

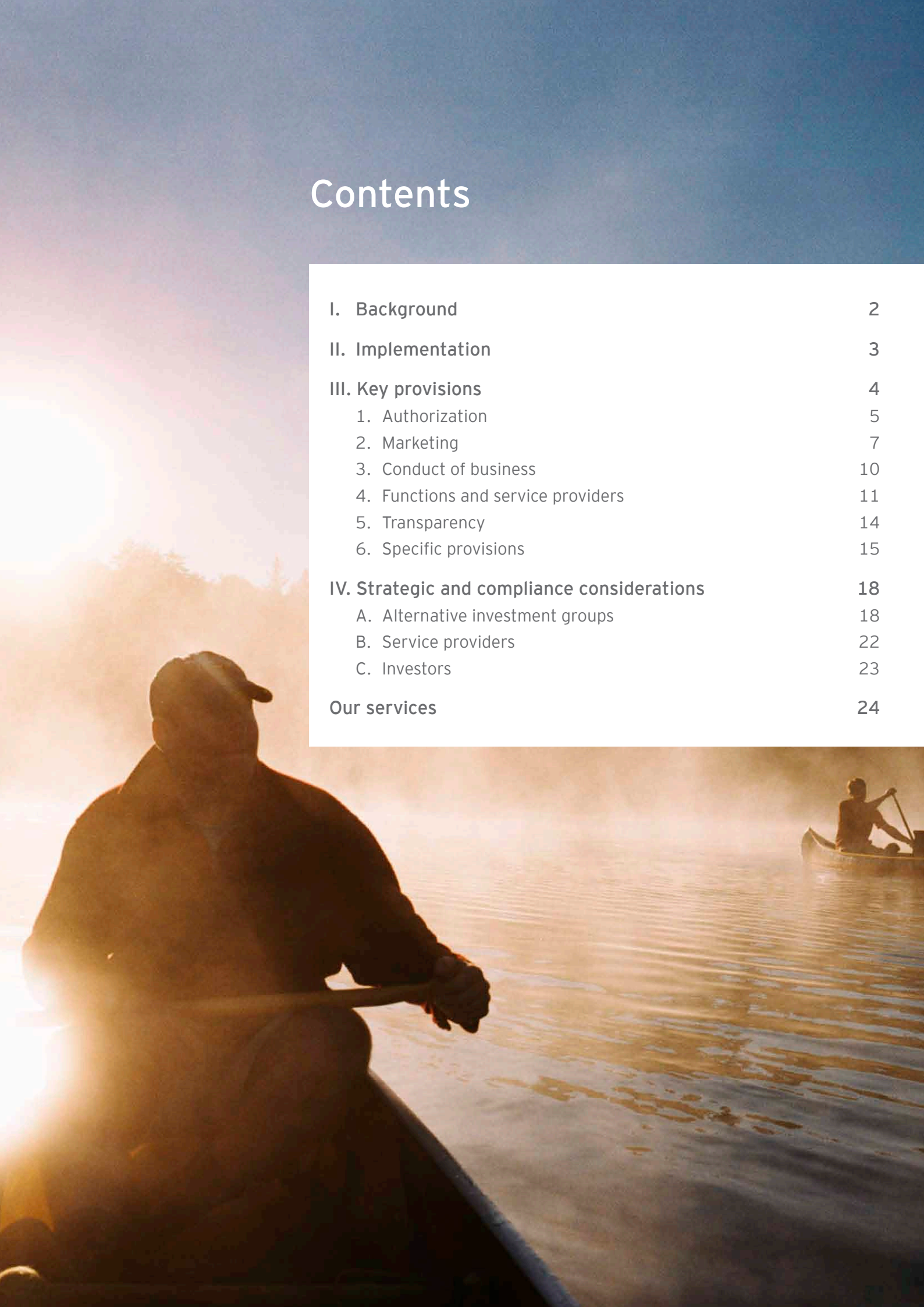
# A new dawn for alternative investments?

Navigating the challenges and opportunities  
of the AIFM Directive



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A vertical photograph on the left side of the page shows a person in a canoe on a misty lake at dawn. The person is silhouetted against the bright light of the rising sun, which creates a hazy, golden glow over the water and the surrounding trees. The sky is a deep blue, transitioning to a lighter hue near the horizon.

# Foreword

The proposed Alternative Investment Fund Managers (AIFM) Directive will have a profound structural impact on the fund industry, both in Europe and internationally.

While the main focus of the AIFM Directive is on managers of funds, the Directive has a broad scope and will impact not only European Union (EU) and non-EU AIFM, but also EU and non-EU domiciled Alternative Investment Funds (AIF), service providers to these funds and their investors.

The Directive covers all alternative sectors such as hedge funds, real estate and private equity, but also traditional sectors where the funds are not registered as UCITS<sup>1</sup>. It applies to funds, certain corporate collective investment vehicles such as joint ventures and may also apply to leveraged managed accounts. Such products are generally for professional investors, but may also be sold to retail investors.

The Directive lays down requirements which must be met by AIFM, covering authorization, capital, marketing, conduct of business, functions and service providers and transparency. Specific provisions cover the use of leverage and acquisition of controlling interests.

In return for more regulation of AIFM, their service providers and funds, the proposed Directive provides for the introduction of passports enabling AIFM to offer their management services and market their AIF throughout the EU.

Given the political pressure for greater regulation over the alternative sector, the Directive, albeit in an amended state, is likely to be approved. Member States will be required to implement this Directive.

We believe that the Directive has ramifications far beyond achieving basic compliance. Alternative investment groups (including promoters, sponsors, advisers, general partners and managers of all types of non-UCITS funds) should conduct a strategic review of their fund ranges and their operating models. Service providers and especially custodians and valuers, will also need to assess the strategic impact on their service offering and operating model and consider how they will react to new obligations and risks introduced by the Directive. Investors will need to consider the restrictions on the access they will have to products and the changes this will have on their portfolio diversification models. The Directive will also have consequences for their investment process. Overall, the Directive will mean new opportunities and challenges for all the key stakeholders in the alternatives sectors' value chain.

This publication provides you with a simple guide to the complex AIFM Directive, and outlines its major strategic and compliance implications for key alternative industry stakeholders. To summarize, we set out how we can help you with your strategic challenges so that you are ready to meet the requirements of the Directive.

<sup>1</sup> Undertakings for collective investment in transferable securities

# I. Background

The European Commission proposed an initial draft of a new Directive introducing a harmonized EU regulatory and supervisory framework for Alternative Investment Fund Managers (AIFM) in April 2009. The initial draft then entered into the EU co-legislative process, which involves the European Parliament and the Council of the European Union.

The AIFM Directive is designed to address a number of risks identified by the Commission relating to AIF, including systemic risk. The Commission is of the view that coordinated EU regulatory oversight is a better mechanism to deal with the potential danger of systemic risk that may arise from the activities of AIF than current fragmented national approaches.

The objectives of the proposed AIFM Directive are to:

- ▶ Extend appropriate regulation and oversight to all actors and activities that embed systemic risks
- ▶ Improve financial stability
- ▶ Ensure that AIFM are subject to a regulatory framework
- ▶ Increase transparency towards regulators and investors, and public accountability for the actions of AIFM
- ▶ Enhance investor protection
- ▶ Develop the EU internal market in the area of alternative investment

Several of the provisions in the Commission's draft were highly controversial.

