



WILLIAM FRY



**PREPARING FOR AIFMD-
TIME FOR ACTION!**



INTRODUCTION

In the wake of the global financial crisis, European authorities crafted what is undoubtedly the most ambitious, complex and controversial legislative initiative to impact the asset management sector in the form of the Alternative Investment Fund Managers Directive (AIFMD). The AIFMD will have a far-reaching and lasting impact on Alternative Investment Fund Managers (“AIFMs”) in Europe and beyond.

In addition to the Directive itself, the European Commission published detailed implementing regulations (the so-called “Level 2 Regulations”) at the end of 2012. While comprehensive, the Level 2 Regulations do not address all the ambiguities contained within the Directive itself. Nonetheless, alternative fund managers and promoters would be well advised to start the process of analysing the impact of AIFMD on their structures and businesses and to take appropriate action in advance of the implementation deadline of 22 July 2013.

This note is intended to highlight some of the primary issues that we feel alternative fund managers and promoters should now be considering in preparation for the implementation of the Directive. Our focus is on promoters who have existing fund products that are domiciled in Ireland or who intend to domicile funds in Ireland, perhaps to avail of the marketing passport provided for in the Directive, which is discussed in further detail below.

WHAT DO WE NEED TO DO RIGHT NOW?

Alternative managers and promoters should now start engaging senior management and, where appropriate external advisers, on:

- The impact AIFMD will have on their current business models and the sustainability of these models, having regard to the investment strategies and distribution arrangements currently being pursued
- Possible restructuring of delegation arrangements and contractual arrangements with other service providers
- Procedures for the implementation of new systems and controls
- Carrying out a review of existing regulatory approvals and preparing to apply for a variation of existing approvals or an application for authorisation, if appropriate

In addition to the impact on AIFMs, the Directive will also have a substantial impact at a product level and will necessitate dialogue with counterparties and other fund service providers on appropriate steps to progress any necessary organisational and contractual changes.

DOES AIFMD APPLY TO MY BUSINESS?

The Directive is intentionally broad in scope and is relevant for all EU-based fund managers and for any non-EU manager whose business has some connection with the EU, either because the non-EU manager markets a fund into the EU, domiciles a fund that it manages in the EU or it delegates activities to an EU-based manager or, indeed, carries out activities on foot of a delegation from an EU-based manager.



The Directive captures the management of all forms of collective investment vehicles that are not authorised as Undertakings for Collective Investment in Transferable Securities (UCITS) (such funds are referred to in the Directive as “Alternative Investment Funds” or “AIFs”). The types of vehicles falling within the scope of the Directive will therefore include most hedge funds, private equity and venture capital funds, property funds and other arrangements where capital is raised from a number of investors for a particular purpose in order to achieve a benefit for those investors. The Directive contains a limited number of exclusions from the definition of an AIF, including holding companies, certain occupational pension funds, joint ventures and certain securitisation vehicles. It is important to note that the definition is not limited to AIFs that are authorised or domiciled within the EU.

It is anticipated that the European Securities and Markets Authority (ESMA) will shortly issue further guidance on precisely what structures should be considered within scope (for example, there is some debate as to whether REITs and other property holding vehicles are in scope). In any event, we would recommend that fund promoters with any EU connection should at least provisionally assume that the Directive will apply to them and start considering what implications this is likely to have on their business and fund structures.

It should be noted that AIFMD is not a product directive and does not (directly) regulate AIFs, which will continue to be authorised and supervised at national level. Several provisions of the Directive require AIFMs to ensure compliance with requirements for which, in some fund structures, AIFMs are not responsible. For example, the Central Bank requires all Irish authorised collective investment schemes to directly appoint a custodian (referenced throughout the Directive as a

“depository”). In such cases, the AIFM has no ultimate control over whether a depository is in fact appointed unless the AIF is self-managed. As the Directive does not seek to regulate AIFs, it cannot require an AIF to appoint a depository. In cases where an AIFM fails to take the necessary steps to remedy the situation or is unable to procure compliance by the AIF, the AIFM should resign. If the AIFM fails to resign in such circumstances, the national authorities should require such resignation and marketing within the EU will no longer be permitted.

ARE THERE ANY EXEMPTIONS FOR SMALLER MANAGERS?

