

Alternative Investment Fund Managers Directive

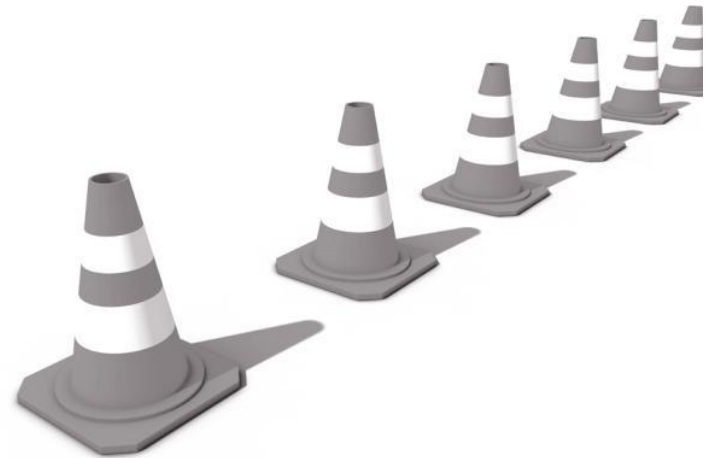
Survival Kit

November 2011



Outline

- > Origin, timeline & scope
- > Determination of AIFM
- > EU Passport / Private Placement
- > Level 1 & Level 2 measures
 - > Operating conditions for the AIFM
 - > Other provisions:
 - > Transparency
 - > Controlling stakes
 - > Leverage



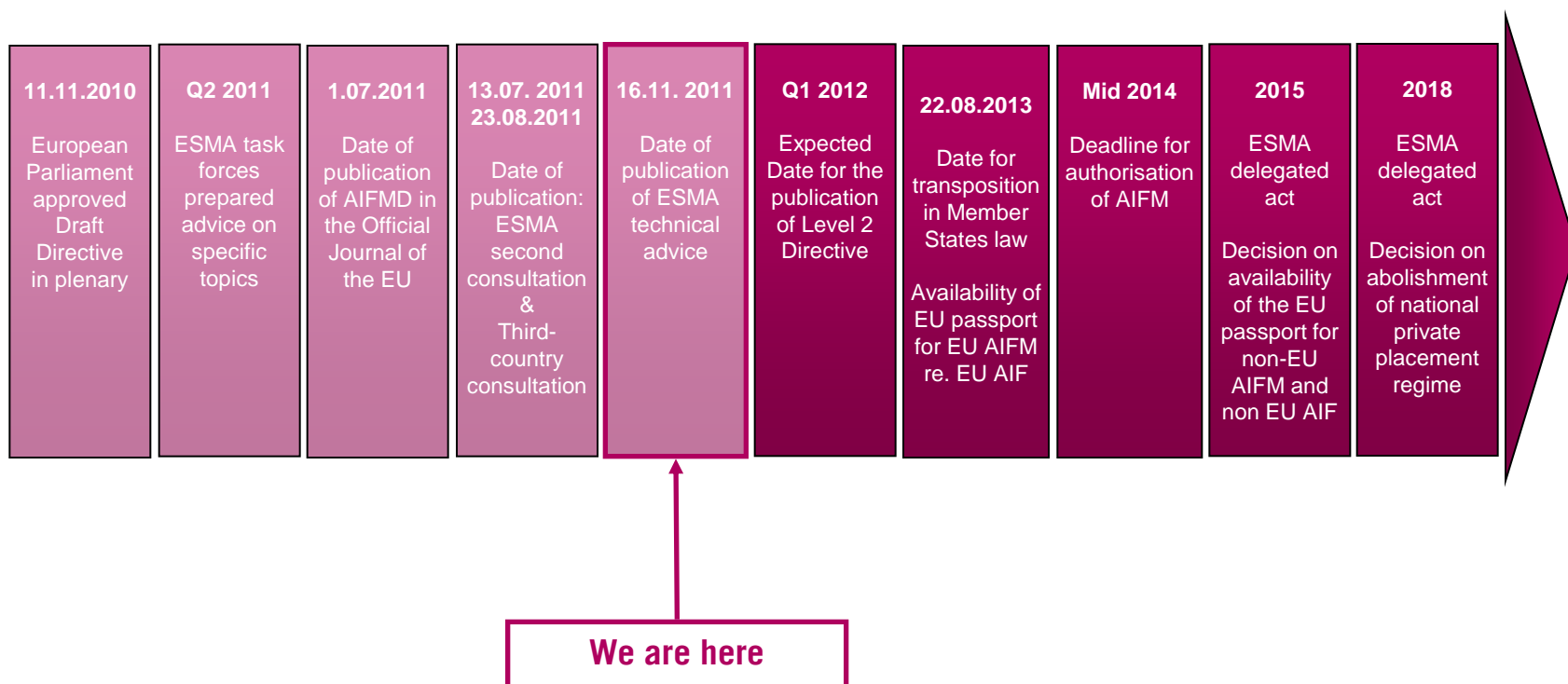
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Origin, timeline & scope

Origin

- > A direct consequence of the conclusions of the G-20 Summit in November 2008
- > Alternative Investment Fund Manager (“AIFM”) will need to apply for authorisation in order to manage Alternative Investment Fund (“AIF”)
- > In return, AIFMD introduces a “passport” enabling AIFM to offer their management services and market their AIF throughout the EU