Both the European Parliament and the Council have been working to define their own positions on the Directive, based on the Commission's draft. However, the final text must represent an agreement between the European Parliament and the Council.

In this respect, with the framework of the rotating Presidency of the Council of the European Union, the Swedish Presidency issued three compromise proposals during the second half of 2009. During the first half of 2010, the Spanish Presidency issued seven compromise proposals, the final one on 11 March 2010. The Economic and Financial Affairs Council granted a mandate for negotiations with the European Parliament on 18 May 2010 based on the 11 March proposal. However, on 27 August 2010, the Belgian Presidency issued a new compromise proposal providing fresh impetus to the negotiations.

The Rapporteur of the Committee on Economic and Monetary Affairs of the European Parliament, Mr. Gauzès, issued his draft report on 23 November 2009. Following the submission of over 1,700 amendments by the members of the European Parliament (an all-time record), the Committee on Economic and Monetary Affairs adopted its position on the draft Directive on 17 May 2010.

## II. Implementation

Once a compromise text is agreed, it must be voted by the European Parliament and approved by the Council of the European Union. The Directive will then require the European Commission to adopt delegated acts (also called “Level 2 measures” or “implementing measures”) clarifying certain elements of the text.

Member States will have to transpose and apply the Directive, probably within 24 months of entry into force. AIFM already established in the EU may have to submit an application for authorization within 12 months of transposition. These provisions remain under negotiation.

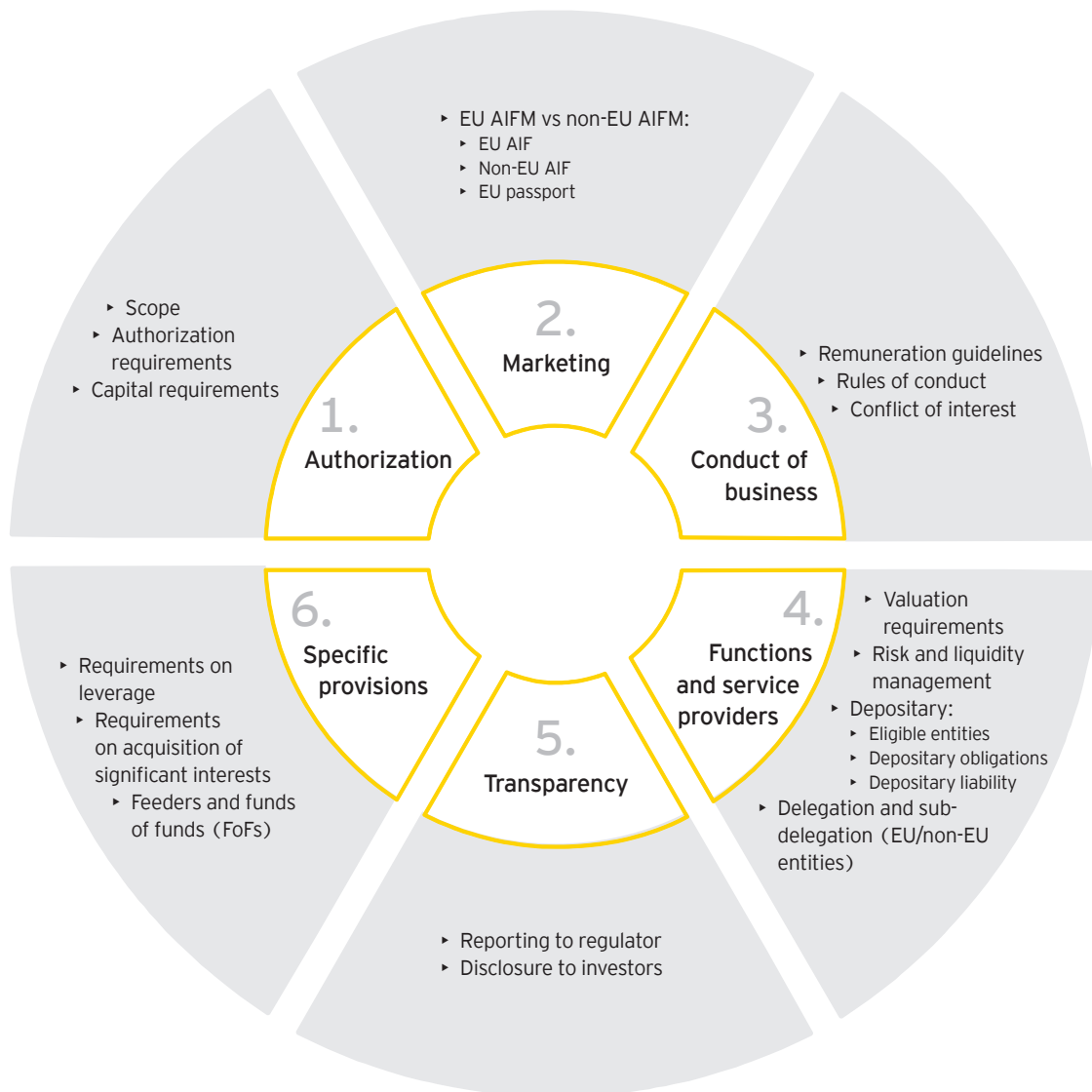
The Commission may review the application and scope of the Directive two years after implementation.



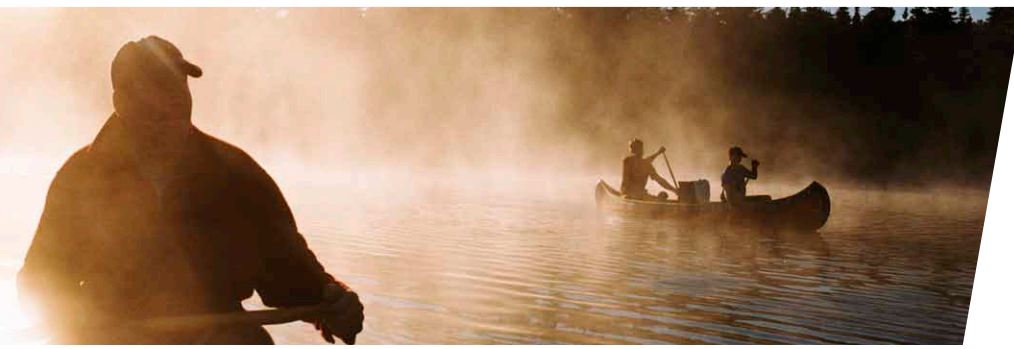
# III. Key provisions

## The key provisions of the AIFM Directive

AIFM key provisions at a glance



This section provides a brief overview of each of the key provisions as they stand today. For many of them, there is still a difference of views between the European Parliament's and the Council's drafts; on some this divergence of views is substantial or even fundamental, such as the provisions in relation to non-EU countries (also referred to as "third countries"). In general we have focused on the main elements which are common to both drafts; where this is not possible, we highlight the differences.



# 1. Authorization

## 1.1 Scope

The AIFM Directive applies to all AIFM established in a Member State whose regular business is to manage one or more AIF, irrespective of whether the AIF is established inside or outside the EU, and of the structure of the AIF. It also applies to AIFM established outside the EU who manage EU AIF or market their AIF in the EU.

An AIF is currently defined as any collective investment undertaking that is not already categorized as a UCITS fund.

