



The European AIFM Directive- New Distribution Opportunities for Hedge Funds

The European Parliament adopted the Alternative Investment Fund Managers Directive (the “Directive”) on 11 November 2010. The Directive contains new rules on the marketing of alternative investment funds in the EU by both European and non-European managers. This paper considers the impact of the provisions of the Directive, the opportunities afforded by this new European “passport” for alternative funds and sets out the timeline for implementation of the new framework.

Background

The Directive was first introduced in response to calls for greater regulation of Alternative Investment Fund Managers (each an “AIFM”). An AIFM is defined to include any legal or natural person whose regular business is to manage one or more alternative investment funds (each an “AIF”), such as hedge funds or private equity funds. An AIF is defined, in summary, as a collective investment undertaking (other than a UCITS fund) that raises capital from a number of investors and invests in accordance with a defined investment policy, for the benefit of those investors.

Much uncertainty surrounded the Directive as it evolved considerably over the past eighteen months prior to its adoption. However, now that consensus has been reached, the alternative investment fund

community can prepare for its implementation in 2013 in earnest.

Impact

The Directive will apply to all EU AIFMs, which manage one or more AIFs, irrespective of where the AIFs are domiciled. The Directive will also apply to all non-EU AIFMs, which manage one or more AIFs domiciled in the EU or market one or more AIFs in the EU. An AIF that is self-managed (i.e. does not appoint a third party manager) will itself be considered as the AIFM. The Directive has different effects depending on whether the AIF or the AIFM is established within or outside the EU. The broad scope of the Directive is designed to ensure a level playing field, and according to the European Commission, to help minimise the risks of regulatory arbitrage.

Exemptions

The Directive provides for a lighter regime for AIFMs where the cumulative AIFs under management fall below a threshold of €100 million. If the AIF is not leveraged and has a lock-in period of five years or more, this threshold is raised to €500 million. Consequently, those AIFMs will not be subject to full authorisation but to a registration in their home Member State.



Such smaller AIFMs will, however, be permitted to 'opt in' to the provisions of the Directive (which they may wish to do to avail of the passporting opportunities for compliant entities. For more, see "Marketing in Europe" below).

The Directive expressly exempts segregated managed accounts, funds managed by public sector entities supporting social security or pension systems, such as certain sovereign wealth funds, or family office vehicles that invest without raising external capital.

Requirements

Authorisation

AIFMs will be required to be authorised under the Directive by the competent regulatory authority of their home state. Conditions for authorisation include:

- Initial capital: self-managed AIFs must have at least €300,000, AIFMs managing one or more AIFs must have at least €125,000;
- Own funds: where the value of the portfolios of the AIFs managed by the AIFM exceeds €250m, additional own funds are required;
- Personnel: the persons conducting the business of the AIFM must be of sufficiently good repute and sufficiently experienced in relation to the investment strategies pursued by each AIF.

In addition, an AIFM will be required to submit a 'programme of activity' setting out the organisational structure of the AIFM, including information on how the AIFM intends to comply with its obligations under the Directive.

Operating Conditions

Authorised AIFMs will be required on an ongoing basis to:

- employ effectively the resources and procedures that are necessary for the proper performance of its business activities;

- take all reasonable steps to avoid conflicts of interests and to identify and manage any conflicts of interest to prevent them from adversely affecting the interests of each underlying AIF and its investors;
- comply with all applicable regulatory requirements so as to promote the best interests of each AIF, its investors and the integrity of the market;
- have sound remuneration policies and practices in place that are consistent with and promote sound and effective risk management;
- implement adequate systems to identify, measure, manage and monitor all risks relevant to each AIF investment strategy;
- set a maximum level of leverage which the AIFM may employ on behalf of each AIF it manages; and
- employ an appropriate liquidity management system for each AIF.

Organisational Requirements

In order to promote the best interests of each AIF an AIFM manages, investors therein and the integrity of the market, the Directive outlines requirements in relation to the use of independent valuations, restrictions on delegation and an independent depositary function.