Smaller EU-based AIFMs are entitled to “register” with national regulators in the EU rather than seek a full authorisation. This “registration-only” regime avoids most of the burden of the Directive and is available to those managers that have:

- assets under managements (AUM) of no more than €100m (including assets acquired through the use of leverage); or
- AUM of no more than €500m, but only where its funds are unleveraged and investors are not permitted to redeem their investments for at least five years.

For these purposes, AUM includes assets managed by affiliates (either linked by common management, control or ownership) of a particular manager. The Level 2 Regulations contain detailed provisions in relation to the calculation of AUM for this purpose and what is required in the event of a temporary breach of the limits.

ARE THERE ANY GRANDFATHERING PROVISIONS FOR EXISTING MANAGERS?

Unfortunately, the precise application of the transitional provisions of the Directive is an issue that remains somewhat confusing. The Directive provides that AIFMs performing activities before 22 July 2013 “shall take all necessary measures to comply with national law stemming from this Directive and shall submit an application for authorisation within 1 year of that date”. It is clear therefore that managers have a one-year grace period within which they are required to apply for authorisation but what is less clear is whether the remaining provisions of the Directive (and in particular those relating to depositaries discussed below) can apply before such authorisation is obtained. In our view it would be extremely difficult (if not impossible) to de-couple the remaining provisions of the Directive from the AIFM authorisation and, at this stage, we believe it is unlikely that the Directive will be interpreted to this effect. Our current understanding is that ESMA is likely to provide some guidance on this point in the coming weeks.

Conversely, the Central Bank has indicated that it intends to be in a position to accept applications for authorisation of AIFMs by the end of the first quarter of 2013 (although we await details of the format of such applications and the required information/documentation). This will be attractive to managers who wish to obtain authorisation (and therefore avail of the marketing passport discussed below) at the earliest opportunity.

WE ALREADY HAVE A REGULATED INVESTMENT FIRM IN THE EU – CAN THIS COMPANY ACT AS AN AIFM?

The Directive provides that a MiFID authorised investment firm cannot also act as an AIFM. However, as a practical matter, we understand that

national regulators will allow for the variation of the authorisation of such firms where appropriate. The Directive prevents an AIFM from carrying out any MiFID investment services, other than (individual) portfolio management, investment advice, safe-keeping and administration and reception and transmission of orders. This restriction may prevent certain MiFID firms from simply “dropping down” to an AIFM authorisation.

It is possible under the Directive for an authorised UCITS management company to also act as an AIFM and such companies will thereby hold a dual-authorisation. This may provide an opportunity for some larger fund groups to rationalise existing management structures within a single entity.

The Directive also provides a mechanism whereby third-country managers (e.g. an SEC-registered investment adviser) can seek authorisation as an AIFM from the national regulator in a “country of reference” within the EU (essentially the country in the EU with which the manager has the closest connection as determined under various criteria). However, for non-EU managers, we envisage that the “self-managed AIF” structure discussed below is likely to provide a more attractive solution in most circumstances.

ARE THERE LIMITS ON THE EXTENT TO WHICH AN AIFM CAN DELEGATE ITS FUNCTIONS?

One of the more contentious and difficult aspects of the Directive and the Level 2 Regulations relates to the issue of “over delegation” of functions and how this could result in an AIFM becoming a “letter-box” entity that would no longer be considered the manager of the AIF. Significant concerns were raised that the provisions of the Level 2 Regulation, as reflected in earlier drafts, would have required many fund managers to carry out significant restructuring



of their operations to comply with the requirements, without any apparent benefits accruing to investors.

While the final version of the Level 2 Regulations still provide that an AIFM shall be deemed to constitute a letter-box entity if it delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself, the final wording adopted at least provides that a qualitative approach must be adopted in the assessment of the extent of any delegation. In particular, when assessing the extent of the delegation of any investment management functions, national competent authorities are required to assess the entire delegation framework, taking account not only of the assets managed under delegation but also of the following qualitative criteria:

- The assets of the AIF and the importance of the assets managed under delegation for the risk/return profile of the AIF
- The importance of the assets under delegation for the achievement of the investment goals of the AIF
- The geographical and sectoral spread of the AIF's investments
- The risk profile of the AIF
- The type of investment strategies pursued by the AIF or the AIFM acting on behalf of the AIF
- The types of tasks delegated in relation to those retained
- The configuration of delegates and their sub-delegates, their geographical sphere of operation and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM

The Level 2 Regulations provide that the Commission will review the application of these provisions after a two-year period and may further specify the conditions under which an AIFM shall be deemed to have delegated its functions to the extent that it becomes a letter-box entity and can no longer be considered to be the manager of the AIF. Furthermore, ESMA may issue guidelines to ensure a “consistent assessment of delegation structures across the EU”.

