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Briefing note

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The Alternative Investment Fund Managers Directive – An Overview

Background

The Alternative Investment Fund Managers Directive (the "**AIFMD**") is a European directive which entered into force on 21 July 2011.

The AIFMD seeks to create a harmonised framework for regulating risks that alternative investment fund managers ("**AIFMs**") pose to investors and to financial stability and to provide a European internal market for AIFM.

The directive covers a wide range of fund products and structures and proposes far-reaching regulation in areas such as authorisation and capital, conduct of business, organisation, transparency and marketing.

It covers not only EU managers but also non-EU managers to the extent they manage alternative investment funds ("AIFs") established in the EU or market AIFs in the EU.

Definition of an AIFM

The AIFMD regulates the manager of the AIF, rather the AIF itself, but Member States are required to ensure that all AIF within scope have a single AIFM responsible for ensuring compliance with the directive. The AIFM is the external manager appointed by or on behalf of the AIF or, if the form of AIF permits internal management and management is in fact provided internally, the AIF itself will be treated as the AIFM.

An AIFM is defined to be any person whose regular business is managing one or more AIF by providing at least the investment management services of portfolio management or risk management. Only one of these services need be provided for an AIFM to be considered 'managing' an AIF and thus requiring authorisation. An individual only advising an AIF will not need authorisation under the AIFMD.

Scope of the AIFMD

Territorial scope

The AFIMD applies to all:

- EU AIFMs
- non-EU AIFMs which manage EU AIFs; and
- non-EU AIFMs which market AIFs in the EU (regardless whether such AIFs are EU/non-EU AIFs).

Investment funds in scope

An AIF is defined to be any collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing in accordance with a defined investment policy which does not require authorisation under UCITS directive.

This will include:

- any non-UCITS funds (which perform similar activities to UCITS funds but are not caught by that directive);
- hedge funds;
- private equity funds;
- investment trusts; and
- real estate firms.

General exemptions

The following entities will not be caught by the AIFMD:

- holding companies;
- institutions for occupational retirement provision;
- supranational institutions (such as the European Central Bank);
- national central banks;
- national, regional and local government bodies or other institutions which manage funds supporting social security and pension systems;
- employee participation schemes or employee savings schemes; and
- securitisation special purpose vehicles.

Small portfolios

AIFMs which either directly or indirectly manage portfolios of AIFs whose assets under management:

- including any assets acquired by leverage, in total, do not exceed EUR 100 million; or
- do not exceed EUR 500 million when the portfolios of AIFs consist of AIFs that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of the initial investment, are required only to be registered with the relevant home-state regulator and to provide limited information in respect of their activities.

Timetable for implementation

The AIFMD was published in the Official Journal of the European Union on 1 July 2011 and came into force on 21 July 2011, this had little practical effect. Below are the key dates for implementation of the AIFMD regime.

Mid 2012

Mid to late 2012 – it is expected that the European Markets and Securities Authority ("**ESMA**") will finalise its draft Level 2 regulations.

22 July 2013 – deadline for transposition into member state law. EU passporting provisions will also come into effect at this time for those AIFM that become authorised.

22 July 2014 – AIFM performing activities under the Directive before its final transposition date are required to submit an application for authorisation by this date.

2015 – ESMA will report on the functioning of the passporting regime for EU AIFs and AIFMs and consider the extension of the passporting regime to non-EU AIFs and AIFMs.

2018 – ESMA to review the directive's impact and to consider ending member state's private placements.

2018+

Transitional provisions

AIFMs performing activities within the scope of the AIFMD before 22 July 2013, are required to take all necessary measures to comply with national law stemming from the AIFMD and must submit an application for authorisation within one year from that date.

In general, there are exemptions from this transitional provision in that:

- An AIFM managing closed-ended AIF which do not make any additional investments after the 22 July 2013 may continue to manage such AIF without authorisation; and
- AIFM managing closed-ended AIF whose final closing has occurred prior to the 22 July 2013 and which will terminate by 22 July 2016 may continue to manage such AIF without complying with the AIFMD or member state implementing laws.