An AIFM is a person whose business is to manage one or several AIF and who is responsible for compliance with the Directive. The AIFM can be the AIF itself (self-managed AIF) or an external entity.

Management services cover investment and risk management, administration and marketing.

The Directive provides for several full or specific exemptions from the Directive's provisions, with opt-in clauses.

## 1.2 Authorization requirements

AIFM in scope of the Directive must be authorized and supervised in accordance with the provisions of the Directive by their home Member State competent authorities, in order to provide management services in the EU in respect of AIF. The application for authorization must include: information on conducting persons, program of activity, how the AIFM intends to comply with the requirements of the Directive, the characteristics of the AIF to be managed, the fund rules or instruments of incorporation, as well as information of delegated activities and safe-keeping of the AIF's assets. The competent authorities may restrict the type of AIF that the AIFM is authorized to manage.

Member States may authorize AIFM to provide additional services including:

- a) Management of portfolios of investments on a discretionary, client-by-client basis
- b) As non-core services: investment advice or safekeeping in relation to units of AIFs

# 1. Authorization

The AIFM Directive captures practically all non-UCITS funds, be they alternative funds or not, as well as other vehicles such as certain joint ventures, and their AIFM. AIFM which fall under the scope of the Directive will need to perform a gap analysis between their current regulatory requirements and those of the AIFM Directive. They may also need to review their products and operating models to benefit from exemptions.

The authorization process will require significant additional compliance resources.

There is substantial alignment between the regulation of AIFM and UCITS management companies.



EU AIFM intending to manage an AIF established in another Member State, either directly through the free provision of services, or via the establishment of a branch, must submit the following documentation to their competent authorities:

- ▶ The name of the Member State in which they intend to provide management services, or establish a branch
- ▶ A program of operations stating the services they intend to perform and identifying the AIF they intend to manage
- ▶ If a branch is established: organizational structure of the branch, addresses in the home Member State from which documents may be obtained and names of persons responsible for the management of the branch

The competent authorities of the AIFM's home Member State shall transmit the complete documentation within one month to the competent authorities of the Member State where the management services will be provided, together with an attestation that they have authorized the AIFM concerned. They shall immediately notify the AIFM of the transmission. The AIFM may commence provision of management services upon receipt of the notification.

### 1.3 Capital and liability insurance

Self-managed AIF will be required to hold an initial regulatory capital of €300,000. AIFM which are appointed as external managers of one or more AIF will be required to hold an initial regulatory capital of at least €125,000. Additional capital will be required for AIFM who manage in excess of €250m. The additional own funds will be calculated as 0.02% of the amount by which the value of the portfolios of the AIFM exceeds €250m, with a €10m cap. AIFM can be exempt from up to 50% of the additional capital if they benefit from a guarantee of the same amount by a credit institution or an insurance undertaking under EU or equivalent supervision. Own funds shall be invested in liquid assets or assets readily convertible to cash in the short term.

Portfolios covered include AIF portfolios managed by the AIFM, portfolios of AIF for which the AIFM has delegated functions and other collective investment undertakings managed by the AIFM, less portfolios which the AIFM is managing under delegation.

At a minimum, AIFM are required to hold own capital equivalent to 25% of their preceding year's fixed overheads.

AIFM are required to cover potential professional liability, which may be achieved through holding professional indemnity insurance.

Overall, capital requirements are aligned with those of UCITS. AIFM may need additional capital injections which will increase financing costs and trap money. This could also represent a barrier to entry for small and mid-size players.



## 2. Marketing

### 2.1 Marketing EU AIF by EU AIFM

Marketing covers the offering or placement, at the initiative of an AIFM or on behalf of the AIFM, of units or shares of an AIF managed by that AIFM to or with EU investors.

Upon authorization, AIFM are entitled to market their AIF to professional investors in any EU Member State - they benefit from a “passport.”

The Directive leaves the marketing of AIF to retail investors in each Member State to that State’s competent authorities’ discretion. Member States may impose stricter requirements than those applicable to marketing to professional investors.

When the AIFM intends to market its AIF in a Member State (its home Member State or a host Member State), a notification procedure must be followed:

- ▶ Notification letter, in the case of marketing in a host Member State
- ▶ Identification of the AIF it intends to market and where the AIF is established
- ▶ AIF rules or instruments of incorporation
- ▶ Identity of depositary
- ▶ A description of, or information on, the AIF available to investors
- ▶ Identification of the Member State in which it intends to market the AIF, if relevant
- ▶ Measures to prevent the fund from being marketed to retail investors, if relevant

In the case of cross-border marketing, the competent authorities of the AIFM’s home Member State shall transmit the complete documentation to the competent authorities of the host Member State, together with an attestation that the AIFM is authorized; upon transmission, they shall notify the AIFM of the transmission. The AIFM may start marketing the AIF in the host Member State as of the date of the notification.

The European Parliament’s draft of the AIFM Directive distinguishes between marketing by the AIFM and reverse solicitation by investors; it would appear that in the case of reverse solicitation, the provisions of the investor’s home Member State private placement regime would apply.

AIFM will be required to comply with notification procedures to obtain authorization to market AIF to professional or retail investors in a Member State, including their home Member State.

AIFM need to review the eligibility of their fund ranges for EU passport, private placement and reverse solicitation options. This may result in changes to the fund range offered (re-domiciliation, mergers, etc.).



## 2.2 Third country AIF and AIFM

The following is a brief overview of the European Parliament's proposed regime for marketing non-EU AIF and marketing by non-EU AIFM in the EU:

- a) For an EU AIFM to market its non-EU AIF in the EU, the third country where the non-EU AIF is domiciled must meet four conditions. These concern the mutual exchange of information with the Member States where marketing is intended on tax matters and cooperation to ensure efficient exchange of all information that is relevant for monitoring the potential implications of the activities of the AIF, evidence of robust standards to combat money laundering and terrorist financing and the granting of comparable market access to EU AIFM on its territory.
- b) Non-EU-based AIFM intending to market shares or units of EU AIF to professional investors across Europe would have to voluntarily subject themselves to the Directive's requirements. Furthermore, the competent authority of the third country would have to sign an agreement with the European Securities and Markets Authority (ESMA) to act as an ESMA-delegated agent in the supervision of the AIFM. The non-EU manager would then be in a comparable situation to an EU-based manager benefiting from a passport for its EU-based funds.

In the case of non-EU AIFM marketing non-EU AIF, the requirements of a) would have to be met by both the third country of the non-EU AIF and the non-EU AIFM, and the requirements of b) would also have to be met.

EU-based professional investors may be prohibited from investing in non-EU funds if the third country does not meet all these criteria.



In view of the ongoing discussions on the third country provisions, the latest draft of the Council's text did not include a draft text on this issue at the time of writing. However, the Council's previous draft proposed a different approach; it restricted the benefits of the passport purely to EU-based managers wishing to market EU-based funds across Europe. In other cases, Member State's national private placement regimes would continue to apply.

An EU AIFM would be allowed to market non-EU funds provided that it complies with most of the provisions of the Directive (a depositary is required to perform the depositary duties under the Directive, but the other depositary provisions are not applicable - see Section 4.3.), that appropriate cooperation arrangements are in place between the AIFM's home Member State competent authority and the supervisory authority of the third country where the AIF is established, and the Member State where marketing is intended allows it.