While some uncertainty remains as to the application of the provisions of the Level 2 Regulations in relation to the delegation of investment management functions by an AIFM, the text of the Regulations appears to us to be workable from a practical perspective and should allow for the continuation of the delegation model commonly employed by fund promoters with Irish domiciled funds.

It also means that in most circumstances it should be possible to establish a self-managed EU AIF (which is specifically provided for in the Directive) or an AIFM within the EU (e.g. an “agency fund manager”) which delegates portfolio management and/or risk management activities to a non-EU manager. This should ensure that the structure developed very successfully in Ireland for UCITS funds can, in most respects, be replicated for AIFs and will enhance the jurisdiction's attractiveness to non-EU managers looking to follow a “co-domiciliation” model by establishing regulated onshore versions of their offshore funds in order to access European assets following the implementation of AIFMD.

Discussions are on-going with the Central Bank of Ireland as to precisely how this delegation model will operate in practical terms, what changes would be required to existing organisational and contractual structures and how these arrangements should be documented.





ARE THERE ANY CAPITAL OR PRUDENTIAL REQUIREMENTS?

An externally appointed AIFM must have an initial capital of at least €125,000, rising to €300,000 for a self-managed AIF.

In addition, AIFMs are required to cover potential liabilities arising from professional negligence but can choose to hold either professional indemnity insurance and/or additional own funds. Detailed rules for calculating the level of PI cover and additional funds are contained within the Level 2 Regulations.

WHAT OPERATIONAL REQUIREMENTS APPLY TO AIFMS?

The Directive places various requirements on the manner in which AIFMs operate. These include requirements relating to the appointment of counterparties, additional due diligence requirements, managing conflicts of interest and risk management, provisions in relation to remuneration of certain staff members and the fair treatment of investors. Some key points to note are as follows:

- **Risk Management**

The Directive requires AIFMs to adopt effective procedures and systems to achieve the objective of ensuring that the risk profile of the AIF is aligned to the profile disclosed to investors. Furthermore, an AIFM is required to ensure the “functional and hierarchical” separation of the risk management and portfolio management functions, taking into account the nature, scale and complexity of their business and the AIFs that they manage.

- **Liquidity Management**

AIFMs are required to implement appropriate liquidity management systems and procedures for each AIF under their management (other

than unleveraged, closed-ended AIFs) to ensure that the liquidity profile of the investments of the AIF is consistent with the underlying obligations to investors. Specifically, an AIFM is required to ensure that redemption terms are disclosed in sufficient detail to investors before they invest in an AIF and should include redemption notice periods, lock-up periods, circumstances where normal redemption mechanics may not apply (e.g. gates and side-pocket arrangements) or may be suspended.

- **Valuation**

The Directive provides that the AIFM is ultimately responsible for the proper valuation of an AIF’s assets but that it may also delegate certain functions to an “external valuer”. An “external valuer” cannot limit its liability to an AIFM for negligence or intentional failure to perform its obligations however, it is clear from the Level 2 Regulations that a distinction is made between valuation and the calculation of the net asset value of an AIF and therefore, in broad terms, a fund administrator with delegated responsibility for calculating an AIF’s net asset value will not necessarily be considered to constitute an “external valuer”.

- **Leverage**

AIFMs are required to have a leverage policy in place which sets a maximum level of leverage in respect of each AIF under its management. This limit must be disclosed to investors and the AIFM’s home state regulator. The Level 2 Regulations contain detailed provisions in relation to the calculation of leverage.

- **Transparency Requirements**

One of the key objectives of the Directive is to

increase the transparency required of AIFMs. This includes annual reporting, disclosure to investors and reporting to regulators in accordance with a prescribed format. Liquidity measures, risk profiles, the use of leverage and levels of remuneration will have to be disclosed and reported.

- **Remuneration**

Annex II of the AIFMD establishes a set of rules with which AIFMs have to comply in establishing and applying the remuneration policies for certain categories of their staff. ESMA issued its final guidelines on sound remuneration policies under the Directive on 11 February 2013. Of particular note, ESMA has taken the view that entities to which portfolio or risk management activities have been delegated, should be subject to the regulatory requirements on remuneration that are equally as effective as those applicable under the guidelines or that appropriate contractual arrangements are put in place to ensure that there is no circumvention of the remuneration rules.

