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We are pleased to provide you with the new issue of our legal information newsletter.

Topical legal questions are discussed and those related to issues that you might encounter.

We hope that you will find it of interest. We would welcome any comment you might have.

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### **THE IMPACT OF THE EU DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS – A.I.F.M.**

*Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 amending Directive 2003/41/EC and 2009/65/EC and Regulations (EC) 1060/2009 and (EU) 1095/2010*

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**INTRODUCTION** - On the 1<sup>st</sup> of June 2011, the so called Alternative Investment Fund Managers - “AIFM” Directive was published in the Official Journal of the European Union. The AIFM Directive, which will enter into force in 2013, was adopted from the European Parliament after thorough discussion within the European Union Institutions.

The need of such a legislation arose by considering that managers of alternative investment funds (AIFMs) are responsible for the management of a significant amount of invested assets in the Union, account for significant amounts of trading in markets for financial instruments, and can exercise an important influence on markets and companies in which they invest.

Specifically, the European Parliament considered that the impact of AIFMs on the markets in which

they operate is largely beneficial, but recent financial difficulties have underlined how the activities of AIFMs may also serve to spread or amplify risks through the financial system. Uncoordinated national responses make the efficient management of those risks difficult.

This Directive therefore aims at establishing common requirements governing the authorization and supervision of AIFMs in order to provide a coherent approach to the related risks and their impact on investors and markets in the Union.

Recent difficulties in financial markets have underlined that many AIFM strategies are vulnerable to some or several important risks in relation to investors, other market participants and markets.

In order to provide comprehensive and common arrangements for supervision, it is necessary to establish a framework capable of addressing those risks taking into account the diverse range of investment strategies and techniques employed by AIFMs. Consequently, the Directive should apply to AIFMs managing all types of funds that are not covered by Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to the undertakings for collective investment in transferable securities (UCITS).

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**SCOPE OF THE DIRECTIVE** – The Directive therefore lays down the rules for the authorization, ongoing operation and transparency of the managers of alternative investment funds (AIFMs) which manage and/or market alternative investment funds (AIFs) in the Union.

The AIFM Directive shall apply to:

- (a) EU AIFMs which manage one or more AIFs irrespective of whether such AIFs are EU AIFs or non-EU AIFs;
- (b) non-EU AIFMs which manage one or more EU AIFs; and
- (c) non-EU AIFMs which market one or more AIFs in the Union irrespective of whether such AIFs are EU AIFs or non-EU AIFs.

It shall be of no significance whether the AIF belongs to the open-ended or closed-ended type; whether the AIF is constituted under the law of contract, under trust law, under statute, or has any other legal form; or the legal structure of the AIFM.

It is however clarified that the Directive shall not apply to:

- (a) holding companies;
- (b) institutions for occupational retirement provision which are covered by Directive 2003/41/EC
- (c) supranational institutions, such as the European Central Bank, the European Investment Bank, the European Investment Fund, the European Development Finance Institutions and bilateral development banks, the World Bank, the International Monetary Fund, and other supranational institutions and similar international organizations, in the event that such institutions or organizations manage AIFs and in so far as those AIFs act in the public interest;
- (d) national central banks;

- (e) national, regional and local governments and bodies or other institutions which manage funds supporting social security and pension systems;
- (f) employee participation schemes or employee savings schemes;
- (g) securitization special purpose entities.

Also, the Directive shall not apply to AIFMs in so far as they manage one or more AIFs whose only investors are the AIFM or the parent undertakings or the subsidiaries of the AIFM or other subsidiaries of those parent undertakings, provided that none of those investors is itself an AIF.

For the purpose of the Directive, AIFs means collective investment undertakings, including investment compartments thereof, which (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorization pursuant to Article 5 of Directive 2009/65/EC;

AIFMs means legal persons whose regular business is managing one or more AIFs.

Determination of the AIFM - Member States shall ensure that each AIF managed within the scope of this Directive shall have a single AIFM, which shall be responsible for ensuring compliance with this Directive. The AIFM shall be either (a) an external manager, which is the legal person appointed by the AIF or on behalf of the AIF and which through this appointment is responsible for managing the AIF (external AIFM); or (b) where the legal form of the AIF permits an internal management and where the AIF governing body chooses not to appoint an external AIFM, the AIF itself, which shall then be authorized as AIFM.

Conditions for taking up activities as AIFM - Member States shall ensure that no AIFMs manage AIFs unless they are authorized in accordance with the Directive.