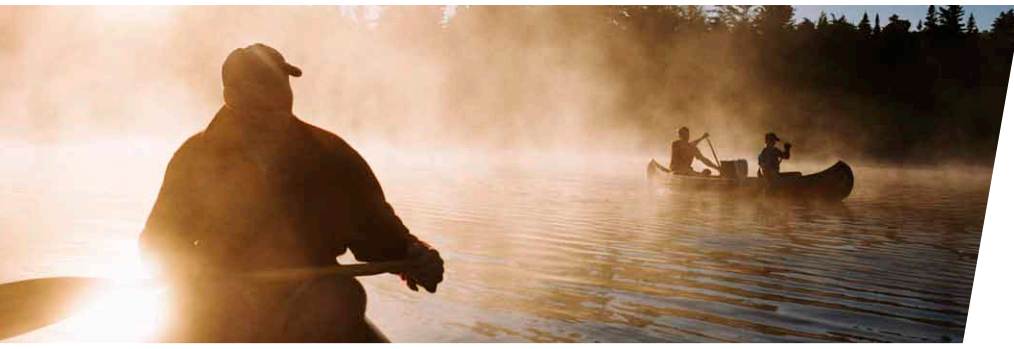
Non-EU AIFM would be able to market EU and non-EU funds in an EU Member State provided that the provisions relating to the annual report, disclosure to investors and reporting to the competent authorities of those of Member States where AIF are marketed are complied with and that there is sufficient information for investors and competent authorities, as well as appropriate cooperation arrangements between the competent authorities in the EU and those of the third country manager for the purpose of systemic risk oversight.

### 2.3 The investor's perspective

The European Parliament's draft text imposes restrictions on the marketing of non-EU AIF, as outlined in Section 2.2. It explicitly restricts investors' access to non-EU AIF to those domiciled in third countries which meet the requirements of 2.2.a). The Council's latest draft does not cover EU investors' access to non-EU AIF.

The third country provisions remain highly contentious and no compromise has been reached between the European Parliament and the Council at the time of writing. However, these provisions will have significant structural impact in the alternative sector, and will therefore be closely monitored.

The AIFM Directive could reduce EU investors' choice of investment options and be perceived as protectionist by non-EU countries, thereby potentially triggering retaliatory measures.



## 3. Conduct of business

### 3. Conduct of business

#### 3.1 Remuneration

AIFM are required to have remuneration policies which promote sound and effective risk management and do not encourage excessive risk taking. The policies and practices shall also be comprehensive and proportionate to the nature, scale and complexity of the AIFM's activity and AIF managed. Detailed requirements are set out in an Annex to the Directive.

Mandatory disclosures in the AIF's annual report include amounts of remuneration paid by the AIFM, split into fixed and variable, and, where relevant, amounts paid by the AIF.

#### 3.2 Rules of conduct

As general principles, an AIFM shall act honestly, with due skill, care and diligence and in the best interests of the AIF or the investors of the AIF it manages and promote the integrity of the market. It shall also ensure that investors are treated fairly, and in particular that no investor may obtain a preferential treatment, unless this is disclosed in the AIF rules or instruments of incorporation. The AIFM shall have appropriate resources necessary to perform its management activities.

#### 3.3 Conflicts of interest

The requirements of the Directive in relation to management and disclosure of conflicts of interest cover organizational and administrative arrangements to ensure that:

- ▶ Conflicts between the AIFM and its employees, the investors in AIF managed, and between the investors/clients are identified and managed or disclosed to investors, as appropriate
- ▶ Tasks and responsibilities deemed incompatible are segregated

Introducing remuneration policies that do not promote undue risk taking can only be supported; in many cases, such requirements only formalize already existing best practices. However, guidelines may require significant interpretation. Moreover, detailed disclosures may contain sensitive information.

AIFM will need to formalize conduct of business requirements, and may be required to review side-letters arrangements.

It will be a challenge to identify conflicts of interest between investors, especially for AIFM with a large investor base. It will also be crucial to understand from the Level 2 measures what "taking all reasonable steps to identify conflicts of interest" means in practice for the AIFM.



## 4. Functions and service providers

### 4.1 Valuation

The AIFM shall ensure that, for each AIF it manages, valuation is performed by an independent external valuer or a unit which is functionally separated from the portfolio management. Assets are required to be valued at least annually, and at a frequency which is appropriate in view of issuances and redemptions, in accordance with rules established in the domicile of the fund or the constitution documents of the fund. The Directive also requires that AIFM ensures appropriate and consistent procedures are in place so that the proper valuation of the assets of the AIF can be performed. The depositary shall ensure that the value of the shares or units of the AIF is calculated in accordance with the applicable law and AIF rules or instruments of incorporation; Member States may also require that an external valuer/auditor verify the procedures and/or valuation where no external valuer is used.

AIFM may need to formalize valuer selection and valuation processes. The authorization requirements and liability provisions will impact valuers.

### 4.2 Risk and liquidity management

The Directive requires AIFM to:

- ▶ Functionally separate risk management responsibilities from portfolio management responsibilities
- ▶ Implement risk management systems in order to measure, monitor and appropriately manage all risks associated with each AIF investment strategy and to which each AIF is or can be exposed
- ▶ Have an appropriate liquidity management system in place which includes stress testing and monitoring the liquidity risk of the AIF to ensure that the liquidity profile of the AIF complies with obligations, and ensure that investment strategy, liquidity profile and redemption policy are consistent

Formalizing risk and liquidity management procedures represents a significant burden. Stress testing will require robust business modeling capabilities.

### 4.3 Depositary

The Directive requires the appointment of a depositary acting independently and in the interest of investors for each AIF managed by the AIFM. The Directive prohibits an AIFM from acting simultaneously as an asset manager and a depositary.

The depositary must be an authorized credit institution having its registered office in the EU and being subject to prudential regulation, an EU MiFID authorized investment firm or another supervised and sufficiently qualified institution.

The depositary of an EU AIF must be established in the AIF's home Member State.



The depositary's duties cover both safe-keeping and supervisory duties:

- ▶ Receiving and booking investors' payments
- ▶ Safe-keeping the financial instruments of the AIF, which can be held in custody
- ▶ Verifying that the AIF, or the AIFM, has obtained ownership of all other assets invested in and maintain records of ownership
- ▶ Other duties are aligned with UCITS provisions and include tasks related to the transactions on shares or units, NAV calculation oversight, as well as to the execution of the AIFM's instructions

Delegation is permitted by the Directive for certain tasks, such as custody and ownership checking tasks, under specific conditions. Any sub-custodian must be selected with skill, care and diligence and subject to an ongoing supervision by the depositary.

The depositary will be liable for losses resulting from failure to perform its obligations; however, the concept of *force majeure* or "external event beyond the depositary's reasonable control" has been introduced to qualify the liability regime. In case of loss of financial instruments held in custody, the depositary shall return similar assets without undue delay. Delegation does not affect the depositary's liability. However, the Directive foresees specific situations where the depositary's liability may be partially shifted to a sub-custodian on a contractual basis, provided strict conditions are met. The AIF investors shall be clearly informed of any such provisions, which introduce some flexibility in the way depositaries may manage their risks.

While we have provided a broad outline, the European Parliament's and the Council's drafts differ substantially on the depositary issues - in particular, on eligible entities, obligations, liability, delegation and also exemptions.