WHAT ARE THE PROVISIONS OF THE DIRECTIVE IN RELATION TO THE APPOINTMENT OF DEPOSITARIES?

General

The appointment of a depositary (typically called a custodian or trustee) will be familiar to Irish-authorized AIFs where the appointment of a depositary is already a regulatory requirement, but marks a radical change for unregulated funds where there is no such requirement. AIFMD contains important provisions relating to the duties and liabilities of depositaries that will impact on the contractual arrangements of existing Irish-authorized AIFs and will inevitably impact on the management of many such AIFs.

Depositary Duties

Currently, depositaries of Irish authorised AIFs have both safe-keeping and supervisory/oversight functions, similar to depositaries of UCITS funds and existing Irish non-UCITS funds. Under AIFMD, the safe-keeping duties are enhanced, added to which there is a new cash monitoring function. Specifically, the depositary must:

- **Cash Monitoring.** Ensure that the AIF's cash flows are properly monitored and that all subscription payments have been received and that the cash of the AIF has been booked into a cash account opened in its name, in the name of the AIFM acting on behalf of the AIF, or in the name of the depositary acting on behalf of the AIF
- **Safe Keeping.** In respect of "financial instruments that can be held in custody" (these are essentially transferrable securities, money market instruments and units of collective investment schemes ("CIS")), hold these in custody in a segregated account opened in the depositary's books in the name of the AIF (or the AIFM acting on behalf of the AIF) and all financial instruments which can be physically delivered to the depositary (e.g. bearer shares)
- **Verification.** In respect of all other assets of the AIF (e.g. derivatives), verify whether the AIF or AIFM acting on behalf of the AIF holds an ownership interest in those assets based on information/documentation provided by the AIF/AIFM and, where available, on external evidence

The depositary must ensure that accurate records are maintained in relation to the above functions.



Assets held in Custody

The Level 2 Regulations set out the types of financial instruments which must be held in “custody”. These are essentially, transferable securities, money market instruments and units of CIS. With regard to units of CIS, the depositary’s safe-keeping duties apply on a look-through basis to the underlying assets, save in the case of fund of funds or master feeder structures where the underlying funds have a depositary which safe-keeps the assets of the underlying CIS. This will

have implications for depositaries of CIS which have holdings in CIS without a custodian e.g. Cayman funds.

Assets which have been transferred to a third party as collateral and assets with prime-brokers are not excluded from the scope of “custody” assets even though possession and control of such assets has been transferred to the collateral-taker. The Commission has taken the view that in these circumstances, custody can be arranged as follows:



- The collateral-taker is the depositary of the AIF or is appointed by the AIF's depositary as sub-custodian over the AIF's collateralised assets.
- The AIF's depositary appoints a sub-custodian that acts for the collateral-taker.
- The collateralised assets remain with the AIF's depositary and are "earmarked" in favour of the collateral-taker.

The Level 2 Regulations provide that if a prime-broker is appointed to an AIF, the AIF must ensure that the prime-broker provides the depositary with reports each business day on assets held by the prime-broker as collateral or otherwise, any asset of the AIF over which the prime-broker has exercised the right of use and a list of the institutions where the cash of the AIF is held.

To what extent can depositaries delegate their functions?

The depositary may not delegate any of the functions described in AIFMD other than safe-keeping functions. It must exercise all due skill, care and diligence in the selection, appointment, periodic review and on-going monitoring of sub-custodians. The depositary must ensure that where the sub-custodian safe-keeps financial instruments which can be "held in custody", that the delegate is subject to regulation in its jurisdiction and certain other requirements. Where the law of a non-EU country requires that certain financial instruments be held in custody by local entities and there are no local entities that satisfy the delegation requirements laid down in AIFMD, the depositary can delegate its functions to a local entity notwithstanding that the requirements have not been fulfilled and are subject to certain conditions including that the AIF or AIFM on behalf of the AIF has instructed the depositary to delegate the custody of such financial instrument to

the local entity.

The provision of services by securities settlement systems are not considered a delegation of custody functions.

What liability will attach to depositaries?

