Alternative Investment Fund Managers Directive: Overview

Introduction

This note provides a brief overview of the key provisions of the Alternative Investment Fund Managers Directive (the "**AIFMD**"). The AIFMD imposes harmonised conditions and requirements on the structure and operation of alternative investment fund managers ("**AIFMs**"), in return for which authorised AIFMs are, for the first time, permitted to avail of a passport to market alternative investment funds ("**AIFs**") to professional investors across the European Union ("**EU**") and to manage AIFs domiciled in member states other than the AIFM's home member state. An AIFM covered by the parameters set out in the AIFMD is not permitted to manage or market relevant AIFs unless authorised under the AIFMD regime. EU member states were required to transpose the AIFMD into national law by 22 July 2013.

The protracted negotiations leading to the final adoption of the AIFMD centred on issues surrounding how these provisions might apply to non-EU AIFMs or non-EU AIFs (ie, access to the EU market for non-EU AIFMs and non-EU AIFs); provisions concerning delegation and valuation; leverage rules; requirements around the depositary function; and the rules on remuneration. Whilst compromise was achieved in relation to each of these matters at framework directive level, the AIFMD provided for a large body of secondary measures to be enacted in order to shape the details in support of the application of the primary legal requirements. The implementing measures take the form of a regulation (the "**Level 2 Regulation**") which directly applied in all EU member states from 22 July 2013 without the need for transposing legislation.

Ireland offers a ready-made solution to many of the issues arising from the introduction of the AIFMD. A self-managed qualifying investor alternative investment fund ("**QIAIF**") may itself apply for authorisation as the AIFM (in effect, a self-managed AIF) and may delegate its investment management functions to an EU or non-EU investment manager. The investment manager would not be the AIFM and therefore would not have to comply in full with the provisions of the AIFMD. The self-managed investment company ("**SMIC**") is a self-managed fund structure which was already firmly embedded within the Irish regulatory framework prior to AIFMD implementation.

For more detailed analysis of key provisions, such as those relating to delegation, disclosure and third country issues, please see our series of AIFMD factsheets on our website.

Scope

The AIFMD regulates AIFMs; it does not regulate AIFs directly. Unless an exception applies, the AIFMD applies to the following managers:

- EU AIFMs which manage one or more AIFs, regardless of whether the AIFs are EU or non-EU AIFs;
- non-EU AIFMs who manage EU AIFs; and
- non-EU AIFMs who market their AIFs in the EU.

A minimum threshold applies in relation to the application of the full scope of the AIFMD; the main provisions of the AIFMD only apply where the AIFM manages assets of €100 million or more. A higher threshold of €500 million applies to AIFMs that do not use leverage and have a five year lock-in period for their investors. All collective investment schemes, other UCITS are AIFs and are caught by the AIFMD so long as the relevant threshold is reached. Exempt AIFMs (ie, AIFMs managing assets under management below the prescribed thresholds) have an obligation to register with, and provide information to, their competent authorities. They may also opt-in to the AIFMD, thereby availing of a passport for their AIFs, provided that they comply in full with the provisions of the AIFMD. The Level 2 Regulation provides for the procedure to be followed by an AIFM when calculating its assets under management and the methodology to be used for specific categories of assets.

The AIFMD creates a number of exemptions for managers and funds which would otherwise fall within the broad definitions contained in the AIFMD, including holding companies; institutions for occupational retirement provision / pension fund managers; employee participation and employee savings schemes; and securitisation special purpose entities.

Authorisation

AIFMs must apply for authorisation to the regulator of their home member state, or in the case of a non-EU AIFM, the member state of reference (see below) (the "**Regulator**"). For authorisation to be granted, the Regulator must be satisfied that the AIFM is capable of complying with the AIFMD, has sufficient capital and assets and is run by individuals who have sufficient experience and who are of good repute. AIFMs seeking authorisation in Ireland must apply for authorisation to the Central Bank of Ireland (the "**Central Bank**").