For AIFM, the depositary requirements represent a significant incremental cost in operating alternative investment vehicles. The liability provisions impose a heavy burden on depositaries:

- ▶ They may raise costs and prevent depositaries from covering more risky or less developed financial markets, thereby putting into question the range of coverage and constitute a barrier to new entrants
- ▶ Concentrating liability on depositaries, even in situations beyond their control, with obligations of restitution, could also contribute to increase systemic risk in the EU market and lead to the depositary effectively becoming the fund's guarantor
- ▶ There may be consolidation in the depositary space, which may not be to the advantage of the asset management industry. This will reduce choice and increase potential counterparty risk



#### 4.4 Delegation of AIFM functions

AIFM are required to inform their home Member State competent authorities before delegating functions.

An AIFM must be in a position to monitor the delegated activity effectively. Where the delegation concerns the portfolio management or risk management, the third party must also be authorized to perform asset management.

An AIFM cannot delegate to the depositary, or any other entity with conflicting interests. It cannot delegate to the extent that it becomes a letter-box entity.

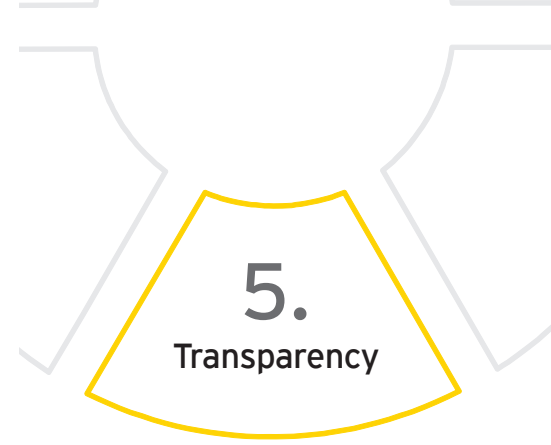
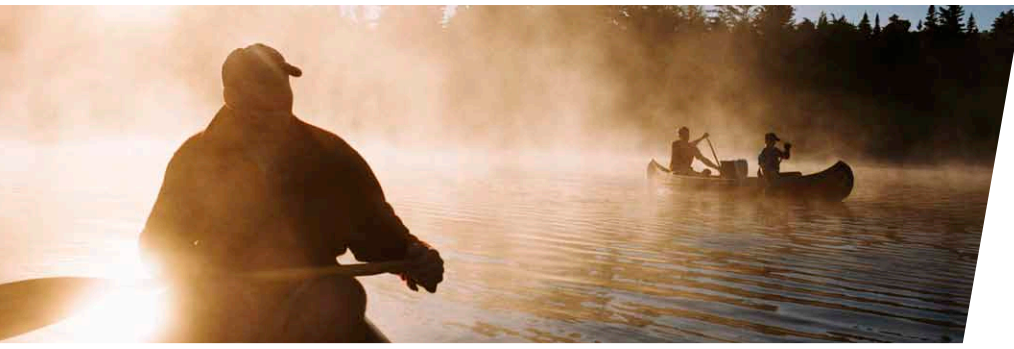
In addition, and under the European Parliament's draft, the third party may not sub-delegate any of the functions delegated to it by the AIFM.

The investors shall be duly informed of any functions delegated, and to whom. The liability of the AIFM is not affected by the fact that it has delegated functions to a third party.

AIFM may be required to review their delegation arrangements. The potential prohibition of sub-delegation might prove especially problematic to several existing business models, while imposing burdensome changes to current delegation arrangements.

AIFM will also need to formalize the information on delegation to be provided to regulators and to investors.

Overall, increased disclosure should benefit investors seeking enhanced transparency.



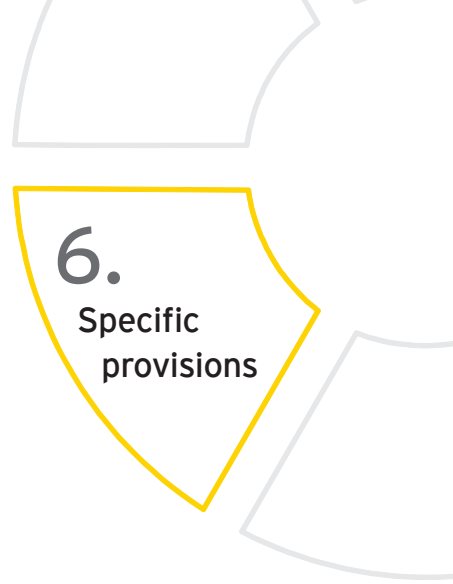
## 5. Transparency: disclosure to investors and reporting to competent authorities

No later than six months following the end of the financial year, the AIFM must make available to investors and competent authorities an audited annual report for each AIF that it manages. It shall include a report on the activities for the financial year.

Disclosures to investors before they invest shall include, *inter alia*: the AIF investment strategy, information on where master funds or FoFs are established, the level of leverage, the identity of the AIF depositary, valuator, auditor and other service providers, the description of any delegated function, a description of the AIF's valuation procedure, liquidity risk management, fees, charges and expenses borne by investors directly or indirectly, a description of any preferential treatment that an investor may obtain, as well as the latest annual report.

An AIFM is required to report to its home Member State competent authorities, for each AIF, on *inter alia*: the principal markets and instruments in which it trades on behalf of the AIF it manages, arrangements for managing the AIF's liquidity, the current risk profile of the AIF and the risk management systems employed, the level of leverage and the use of short selling on account of AIF managed.

The Directive promotes greater transparency of AIFM activities. It is difficult not to support this in principle; however, it represents an additional cost burden. Moreover, some of the information to be disclosed may be sensitive, such as side-letters, remuneration details, or information on significant interests.



## 6. Specific provisions

### 6.1 Requirements on leverage

The Directive requires additional disclosures to investors and regulators for managers who manage leveraged AIF. Leverage is any method by which an AIFM increases the exposure of an AIF it manages to particular investments whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means.

An AIFM that is subject to these obligations must, in addition to regularly disclosing actual leverage used in each fund in the preceding period, disclose to its investors the maximum level of leverage which the AIFM may employ on behalf of the AIF, as well as, periodically, the total amount of leverage employed by that AIF.

The AIFM must report to its home Member State competent authority the overall leverage employed by each fund, a breakdown of leverage between borrowing of cash or securities and leverage embedded into financial derivatives, and the identity of the five principal sources of borrowed cash or securities, as well as the amount of leverage received for each of those entities.

The national regulator will use the information it gathers on leverage to identify potential impact of leverage on systemic risk in the financial sector and the risk of market disorder.

The proposal also contains provisions on the application of limits on leverage, and the roles of the AIFM home Member State competent authorities and the ESMA/Committee of European Securities Regulators (CESR) in this respect.

AIFM will be required to measure and report on leverage according to the definition in the Directive. They may also need to comply with restrictions imposed by competent authorities. The impact will vary depending on the AIF business model.



## 6.2 Requirements on acquisition of significant interests

Where an AIFM managing one or more AIF which acquire (individually or in aggregation) a “significant interest or controlling influence”<sup>2</sup> over an EU-domiciled non-listed company, alone or together with another AIFM upon agreement, information must be disclosed to the company, and included in the annual report of the AIF in respect of each company. The measures do not apply in the case of acquisition of a significant interest or controlling influence over small companies. However, they will also apply, partially or fully, in the case of acquisition of a significant interest or controlling influence over an issuer.