The depositary's liability to the AIF (or to the AIF investors) is near strict liability; on loss of financial instruments held by it "in custody"; a depositary must return identical financial instruments or the corresponding amount to the AIF without undue delay, even if the instruments were in the custody of a sub-custodian. The depositary will not be liable if it can prove that the loss has arisen as a result of external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary (e.g. a natural event beyond human control or influence, a change in the law or war, riots or another major upheaval). In the case of a loss of financial instruments held in custody by a sub-custodian, the depositary can discharge itself of its liability where:

- The contract between the depositary and the sub-custodian explicitly transfers liability to the sub-custodian and makes it possible for the AIF/AIFM to claim against the sub-custodian in respect of the loss or for the depositary to make such a claim on their behalf.
- The contract between the AIF/AIFM and the depositary (i) expressly permits such a discharge of liability and (ii) establishes an "objective reason" to contract such a discharge.

Investors must be informed of such arrangements before they invest in an AIF.



The depository may also be able to discharge itself of its safe custody liability where the law of a non-EU country requires that certain financial instruments be held in custody by a local entity and there are no local entities that satisfy the normal eligibility requirements for sub-custodians, subject to certain conditions including that the depository is instructed by the AIF/AIFM to appoint the relevant local entity as sub-custodian.

In the case of other losses (e.g. in respect of depository duties relating to assets subject to verification, cashflow monitoring and supervision) which the AIF investors may suffer, liability only flows if there is a negligent or intentional failure on the part of the depository to comply with its obligations under the Directive.

What are the implications of the depository provisions for managers?

It remains to be seen whether or not sub-custodians are willing to take on the transfer of the depository's liability (in circumstances where that is possible). If sub-custodians are prepared to do this it will undoubtedly increase sub-custodial fees. The result of the strict liability regime and the additional arrangements required to appoint collateral-takers as sub-custodians is that depository services are likely to be more costly than the traditional custody or prime-brokerage services that AIFMs are familiar with. In addition, AIFMs may find it difficult to invest AIF assets in certain countries, e.g. emerging markets because the AIF's depository may be unwilling to take on the risk of failure by sub-custodians in such markets. Issues also arise for AIF funds of hedge funds because of the increased liabilities of sub-custodians in respect of underlying funds with a custodian.

AIFMD imposes certain requirements with respect

to the content of the contract with the depository and the delegations of the AIFM with respect to the depository. This means that all existing formal legal contracts between AIFs/AIFM and depositaries will need to be reviewed and updated.

WHAT DOES THE AIFMD PASSPORT MEAN?

Once authorised under the Directive, an AIFM will be able to market AIFs to professional (essentially institutional) investors throughout the EU on the basis of a single registration. Managers can continue to market AIFs to non-professional investors to the extent that this is permitted under national law. However, it is clear that a number of key European jurisdictions intend to limit their private placement regimes on transposing the Directive and therefore the marketing "passport" under the Directive is becoming increasingly valuable.

HOW IS AIFMD BEING IMPLEMENTED IN IRELAND?

AIFMD will be transposed into Irish Law by way of Statutory Instrument, supplemented by the Central Bank's requirements.

In February 2013, the Central Bank issued a feedback statement and a revised draft of its new AIF handbook following upon its October 2012 consultation on the implementation of AIFMD in Ireland. The Central Bank has made it clear that applications for authorisation as an AIFM will be processed prior to 22 July 2013 but that authorisation will not issue until that date, at the earliest. The Central Bank had originally proposed applying all AIFMD requirements to all Irish AIFs, regardless of whether or not the AIFM managed assets falling below the AIFMD thresholds (referred to above). It is now agreed that managers of qualifying investor funds ("QIFs") (i.e. Central Bank authorised funds marketed to high net worth individuals and



institutions investing a minimum subscription of €100,000) authorised after 22 July 2013 and managed by AIFMs below the threshold will have two years from their date of launch to apply for authorisation. The rationale behind this is to give start-up AIFMs time to grow their businesses before becoming subject to the full AIFMD regime. All retail AIFs will however be required to have an authorised AIFM. In addition to the AIF handbook, the Central Bank is preparing new application forms for AIFs and AIFMs so that applications for authorisation under AIFMD can be received and processed by 22 July 2013.



HOW CAN WILLIAM FRY HELP?

At William Fry, we are offering comprehensive advice, guidance and support services to our clients in relation to the implications of AIFMD on their business, including reviewing their current structures/models to assist them in their compliance requirements under the Directive and enabling them to avail of the Directive's marketing opportunities..

If you would like to know more about the services which we are offering, please contact our partners listed below or your usual contact at William Fry.

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