Minimum Capital Requirements

Internally managed or self-managed funds are required to have €300,000 in initial capital and external managers of one or more funds must have at least €125,000, increasing on a sliding scale to a maximum of €10 million according to the total value of assets under management. AIFMs must also have additional own funds which are appropriate to cover potential liability risks arising from professional negligence or hold professional indemnity insurance against liability arising from professional negligence. The Level 2 Regulation establishes a common definition for professional liability risks, provides an indicative list of events to be covered and provides for a number of qualitative requirements for AIFMs to appropriately monitor operational risks.

Marketing Provisions

An AIFM may only market an AIF to EU investors if the AIFM is authorised by a relevant EU regulator or complies with national private placement regimes. Marketing is defined in the AIFMD so as to exclude reverse enquiries by investors; thus "passive" marketing by AIFMs is not considered to be "marketing" under the AIFMD.

The AIFMD provides a framework for marketing to professional investors. The definition of professional investor is adopted from the Markets in Financial Instruments Directive ("**MiFID**"). Each member state can decide under national private placement rules if it permits marketing of all or certain types of EU or non-EU AIFs to retail investors. There is no passport for marketing to retail investors.

Depositary Provisions

Eligible Depositaries

An AIFM must appoint a single depositary in respect of each AIF it manages. The depositary can either be an EU credit institution, an EU investment company or a UCITS depositary. An AIFM cannot act as a depositary. A prime broker acting as a counterparty to an AIF may not act as a depositary unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker and any potential conflicts of interest are properly identified, managed, monitored and disclosed to the AIF investors.

Third Country Depositaries

The depositary of an EU AIF must have its registered office or a branch in the AIF's home member state (ie, the member state where the AIF was first authorised). A non-EU AIF must have a depositary established in the country in which the AIF is established or in the home member state of the AIFM managing the AIF (or member state of reference in the case of non-EU AIFM). Where the depositary is established in a third country, a number of conditions must be met, including the requirement that there be co-operation and information exchange arrangements in place between the depositary's supervisor, the AIFM's regulator and the regulator in each member state where the AIF is intended to be marketed. Depositaries in the third country where the depositary is established must be subject to effectively enforced prudential regulation and supervision to the same effect as that under EU law.

Depositary Liability Regime

Generally, the depositary remains liable for the failures of its delegates. The AIFMD differentiates between the depositary's custody duties and safekeeping (ie, record keeping) duties. The AIFMD provides that a depositary can avoid liability for loss of financial instruments, which are subject to the custody obligation, where the loss of the financial instrument is due to an external event beyond the reasonable control of the depositary, the consequence of which would have been unavoidable despite reasonable efforts.

The Level 2 Regulation contains detailed provisions relating to the obligations and rights of depositaries taking into account that the core function of such entities is the protection of the AIF's investors. It expands on the AIFMD requirements relating to the monitoring of cash flows of an AIF, the scope of financial instruments to be held in custody, general oversight duties, delegation of custody and liability for the loss of financial instruments held in custody.

Leverage

The AIFM must set a maximum level of leverage for each AIF it manages. The AIFM must comply with this maximum at all times and must be able to demonstrate to its Regulator that the levels set are reasonable. The Regulator will assess the risks which the use of leverage employed by the AIFM could entail and may impose limits on the level of leverage that an AIFM may employ, or other restrictions on the management of the AIF.

Two methods for calculating leverage are provided for in the Level 2 Regulation: the "gross" and "commitment" methods. However, the European Commission (the "**Commission**") may adopt further delegated acts on an additional and optional method for the calculation of leverage, on the basis of technical advice developed by the European Securities and Markets Authority ("**ESMA**").

Delegation

An AIFM must notify its Regulator if it chooses to delegate any of its functions. The AIFM must be able to objectively justify the entire delegation structure and will have to review the services provided by each delegate on an ongoing basis. It may only delegate its portfolio and / or risk management functions to regulated entities; where this condition cannot be satisfied, delegation is subject to the prior authorisation of the Regulator.