An AIFM acquiring a significant interest or controlling influence over an EU-domiciled non-listed company is required to notify the below to the non-listed company and its shareholders:

- ▶ Resulting voting rights
- ▶ Conditions under which control was reached, including the identity of shareholders
- ▶ Date at which the significant interest or controlling influence was reached

In addition, information must be disclosed to the non-listed company, its shareholders and employees’ representatives, including, *inter alia*:

- ▶ Identity of the controlling AIFM
- ▶ Policy with regards conflicts of interest
- ▶ Communication policy

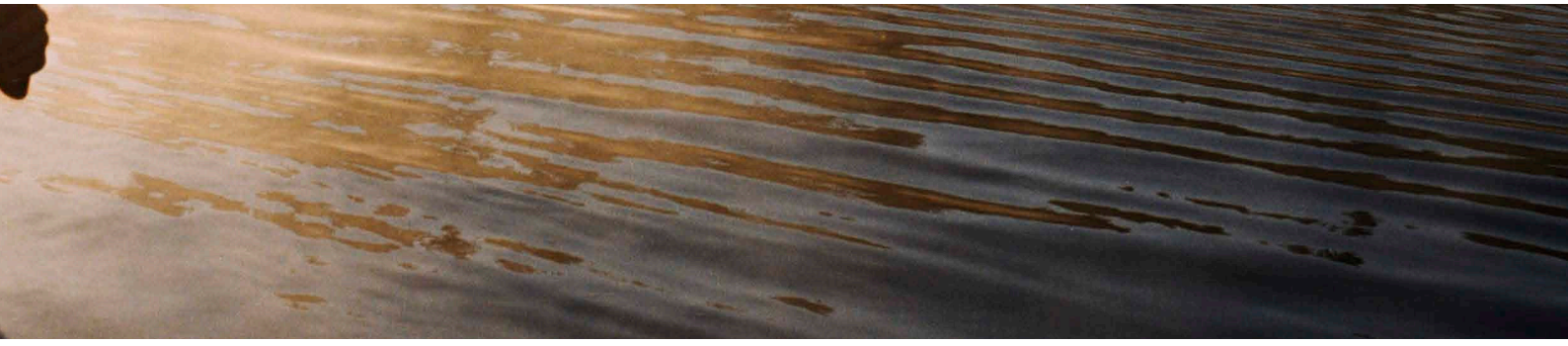
Disclosures to competent authorities of AIFM and target company home Member States are also foreseen.

In addition, the AIF annual report shall, for each non-listed company in which it has acquired a significant interest or controlling influence, provide information on, *inter alia*:

- ▶ Operational and financial developments, including revenues and earnings and capital structure
- ▶ Number of employees and information on turnover
- ▶ Significant divestment of assets

Provisions related to significant interest remain contentious, particularly in the private equity arena where the AIFM Directive requirements could represent an additional burden and entail disclosing sensitive information. This topic shall be closely monitored.

<sup>2</sup> The European Parliament’s draft and the previous draft of the Council differed significantly on the thresholds for these measures to apply. For the European Parliament, a significant interest or controlling influence trigger threshold starts at 10% of the voting rights; for the Council, control meant over 50% of the voting rights. At the time of writing, the latest draft of the Council’s text did not include a draft text on the issue of significant interests or controlling influence.



### 6.3 Restrictions on feeders and FoFs

Both the European Parliament's and the Council's drafts introduce some specific restrictions on FoFs and feeder funds.

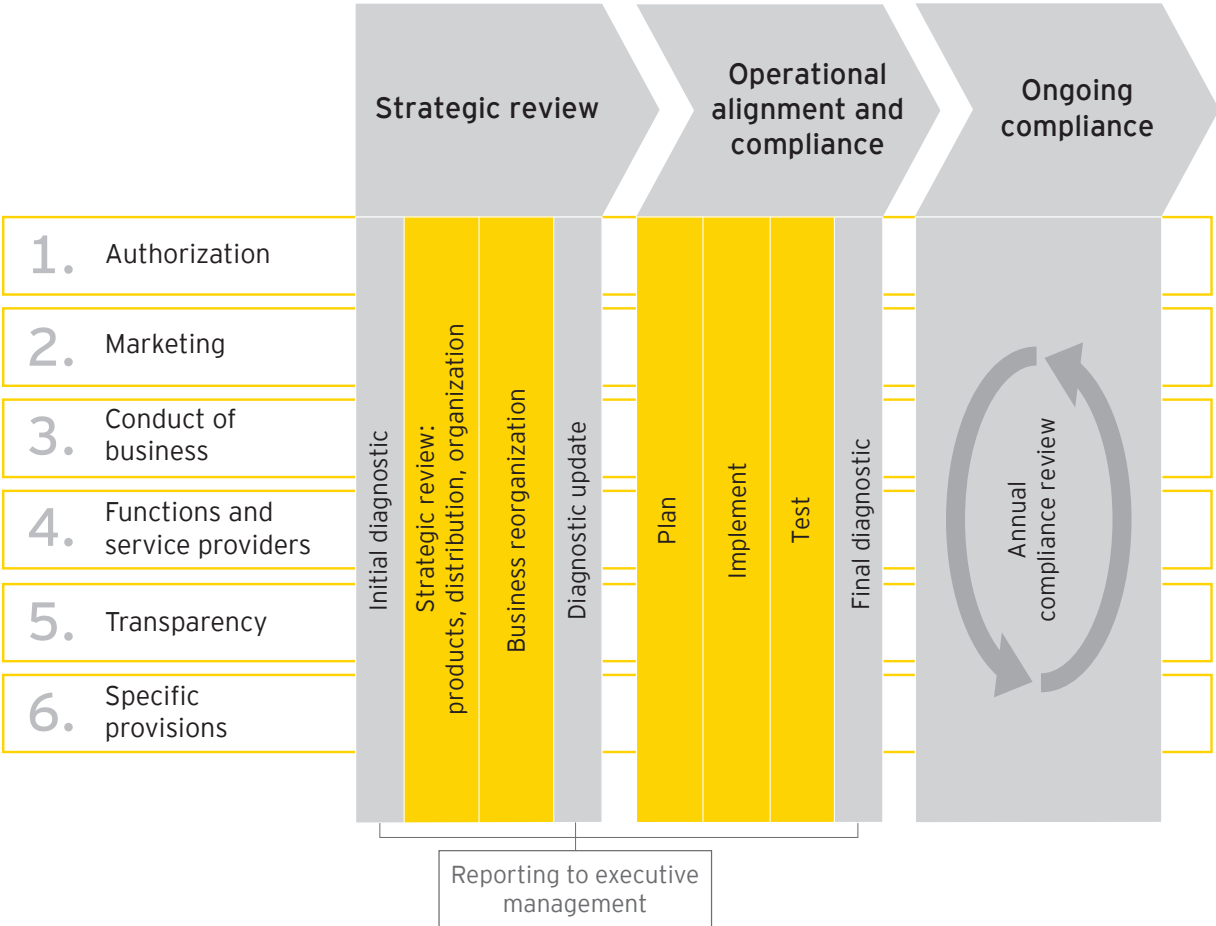
Under the European Parliament's draft, Member States cannot allow retail investors access to AIF which invest more than 30% of their assets in other AIF which do not benefit from the EU passport.

The Council's draft requires that a feeder AIF invest in a master AIF established in an EU Member State and be managed by an authorized AIFM in order to benefit from the EU passport.