Core provisions

Authorisation

- AIFM require authorisation from their home-state regulator to carry on their portfolio and/or risk management activities. Such authorisation will also permit them to market funds.
- An AIFM must meet a number of requirements in order to be granted authorisation, including capital requirements: external AIFMs must have a minimal capital of EUR 125,000 and internally managed funds must have EUR 300,000. AIFM managing portfolios exceeding EUR 250 million must provide additional own funds corresponding to 0.02% of the excess amount, subject to an overall cap on capital of EUR 10 million.

Disclosure and reporting

- AIFM's must prepare an annual report for each AIF they manage or market in the EU which must be provided to investors on request.
- AIFM's must provide investors with minimum information, pre-investment including in respect of investment strategy, objectives, and liquidity and risk management arrangements.
- AIFM's must regularly disclose information, for instance relating to their risk management arrangements and the results of any recent stress tests performed.

Leverage

Leverage is defined widely, to include "any method by which the exposure of an AIF is increased, whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means." The draft Level 2 text sets out more detailed explanations in respect of the calculation of leverage and makes clear that leverage should be expressed as a ratio.

The AIFMD imposes special requirements on AIFMs which use leverage in their investment strategy. These include:

- ***Risk management:*** AIFMs are generally required to have a risk management function (subject to the principle of proportionality). As part of the general risk management requirements an AIFM must set a maximum level of leverage for each AIF it manages taking account of a number of factors including the AIFs investment strategy and the type of leverage it employs.
- ***Liquidity management:*** any AIFM which is not an unleveraged closed-ended AIF must employ appropriate liquidity management systems and regularly conduct stress tests under normal and exceptional liquidity conditions.
- ***Disclosure to investors:*** an AIFM must disclose to investors where it uses leverage, the types and sources of leverage and any associated risks.
- ***Reporting obligations:*** where an AIF employs leverage on a "substantial basis[1]" the annual report to the regulator must include information relating to the overall leverage employed, a breakdown of the types of leverage used and the identity of the five largest sources of borrowed cash or securities and the amounts received from those sources.
- ***Potential leverage limits imposed:*** the competent member state regulator may, where it is deemed necessary, (on an assessment of the information provided by an AIFM, regarding leverage limits and levels) for the stability and integrity of the financial system and after having notified ESMA, impose limits on the level of leverage that an AIFM is entitled to employ with respect to the AIFs under its management.

[1] Article 113 of the Level 2, draft guidance states that leverage will be considered to be employed on a substantial basis when the exposure of an AIF (as calculated in accordance with specific methods) exceeds two times its net assets.

Depositary liability

- An AIFM must appoint a single depositary, responsible for cash-flow management, supervision of assets and safe-keeping, for each AIF it manages. The agreement with the depositary must comply with the minimum content requirements set out in level 2 text.
- A depositary can delegate is safe-keeping function by appointing a sub-custodian to hold assets in custody.
- AIFMD imposes safe-keeping obligations on depositaries in respect of financial instruments held in custody by the depositary itself or a third party sub-custodian of a depository.
- The AIFMD provides for strict liability for any loss of financial instruments held in custody (either by the depository itself or a third party sub-custodian) requiring that the depository return identical financial instruments or a cash equivalent to the owner of the assets without undue delay.
- A depository will only be exempted from this strict liability if the loss of a financial instrument (1) results from an external event, (2) the external event is beyond the reasonable control of the depository and (3) the depository could not have avoided the loss despite all reasonable efforts. In order for a loss to be excluded as an external event, a depository must ensure it used all reasonable efforts to avoid the loss caused by such external event.

Passporting

- An AIFM can get an EU passport to market entities or arrangements it manages that are AIFs, to professional investors in other EU member states.
- The AIFM must notify its home state regulator of the other member states in which it wishes to exercise its passport, providing information including the AIF rules and other information generally available to investors. The home state regulator will then notify the relevant oversees regulators within 20 days and confirm to the AIFM that it has done so. Once the AIFM receives this confirmation, it can begin marketing in those other member states.
- An AIFM must notify its home state regulator of any changes in the information provided to the home-state regulator, (including presumably the AIF rules or strategies) one month before they take effect and any unplanned changes must be notified immediately. This could clearly impact on AIFM's flexibility to change the terms and strategy of an AIF in a response to market changes or to reflect investor demands.

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