competent authorities, including details of liquidity management and risk management arrangements, asset categories in which the AIF is invested, results of stress testing and, where an AIF employs leverage on a substantial basis, information on the use and sources of that leverage.

## Leverage

With regard to leverage, in addition to the reporting requirements outlined above, the AIFMD requires AIFM to set a maximum level of leverage which the AIFM may employ on behalf of each AIF it manages. The AIFM must also limit the extent of its right to reuse any collateral or guarantee that may be granted under a leveraging arrangement. It must be capable of demonstrating that leverage limits it sets are reasonable and that it complies with them at all times. The authorities of the home Member State of the AIFM may (following notification to ESMA, the European Systemic Risk Board and, if applicable, competent authorities of the AIF) set limits to leverage that an AIFM may employ, or impose other restrictions on the management of the AIF, if this is deemed necessary to prevent the build-up of systemic risk in the financial system or disorderly markets. This contrasts with the approach previously proposed by the Parliament, under which ESMA would have been tasked with setting limits to leverage.

## Delegation

An AIFM which intends to delegate one or more of its functions to a third party must notify its home Member State authorities before the delegation arrangements become effective. The AIFM must be able to provide objective reasons for the delegation, and the delegate must dispose of sufficient resources and be managed by persons of sufficient repute and experience to perform the tasks in question. Delegation must not prevent effective supervision of the AIFM or the AIFM's ability to act in the best interests of investors, and the AIFM must have selected the delegate with due care and retain an ability to monitor its activities. Where the delegation concerns portfolio or risk management, the delegate must be authorised or registered for asset management purposes and subject to supervision, or the delegation must have been approved by the competent authorities of the home Member State of the AIFM. Delegation of portfolio or risk management to non-EU entities is only permitted if there is suitable cooperation between the AIFM's home Member State and the relevant third country. The AIFM remains strictly liable for all functions it has delegated or the delegate has sub-delegated.

## Depositary

For each AIF they manage, AIFM are required to appoint a single depositary. For EU AIF, the depositary must have its registered office or a branch in the Member State where the AIF is authorised or registered. The depositary must be a European credit institution, a MiFID investment firm or any institution which has been determined by a Member State to be an eligible depositary under the UCITS Directive. Throughout a period of four years after the effective date of the Directive, a transitional provision will allow competent authorities to permit the appointment of credit institutions in Member States other than the Member State where the AIF is authorised or registered.

For AIF with a minimum five-year lock-in period that do not invest in financial instruments that are capable of being held in custody (which potentially includes certain real estate AIF) or which generally carry on private equity strategies, the depositary may also be a registered or regulated professional entity capable of providing sufficient guarantees to effectively perform the depositary function. The AIFM itself may not act as depositary in any instance, but a prime broker acting as counterparty to an AIF may do so if it can separate its depositary and prime brokerage functions.

For non-EU AIF, the depositary must be an entity subject to EU-equivalent prudential regulation and supervision which has its registered office or a branch in the third country where the AIF is authorised or registered, or in the home Member State or Member State of reference of the AIFM. Additionally, a depositary in a third country can only be appointed subject to the following conditions:

- There must be cooperation and exchange of information agreements between the Member States in which the non-EU AIF is marketed and the home Member State of the AIFM (if different).
- Depositaries in the third country must be subject to EU-equivalent prudential regulation and supervision.
- The third country must not be on the blacklist of the Financial Action Task Force ("FATF") on anti-money laundering and terrorist financing.
- There must be OECD-compliant tax information-exchange arrangements between the home Member State of the AIFM, the third country where the AIF is established, and each other Member State where the AIF is marketed.
- The depositary must be contractually liable to the AIF in accordance with the Directive requirements.

The depositary can delegate to third parties provided it does not intend to avoid the requirements of the Directive, it can demonstrate objective reasons for the delegation, it has exercised due care, skill and diligence in selecting and appointing the third party, and it has satisfied itself of the appropriate structure, expertise, regulation, supervision, auditing and operational procedures of the third party. Some of these requirements can be avoided if the law of a third country requires that certain financial instruments are held in custody by a local entity, if the depositary is instructed to delegate to the third-country entity by the AIFM or AIF, and if investors are duly informed.

In respect of liability for activities carried out by the depositary itself, the basic position is that the depositary will be liable to the AIF or to its investors for any loss of financial instruments it holds, although it can avoid liability if it can prove that such loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. The depositary will in all cases be liable for any loss to the AIF or investors resulting from its negligent or intentional failure to comply with the Directive.

