

# New challenges. New solutions.

## Client Advisory Update: The Alternative Investment Fund Managers Directive (AIFMD)

SHEENAGH GORDON-HART  
Industry and Client Research Executive

1 NOVEMBER 2010

### AIFMD text agreed

- Finally, after much discussion and disagreement, the text of the Alternative Investment Fund Managers Directive was agreed by the Council of the European Union at a meeting in Luxembourg on 27 October.
- Negotiations with the European Parliament are expected to be completed rapidly with a view to enabling passage into law at first reading.
- One of the major sticking points in the negotiations has been the passport – the Directive seeks to address this as outlined in the summary below.
- Intense lobbying has removed or watered down many of the most contentious issues, but capital, marketing and depositary requirements remain areas where real changes will have to be made to an AIFM's business.

### 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'.

The legislation seeks to regulate the activities of alternative investment managers, that are broadly, but subject to very limited exceptions, managers of collective investment vehicles that are not UCITS.

This note sets out a summary of some of the key provisions of the text agreed by the European Council on 27 October 2010. This text is expected to be voted upon by EU Member State Ambassadors on 3 November 2010 and then voted in plenary by the European Parliament on 10/11 November 2010.

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Sheenagh Gordon-Hart  
[sheenagh.gordon-hart@jpmorgan.com](mailto:sheenagh.gordon-hart@jpmorgan.com)

## Scope

Subject to a number of exceptions and restrictions, the Directive will apply to:

- All EU AIFM managing EU AIF or non-EU AIF
- All non-EU AIFM managing EU AIF
- All non-EU AIF marketing EU AIF or non-EU AIF within the EU

Authorisation of EU AIFM in the first instance is for management of EU AIF in the AIFM's home Member State, and subject to notification requirements, to management of EU AIF in other Member States and marketing of EU AIF to professional investors in the EU. There are also conditions which if satisfied, permit an EU AIFM to market non-EU AIF to professional investors and enable authorisation of non-EU AIFM to manage EU AIF and/or market AIF with a passport.

## Exemptions

There is a general exemption for AIFM managing funds in which the AIFM (or its parent or subsidiaries) are the sole investors, provided that none is itself an AIF. There are then further limited exemptions granted for:

- AIFM managing portfolios that in aggregate do not exceed €500 million where none of the AIF is leveraged and where there are no redemption rights for five years from inception
- For AIFM employing leverage, the threshold falls of €100 million

The limitation of the exemptions above are that such AIFM must comply with registration and disclosure requirements and naturally cannot benefit from other provisions of the Directive.

## Capital

The capital requirements are set out in Article 9 and require an internally managed AIF to have own funds of at least €300,000. When an AIFM is appointed as an external manager of one or more AIF, the minimum capital requirement is €125,000 plus 0.02% of the value of funds managed in excess of €250 million, subject to a cap of €10 million. In addition AIFM are required to carry professional indemnity insurance or to have sufficient additional funds to cover potential liability in respect of professional negligence.

## Risk Management

Article 15 sets out the risk management requirements including, inter alia, the requirement to separate risk management functionally and hierarchically from other activities including portfolio management. This article also requires AIFM to set out the maximum leverage to be employed in respect of each AIF and to specify the extent of re-use of collateral. In para 2 of the article the AIFM must implement adequate risk management systems in order to identify, measure, manage and monitor risk and to review these at least once a year. However in para 5, the Commission by delegated acts will specify, inter alia, the risk management systems to be employed and the frequency of review.

## Investment in Securitisation Positions

Article 17 states that the Commission will by delegated acts set out detailed requirements governing the circumstances in which an AIFM will be permitted to invest in a securitisation (to ensure the originator, the sponsor or the original lender retains at least 5%) and qualitative requirements that must be met by AIFM that invest in those securities or other financial instruments.

## Valuation

The valuation requirements are set out in Article 19 which requires the AIFM to establish procedures to ensure proper and independent valuation of the AIF assets at a frequency no less than once a year. The valuation function can be carried out either by an independent external valuer with no links to the AIFM or AIF or by the AIFM itself provided there is functional separation of the valuation function from both the portfolio management and remuneration policy functions and that employees are protected from undue influence. The depositary of an AIF cannot be appointed as an external valuer unless there is functional and hierarchical separation and potential conflicts of interest are identified, managed and disclosed to AIF investors.

Para 5 of this Article deals with the qualification of external valuers (mandatory professional registration or legal or regulatory provisions or professional rules of conduct) and the requirement to demonstrate that the valuer can furnish sufficient professional guarantees to perform the function. In addition para 6 of this Article prohibits sub-delegation of valuation.