Where the delegate is in a non-EU country, cooperation arrangements between the Regulator and that of the non-EU country must be in place, the third country entity must be authorised or registered for the purpose of asset management and it must be effectively supervised by an independent competent authority.

The AIFMD provides that an AIFM may not delegate to the extent that it is no longer regarded as the manager of the AIF and is merely a "letter box entity". Portfolio management or risk management functions cannot be delegated to the depositary, to a delegate of the depositary, or to any other entity whose interests may conflict with those of the AIFM or the investors of the AIF that it manages unless the delegate functionally and hierarchically separates the function of portfolio management or risk management from the other tasks which it performs that represent a conflict of interest. The conditions under which an AIFM may delegate its functions and the criteria for determining whether an AIFM ought to be deemed a letterbox entity are elaborated upon in the Level 2 Regulation.

Valuation

The valuation function may be carried out by the AIFM itself, or it may appoint an external valuation agent. Where the AIFM decides to carry out the valuation function itself, it must ensure that the process is functionally independent from the portfolio management and remuneration functions of the AIF and that measures are put in place to mitigate conflicts of interest. Where an external valuer is appointed, the AIFM must be able to demonstrate that the delegation is to an external valuer that is professionally recognised, can furnish professional guarantees and has been appointed pursuant to the AIFMD delegation provisions. The external valuer may not itself delegate the valuation function to a third party. ESMA's final advice to the Commission on the Level 2 measures clarified that where a third party such as an administrator carries out the calculation of net asset value (as distinct from valuing the assets of the fund), it is not to be considered an external valuer for the purposes of the AIFMD. An AIFM's liability towards the AIF and its investors shall not be affected by the fact that the AIFM has appointed an external valuer.

Remuneration Policies and Practice

The AIFMD introduces requirements for the AIFM to have remuneration policies and practices that are consistent with and promote sound and effective risk management and do not encourage excessive risk taking. Annex II of the AIFMD establishes a set of rules (largely based on those contained in amendments to the Capital Requirements Directive ("**CRD III**")) with which AIFMs have to comply when applying the remuneration policies for certain categories of staff. ESMA's "Guidelines on Sound Remuneration Polices under the AIFMD" set out guidance explaining how firms may comply with the Annex II principles.

Non-EU AIFMs and Non-EU AIFs

Upon transposition into national law, the marketing passport automatically became available to EU AIFMs managing EU AIFs. However, non-EU AIFs and non-EU AIFMs may not avail of the passporting regime until ESMA recommends that the passport ought to be extended and the Commission passes the necessary secondary legislation. ESMA delivered an initial opinion on the extension of the passport in July 2015, recommending that the passport be extended to Guernsey, Jersey and Switzerland (subject to the enactment of pending legislation in the case of Switzerland).

In July 2016, ESMA published its second set of advice indicating that the passporting regime under AIFMD should be extended to Canada and Japan, as well as Guernsey, Jersey and Switzerland. In regards to Hong Kong, Singapore and Australia, ESMA concluded that these countries had met the relevant assessment criteria, albeit with relatively minor obstacles remaining to market access. In relation to the US, ESMA noted concerns regarding reciprocal market access and a disparity of treatment which could result from extending the AIFMD passport to that jurisdiction. As such, ESMA has suggested that the AIFMD passport be extended to a restricted category of US funds. Due to the pending implementation of AIFMD-like regimes in Bermuda and the Cayman Islands, ESMA was unable to finalise its assessment of those jurisdictions. Likewise, it could also not reach a definitive assessment on the status of the Isle of Man at the time.

The Commission was due to give its final decision on extending the AIFMD passport to third countries in mid-October 2016, three months after ESMA issued its second set of advice. However, the Commission has not yet passed the necessary legislation to extend the AIFMD passport to third countries and currently there is no clear timescale for its implementation.

