

CLIENT ADVISORY UPDATE

# The Alternative Investment Fund Managers Directive (AIFMD)

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## Key announcement

- This week, the European Union held two key votes<sup>1</sup> on separate drafts of the Alternative Investment Fund Managers Directive (AIFMD)
- Once details are agreed, the Directive is expected to come into force by the end of 2012.
- The Directive seeks to regulate a broad range of Alternative Investment Fund Manager(AIFM) activities and investments and is likely to have a significant impact on institutional investors both within and outside the European Union

## Background

In April 2009, in response to the financial crisis and volatility in global markets, the European Commission drafted the Alternative Investment Fund Managers Directive, which aims to create a '*comprehensive and effective regulatory and supervisory framework for AIFM in the European Union*'.

This week the European Parliament and the Council agreed separate versions of the draft Directive (the "ECON text" and the "Council text" respectively). A final text may be agreed between the institutions by July 2010. Following implementation the Directive could become national law within the EU by late 2012.

The scope of the legislation is broader than its name would suggest, as it impacts a broad range of collective investment vehicles which are not traditionally regarded as "alternative investments", including non-UCITS schemes which are authorised under national laws. It regulates the activities of alternative investment managers, rather than the funds themselves, and there has been concern that one effect will be to limit the ability of EU professional investors to access funds that are not domiciled in the EU. There are detailed provisions on organisation, valuation, depositary liability, leverage, reporting and many other requirements.

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<sup>1</sup> One vote on 17 May by the Economic and Monetary Affairs Committee of the European Parliament and a vote on 18 May by the European Council of Ministers, using separate texts.

The measure has been the subject of great controversy. Some claim that the draft legislation is disproportionate and argue that the alternative investment funds industry is not responsible for the credit crisis. Concerns have also been expressed that the legislation has been prepared with insufficient public consultation and without a proper impact assessment; particularly as the provisions which are finally adopted for the AIFM Directive are expected to influence changes to the UCITS Directive. Regardless, subject to further negotiation and implementation, it now appears that many of the proposals will be adopted.

## Why this Directive is important

The impact of the Directive on our clients' and our own business operations is expected to be significant. Understanding what this legislation might mean is therefore crucial to institutional investors, alternative investment managers and service providers alike.

In this advisory note, we will cover the key measures within the Directive that J.P. Morgan believes will impact our clients' business:

- **Third country funds** - how asset managers outside the European Union can market their funds within the EU
- **Depository and Valuation Services** - how the Directive will change operating models for institutional investors

### 1. THIRD COUNTRY FUNDS

The ECON text proposes that where a Third Country (i.e. non-EU) AIFM wishes to access the European market, the country where the AIFM or the fund is domiciled or registered should meet a number of conditions including:

- Adequate anti-money laundering and counter terrorist financing standards
- Reciprocal access to marketing of EU funds in its territory
- Efficient exchange of information related to taxation
- Finally, the country where the fund is located must recognise and enforce judgements given in the EU on issues connected to the Directive on the basis of principles set forth in the 1958 New York convention regarding foreign arbitral awards

There will be a three year transition period for these requirements to be met. Passive marketing is prohibited unless these conditions are complied with. The relevant third country regulators are expected to act as agents for the EU in the supervision of that manager. A key point that emerges in the ECON text is that a professional investor may not invest in an AIF domiciled in a third country that does not meet the conditions outlined above.

According to the Council text, the entire Directive except the depository provisions would apply to a third country AIFM wishing to market in the EU.

In light of this provision, we believe that European institutional investors, such as pension funds may find it difficult to access the full array of investment vehicles they require in order to effectively manage their portfolios and consequently, impair their ability to meet their scheme obligations.

Importantly, AIFMs wishing to do business in the European market will also be required to produce an annual report for each AIF they manage, including audited accounts and details of investment strategy, asset types, risk management processes, leverage used, and principal market exposures and concentrations held.

## 2. DEPOSITARY SERVICES

Each AIF must have a depositary separate from the AIFM, to ensure that subscriptions and redemptions are booked on a segregated account, to safe-keep financial instruments and to verify ownership of any other assets. The depositary must also ensure that sales, redemptions, repurchase and cancellation of units or shares, and valuation of assets, are carried out in accordance with relevant national law and AIF rules.