The Article also makes clear that the AIFM is responsible for the proper valuation of assets whether or not an external valuer has been appointed. However, the external valuer is liable to the AIFM for losses arising from negligence or intentional failure to perform its task.

## Delegation

The issue of delegation is clearly extremely important and Article 20 deals with the conditions attaching to delegation of AIFM functions. The Article contains the requirements that home state competent authorities must be informed of the intention to delegate, the AIFM must be able to justify their structure of delegation, and delegates must have sufficient resources to undertake the delegated functions. Special requirements are laid out for the delegation of portfolio and risk management in respect of which these functions can only be delegated to undertakings authorised and registered for asset management and subject to supervision. If the latter conditions cannot be satisfied then the approval of the home state competent authorities must be obtained. If the delegation of these functions is to a third country undertaking then there must be cooperation between the supervisory authority of that undertaking's home state and the competent authorities of the home state of the AIFM.

Sub-delegation is permitted subject to notification of home state competent authorities and AIFM consent.

## Depository

The provisions on depositaries contained in AIFMD have been through a number of iterations. There are concerns that pinning strict liability on depositaries would have negative, and possibly unintended, consequences, potentially magnifying systemic risk and rendering many investment strategies uneconomic or impossible to pursue. The current text requires all AIFs to appoint a single depository, which must be:

- An EU credit institution, or
- A MiFID firm, or
- Another institution subject to prudential regulation and ongoing supervision and within a category eligible to act as a depository under Article 23 of UCITS Directive

However, in respect of a third country AIF this can be a credit institution subject to effective prudential regulation and supervision.

In respect of funds which have no redemption rights exercisable for a period of five years from the date of the initial investment, and which do not generally invest in assets that are required to be held in custody or invest in non-listed companies for certain purposes, depository functions can be carried out by an entity that carries out depository functions as part of its business activities provided such entity is subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct, and can furnish sufficient financial and professional guarantees.

In order to avoid conflicts of interest an AIFM may not act as depository and a prime broker who is also counterparty to the AIF may not act as depository unless its depository responsibilities are hierarchically and functionally separate from those of its prime brokerage functions and conflicts are adequately identified, managed and disclosed.

The depository of an EU AIF must be in the home Member State of the AIF. For non-EU AIF the depository must be in the home country of the AIF, or the home Member State of the AIFM, or the home state or 'Member State of Reference' of the AIFM managing the AIF. There are fairly onerous requirements laid out for acceptance of a third country depository including inter alia:

- The competent authorities of the Member States in which the AIF is to be marketed, and if different the home Member State of the AIFM, have signed cooperation and exchange of information arrangements with the competent authorities of the depository;

- In the third country where the depository is established depositaries are subject to effective prudential regulation (including minimum capital requirements) and supervision which have the same effect as the provisions laid down in European Union law and are effectively enforced;
- The third country where the depository is established is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force on anti-money laundering and terrorist financing;
- The Member States in which the shares or units of the third country AIF are intended to be marketed, and, insofar different, of the home Member State of the AIFM, have signed an agreement with the third country where the depository is established which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information in tax matters including multilateral tax agreements.

Depositaries are required, inter alia, to monitor AIF cash flows, to ensure valuation of shares or units are carried out in accordance with national law and AIF rules, and to safekeep those assets that can be safekept, registering such holdings in segregated accounts. For other assets the depository is required to verify ownership of the AIF (or the AIFM on behalf of the AIF) based on documents and information provided by the AIFM and where possible external evidence.

Para 11 of Article 21 deals with liability and states that 'the depository shall be liable for the loss of financial instruments held in custody' and requires return of assets (or equivalent) 'without undue delay'. Further the text states that the depository shall not be liable if it can prove that the 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'.

Para 12 of Article 21 provides that the depositary can discharge its liability for loss if there is a written contract between the depositary and the AIF or AIFM that specifically allows for such a discharge and establishes the objective reason to contract such a discharge, all the requirements for delegation of the depositary functions have been met and there is a written contract between the depositary and its delegate that explicitly transfers the liability to that delegate and makes it possible for the AIF or AIFM to make a claim for loss of financial instruments against the delegate or for the depositary to make a claim on their behalf.

In respect of delegation in a third country where the delegation requirements cannot be satisfied, the depositary can discharge itself of liability if the AIF or the AIFM on behalf of the AIF instructed the depositary to delegate the custody to a local entity, there is a written contract between the depositary and the AIF, or the AIFM acting on behalf of the AIF, which expressly allows such a discharge under certain explicit conditions, and the investors of the relevant AIF have been duly informed of this discharge and the circumstances justifying the discharge prior to their investment.