Timeline



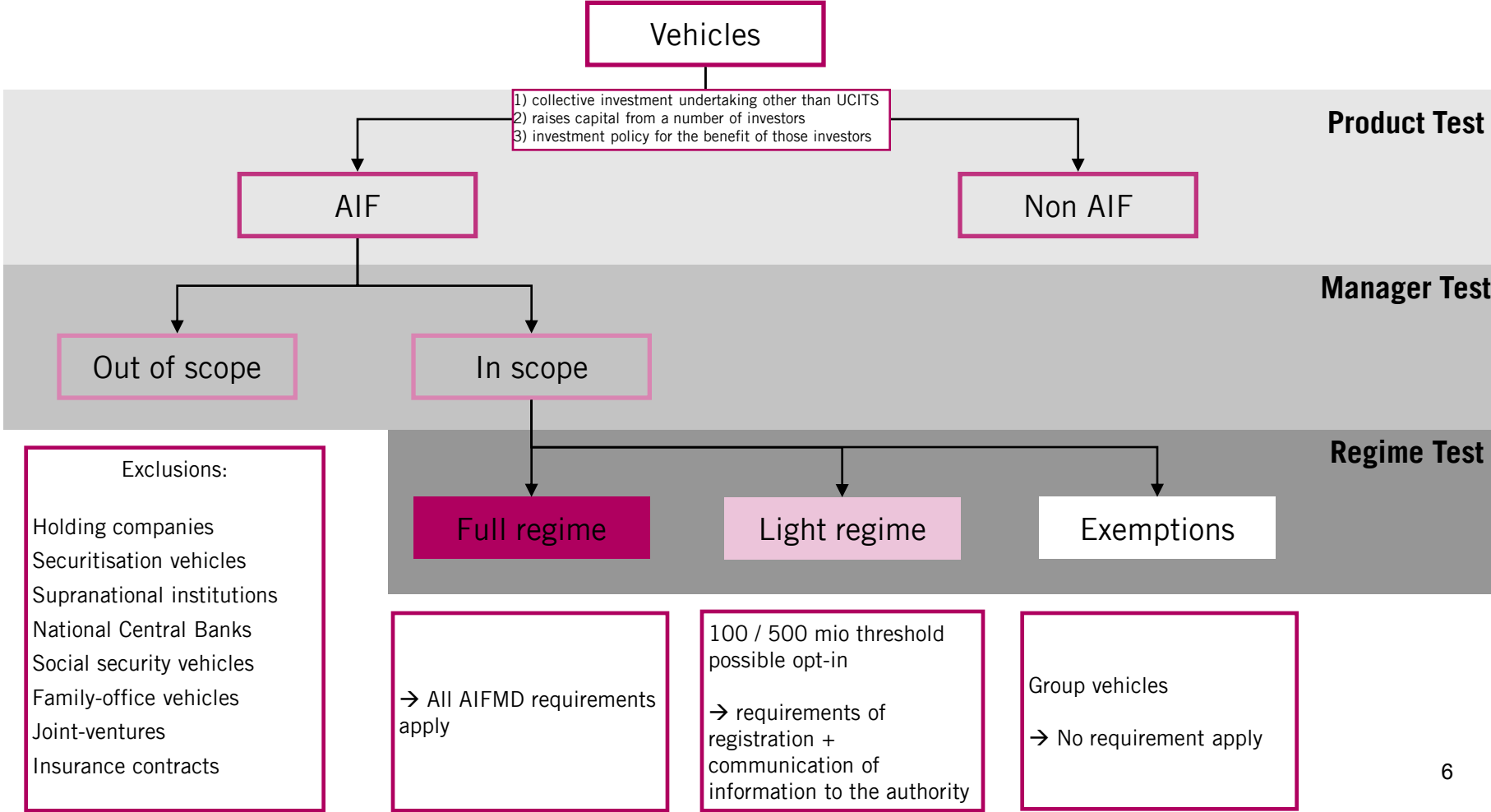
Scope

- > AIF means:
 - > any collective investment undertaking other than UCITS
 - > which raises capital from a number of investors (i.e. at least 2)
 - > Raising capital vs. Wealth Management
 - > Look-through nominee
 - > with a view to investing it in accordance with a defined investment policy for the benefit of those investors

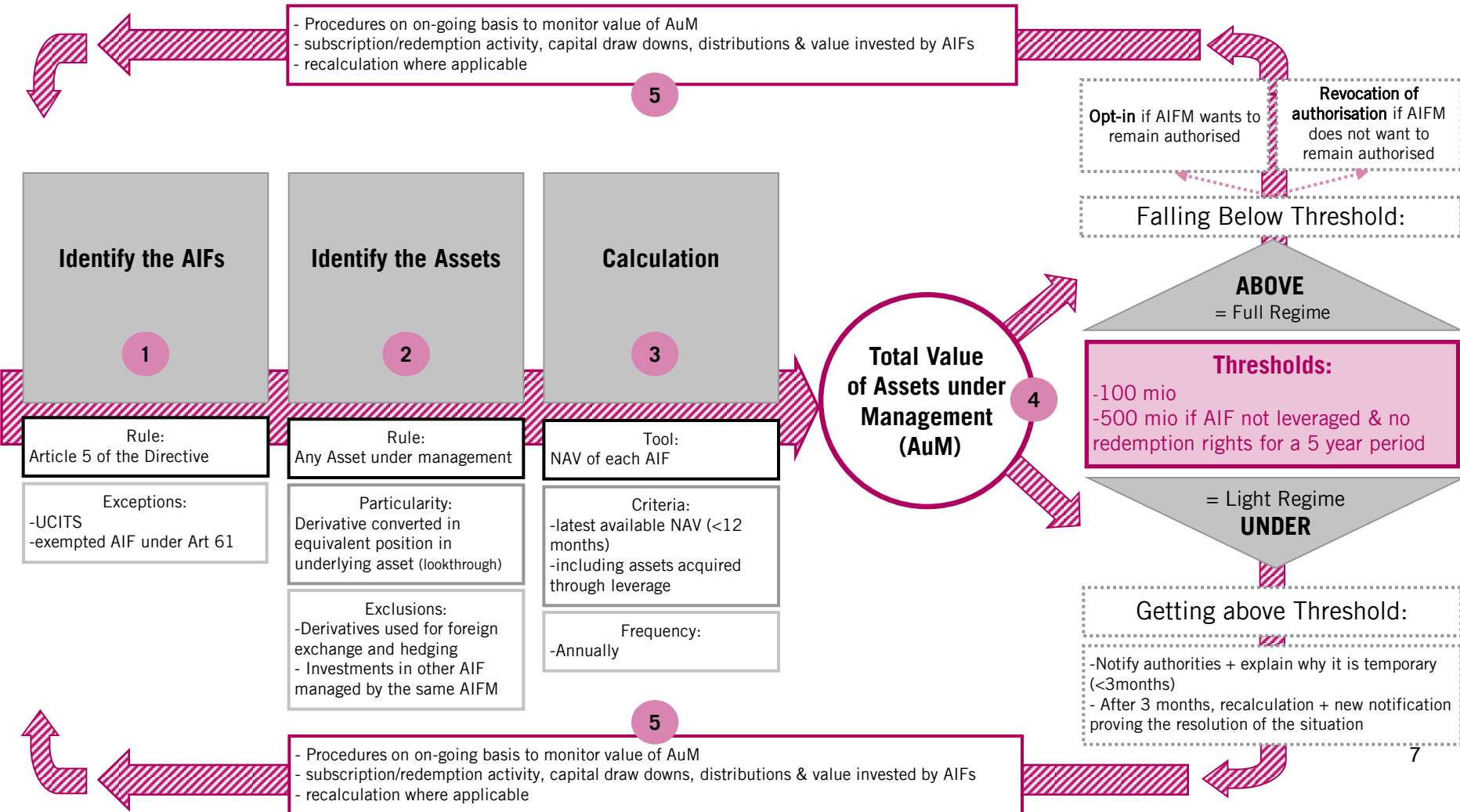
- > AIFM = legal persons whose regular business is managing one or more AIF

- > Fall within the Directive
 - > EU AIFM managing EU or non-EU AIF
 - > Non-EU AIFM managing EU AIF
 - > Non-EU AIFM marketing EU or non-EU AIF

Scope (ctd)



Are you below or above the thresholds?



Geographical scope

- > AIFMD regulates all AIFM (EU or non-EU) managing or marketing AIFs (EU or non-EU) in the EU
- > AIFMD is not applicable to non-EU AIFM which manages a non-EU AIF marketed outside the EU

- > Pitfalls:
 - > Risk of unlevel playing field re. private placement regime
 - > Absence of reciprocity principle in AIFMD

General application

22 July 2013: EU AIFM that manages EU AIF get passported (every EU AIF and EU AIFM must comply with all the requirements of the Directive)

Particular exemptions (art 61):

- > Closed-ended fund that do not make any additional investment after 22 July 2013: the AIFM can continue to manage the AIF without complying with AIFMD.
- > Closed-ended fund with a subscription period that ends before 22 July 2013 and are constituted for a period of time that does not exceed 22 July 2016: the AIFM can continue to manage the AIF without complying with AIFMD

22 July 2015: ESMA can widen the application of the passport to non EU AIF/non EU AIFM

22 July 2018: ESMA can decide to abolish the Private Placement Regime

Determination of the AIFM

Determination of the AIFM

You will be characterised as AIFM if you carry out at least:

- > Portfolio management
- > Risk management

In addition, AIFM may also provide:

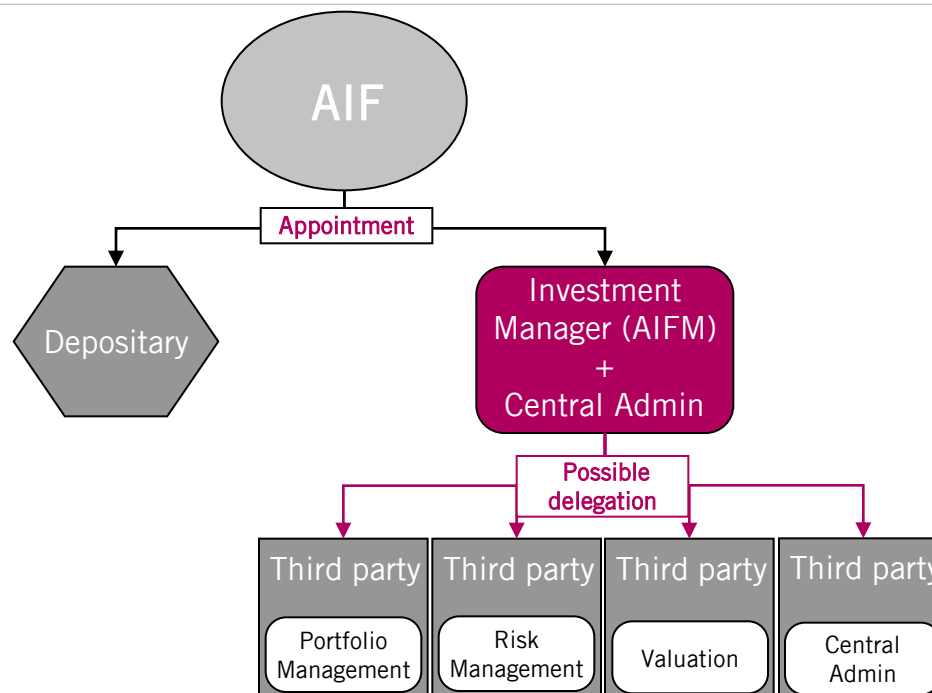
- > Administration
- > Marketing
- > Activities related to the assets of AIF