Valuation

Under the Directive, an AIFM will be required to ensure that, for each AIF it manages, appropriate and consistent procedures are established so that valuation of the assets of the AIF can be performed in accordance with the Directive and the AIF's own rules. The 'proper and independent' valuation of assets must be in accordance with the laws of the jurisdiction where the AIF is domiciled, be performed at least annually for open-ended AIFs and may be performed by the AIFM (provided that the valuation function is functionally independent from portfolio management and remuneration policy) or an independent third party valuer.

There has been some commentary on what is meant by 'valuation' of the assets of an AIF under the Directive, as opposed to calculation of its net asset value, and whether these activities could or should be performed by a single entity or two separate entities. It is hoped that the so-called "Level 2" measures will clarify some of the opaque language used in the Directive.

Delegation

The Directive imposes conditions on the delegation of an AIFM's functions to third parties, including to those outside the EU. Such requirements include those relating to notification, justification and expertise. Where the delegation is given to a third-country undertaking, co-operation between the competent authorities of the home Member State of the AIFM and the supervisory authority of the undertaking is required. The AIFM will be required to monitor any delegate's activities and replace them where necessary. There are restrictions on delegation where conflicts of interest may arise.

Depositaries

As the functions of the depositary are critical for investor protection, all AIFMs will be required to ensure that each AIF they manage appoint an independent and qualified depositary, which will be responsible for overseeing the AIF's activities and ensuring that the AIF's assets are appropriately protected. An eligible depositary must be located as follows:

- a) for an EU AIF, the depositary must be established in the home Member State of the AIF;
- b) for a non-EU AIF, the depositary must be established in the third country where the AIF is established, or in the home Member State of the AIFM managing the AIF, or, as the case may be, in the Member State of reference of the AIFM.

An AIFM may not act as depositary. A prime broker is also prohibited from so acting, unless it has 'functionally and hierarchically' separated its functions as a prime broker from those as a depositary, among other requirements.

Depositaries will be held to a high standard of liability in the event of a loss of assets and the burden of proof will reside with the depositary. The Directive requires that if a depositary legally delegates its tasks to others, it must provide a contract which allows the AIF or AIFM to claim damages against the entity to which the tasks are delegated. This is intended to ensure that at no point in the chain will liability be irretrievably lost. The European Parliament also secured a requirement that the AIF investors concerned must be informed about the potential delegation of liability and the reasons for this. These new rules are likely to create additional operational and compliance burdens for depositaries.

Transparency

One of the aims of the Directive is to enhance the transparency of AIFMs and the AIFs that they manage. The new transparency requirements cover disclosure to investors prior to investment, reporting obligations to competent authorities and detailed disclosures in AIF annual reports.

Meeting the Organisational Requirements

In order to meet the organisational requirements of the Directive one option for AIFMs is to seek to amend the terms of their existing alternative products to try to comply with its requirements, while another is to select to use a form of fund which already largely satisfies these requirements by definition. In relation to this latter option a product which meets the material requirements of the Directive is the Irish domiciled Qualifying Investor Fund (the "QIF").

As an on-shore, European, fully regulated product, subject to a requirement to have an independent depositary and administered and valued by entities authorised and supervised by the Central Bank of Ireland, the QIF automatically meets the material requirements of the Directive.

The QIF is already the vehicle of choice for European hedge funds, with the latest industry figures showing that 63% of European hedge funds are constituted as QIFs. The advent of the Directive has already



fostered considerable attention on this product and the number of QIFs authorised has doubled in the last 12 months.

Redomicile or Establish Afresh?

In terms of using the QIF as an investment product it is possible for an AIFM to either establish a new product or to convert an existing fund. In this later regard it can be noted that pursuant to legislation passed in Ireland in 2009 it is possible to redomicile an existing fund from a range of offshore jurisdictions, including Cayman, Bermuda and the BVI and to have this authorised in Ireland as a QIF. This ensures a seamless transition without triggering a taxable event and allows established managers to maintain their track record. Such a move will typically not require the consent of existing investors.