In either version, a depositary can be an EU credit institution or a MiFID investment firm. The Council text provides for the grandfathering of existing EU depositaries, which was particularly important for the UK and Irish sectors, while the ECON text would permit the role to be performed by another legal person authorised by the competent authorities of the home Member State of the AIFM, provided that they are subject to adequate supervision and have sufficient standing.

On depositary services, the original Commission text said that the depositary ‘shall be liable for....any losses suffered’ as a result of its failure to perform its obligations, and the burden of proof was reversed. This represented a departure from the current UCITS standard and the normal legal principles which govern depositary liability; and it was understood to represent a transfer of risk to depositaries which could result in significant additional costs. There is better alignment with normal legal principles in the current ECON text, which now provides that the failure to perform should be ‘intentional or negligent’ or the losses arise as a result of improper performance. This should be sufficient to reassure investors that depositaries will be liable for failing to meet the required standards of performance.

Both the Council text and the ECON text impose an obligation on the depositary to return (i.e., restitute) assets which have been entrusted to them for safe-keeping. The extent of this obligation has created concern, because it could create or exaggerate systemic risks; particularly if there is a failure of a subcustodian institution or critical market infrastructure which prevents the immediate return of assets which are detained through, for example, the operation of insolvency or administrative proceedings affecting a subcustodian. While limited exceptions have been created in both texts, they are not clearly defined, and concern remains that markets with less developed infrastructure or systemic problems may become restricted or closed to investment by AIFs, if depositaries are unable or unwilling to bear the associated risks.

An area which remains to be clarified is the relationship between the AIFM, depositary and prime brokers, for AIFs which use prime brokers. Differences remain between the Council text and the ECON text, including provisions concerning the reallocation of liability between the depositary and other service providers, but only the ECON text explicitly refers to a prime broker as a distinct service provider to AIFs. The only thing that is clear about the current provisions is that they need further work.

## 3. VALUATION

The ECON text requires that the process for valuation of assets and calculation of the Net Asset Value (NAV) of the AIF must be functionally or legally independent of the AIFM and the process must be subject to depositary oversight. The AIFM may delegate this process to ensure such independence, but the AIFM remains responsible for the valuation. The ECON text also requires that any external valuer is qualified and capable and establishes that the Commission will determine eligibility criteria for independent valuers.

Under the ECON text, periodic valuation of real estate funds is optional and subject only to AIF rules. Similarly for private equity funds periodic valuation is optional subject to AIF rules and redemption and subscription requirements.

The Council text differs significantly from ECON, in that independence is a pre-requisite if the AIFM has performance-related remuneration. In all other cases, the AIFM 'shall ensure the independence of the valuation function in view of the nature, scale and complexity of each AIF that it manages'.

A further significant difference between the two texts is that the Council text requires that an independent valuer must:

- Be subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct
- Furnish sufficient professional guarantees to be able to effectively perform the relevant valuation function
- Possess professional indemnity insurance which must be appropriate to the valuation function in question and any potential liability that arises

It is unclear what professional rules would apply to valuers, at this stage. Furthermore, an independent valuer will be liable to AIFM, the AIF or the investors of the AIF for any losses suffered by them as a result of its failure to perform the valuation in accordance with the applicable rules.

## What action should clients take?

This advisory note summarises the key measures within the Directive that J.P. Morgan believes will impact our clients' business.

We will be inviting clients to an online seminar to discuss your reactions and provide an update on this matter on Wednesday 26 May, 2010, and would welcome your participation. Meanwhile, we would encourage all our clients to contact their usual J.P. Morgan representative to discuss specific queries in more detail.

Following this week's two votes, the Council and the Parliament will now seek to reach a consensus on the final text of the AIFM Directive with the assistance of the Commission. It is anticipated that this process will take a further two months, and a target date for the AIFM Directive to become law has been set for the end of July 2010. We will provide a further advisory note once the legislation is finalised.

The full text of the original draft of the Directive is available at:

[http://ec.europa.eu/internal\\_market/investment/docs/alternative\\_investments/fund\\_managers\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf)

Parliament Press Release: [http://www.europarl.europa.eu/news/expert/infopress\\_page/042-74646-137-05-21-907-20100517IPR74645-17-05-2010-2010-false/default\\_en.htm](http://www.europarl.europa.eu/news/expert/infopress_page/042-74646-137-05-21-907-20100517IPR74645-17-05-2010-2010-false/default_en.htm)

Council Press Release: [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ecofin/114493.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/114493.pdf)

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