Member States shall require that no external AIFM engage in activities other than those referred to in Annex I to the Directive and the additional management of UCITS subject to authorization under Directive 2009/65/EC.

Member States shall require that no internally managed AIF shall engage in activities other than the internal management of that AIF in accordance with Annex I.

By way of derogation to this principle, Member States may authorize an external AIFM to provide the services of (a) management of portfolios of investments, including those owned by pension funds and institutions for occupational retirement provision in accordance with Article 19(1) of Directive 2003/41/EC, in accordance with mandates given by investors on a discretionary, client-by-client basis; or (b) non-core services comprising:

- (i) investment advice;
- (ii) safe-keeping and administration in relation to shares or units of collective investment undertakings;
- (iii) reception and transmission of orders in relation to financial instruments.

**AUTHORIZATION** - Member States shall require that AIFMs apply for authorization from the competent authorities of their home Member State.

The competent authorities of the home Member State of the AIFM shall not grant authorization unless (a) they are satisfied that the AIFM will be able to meet the conditions of the Directive; (b) the AIFM has sufficient initial capital and own funds; (c) the persons who effectively conduct the business of the AIFM are of sufficiently good repute and are sufficiently experienced also in relation to the investment strategies pursued by the AIFs managed by the AIFM; (d) the shareholders or members of the AIFM that have qualifying holdings are suitable taking into account the need to ensure the sound and prudent management of the AIFM; and (e) the head

office and the registered office of the AIFM are located in the same Member State.

Authorization shall be valid for all Member States. The relevant competent authorities of the other Member States involved shall be consulted before authorization is granted to (a) subsidiary of another AIFM, of a UCITS management company, of an investment firm, of a credit institution or of an insurance undertaking authorized in another Member State; (b) a subsidiary of the parent undertaking of another AIFM, of a UCITS management company, of an investment firm, of a credit institution or of an insurance undertaking authorized in another Member State; and (c) a company controlled by the same natural or legal persons as those that control another AIFM, a UCITS management company, an investment firm, a credit institution or an insurance undertaking authorized in another Member State.

**AUTHORIZATION REFUSAL** - The competent authorities of the home Member State of the AIFM shall refuse authorization where the effective exercise of their supervisory functions is prevented by any (a) close links between the AIFM and other natural or legal persons; (b) the laws, regulations or administrative provisions of a third country governing natural or legal persons with which the AIFM has close links; or (c) difficulties involved in the enforcement of those laws, regulations and administrative provisions.

Initial capital and own funds. Member States shall require that an AIFM which is an internally managed AIF has an initial capital of at least EUR 300 000. Where an AIFM is appointed as external manager of AIFs, the AIFM shall have an initial capital of at least EUR 125 000.

Where the value of the portfolios of AIFs managed by the AIFM exceeds EUR 250 million, the AIFM shall provide an additional amount of own funds (or a bank guarantee to the same extent). That additional amount of own funds shall be equal to 0,02 % of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million but the required

total of the initial capital and the additional amount shall not, however, exceed EUR 10 million.

**PROFESSIONAL LIABILITY** - To cover potential professional liability risks resulting from activities AIFMs may carry out pursuant to this Directive, both internally managed AIFs and external AIFMs shall either (a) have additional own funds which are appropriate to cover potential liability risks arising from professional negligence; or (b) hold a professional indemnity insurance against liability arising from professional negligence which is appropriate to the risks covered.

Own funds shall be invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions.

**AUTHORIZATION WITHDRAWAL** - The competent authorities of the home Member State of the AIFM may withdraw the authorization issued to an AIFM where that AIFM (a) does not make use of the authorization within 12 months, expressly renounces the authorization or has ceased the activity covered by the Directive for the preceding 6 months; (b) obtained the authorization by making false statements or by any other irregular means; (c) no longer meets the conditions under which authorization was granted; (d) no longer complies with Directive 2006/49/EC if its authorization also covers the discretionary portfolio management service referred to in point (a) of Article 6(4) of this Directive; (e) has seriously or systematically infringed the provisions adopted pursuant to this Directive; or (f) falls within any of the cases where national law, in respect of matters outside the scope of the Directive, provides for withdrawal.

**GENERAL PRINCIPLES** - Member States shall ensure that, at all times, AIFMs (a) act honestly, with due skill, care and diligence and fairly in conducting their activities; (b) act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market; (c) have and employ effectively the resources and procedures that are necessary for the proper performance of their

business activities; (d) take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable, disclose, those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated; (e) comply with all regulatory requirements applicable to the conduct of their business activities so as to promote the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market; (f) treat all AIF investors fairly.