QIFs have many of the characteristics of traditional offshore products – including complete tax neutrality, no restrictions on investments or leverage, speed to market (24 hours, subject to certain conditions) and a minimum investment of €100,000 (approximately US€130,000) but they also have a number of comparative advantages including potential access to Ireland's substantial network of 60 double tax treaties as well as being able to benefit from the new passporting opportunities under the Directive, outlined below.

The primary advantages of complying with the Directive are discussed in further detail below.

Marketing in Europe

Passport

One of the cornerstones of the Directive is the introduction of a 'single market framework' to regulate the offer or placing of shares or units in an AIF. It introduces a European 'passport' under which authorised AIFMs can market EU AIFs to professional investors throughout the EU, subject to a notification procedure. The passport for EU AIFMs marketing EU AIFs comes into effect with the Directive (early 2013). Accordingly, Irish QIFs managed by EU investment managers will be able to take advantage of this new passport from that date.

The Directive as adopted will enable non-EU AIFMs to market to investors across the EU without first having to seek permission from each Member State and comply with different national laws. Non-EU AIFMs will only obtain a passport if the non-EU country in which they are located meets minimum regulatory standards and has agreements in place with Member States to allow information sharing. There will be at least a two year time lag before a passport is available for non-EU AIFMs marketing any AIFs or for EU AIFMs marketing non-EU AIFs in Europe as it is dependent on the European Securities and Markets Authority ("ESMA") issuing positive advice in this regard (which is expected in early 2015). Accordingly, Irish QIFs managed by US investment managers should be able to take advantage of this passport from 2015.

Assuming that the passport regime is extended in 2015, a non-EU AIFM will apply for authorisation from its "Member State of reference", which is the Member State with which it has the closest relationship. Authorisation is subject to a number of specific requirements including the appointment of a local legal representative and the existence of cooperation arrangements with the AIFM's home regulator.



Private Placement

When relying on national private placement regimes, to the extent that these exist in each case, an AIFM must satisfy certain conditions which are outlined in the table below. While it was a concession that national private placement regimes were retained under the Directive, it is intended, in the long-term, to abolish such national regimes and replace these with European marketing passports. Individual Member States may also abolish the existing private placement regimes in advance of this. The Directive provides that if the passport is extended to non-EU AIFMs and AIFs, ESMA will issue further advice after three years on whether national private placement regimes should be terminated.

The below table summarises the marketing framework under the Directive:

		EU AIFM	Non-EU AIFM
EU AIF	Passport	Following authorisation and notification under the Directive, an AIFM may market an EU AIF to professional investors in other Member States (from 2013)	To avail of passport, an AIFM must obtain authorisation from competent authority of its Member State of reference and comply in full with the Directive and specific cooperation conditions (from 2015)
	Private Placement	N/A (as an EU AIFM will be entitled to avail of passport)	An AIFM may market an EU AIF to professional investors in any Member State under its national private placement rules subject to complying with conditions laid down in the Directive (existence of cooperation arrangements, tax information exchange etc.) (until 2018*) (from 2015, the AIFM must be authorised)
Non-EU AIF	Passport	Subject to complying in full with the Directive and specific conditions (existence of cooperation arrangements, tax information exchange etc.), an authorised AIFM may market a non-EU AIF to professional investors in other Member States (from 2015)	Where an authorised AIFM is in full compliance with the Directive and the country in which the AIF is located satisfies certain conditions relating to cooperation and tax information sharing, the AIFM will be able to exercise passport rights in marketing its non-EU AIF in the same way as an EU AIFM (from 2015)
	Private Placement	Authorised AIFM may market a non-EU AIF in any Member State under its national private placement rules subject to full compliance with the Directive and certain conditions (existence of cooperation arrangements, certain depositary requirements etc.) (until 2018*)	AIFM may market a non-EU AIF in any Member State under its national private placement rules provided that it complies with the transparency provisions of the Directive (until 2018*)

* If ESMA advises that it is appropriate to do so, the Directive contains provisions to facilitate the abolition of the private placement regime five years after the Directive comes into force (2018). Individual Member States are free to amend or close their private placement regimes in advance of this.