EU AIFMs managing non-EU AIFs and non-EU AIFMs managing non-EU AIFs may continue to make use of national private placement regimes ("**NPPRs**") until at least 2018. Until the passport is extended, NPPRs are the sole regime available to non-EU AIFs and non-EU AIFMs wishing to market in the EU. However, this is not simply a case of carrying on under the terms of pre-existing NPPRs as the AIFMD imposes mandatory conditions which apply over and above the NPPRs. For example, non-EU AIFMs seeking to privately place non-EU AIF or EU AIF are subject to requirements including annual reporting, mandatory investor disclosure obligations and regular reporting to the relevant member state authorities with respect to a list of prescribed matters.

EU AIFMs seeking to privately place non-EU AIFs are required to comply in full with the AIFMD, excluding the depositary provisions. In the case of both non-EU AIFMs seeking to privately place non-EU AIFs or EU AIFs and EU AIFMs seeking to privately place non-EU AIFs, there must be co-operation arrangements between the relevant EU and non-EU regulatory authorities involved, and the relevant non-EU jurisdiction concerned must not be listed as a non-cooperative country by the Financial Action Task Force.

In 2018, ESMA is required to provide a recommendation as to the desirability of terminating the NPPRs. If it does so, the Commission will have to pass secondary legislation phasing out NPPRs. However, given that ESMA still has a lot of work to do in reviewing the extension of the AIFMD passport to non-EU jurisdictions; it is unlikely that the NPPRs will be abolished in the near future.

Member State of Reference

If a non-EU manager intends to avail of the passport (when extended to non-EU AIFMs), it will have to apply for authorisation to its member state of reference ("**MSR**"). The AIFMD provides that the MSR should be the country where the AIFM intends to develop effective marketing. Level 2 measures adopted by the Commission regarding the procedure for determining the MSR require that, in proving the intention to develop effective marketing, the non-EU AIFM must indicate the member states where distributors are going to promote units or shares of AIFs, the number of target investors in each member state, the official languages into which promotional documents have been translated and the distribution of marketing activities across the member states where the non-EU AIFM intends to market its AIFs. There is no need for the non-EU AIFM to establish a physical presence (eg, a branch) in its MSR or anywhere in the EU. The non-EU AIFM must have a "legal representative" in the MSR who will be the official contact point for the MSR regulator and will be responsible for the "compliance function relating to the management and marketing activities performed by the AIFM under the Directive together with the AIFM".

Ireland and the AIFMD

Ireland was the first country to accept applications for authorisation as an AIFM and was among the few member states to transpose the AIFMD into national law by the 22 July 2013 deadline. Matheson advised the first AIFM to be authorised in Europe.

Prior to implementation, the Irish regulatory regime already incorporated many of the provisions set out in the AIFMD, such as the depositary requirement and the requirement that funds be administered and valued by entities authorised and supervised by the Central Bank. In terms of the valuation requirements within the AIFMD, it is worth noting that Ireland is the largest centre for hedge fund administration in the world and so Irish service providers are well positioned to perform the valuation role under the AIFMD. Furthermore, the AIFMD provides that, where the legal form of the AIF permits internal management and the AIF chooses not to appoint an external AIFM, the AIF may itself be authorised as an AIFM. As noted above, in Ireland, the self-managed investment company is a self-managed fund structure permitted for UCITS and non-UCITS which was already firmly embedded within the Irish regulatory framework prior to the implementation of the AIFMD.

Transitional Provisions

The Central Bank confirmed at an early stage that it will authorise Irish AIFs which have a non-EU AIFM. Any such non-EU AIFMs are not required to fulfil the obligations imposed on AIFMs immediately but benefit from a transitional period until the Commission reaches a decision on extending the AIFMD passport. In the interim, any QIAIF authorised after 22 July 2013 with a non-EU AIFM must ensure that it and its non-EU AIFM comply with the provisions of the AIF Rulebook that apply in the case of QIAIFs with registered AIFMs. This means that the QIAIF will have to comply with the AIFMD depositary requirements, with the important exclusion of the AIFMD depositary liability provisions.

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team can be accessed at www.matheson.com.

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