In respect of liability for delegated activities, the basic position is that the depositary will be strictly liable for losses caused by delegates or sub-delegates. However, the depositary can avoid liability for loss of financial instruments held by a sub-custodian if there is a contract between the depositary and the AIF (or the AIFM acting on behalf of the AIF) which allows a discharge of liability on the basis of an objective reason, if there is a further contract between the depositary and the sub-custodian allowing for liability to be transferred to the sub-custodian and for the AIF (or the AIFM) to make a claim against the sub-custodian, and if the depositary complied with the Directive when appointing the sub-custodian. Finally, the depositary can also avoid liability for loss of financial instruments held by a third-country sub-custodian that is not subject to effective prudential regulation and supervision or external auditing if equivalent contractual arrangements are in place, if the law in the third country requires financial instruments to be held locally, if the constitutional documents of the AIF allow such a discharge, if the delegation was instructed by the AIF or the AIFM, and if investors have been informed.

## Remuneration

Remuneration of AIFM staff (including senior management, risk-takers, and staff who are in the same remuneration bracket as these first two categories) whose professional activities have a material impact on the risk profile of the AIFM or of the AIF they manage will be subject to risk-adjustment principles. The remuneration provisions are designed to achieve alignment with the CRD3 rules on remuneration that have applied to banks, building societies and investment firms since 1 January 2011, and are due to be supplemented by guidelines to be produced by ESMA. Compliance by AIFM with applicable provisions is subject to the proportionality principle (to take account of the size, internal organisation, and the nature, scope and complexity of the activities of the AIFM), and at least 50% of variable remuneration awarded to relevant staff must consist of shares of the AIF concerned, equivalent ownership interests, share-linked instruments or equivalent non-cash instruments. These instruments will also be subject to a retention policy designed to align incentives with the interests of the AIFM and the AIF it manages or the investors of the AIF.

## Private equity

The provisions on private equity generally apply to AIFM which manage one or several AIF which individually or jointly acquire control of an EU-based non-listed company ("control" being defined as more than 50% of voting rights in the company), and AIFM which cooperate with other AIFM to jointly manage AIF that acquire control of an EU-based non-listed company. These provisions do not apply where the AIF acquire control of small or medium enterprises (as per the EU definition) or of real estate special purpose vehicles.

An AIFM must notify its home regulator, the non-listed company and the shareholders of the company when the voting rights in the company held by an AIF managed by the AIFM reach, exceed or fall below 10%, 20%, 30%, 50% and 75%. These parties must be provided with information on the AIFM, its conflict of interests policy and its communication policy regarding the company. Additionally, the company, its shareholders and its employees must be provided with information on the AIFM's future intentions regarding the company and the likely repercussions for employees. The AIFM must also procure that the board of the company provides this information to the employees of the company or their representative, and that relevant past and likely future developments are taken into account in the company's annual report.

On the issue of asset stripping, the AIFMD contains provisions that apply in respect of the acquisition of control of EU-based non-listed companies as well as issuers. In the period of 24 months from the acquisition, an AIFM must refrain from facilitating, supporting or instructing, and must use its best efforts to prevent, (i) any capital reduction; (ii) any share redemption; (iii) any distribution to shareholders or own share purchase where the net assets of the company fall short of (or would consequently fall below) its subscribed capital and non-distributable reserves; and (iv) any distribution to shareholders which would exceed the amount of available profits.

## Basic EU passporting

The basic passporting provisions in the Directive allow EU AIFM to manage EU AIF throughout the European Union (on a cross-border basis or via a local branch), and to market EU AIF to professional investors in other member states. However, there is no EU passport permitting marketing of AIF to retail customers. Member States are free to ban marketing to investors who fall outside the definition of professional investors, or they may permit such marketing under non-discriminatory rules. The AIFMD defines "professional investor" narrowly in accordance with MiFID.

## Third-country AIFM and AIF

The AIFMD takes a dual approach to third-country AIFM and AIF. Throughout a transitional period, it will retain the possibility for EU-AIFM to market non-EU AIF and for non-EU AIFM to market to investors under the private placement rules of individual EU Member States. Additionally, it envisages the introduction of a passporting framework for the benefit of non-EU AIFM and non-EU AIF. Another noteworthy feature of the Directive is that it excludes reverse solicitation from its scope, enabling any AIFM (including non-EU AIFM) to accept subscriptions from professional investors in respect of any AIF (including non-EU AIF) without needing to comply with any requirements of the Directive, so long as the investors invest at their own initiative.