# IV. Strategic and compliance considerations

## A. Alternative investment groups

Alternative investment groups (including promoters, sponsors, advisers, general partners and managers of all types of non-UCITS funds, whether standalone or part of a larger financial services organization), should consider a strategic review of their fund ranges and operating models before implementing a value-adding compliance process. At Ernst & Young, we summarize this process as follows:



## Strategic review

## Operational alignment and compliance

## Ongoing compliance

### Products and distribution

This phase will focus on:

- ▶ **Investor base:** meeting the changing needs of European and international, professional and retail investors under the new regulatory regime
- ▶ **Marketing:** benefiting (where possible) from the EU passport for AIF
- ▶ **Product styles:** choosing the right mix of regulated/unregulated, open/closed-ended, single fund/FoF, offshore/onshore, etc.
- ▶ **Investment strategies:** changes to target asset class/sector, geographic area and use of leverage

Alternative investment groups may consider, *inter alia*, the following options:

- ▶ **Re-domiciliation of existing AIFM/AIF:**
  - ▶ Onshore to the EU
  - ▶ Offshore outside the EU
- ▶ **Restructuring of existing AIFM/AIF:**
  - ▶ Some AIFM may need to be wound up, with AIF entering a run-off process
  - ▶ Some AIFM may choose to offer their investors shares or units in another AIF or product
  - ▶ Some AIFM may wish to negotiate with investors to merge existing AIF
- ▶ Creation of new AIF onshore in the EU
- ▶ Establishment of master-feeder or FoF structures
- ▶ Review of products to benefit from exemptions (by type, size or sector)

### Operating models

Alternative investment groups will need to determine the optimal platform to service their fund range, and benefit from the passport for AIFM and any relevant exemptions available. The options open relate to:

- ▶ **Configuration:** the optimal combination of own and third-party or joint venture service providers

- ▶ **Delegation:** the functions which will remain in-house, and those which may be outsourced by the AIFM, such as administration, valuation and marketing. The depositary must be independent of the AIFM
- ▶ **Domicile:** the choice of domicile or location of the AIFM, AIF and service providers. The AIFM passport enables an AIFM in one EU Member State to manage AIF in another directly or via the establishment of a branch. AIFM may also delegate functions to service providers on a cross-border basis

The strategic choice of domiciles to be made will be heavily dependent on factors including:

- ▶ **Reputation,** in particular with regard to distribution channels and reputation of investors
- ▶ **Regulatory environment** such as accessibility, knowledge and responsiveness of the regulator, as well as local practice in areas such as outsourcing
- ▶ **Stability** of the political, economic, and social environment
- ▶ **Achieving tax neutrality** for products by considering direct and indirect taxation implications at AIFM, fund and investor levels
- ▶ **Operational factors** such as relocation costs, local infrastructure, and the qualifications and knowledge of the workforce
- ▶ **Service provider considerations** such as their expertise, ability to work with AIFM from an operational and business perspective and their ability to meet specific local market requirements. For the depositary, risk management will be critical; the strength of its network in markets serviced will be crucial
- ▶ **Location influencers** such as proximity to investors, language and cultural alignment are also key. In addition, the attractiveness of the location for key management, the accessibility and ease of the business environment will play a role

- ▶ **Internal factors** such as risk management and compliance considerations

Adequate information must be provided to investors about the changes required to comply with the AIFM Directive. The AIFM Directive may change their investment allocations.

Investors will also be interested in changes to the operating platform, and in particular the cost and benefits of enhanced procedures and controls as a result of the new regulation.

Overall, Ernst & Young recommends that the objectives of this strategic review should primarily focus on how to realign the operating model to add value for the longer term, rather than ensuring compliance with the AIFM Directive and other interdependent regulatory changes. Handled in the right way, change brought about by the Directive can generate positive returns on investment from what would otherwise be a pure “sunk cost” to comply with a mandatory regulatory change – some elements of which will constitute a recurring annual cost to the business.

### Business reorganization

Alternative investment groups' optimization of their strategy and organizational model could represent a significant structural change in the sector. Ernst & Young believes that a significant number of mergers, acquisitions, spin-offs, liquidations, relocations and outsourcing initiatives could be triggered as result of this regulation and other regulatory changes both within Europe and overseas, in the broader context of the new global landscape that is emerging as the financial crisis subsides.

Strategic review

Operational  
alignment and  
compliance

Ongoing  
compliance

Once reorganized, AIFM will need to complete a compliance exercise to ensure that all of the requirements of the Directive are met. Compliance considerations for AIFM include:

- 1. Authorization**
  - ▶ Review current scope of activities of management entities
  - ▶ Establish/upgrade EU-regulated management entities
  - ▶ Boost capital and liability insurance to meet requirements
  - ▶ Review structure and products to benefit from exemptions (by type, size or sector)
- 2. Marketing**
  - ▶ Review eligibility of fund ranges for EU passport, private placement and reverse solicitation approaches
  - ▶ Review of strategy in relation to EU and international/professional and retail investors
  - ▶ Review of fund ranges with a view to re-domiciliations, mergers, etc.
  - ▶ Complying with provisions on marketing in home and other Member States
- 3. Conduct of business**
  - ▶ Update of remuneration policies, and disclosure of previously confidential information
  - ▶ Formalize conduct of business procedures to meet requirements
  - ▶ Formalize conflicts of interest identification, management and disclosure
- 4. Functions and service providers**
  - ▶ Formalize selection of independent valuers or functional independence (Chinese walls), and comply with additional valuation requirements
  - ▶ Formalize risk management functional independence or selection of third-party service provider
  - ▶ Formalize risk management procedures, stress testing and liquidity management
  - ▶ Review of depositary arrangements, including capacity to meet obligations and liability
  - ▶ Manage incremental depositary cost and invest resources to manage relationship with the depositary and provide it with evidence
  - ▶ Review service provider arrangements
  - ▶ Service provider Requests for Proposal (RFP), initial due diligence, selection and ongoing due diligence; review of current service provider agreements
  - ▶ Formalize information on delegation to be provided to regulators and to investors
- 5. Transparency**
  - ▶ Implementation/upgrade of regulatory reporting process
  - ▶ Implementation of enhanced disclosure requirements into the investor reporting process
  - ▶ Prepare for disclosure of previously confidential information
- 6. Specific provisions**
  - ▶ Compliance with leverage provisions (reporting, limits)
  - ▶ Compliance with acquisition of significant interest provisions (trigger thresholds, notification, disclosure)
  - ▶ Review of compliance with provisions on feeders and FoFs

Strategic review

Operational  
alignment and  
compliance

Ongoing  
compliance

Going forward, AIFMs should also implement an annual compliance review process to ensure that they continue to meet the requirements of both the AIFM Directive and other regulatory changes.



## B. Service providers

Service providers, such as depositaries and fund administrators, will need to re-assess their strategy and operations in the light of market changes triggered by the AIFM Directive.