Two options:

- 1) The AIFM can be an external manager appointed by or on behalf on the AIF
- 2) The AIFM can be the AIF itself (“self-managed AIF”) provided that:
 - > The legal form of the AIF permits an internal management (e.g., SICAV)
 - > The AIF’s governing body chooses not to appoint an external AIFM



External manager

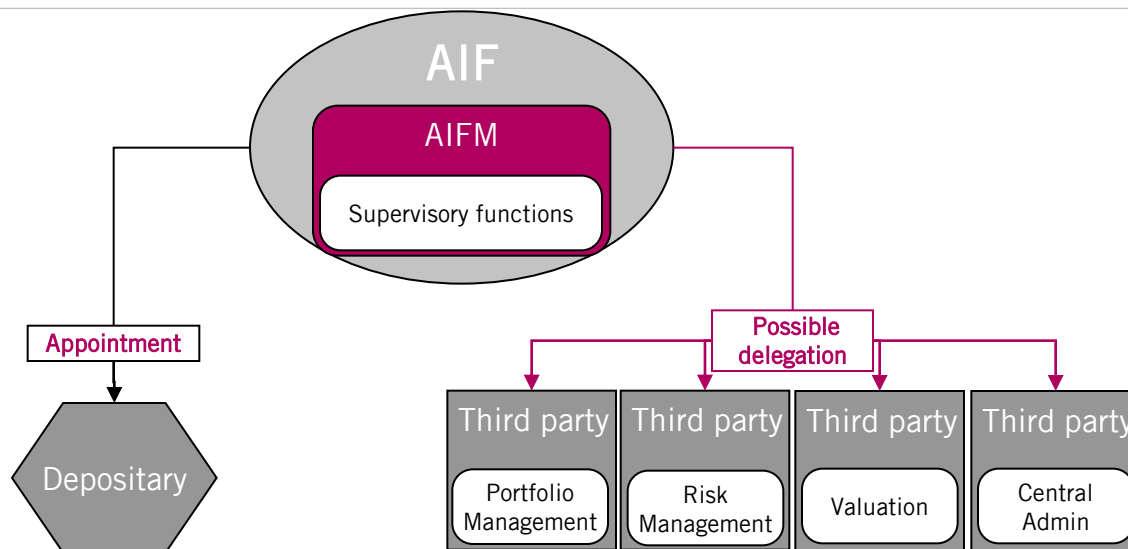


An AIF which appoints an external manager as AIFM

> which may delegate the portfolio management, risk management, valuation and/or central administration functions

> which appoints an entity to provide depositary service

Self-managed AIF



A self-managed AIF

> which may delegate the portfolio management, risk management, valuation and/or central administration functions

> which appoints an entity to provide depository service

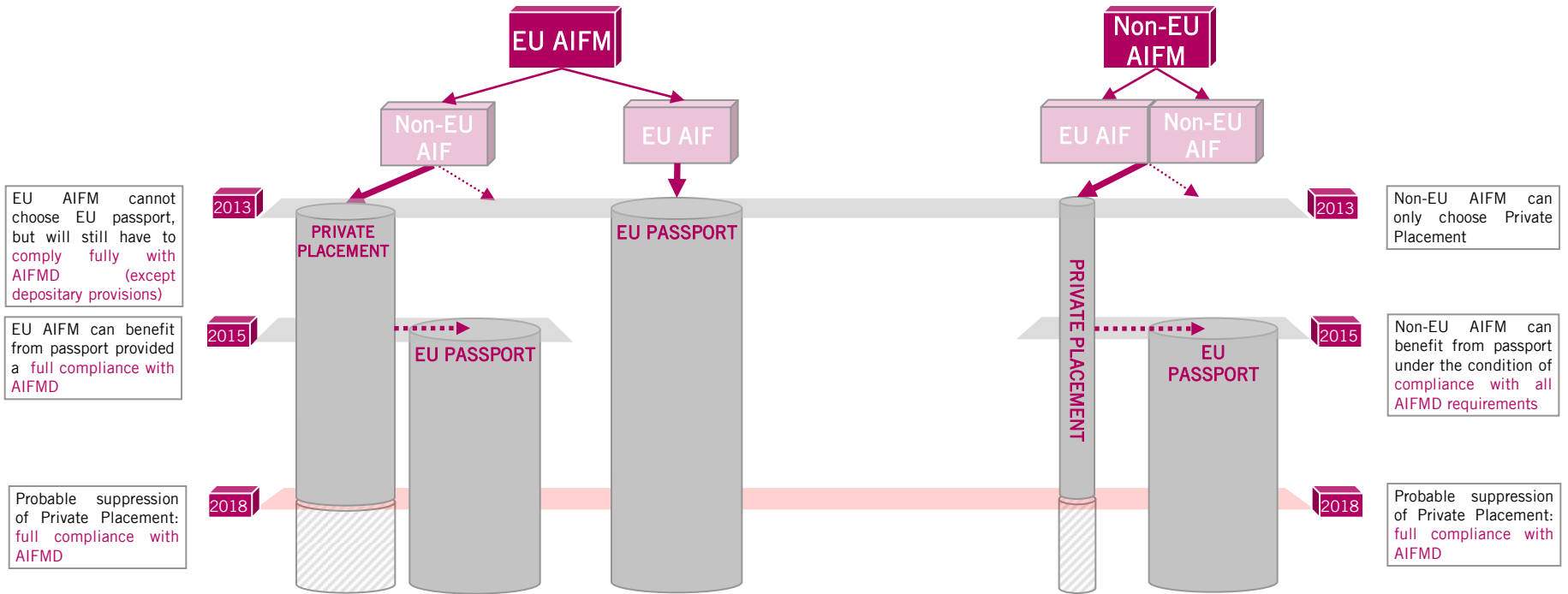
EU Passport / Private Placement

EU passport

- > AIFMD provides for two types of passport:
 - > EU marketing passport
 - > EU management services passport



Various regimes



EU AIFM cannot choose EU passport, but will still have to comply fully with AIFMD (except depository provisions)

EU AIFM can benefit from passport provided a full compliance with AIFMD

Probable suppression of Private Placement: full compliance with AIFMD

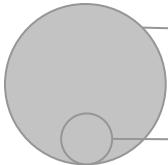
Non-EU AIFM can only choose Private Placement

Non-EU AIFM can benefit from passport under the condition of compliance with all AIFMD requirements

Probable suppression of Private Placement: full compliance with AIFMD

EU AIFM must use the AIFMD passport from 2013 on, and cannot choose Private Placement to market an EU AIF: → Full compliance with AIFMD

This diagram aims to provide a global vision of the various regimes available over time and their implication in terms of level of requirement, for both EU Managers, and non-EU Managers. It should be read along with the following tables.