The third-country passport will not take effect at the same time as the general Directive regime. In 2015 (two years after the effective date of the Directive in 2013 – see the timeline below), ESMA will issue an opinion on the functioning of the basic EU management and marketing passport, and advise the Commission on the application of the passport to the marketing of non-EU AIF by EU AIFM throughout the European Union, on the management and/or marketing of AIF by non-EU AIFM throughout the European Union, and on the functioning of national private placement regimes. If the advice issued by ESMA is favourable to the introduction of a third-country passport, the Commission will adopt measures to bring the passport into effect at a date then to be determined (but likely to be in 2015).

In 2018, three years following the likely entry into effect of the third-country passport, ESMA is due to issue further advice on the functioning of this passport and of private placement regimes, and if the advice is favourable to discontinuing private placement regimes, the Commission will adopt measures to bring those regimes to an end at a date then to be determined (but likely to be in 2018). The process is therefore designed to facilitate an eventual replacement of private placement regimes by the passport, but the outcome is not set in stone and will depend on an appraisal of developments in the industry and the effectiveness of the evolving regulatory infrastructure.

### **Third-country passport**

Under the third-country passporting provisions, authorised EU AIFM may market third-country AIF (and feeder AIF whose master AIF is not EU-based or not managed by an authorised EU AIFM) to professional investors throughout the EU if the following conditions are met:

- The AIFM must comply with all the relevant Directive requirements.
- There must be arrangements for the exchange of supervisory information between the home Member State of the AIFM, the third country where the AIF is established, and the other Member States where the AIF is marketed.
- There must be OECD-compliant tax information-exchange arrangements between the home Member State of the AIFM, the third country where the AIF is established, and each other Member State where the AIF is marketed.
- The third country must not be on the blacklist of the Financial Action Task Force (“FATF”) on anti-money laundering and terrorist financing.

The conditions for the exercise by non-EU AIFM of the marketing passport in relation to EU AIF and non-EU AIF, or of the management passport in relation to EU AIF, are broadly equivalent to those outlined above, although non-EU AIFM are also required to disclose their marketing strategy to, and appoint a single legal representative in, their Member State of reference, and third-country laws governing the non-EU AIFM must not prevent its effective supervision by competent authorities. EU and non-EU AIFM can exercise the passport following notification to, and approval of the intended activities by, the competent authorities of their home Member State or Member State of reference (as applicable).

### **Private placement**

For as long as private placement remains permissible, Member States will be able to allow authorised EU AIFM and non-authorised non-EU AIFM to market third-country AIF they manage to professional investors on their territory under the following conditions:

- EU AIFM must comply with all the Directive requirements (although these are reduced in relation to appointment of a depositary), while non-EU AIFM only need to comply with the Directive requirements on transparency and private equity.
- Cooperation arrangements relating to systemic risk oversight and information exchange must be in place between the home Member State of the EU AIFM and the relevant third country, or in the case of a non-EU AIFM, between that non-EU AIFM’s home state, the Member State(s) in which the marketing occurs and, if applicable, the Member State of any EU AIF which is being marketed.
- The third country must not be on the blacklist of the FATF on anti-money laundering and terrorist financing.

Although the continued operation of private placement regimes is to be welcomed, the current flexibility of these regimes is likely to be diminished by the overarching requirement for AIFM to comply with the Directive, and market access may be inhibited by the requirement for new cooperation agreements. The usefulness of these provisions may also be reduced by the fact that Member States will remain free to add further conditions to them or discontinue their private placement regimes altogether (and some Member States already restrict private placement considerably at present).