No investor in an AIF shall obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF rules or instruments of incorporation.

AIFMs shall not be permitted to invest all or part of the client's portfolio in units or shares of the AIFs it manages, unless it receives prior general approval from the client.

**REMUNERATION** - Member States shall require AIFMs to have remuneration policies and practices for those categories of staff, including senior management, risk takers, control functions, and any employees receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of the AIFMs or of the AIFs they manage, that are consistent with and promote sound and effective risk management and do not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage.

**CONFLICTS OF INTEREST** - Member States shall require AIFMs to take all reasonable steps to identify conflicts of interest that arise in the course of managing AIFs between (a) the AIFM, including its managers, employees or any person directly or indirectly linked to the AIFM by control, and the AIF managed by the AIFM or the investors in that AIF; (b) the AIF or the investors in that AIF, and another

AIF or the investors in that AIF; (c) the AIF or the investors in that AIF, and another client of the AIFM; (d) the AIF or the investors in that AIF, and a UCITS managed by the AIFM or the investors in that UCITS; or (e) two clients of the AIFM.

AIFMs shall maintain and operate effective organizational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors.

AIFMs shall segregate, within their own operating environment, tasks and responsibilities which may be regarded as incompatible with each other or which may potentially generate systematic conflicts of interest. AIFMs shall assess whether their operating conditions may involve any other material conflicts of interest and disclose them to the investors of the AIFs.

Where organizational arrangements made by the AIFM to identify, prevent, manage and monitor conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to investors or their interests will be prevented, the AIFM shall clearly disclose the general nature or sources of conflicts of interest to the investors before undertaking business on their behalf, and develop appropriate policies and procedures.

Where the AIFM on behalf of an AIF uses the services of a prime broker, the terms shall be set out in a written contract. In particular any possibility of transfer and reuse of AIF assets shall be provided for in that contract and shall comply with the AIF rules or instruments of incorporation. The contract shall provide that the depositary be informed of the contract.

**RISK MANAGEMENT** – AIFMs shall functionally and hierarchically separate the functions of risk management from the operating units, including from the functions of portfolio management. AIFMs shall implement adequate risk management systems in

order to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed.

AIFMs shall set a maximum level of leverage which they may employ on behalf of each AIF they manage as well as the extent of the right to reuse collateral or guarantee that could be granted under the leveraging arrangement, taking into account a number of criteria that the Directive sets forth.

**LIQUIDITY MANAGEMENT** – A controverted provision AIFMs shall, for each AIF that they manage which is not an unleveraged closed-ended AIF, employ an appropriate liquidity management system and adopt procedures which enable them to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations.

AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to assess the liquidity risk of the AIFs and monitor the liquidity risk of the AIFs accordingly. Further, AIFMs shall ensure that, for each AIF that they manage, the investment strategy, the liquidity profile and the redemption policy are consistent.

AIFMs shall use, at all times, adequate and appropriate human and technical resources that are necessary for the proper management of AIFs. In particular, the competent authorities of the home Member State of the AIFM, having regard also to the nature of the AIFs managed by the AIFM, shall require that the AIFM has sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms.

AIFMs shall ensure that, for each AIF that they manage, appropriate and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed in accordance with this Article, the applicable

national law and the AIF rules or instruments of incorporation.

2. The rules applicable to the valuation of assets and the calculation of the net asset value per unit or share of the AIF shall be laid down in the law of the country where the AIF is established and/or in the AIF rules or instruments of incorporation.

3. AIFMs shall also ensure that the net asset value per unit or share of AIFs is calculated and disclosed to the investors in accordance with this Article, the applicable national law and the AIF rules or instruments of incorporation.

The valuation procedures used shall ensure that the assets are valued and the net asset value per unit or share is calculated at least once a year.

If the AIF is of the open-ended type, such valuations and calculations shall also be carried out at a frequency which is both appropriate to the assets held by the AIF and its issuance and redemption frequency.

If the AIF is of the closed-ended type, such valuations and calculations shall also be carried out in case of an increase or decrease of the capital by the relevant AIF.

The investors shall be informed of the valuations and calculations as set out in the relevant AIF rules or instruments of incorporation.