Full application of the AIFM Directive (all the requirements, including depository)

Only a few requirements of AIFM Directive applied

EU marketing passport

AIFM	AIF	EU marketing passport	Depository	Valuation	AIFMD requirements
EU	EU	Yes * From 2013	Yes Location: home member state of AIF	Yes	Compliance with full AIFMD
EU	Non-EU	Yes From 2015**	Yes Location: country of AIF or home member state of AIFM	Yes	Compliance with full AIFMD except provisions re: “rights of EU AIFM to market and manage EU AIF in EU” Cooperation in place between home member state of AIFM and country of AIF Country of AIF is not on FATF non-cooperative countries list Country of AIF has signed OECD Model Tax Convention for exchange of information with home member state of AIFM and each member state where AIF is marketed

* If the feeder is an EU AIF and the master is an non-EU AIF: no EU passport available

** subject to ESMA's prior analysis and approval

EU marketing passport (ctd)

AIFM	AIF	EU marketing passport	Depository	Valuation	AIFMD requirements
Non-EU	EU	Yes From 2015*	Yes Location: home member state of AIF	Yes	<p>Compliance with full AIFMD except provisions re: “rights of EU AIFM to market and manage EU AIF in EU”</p> <p><u>Requirements for authorisation of non-EU AIFM:</u></p> <p>AIFM has a legal representative in its member state of reference</p> <p>Cooperation in place between member state of reference of AIFM, member state of AIF and country of AIFM</p> <p>Country of AIFM is not on FATF non-cooperative countries list</p> <p>Country of AIFM has signed OECD Model Tax Convention for exchange of information with member state of reference of AIFM</p>
Non-EU	Non-EU	Yes From 2015*	Yes Location: country of AIF or member state of reference of AIFM	Yes	<p>Same as box above and, in addition, re. the AIF:</p> <p>Cooperation in place between member state of reference of AIFM and country of AIF</p> <p>Country of AIF is not on FATF non-cooperative countries list</p> <p>Country of AIF has signed OECD Model Tax Convention for exchange of information with member state of reference of AIFM</p>

* subject to ESMA’s prior analysis and approval

Private placement

AIFM	AIF	Management & marketing	Private Placement	Depositary	Valuation	AIFMD requirements
EU	EU	Yes	No	AIFMD provisions applicable	AIFMD provisions applicable	The manager of the AIF must be authorised as AIFM under AIFMD as from 2013 → Full AIFMD applies
EU	Non-EU	Yes	Yes Until 2018*	AIFMD provisions not applicable But appointment of an equivalent entity in the country of AIF	Yes	Full AIFMD applies ex. depositary Cooperation in place between home member state of AIFM and country of AIF Country of AIF is not on FATF non-cooperative countries list
Non-EU	EU	Yes	Yes Until 2018*	Application of the rules of the member states where AIF is marketed	Valuer subject to national rules applicable to AIF	Compliance with annual report, disclosure to investors and reporting obligation to regulators requirements Compliance with controlling stakes reporting requirements Cooperation in place between member state where AIF is marketed, country of AIFM and member state of AIF Country of AIFM is not on FATF non-cooperative countries list
Non-EU	Non-EU	Yes	Yes Until 2018*	Same as box above	Same as box above	Same as box above + Country of AIF is not on FATF non-cooperative countries list

* subject to ESMA's prior analysis and approval

EU management services passport

AIFM	AIF	EU management services passport	AIFMD requirements
EU	EU <small>(established in another member state than the AIFM)</small>	Yes From 2013	<ul style="list-style-type: none"> - AIFM must be authorised to manage that type of AIF - Communication of information by the AIFM to the competent authority of its home member state (which will transmit it to the competent authority of the host member state of the AIFM) <ol style="list-style-type: none"> 1) Member state in which AIFM intends to manage AIF (either directly or via a branch) 2) Program of operations stating the services to be performed by AIFM and identifying the AIF it intends to manage - If the AIFM intends to <u>establish a branch</u>, it shall provide additional information: <ol style="list-style-type: none"> 1) Organisational structure of the branch 2) Address in the home member state of the AIF for which documents may be obtained 3) Names and contact details of persons responsible for the management of the branch
EU	Non-EU	N/A	N/A

EU management services passport (ctd)

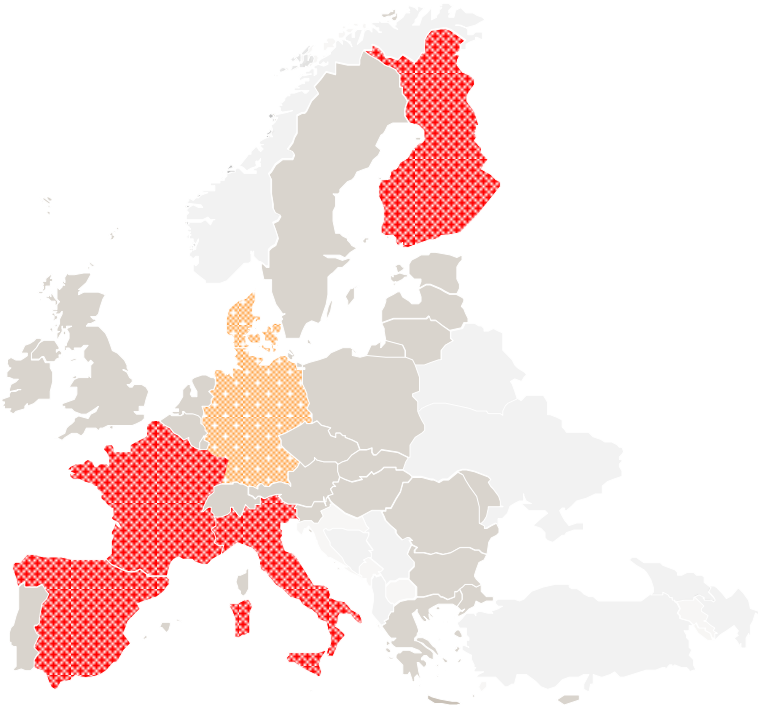
AIFM	AIF	EU management services passport	AIFMD requirements
Non-EU	EU (established in a member state other than the member state of reference of the AIFM)	Yes From 2015 *	<ul style="list-style-type: none"> - AIFM must be authorised to manage that type of AIF - Communication of information by the AIFM to the competent authority of its member state of reference (which will transmit it to the competent authority of the host member state of the AIFM) <ol style="list-style-type: none"> 1) Member state in which AIFM intends to manage AIF (either directly or via a branch) 2) Program of operations stating the services to be performed by AIFM and identifying the AIF it intends to manage - If the AIFM intends to <u>establish a branch</u>, it shall provide additional information: <ol style="list-style-type: none"> 1) Organisational structure of the branch 2) Address in the home member state of the AIF for which documents may be obtained 3) Names and contact details of persons responsible for the management of the branch
Non-EU	Non-EU	N/A	N/A