The Commission will by delegated acts have significant further work to do, including inter alia, to:

- Determine the particulars to be included in the depositary agreements
- Establish criteria for judging whether the prudential regulation and supervision in third countries are to the same effect as required under European Union law and are effectively enforced
- Specify the types of financial instruments included in the scope of a depositary's custody duties
- Define the due diligence duties of depositaries

- The conditions and circumstances under which financial instruments shall be considered as lost
- Define what is to be understood by 'external events beyond reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary'.

## Private Equity

Private equity funds have very detailed requirements to comply with under this Directive. Article 27 requires an AIFM to notify its Home State competent authorities when the proportion of voting rights in non-listed companies reaches, exceeds or falls below the thresholds of 10%, 20%, 30%, 50% and 75%.

Member States shall require that when an AIF acquires control over a non-listed company pursuant to the Directive, individually or jointly, the AIFM must notify the non-listed company, its shareholders and the competent authorities of the home Member State of the AIFM.

The notification requirements as far as the competent authorities are concerned are detailed, including, inter alia, the outcome in terms of voting rights, the conditions under which control has been reached, including information about the identity of the different shareholders involved, any natural person or legal entity entitled to exercise voting rights on their behalf and, if applicable, the chain of undertakings through which voting rights are effectively held.

In its notification to the non-listed company, the AIFM is additionally required to ask that the employees or their representatives be informed.

There are further disclosure and notification requirements regarding the financing of the acquisition, impact on employment and communications with employees.

Asset stripping is dealt with in Article 30 and sets out some fairly stringent constraints on activity by an AIF acquiring control in a non-listed company. For example for twenty four months following acquisition of control the AIFM:

- May not facilitate, support or instruct any distribution, capital reduction, share redemption and/or acquisition of own shares by the company;
- May not vote in favour of a distribution, capital reduction, share redemption and/or acquisition of own shares by the company;
- Must use its best efforts to prevent distributions, capital reductions, share redemptions and/or the acquisition of own shares by the company,

Where any such distribution would result, inter alia, in the net assets of the company becoming lower than the amount of the subscribed capital plus non-distributable reserves, or if the distribution would exceed the profits at the end of the previous financial year plus profits brought forward and sums drawn from reserves available for this purpose less any losses brought forward and sums properly placed in reserve.

## Passport

The text explains that the approach to passporting is based on 'uncertainty as to the practical consequences and possible difficulties' resulting from a harmonised framework and a European internal market for non-EU AIFM managing and/or marketing in the EU and EU AIFM managing non-EU AIF. Hence the Directive provides for a passporting regime to apply to such situations after a transitional period of two years, and that for a further three years the passporting regime shall co-exist with national private placement regimes (PPRs) subject to minimum conditions. After this five year transition it is envisaged that national PPRs would be terminated. There will also be a review of the impact and effectiveness of the Directive four years after the transposition date.

## Marketing of EU AIFs

Article 31 deals with the marketing of EU AIFs in their home state and Article 32 deals with marketing of EU AIFs in other Member States. In common with UCITS IV, cross-border marketing will be facilitated by communication between Home Member State and Host Member State regulatory authorities. In essence the AIFM files required information (the notification file) with its Home Member State authority and the latter has twenty days to transmit the complete notification file to the Host Member State authority, together with its attestation as to the authorisation of the AIFM. At this point the Home Member State authority notifies the AIFM of transmission and marketing can commence immediately.

## EU AIFM Managing non-EU AIF

The requirements for EU AIFMs managing non-EU AIFs that are not marketed in the EU are dealt with in Article 34. This requires that the Directive be applied except in respect of the depositary provisions and the annual report. The Article also requires that there be appropriate cooperation arrangements between the Home Member State competent authorities of the EU AIFM and the supervisory authorities of the third country in which the AIF is established.

The conditions for marketing of a non-EU AIF are laid out in Article 35 which requires compliance with the Directive and additional requirements on cooperation and exchange of information. Where the competent authority of another Member State disagrees with the assessment of an application pursuant to this Article the matter can be referred to ESMA, the soon to be established European Securities and Markets Authority.

## Why this Directive is important

There are many other provisions in this Directive related to conflicts of interest, remuneration, liquidity management, annual reports, investor disclosures, and supervisory cooperation, to name but a few.

Now that we are very close to what will be passed into law, the industry will turn its mind to the key business challenges of implementation.

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

The compliance and reporting burden will be high and J.P. Morgan will work with their clients to ensure we can help them meet their obligations in a fast changing world.