Re-organization within the sector will create new opportunities and threats for service providers, such as:

- ▶ Restructuring of asset managers:
  - ▶ Concentrating activities in onshore domiciles
  - ▶ More aggressive outsourcing strategies
  - ▶ The results of M&A activities
- ▶ Restructuring of service providers (e.g., mergers, acquisitions, spin-offs). Drivers may include, for example:
  - ▶ Financial services groups deciding to sell service provider businesses or set up new joint ventures
  - ▶ Underperforming service providers being taken over or wound down
- ▶ Relocation: a service provider may choose to relocate or concentrate activities in key hubs
- ▶ Outsourcing: depending on the final provisions of the Directive, and the subsequent Level 2 implementing measures in relation to sub-delegation, service providers may consider increased outsourcing of certain activities to reduce costs or improve geographical reach

A key challenge for service providers will be to meet the initial surge in demand for their services, whilst maintaining strict quality and risk management standards at competitive prices. Service providers may therefore need to attain critical mass and should certainly look to implement robust and efficient processes and procedures.

### Depositaries

Strategic and compliance considerations for depositaries will include:

- ▶ Clear definition of professional responsibilities under the Directive and the development of a practical operating model
- ▶ Consideration of geographical markets covered
- ▶ Strategic review of market strategy and service offering, including related value added services offered by depositary network, in light of the opportunities and obligations of the Directive
- ▶ Review of capacity to perform all required functions
- ▶ Evaluation of the additional depositary costs due to the Directive
- ▶ Ensuring that arrangements for delegated functions meet the requirements of the Directive
- ▶ Ensuring sufficient professional indemnity cover in case of any litigation

### Fund administrators

Strategic and compliance considerations for fund administrators will include:

- ▶ Strategic review of market strategy and service offering, including valuation services, in light of the opportunities and obligations of the Directive
- ▶ Review of operating model, including automated processes
- ▶ Compliance with provisions on delegation of AIFM tasks
- ▶ Ensuring sufficient professional indemnity cover in case of any litigation

### Valuers

Strategic and compliance considerations for valuers will include:

- ▶ Strategic review of market strategy and service offering, in light of the opportunities and obligations of the Directive
- ▶ Implementation of appropriate and consistent valuation procedures, and appropriate disclosure thereof
- ▶ Compliance with provisions on delegation of valuation function
- ▶ Ensuring sufficient professional indemnity cover in case of any litigation

## C. Investors

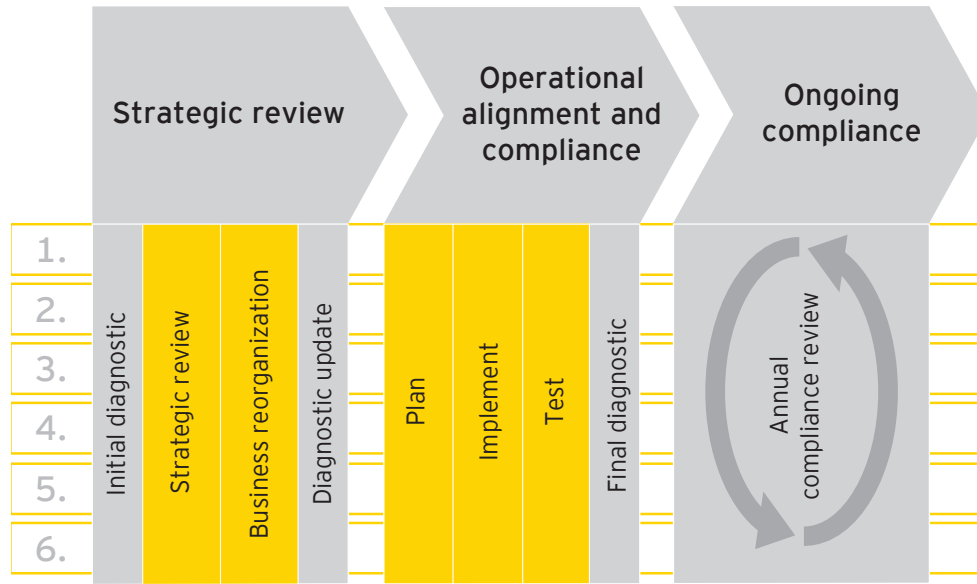
Investors, including FoFs, will need to carry out their own strategic review in view of the new requirements and opportunities.

As some markets and products may no longer be accessible to them, institutional and professional investors should review the investment options open to them as the full impact of the AIFM Directive becomes clear. Portfolio diversification models may need to be adjusted accordingly and investment disposals undertaken, in an efficient way. No doubt compliance with this Directive will form a pillar of investor due diligence going forward.

Investors may also wish to try and ensure that relevant third countries are included in the list that it is currently proposed will be established by ESMA, when investing in a non-EU AIF.



# Our services



## A. Alternative investment groups

- ▶ Facilitate an effective strategic review
- ▶ Perform an initial diagnostic of current organization (products, distribution, organization and domicile of the management platform) and operational readiness against the Directive's key provisions (risk and liquidity models, key controls, financial framework and reporting, service provider arrangements, etc.), including recommendations based on gaps identified and potential areas for strategic change
- ▶ Analyze and provide tax advice on any potential re-organization and establish a step plan for change
- ▶ Assistance in technical migration of entities and platform to new structures, including advice on specific domiciles

- ▶ Assistance in implementing key compliance work streams related to the Directive; amongst others, this would cover:
  - ▶ Review and upgrade of risk and liquidity management systems
  - ▶ Update regulatory reporting and disclosures to investors
  - ▶ Review of depositary arrangements (risk/selection/delegation)
  - ▶ Advice on the portfolio valuation processes, including methodology and documentation
- ▶ Design and delivery of bespoke training
- ▶ Testing and assurance
- ▶ Assist in establishing or upgrading compliance function
- ▶ Assist with the application process with the regulator

- ▶ Provide assurance on compliance with the Directive and any other relevant regulatory requirements on an ongoing basis; this could cover:
  - ▶ Test of automated reporting processes and controls
  - ▶ Statutory audit services for funds managed
  - ▶ Provide independent valuation opinions

## B. Service providers

- ▶ Assist service providers to quickly assess the main strategic opportunities and risks triggered by the Directive
- ▶ Market entry support and development of an operational change program specifically for custodians, administrators and valuers
- ▶ Assess the adequacy of risk management processes

- ▶ Definition of technical framework and roles and responsibilities of service providers under the Directive
- ▶ Assist in implementing efficient and effective operating models, including risk management, valuation reviews and delivery of value added services
- ▶ Review of pricing structure

- ▶ Assurance on risk and control framework (e.g., SAS 70 reports)
- ▶ Provide ongoing regulatory advice

## C. Investors

- ▶ Perform an impact assessment by analyzing existing portfolio structures and investment processes in the light of changing investment options available under the Directive

- ▶ Assist in updating or developing investment policies and procedures to take account of Directive requirements
- ▶ Update due diligence protocols

- ▶ Provide transaction support services
- ▶ Provide ongoing regulatory advice



## Our approach:

- ▶ Simple three-step approach
- ▶ Insightful high-level diagnostics to initiate and track progress
- ▶ Open, modular approach in terms of resourcing
- ▶ Tailored to clients:
  - ▶ Wishing to comply with the Directive's mandatory requirements on an ongoing basis
  - ▶ Wishing to maximize value added through organizational and operational changes triggered by the Directive

## Our offer:

- ▶ A dedicated multidisciplinary service team with clear points of contacts and accountability
- ▶ Access to experienced professionals in the areas of tax, regulatory, performance improvement, risk management, valuation and business modeling
- ▶ Seamless coordination across EMEIA via our dedicated AIFM network
- ▶ A coordinated approach across private equity, hedge funds and real estate segments

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