* subject to ESMA's prior analysis and approval

Marketing Impact

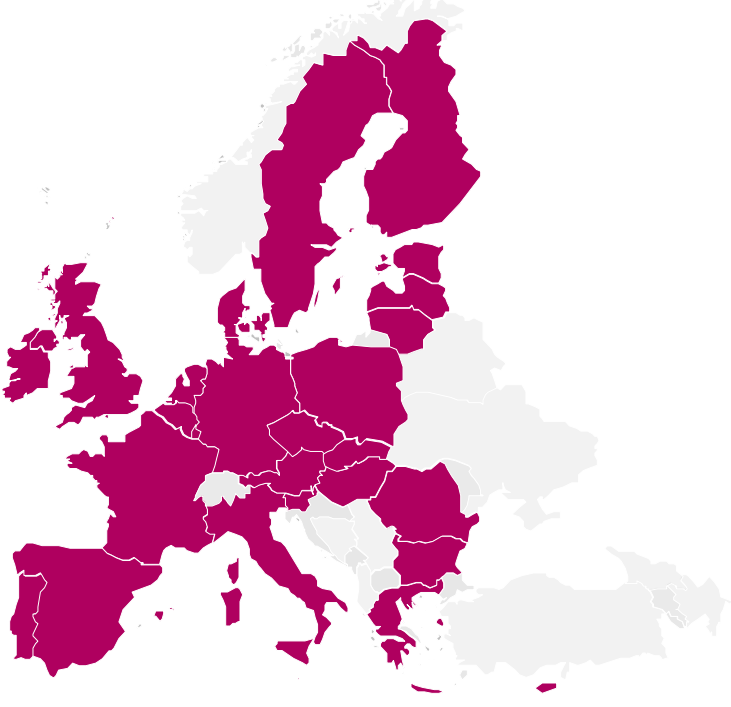
EU Private Placement vs EU Passport

Private Placement Regime



- Not permitted or extremely restricted
- Limited scope

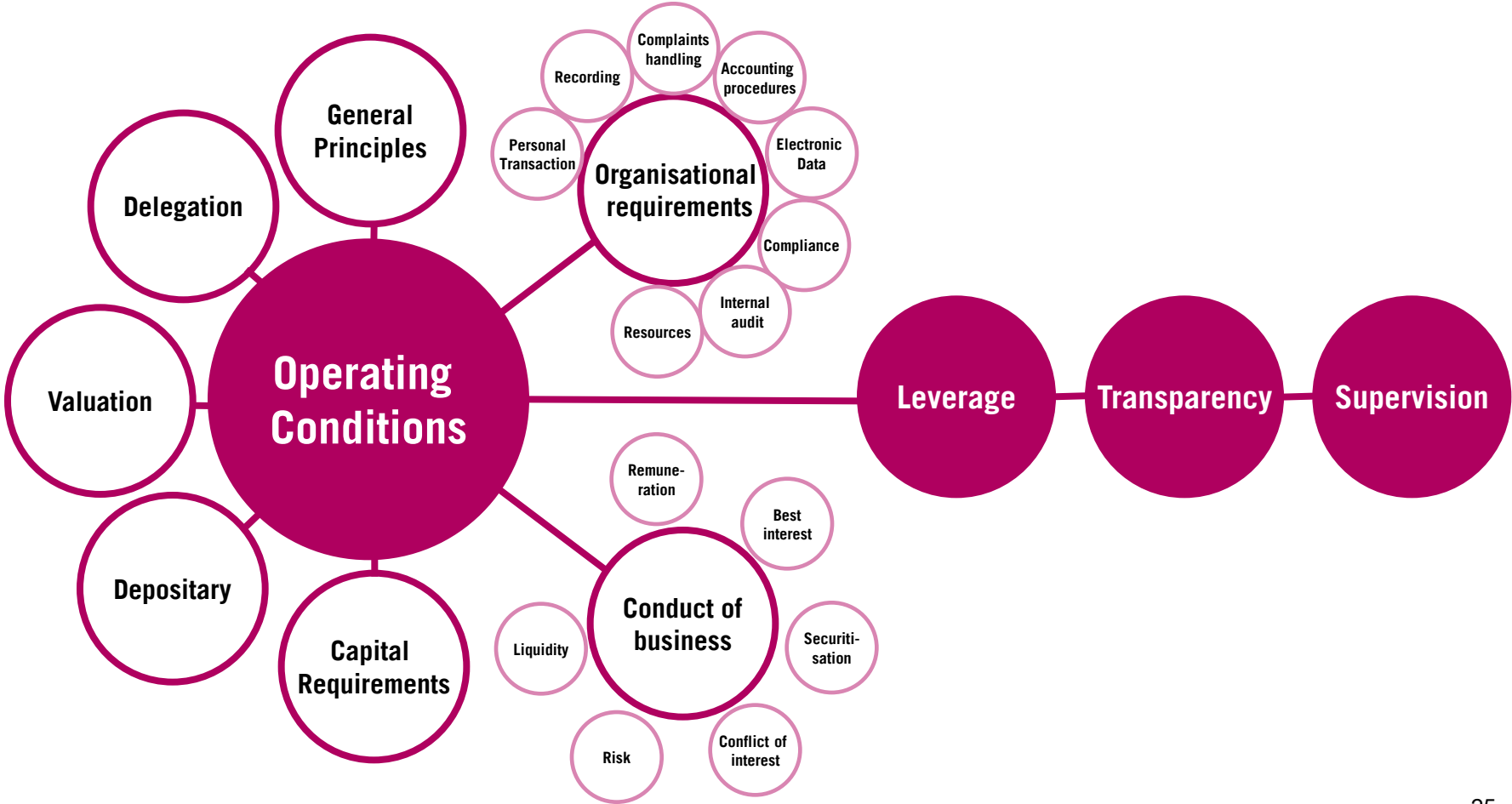
Passport Distribution



- Free and direct marketing countries

AIFM Directive's provisions

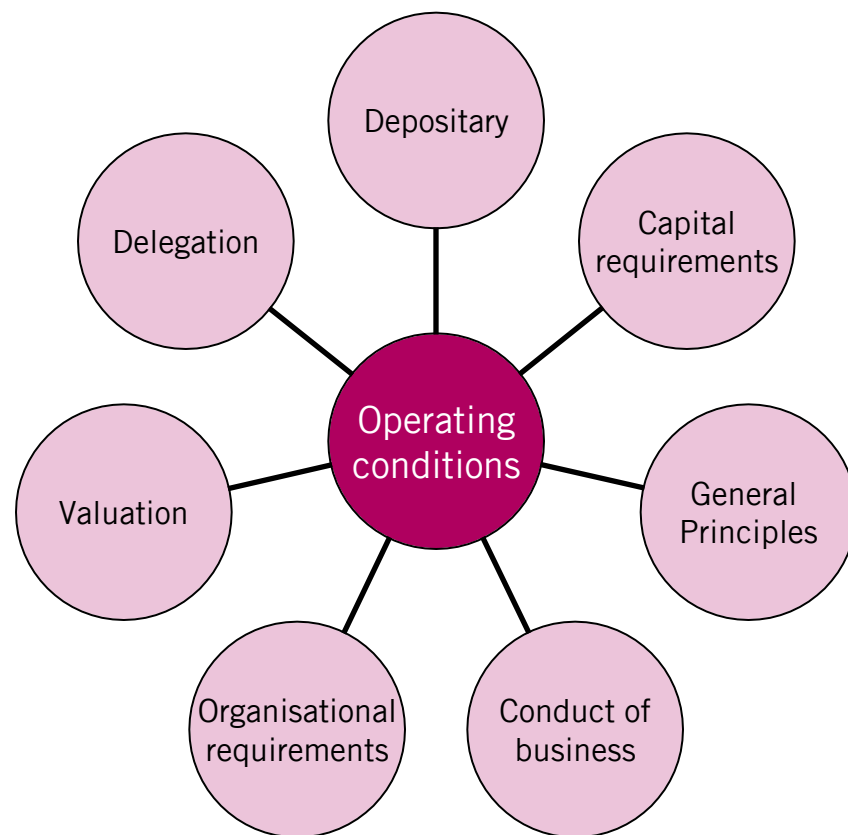
Touching points



Operating conditions for the AIFM

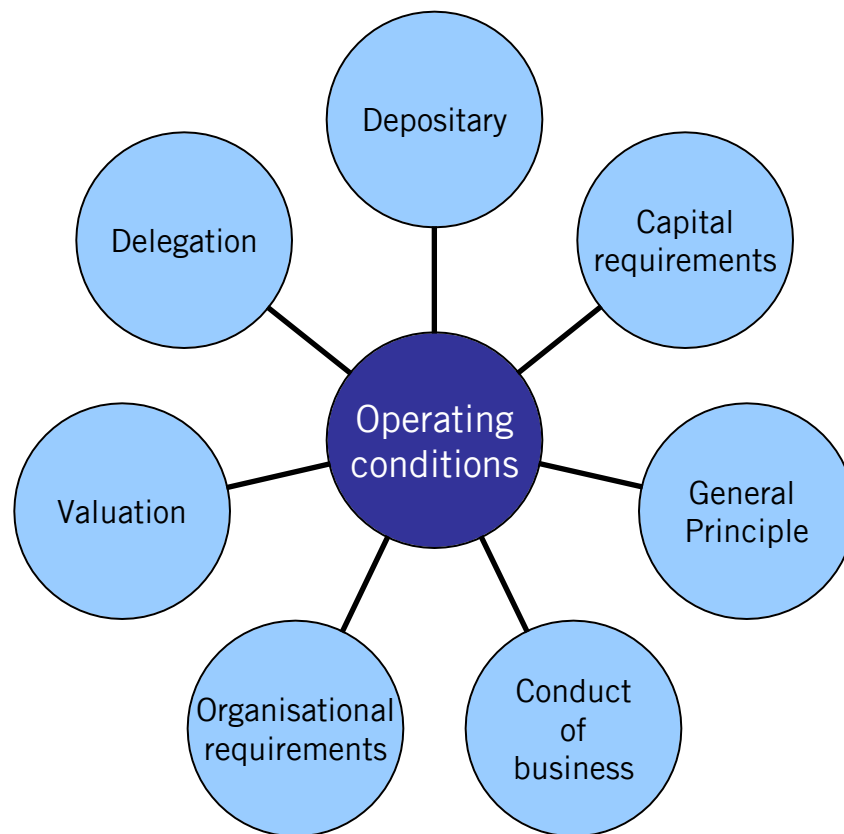
General view: Operating conditions - Level 1

This diagram represents the whole variety of subject addressed by **Level 1** of AIFMD, i.e the **Directive**.