Marketing Outside Europe – Future Developments?

While the scope of the passport available under the Directive is limited to the EU, it will of course be possible to distribute an AIF complying with the Directive beyond the EU, subject to the national rules applicable in each target jurisdiction. However, in the case of the existing pan European product, the UCITS, numerous countries outside the EU (“Third Countries”), for example in South America, the Middle East and Asia, have come to recognise this as the defacto international standard and this facilitates local registration and distribution in these jurisdictions.

Accordingly, it may be that the Directive will in time come to be seen in the same light by the alternative industry and AIFs which comply with it may, in future, also be recognised by regulators and national authorities in countries outside the EU.

Target Investors

The scope of the Directive relates to marketing to professional investors (applying MiFID standards). Marketing to retail investors (i.e. non-professional investors) is defined by each Member State in its own territory and they can impose stricter requirements than those for professional investors, provided that Member States do not favour domestic AIFs over non-domestic AIFs proposing to market on a retail basis.

Private Equity Funds

The European Parliament insisted from the outset on the need to combat asset stripping. Accordingly, the Directive contains provisions which limit distributions and capital reductions within the first two years that a company is taken over by a private equity investor. Private equity investors will also have to comply with detailed information and disclosure requirements particularly regarding information on the planned strategy for the company.

Timeline

Below is a summary of the expected timeline for the Directive:

- the Directive is due to come into force in early 2011, upon publication in the Official Journal;
- Level 2 measures, expanding on the general principles of the Directive, are aimed to be finalised by early 2012;
- the Directive is to be transposed into local law in each Member State by early 2013;
- passport regime for EU AIFMs of EU AIFs will commence in early 2013;
- passport regime for non-EU AIFMs and non-EU AIFs will probably commence in early 2015;
- review of application and scope of the Directive by ESMA in 2017; and
- private placement regime may end in 2018.

The new European Securities and Markets Authority (“ESMA”, formerly CESR) and the European Commission will now work on preparing the Directive guidelines and implementing legislation, with input from national regulators such as the Central Bank of Ireland.

Conclusion

While many issues remain to be ironed-out through the Level 2 process, the Directive is expected to result in greater investor protection through increased transparency and more robust regulation of the alternative investment fund industry. The Directive has been welcomed by the Irish Funds Industry Association which notes that the harmonised framework will introduce the opportunity to passport Irish QIFs throughout Europe.

Ireland is ready for the Directive, with the Irish regulatory regime already aligned with many of the requirements of the Directive. Irish regulated AIFs, such as QIFs, for example, are already required to have an independent depositary and are administered and valued by entities authorised and supervised by the Central Bank of Ireland.



As an on-shore, European, fully regulated product, the QIF automatically meets the material requirements of the Directive which is of particular interest to AIFMs wishing to avail of the passport when it comes into effect in 2013 (for EU AIFMs) and 2015 (for non-EU AIFMs). Having such a passport for EU-wide distribution, for a product suitable for more aggressive and leveraged strategies, including hedge funds, private equity funds and real estate funds, will be a tremendous advantage to managers seeking wider access to European capital.

The contents of this briefing note are to assist access to information and do not constitute legal or other advice. Readers should obtain their own legal and other advice as may be required.

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About Mason Hayes+Curran

Mason Hayes+Curran is a full service, business law firm with 51 partners and over 270 employees specialising in Irish law. With offices in Dublin, London and New York the firm delivers sophisticated legal services to an extensive Irish and international client base. Our investment funds lawyers have a wealth of experience in the investment funds industry and have been involved in the development of policy and regulation in Ireland. We advise on the establishment and ongoing operation of Irish domiciled investment funds and our dedicated team of investment funds lawyers can also draw upon the expertise of specialist lawyers from our tax, corporate, banking, litigation, intellectual property, data protection, regulatory and compliance practices whenever required. For further information with regard to the topics covered in this Update, or Irish investment funds law generally, please see the contacts listed below:

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