AIFMs shall ensure that the valuation function is either performed by (a) an external valuer, being a legal or natural person independent from the AIF, the AIFM and any other persons with close links to the AIF or the AIFM; or (b) the AIFM itself, provided that the valuation task is functionally independent from the portfolio management and the remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence upon the employees is prevented.

For each AIF it manages, the AIFM shall ensure that a single depositary is appointed. The appointment of

the depositary shall be evidenced by written contract. The depositary shall be for instance a credit institution having its registered office in the Union and authorized in accordance with Directive 2006/48/EC; or an investment firm having its registered office in the Union, subject to capital adequacy requirements in accordance with the relevant EU statutory regulations.

The depositary shall in general ensure that the AIF's cash flows are properly monitored, and shall in particular ensure that all payments made by or on behalf of investors upon the subscription of units or shares of an AIF have been received and that all cash of the AIF has been booked in cash accounts opened in the name of the AIF or in the name of the AIFM acting on behalf of the AIF or in the name of the depositary acting on behalf of the AIF.

In addition to the above tasks, the depositary shall (a) ensure that the sale, issue, re-purchase, redemption and cancellation of units or shares of the AIF are carried out in accordance with the applicable national law and the AIF rules or instruments of incorporation; (b) ensure that the value of the units or shares of the AIF is calculated in accordance with the applicable national law, the AIF rules or instruments of incorporation and the relevant procedures; (c) carry out the instructions of the AIFM, unless they conflict with the applicable national law or the AIF rules or instruments of incorporation; (d) ensure that in transactions involving the AIF assets any consideration is remitted to the AIF within the usual time limits; (e) ensure that an AIF's income is applied in accordance with the applicable national law and the AIF rules or instruments of incorporation.

**TRANSPARENCY REQUIREMENTS** - An AIFM shall, for each of the EU AIFs it manages and for each of the AIFs it markets in the Union, make available an annual report for each financial year no later than 6 months following the end of the financial year. The annual report shall be provided to investors on request. The annual report shall be made available

to the competent authorities of the home Member State of the AIFM, and, where applicable, the home Member State of the AIF.

AIFMs shall for each of the EU AIFs that they manage and for each of the AIFs that they market in the Union make available to AIF investors the information which Article 26 describes before they invest in the AIF, as well as any material changes thereof. This information shall cover for instance (a) a description of the investment strategy and objectives of the AIF, information on where any master AIF is established and where the underlying funds are established if the AIF is a fund of funds, a description of the types of assets in which the AIF may invest, the techniques it may employ and all associated risks, any applicable investment restrictions, the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks etc.

Among other requirements, AIFMs shall, for each of the EU AIFs that they manage and for each of the AIFs that they market in the Union, periodically disclose to investors (a) the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature; (b) any new arrangements for managing the liquidity of the AIF; (c) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks.

Also, an AIFM shall regularly report to the competent authorities of its home Member State on the principal markets and instruments in which it trades on behalf of the AIFs it manages.

It shall provide information on the main instruments in which it is trading, on markets of which it is a member or where it actively trades, and on the principal exposures and most important concentrations of each of the AIFs it manages.

**OTHER REQUIREMENTS** - Another noteworthy requirement is that Member States shall require that when an AIF acquires, disposes of or holds shares of

a non-listed company, the AIFM managing such an AIF notify the competent authorities of its home Member State of the proportion of voting rights of the non-listed company held by the AIF any time when that proportion reaches, exceeds or falls below the thresholds of 10 %, 20 %, 30 %, 50 % and 75 %. This notice shall be given pursuant to the requirements that the provisions of the Directive set forth.

Further, the directive provides for regulatory restrictions on fundraising. For instance, Member States shall ensure that an authorized EU AIFM may market to professional investors in the Union units or shares of non-EU AIFs it manages and of EU feeder AIFs that do not fulfill the requirements referred to in the second subparagraph of Article 31(1) as soon as the conditions laid down in the Directive are met.

**CONCLUSIONS** – As observed from the domestic Fund Management Associations, the new statutory regulation involves the management at the EU level of beyond 2100 billion of Euros in closed funds, hedge funds, real estate funds and other type of alternative funds. By considering the amount of investments concerned managed from these type of funds, clear is the importance of the new requirements the Directive sets forth. In this context, verifying the real impact of these norms – like for instance those about the appointment of a depositary, the disclosure or informative requirements in case of acquisition of a majority stake – shall be material to assess whether a balance between the efficiency of the management activity and the protection of the investor has been achieved.

*Article contributed by Riccardo G. Cajola*