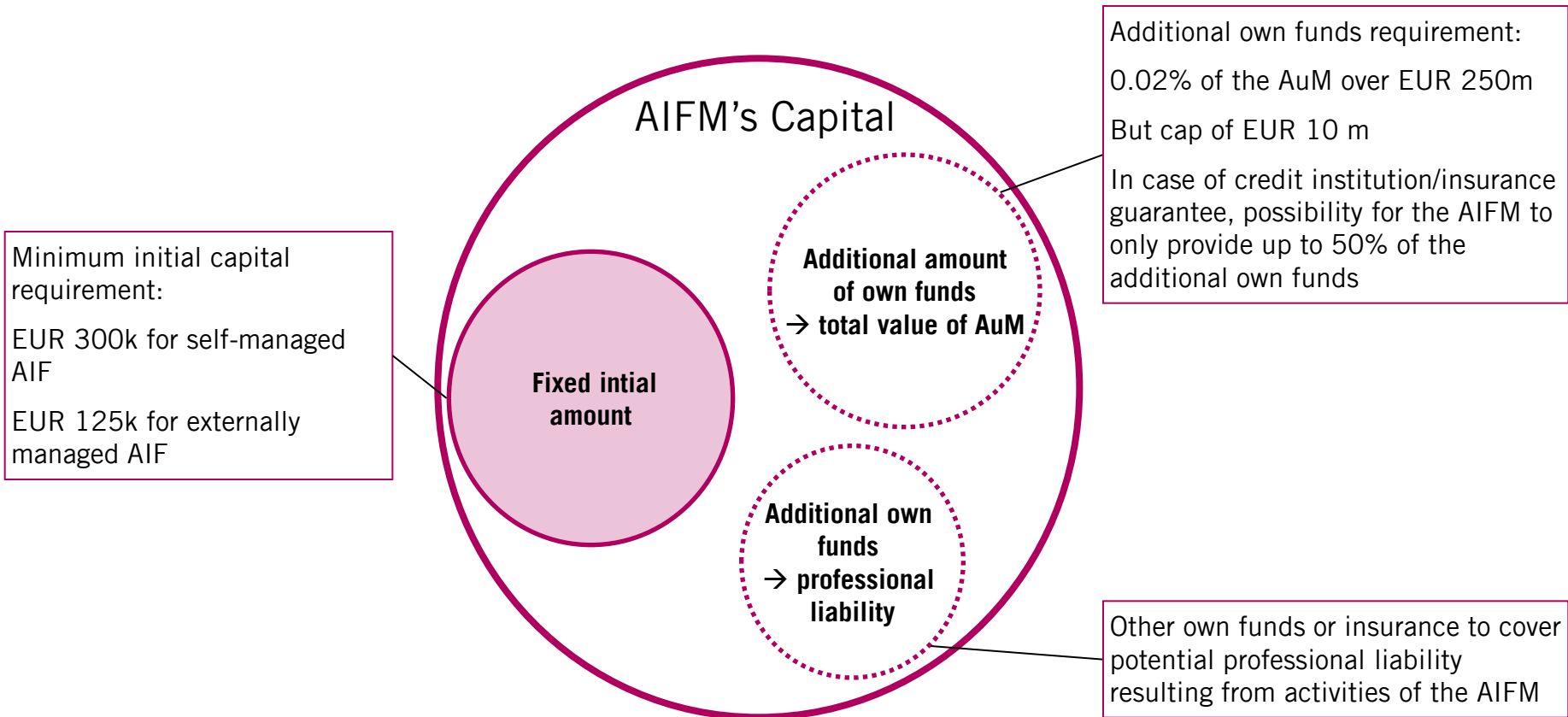


General view: Operating conditions - Level 2

This diagram represents the whole variety of subject addressed by **Level 2** of AIFMD, i.e **ESMA technical advice to the EU commission**.



Capital requirements - Level 1



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Operating conditions

Capital requirements - Level 2

Additional own funds covering professional liability



Negligent act, omission or error → breach of legal obligations, rules of Aof, duty of skill and care, terms of appointment and obligations of confidentiality

Failure by senior management to establish procedures to prevent dishonest, fraudulent, malicious act by AIFM's staff or any party for whom AIFM has vicarious liability

Risks arising from professional negligence

Negligent loss of document evidencing title of assets

Misrepresentation or misstatement made to AIF, investor, any party for whom AIFM has vicarious liability

Improper valuation of assets and calculation of unit/share price

Need to be covered

Qualitative requirements

- Internal operational risk management policies and procedures (regular review)
- Recording of operational failures and loss experience → used to run tests
- Regular internal reporting
- Ensure covering of risks at all time

Quantitative requirements

- Additional own fund requirements = 0.01% of the value of the portfolios of AIF managed by AIFM
- Competent authority of home Member State can lower to 0.008% provided that the covering is sufficient. Conversely, it can raise it if the covering is insufficient

Secondary Additional own funds and/or Professional Indemnity Insurance

Additional Own Funds

Only respect of additional own fund level disclosed by the quantitative requirement (0.01% portfolio value)

Professional Indemnity Insurance

The qualitative requirements can be replaced by such insurance policy, provided several strict requirements are respected (wide enough to cover all the risks + liability of staff, policy provided by 3rd party, duly authorised, ...)

Combination of both regimes

- Min 10% additional own funds
- Compliant professional indemnity insurance
- Combination formula → adequate covering of risk

General Principles - Level 1



- > AIFM shall:
 - > Act honestly, with due skill and diligence and fairly in conducting their activities
 - > Act in the best interest of the AIFs, the investors, and the integrity of the market
 - > Have and employ effectively the resource and procedures that are necessary for the proper performance of their business activity
 - > Take all reasonable steps to avoid conflict of interests
 - > Comply with all regulatory requirements applicable to the conduct of their business
 - > Treat all investors fairly

- > Specific requirements for Portfolio management

General Principles - Level 2



Best interest : AIF, investors & integrity of the market

- Appropriate policies and procedures to prevent malpractices that are expected to affect the stability and integrity of the market (ex: market timing, late trading,...)
- Prevent undue costs being charge to AIF and investors (excessive trading costs,...)

Execution of decision on behalf of the AIF

- The AIFM shall act in the best interest of the AIF or the investors
- AIFM shall take into consideration the following variable to achieve the best possible result: price, costs, speed, likelihood of execution and settlement, size, nature, ...
- Implementation of a written execution policy

Inducement

Strict limitation of the payment or reception of fee or commission, or non-monetary benefit, to specific case

Handling of order

AIFM shall

- Establish procedures and arrangements which provide for the prompt, fair and expeditious execution of orders on behalf of the AIF
- Ensure that the financial instruments, sums of money or other assets are promptly and correctly delivered to (or registered in the account of) the appropriate AIF

This requirement does not concern investment in assets made after extensive negotiation on the term of the agreement (e.g investment in real estate, partnership interest or non-listed companies) because no "order" is executed → specific due diligence requirements

General Principles

Due Diligence requirement

Extensive Due diligence requirements in relation to investment by the AIF

Written policies, and precise requirements (business plan, pre-trade, compliance with investment policies,...)