### **Management of non-EU AIF marketed outside the European Union**

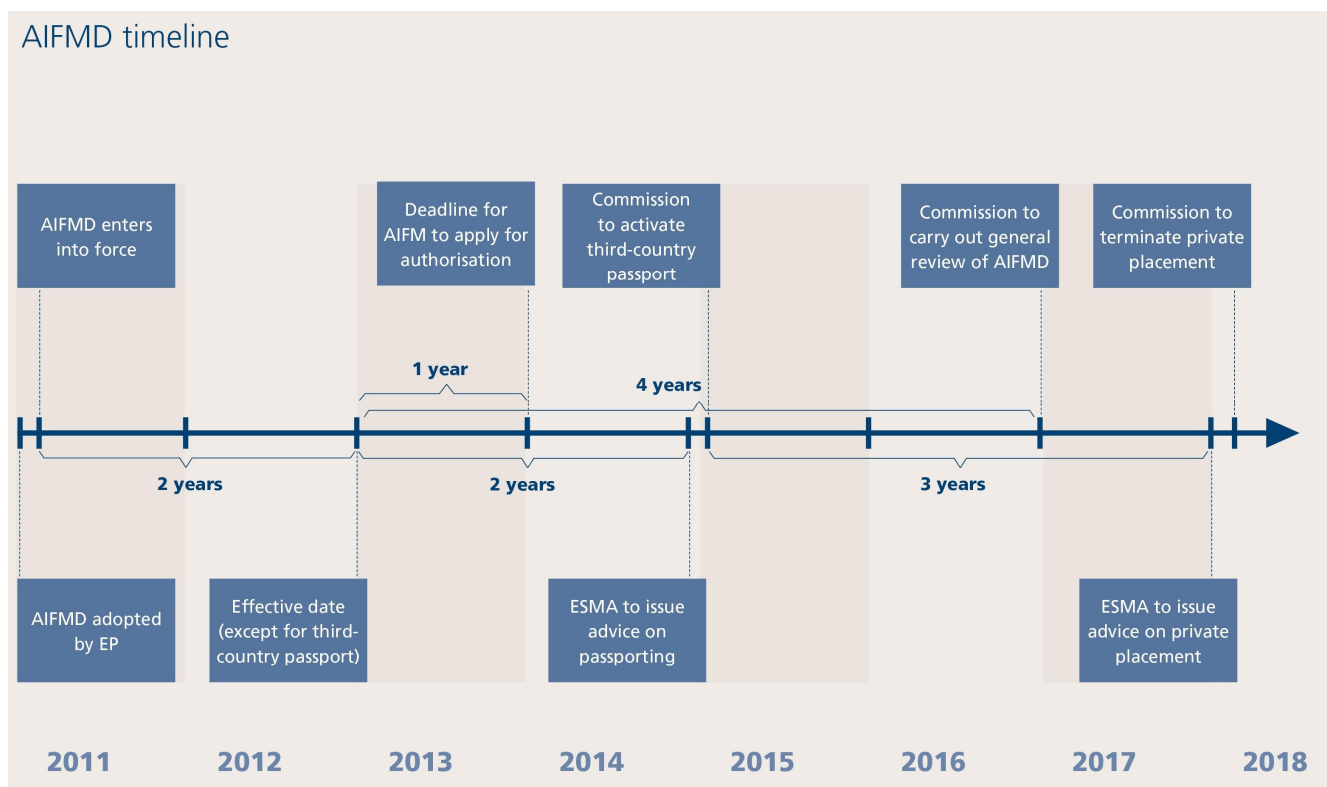
EU AIFM that wish to manage non-EU AIF marketed outside the EU must comply with the Directive (with the exception of the depositary and annual reporting requirements), and there must be arrangements for the exchange of supervisory information between the home Member State of the AIFM and the third country where the AIF is established.

## **A new beginning**

Some in the funds sector may be breathing a sigh of relief over the final content of the Directive. Compared with the initial draft proposed by the Commission in April 2009, the principal advances achieved are the inclusion of new exemptions for joint ventures and managers of private wealth undertakings, increased flexibility for the appointment of depositaries and sub-custodians, extended provisions allowing depositaries to avoid liability for acts of sub-custodians (although it may be argued that this will benefit some industry participants at the expense of others), a dual passporting and private-placement approach to third-country AIFM and AIF, removal of reverse solicitation from the scope of the Directive, and importantly, the incorporation of provisions setting out a framework for a general review of the Directive (scheduled to take place four years after its effective date) and a review of the third-country provisions more specifically. However, there are elements of the Directive that seem unnecessarily onerous and/or the inclusion of which represents a muddled political compromise rather than a real attempt to address systemic risk or market failures in the sector.

Throughout the two-year implementation period commencing in June 2011, the Commission and ESMA will adopt various implementing measures and guidelines to flesh out the detail of the new framework. ESMA has already appointed four taskforces headed by national regulators to focus on developing the Directive provisions relating, respectively, to (1) scope and types of AIFM, (2) authorisation/delegation/organisational requirements, (3) depositaries, and (4) transparency/leverage/risk/liquidity requirements. These taskforces are working together with the industry and their findings will feed into the technical advice which ESMA will deliver to the Commission in November this year, and which will form the basis for the Level 2 measures the Commission will adopt in 2012.

While the AIFMD will have a less adverse effect on the alternative investment and private equity sectors than originally feared, the industry will need to continue lobbying throughout the implementation period in order to preserve and extend the advances achieved to date.



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