Fair Treatment

Fair treatment by an AIFM includes that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors

The Consultation Paper originally proposed another version that was more strict, but this lighter formulation was preferred to allow competent authorities to take into account specificities of cases.

Operating conditions

Conduct of business - Level 1



- > Principles of honesty, due skill, care, diligence, AIFs best interest and treating investors fairly
- > Remuneration policy to avoid inappropriate risk taking
- > Management of conflicts of interest (if not possible, disclosure of conflicts to investors)
- > Segregation of risk management and portfolio management
- > Risk and liquidity management
- > Limits on investment in securitisations

- > All to be expanded by Level 2 measures

Conduct of business - Level 2 Conflict of interest



Types of conflict of interest: 5 points test

- 1) Financial gain/avoid financial loss at the expense of AIF/investors
- 2) Interest in the outcome of a service/transaction involving AIF
- 3) Financial/other incentive to favour
 - (i) other interests than those of AIF,
 - (ii) one (a group of) investor over another
- 4) Same activity carried for the AIF and another AIF/UCITS/Client
- 5) Inducement in relation to portfolio management activities (monies, goods, services other than standard commission or fee)

1 Conflict of interest

Record keeping

- Regularly updated records
- Disclosure to investors by durable medium or website (also in case of delegation)

Conflict of interest policy

- In writing
- **Proportionality** of the policy with nature, scale and complexity of the business

Strategies for the exercise of voting rights

- Adequate and effective strategies for determining when and how voting rights are to be exercised
- Measures and procedures for monitoring and ensuring the exercise of the right and prevent the potential conflict of interest

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Operating conditions

Conduct of business - Level 2 Risk Management



Permanent Risk Management function

Permanent Risk Management Function appointed by AIFM that shall:

- Implement effective RM policies and procedures
- Ensure and monitor compliance with risk limits
- Provide senior management with regular update on current level of risk incurred by AIF

The responsibility of setting risk limits for the AIFM remains in the hands of AIFM's governing body or senior management
The RM function must be **functionally and hierarchically independent** from operation units : **Proportionality**

Risk Management Policy

Risk Management Policy established by AIFM that shall:

- Enable the AIFM to assess the exposure of AIF to market, liquidity, counterparty and any other relevant risk (including operational) potentially detrimental
- Comply with minimum substance requirements listed by ESMA
- Be monitored, assessed and periodically reviewed by AIFM (any material changes shall be disclosed to competent authority)

Proportionality of the policy with nature, scale and complexity of the business + when no functional and hierarchical separation → safeguards

2 Risk Management

Measurement and Management of Risk

Implementation of policy and procedure to identify, monitor and manage risk

AIFM should employ proportionate and effective risk measurement techniques, including:

- Quantitative measures → quantifiable risks
- Qualitative methods

Stress tests and back tests to assess the adequacy of RM policies and procedures → Corrective actions

Risk limits

Definition and implementation by the AIFM of quantitative and/or qualitative risk limits, addressing:

- Market risks
- Credit risks
- Counterparty risks and
- Operational risks

→ Adaptation to each AIF

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Operating conditions

Conduct of business - Level 2 Liquidity Management



Liquidity Management Policies and Procedures

For each AIF that is not an unleveraged closed-ended AIF, establishment of liquidity management policies and procedures in order to:

- Monitor liquidity risk
- Ensure the compliance with underlying obligation to investors, counterparties, creditors and other counterparties

Alignment with investment strategy, liquidity profile and redemption policy

Stress Tests

Under normal and exceptional liquidity conditions
Specific situations to be simulated (shortage of liquidity, atypical redemption request)

Proportionality in the frequency of such tests

AIFM shall act in the best interest of the investor in relation with the outcomes of any stress test

Measurement and Management of Liquidity

Appropriate liquidity measurements arrangements and procedures to assess qualitative and quantitative risks of positions/intended investments

Compare with liquidity management of the AIFM that manage other collective investment undertaking in which the AIF invests

Consider & put into effect the tools and arrangements necessary to manage the liquidity risk of each AIF

3 Liquidity Management

Liquidity Limits

Implementation of adequate limits for liquidity of each AIF
Proportionality to nature, scale & complexity + consistence with redemption policy)

Determination of a course of action in case of excess

Operating conditions

Conduct of business - Level 2 Securitisation



- > Requirements for
 - > Retained interest
 - > Sponsors and originator credit institutions
 - > Transparency and disclosure of retention
 - > Risk and liquidity management
 - > Monitoring procedures
 - > Stress tests
 - > Formal policies, procedures and reporting

- > Specificities of the Investment by UCITS

Operating conditions

Organisational requirements - Level 1



- > AIFM shall, at all times, use **adequate and appropriate** human / technical resources necessary for the proper management of AIF (i.e., anticipated 2 conducting officers)
- > AIFM must have:
 - > sound administrative and accounting procedures
 - > adequate internal control mechanisms (e.g., rules for employee personal transactions)
 - > the capacity to reconstruct each transaction involving the AIF
 - > control arrangements for electronic data processing
 - > control arrangements to ensure that AIF's assets are invested in line with its constitutive documents

Organisational requirements - Level 2



General requirements:

- > Decision-making procedures and organisational structure
- > Internal control mechanisms to secure compliance
- > Internal reporting and communication of information (at all levels of AIFM) + effective information flows with any third party involved
- > Security, integrity & confidentiality of information safeguarding procedures
- > Business continuity policy (in case of interruption of systems and procedures)
- > Accounting policies and procedures
- > Monitoring and evaluation of the systems

Proportionality of the procedures and policies with nature, scale and complexity of the business.

Operating conditions

Organisational requirements - Level 2 (ctd)



Resources:

- > Sufficient personnel with **skill, knowledge and expertise** necessary
- > Multiple functions performed by a single person, to be discharged with equal sound, honesty and professionalism
- > Consideration for nature, scale and complexity of business when assessing the resources necessity

Electronic data processing:

- > Suitable electronic system for timely and proper recording (portfolio transaction/subscription or redemption order)
- > High level of security

Accounting procedures:

- > Accounting procedure and policies → investor protection + accurate calculation of NAV
- > Separated accounts for each compartment of an AIF

→ These provisions are in line with Articles 5, 7 and 8 of UCITS Level 2

Organisational requirements - Level 2 (ctd)



Control by senior management and supervisory function:

- > Senior management/supervisory function responsible for AIFM's compliance with AIFMD obligations
 - > AIFM shall ensure that senior management / supervisory function is responsible for:
 - > approval/oversee/review & implementation of the general investment policy, risk management policy, adequacy of internal procedures for investment decision,
 - > ensuring presence/application of : permanent compliance function, investment strategies, risk limits, remuneration policy
 - > take appropriate measure to address deficiencies
 - > Senior management/supervisory shall receive reports on matters of compliance, internal audit, risk management, implementation of investment strategy
 - > When AIF = contractual form (FCP), ie no legal personality, senior management approves the investment strategy of each managed AIF
 - > When AIF = statute form (SICAV), ie legal personality senior management oversees the investment strategy of each managed AIF
- These provisions are in line with Article 9 of UCITS Level 2

Organisational requirements - Level 2 (ctd)



Permanent compliance function:

- > Adequate procedure to detect any risk of failure by AIFM and minimize such risk
 - > Establishment of a permanent and effective compliance function:
 - > Appointment of a compliance officer, that must be independent of activity, with not-influencing remuneration
 - > Necessary authority, resource, expertise, access to information,
 - > No obligation to establish an independent compliance unit if disproportionate → document the reasons
- This provision is in line with Article 10 of UCITS Level 2, and Article 6 of MiFID Level 2

Organisational requirements - Level 2 (ctd)



Internal audit function:

- > When **appropriate and proportionate**, independent internal audit function to control audit and evaluate systems & arrangements

Personal transactions:

- > Adequate arrangement to prevent activities implying personal transaction (misuse/disclosure of confidential information, conflict with AIFM obligation, etc.)
- > Record personal transaction & immediate information of AIFM, also when delegation
- > Not only personal transaction with financial instruments but also with other assets

→ These provisions are in line with Articles 11 and 13 of UCITS Level 2, and Article 8 of MiFID Level 2

Organisational requirements - Level 2 (ctd)



Recording of portfolio transaction:

- > Immediate, for each portfolio, following precise information requirements (asset, quantity, price, ...)

Recording of subscription and redemption orders:

- > Without undue delay, following precise information requirements (relevant AIF, date & time,...)

Recordkeeping requirements:

- > Minimum 5 year period (unless national law prescribes more).
- > Accessibility to other AIFM (in case of transfer), competent authority

Complaints handling:

No requirements

→ These provisions are in line with UCITS Level 2 and MiFID Level 2

Valuation - Level 1



- > Appointment of independent valuer of assets and NAV
- > Valuation to be carried out at least once a year
- > Valuation periodicity to be adapted depending on types of assets and frequency of issuance and redemption of units
- > External or internal valuer, provided that independency from portfolio management, remuneration policy and conflicts of interest are avoided
- > External valuer subject to mandatory professional registration, sufficient professional guarantees and appointment subject to delegation provisions
- > Rules to be expanded by Level 2 measures

Valuation - Level 2



Valuer

External Valuer

Professional guarantees:

- Written documents signed by the valuer or its representatives
- Should contain evidence of the external valuer's qualification and ability, notably:
 - (i) Sufficient personnel and technical resources
 - (ii) Adequate procedures
 - (iii) Adequate knowledge & understanding

Process of exchange of information

Internal Valuer

Safeguards for functionally independent performance of valuation tasks

Policies, Procedures & Models

Format and substance for policies & procedures

- Written policies & procedures → sound, transparent & appropriately documented valuation process
- Reference to the valuation methodologies for each type of asset
- Obligation, role and duties of all parties involved in valuation

Models used to value assets

- Reasons to use a model, type, underlying data & assumption shall be explained in the policies & procedures
- Models to be validated by expert and approved by senior management

Reviews

- Appropriateness of procedures, policies & valuation methodologies to be reviewed at least once a year + before new investment strategy/new asset not covered by current strategy

Calculation

NAV calculation

- Each time there is (i) issue, (ii) subscription, (iii) redemption, (iv) cancellation of units/share
- At least once a year
- Remedial procedures in case of incorrect calculation

Consistent application of valuation methodologies

- To all assets taking into account the investment strategies and the types of assets.

Review of valuation by AIFM

- AIFM must be able to demonstrate that AIFs are properly valued
- Checks to be run (review process described in the procedures & policies)
- No precise list of control but suggestions given in the advice

Delegation - Level 1



- > AIFM can delegate one or more functions to third parties
- > If delegation of portfolio or risk management, mandate to undertakings which are authorised or registered for the purpose of asset management and subject to supervision only
- > Delegation must be justified with objective reasons
- > If condition cannot be satisfied, delegation may be given under approval of AIFM regulator
- > In addition, if delegation to a third-country undertaking, requirement of co-operation between AIFM regulator and supervisory authority of third-country undertaking
- > Sub(-sub)-delegation authorised subject to AIFM consent + same conditions continue to apply

Delegation - Level 2 General provisions



Activities subject to delegation rules

Not all types of activities trigger the application of Article 20 of AIFMD that imposes all the following rules (general principles, objective reason, dispositions on entities, and on operational implementation)

Are concerned only the task regarded as critical or important:
→ A failure of the performance of this task would materially impair the continuing compliance of the AIFM with the conditions of its authorisation, its financial performance or the soundness and continuity of its function

Activities excluded de facto:

- Provision of advisory services and other services that are not part of usual tasks of collective management of an AIF
- Purchase of standardised services

Objective reasons to delegate

To be authorised to delegate, the AIFM shall demonstrate objective reasons that justify the delegation structure.

→ More efficient conduct of the AIFM's management of the AIF

Objective reasons for delegation include (but are not limited to):

- Optimising of business functions and processes
- Cost saving
- Expertise of the delegate in administration / specific market / investment
- Access of the delegate to global trading facilities

The rule of "justification" with objective reasons is based on the UCITS approach.

1 General Provisions

General Principles

- 1) Delegation should not result in the delegation of senior management's responsibility
- 2) Obligation of AIFM towards AIF/investors shall not be altered
- 3) AIFM's respect of the conditions to be authorised under AIFMD shall not be undermined
- 4) AIFM shall ensure that the delegate carries the function effectively and in accordance with laws and regulatory requirements
 - Determination of review methods
 - Take appropriate actions in functions carried wrongfully
- 5) AIFM should retain necessary expertise and resources to be able to supervise and manage risks associated with delegation. AIFM should also check that the delegate does the same with sub-delegate
- 6) AIFM shall ensure the continuity and quality of delegated tasks
- 7) A written agreement shall define clearly the rights and obligation of the AIFM and the delegate
- 8) If portfolio management delegated, it shall be in accordance with the investment policy of the AIFM

Action to be taken by delegate to ensure the respect of the general principle:

- Disclosure of any development that may have a material impact on its ability to carry out the delegated functions
- Protection of confidential information
- Establishment of a contingency plan for disaster recovery

Operating conditions

Delegation - Level 2 Entities issues



Resources, experience & good repute

The AIFM has to evaluate if the delegate has sufficient resources to perform the task and if the persons conducting the task in the delegate entity have sufficient experience and good repute.

Factors to be considered:

- 1) Substance: AIFM shall check the adequacy of the resource (sufficient personnel with skills, knowledge and experience)
- 2) Knowledge: AIFM shall check whether the persons have appropriate theoretical knowledge & practical experience
- 3) Good repute: AIFM shall check the records of the persons.

Negative records include relevant criminal offences, judicial proceedings and administrative sanctions.

factor 3) satisfied de facto if delegate is regulated in EU

Types of institution

The following entities should be considered as authorised for the purpose of asset management and subject to supervision:

- Management Companies authorised under the UCITS Directive
- Investment firms authorised under MiFID to perform portfolio management
- Credit Institutions authorised under Directive 2006/48/EC having the authorisation to perform portfolio management under MiFID; and
- Externally appointed AIFM authorised under AIFMD

Investment companies authorised under UCITS Directive and internally managed AIF are not listed because they are not allowed to engage in activities other than portfolio management

2 Entities issues

Third country counterparty

The criteria

- For third country authority: independence (ensured by compliance to international standards, like IOSCO or Basel)
- For third country undertakings: authorised/register/supervised by home MS supervisory authority; or -authorised/registered on local criteria **(equivalent to EU*)** + supervised by independent competent authority

**Equivalence assessment of the local legislation based on ESMA's criteria*

The relationship

- Written agreement between authorities of the countries of (i) AIFM & (ii) delegate
- Template to be provided by ESMA (to be based on IOSCO's models)
- The agreement should provide the following rights to home MS authority:
 - (i) Access to documents/information
 - (ii) Request on-site inspection
 - (iii) Immediate information from third country authority in case of breach
 - (iv) Enforcement powers in case of breach

Letter box entity

The AIFM shall not delegate its activities so much that it becomes a letter box entity.

ESMA provides the criteria to determine when an AIFM can be considered as a letter box entity:

- 1) AIFM no longer retains necessary resource and expertise to supervise the delegation and manage the risk associated with it
- 2) AIFM no longer has the power
 - (i) To take decisions in key areas under the responsibility of senior management
 - (ii) To perform senior management function (implementation of investment policy, investment strategy, ...)

Besides, AIFM must always perform at least investment management functions

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Operating conditions

Delegation - Level 2 Operational issues



Conflict of interest

Criteria whether a delegation/sub-delegation would result in a material conflict of interest:

- AIFM and delegate are member of the same group or have any other contractual relationship
- Delegate and investors are members of the same group or have any other contractual relationship

Criteria for the functional and hierarchical independence of risk or portfolio management:

- Separation is ensured up to delegation/sub-delegation
- Avoidance of combination of RM task with operating tasks or super
- Avoidance of combination of portfolio management task and oper

Criteria to assess whether conflicts are properly identified, managed, monitored and disclosed to the investors:

- Delegate has to take reasonable steps
- Disclosure of potential conflict of interest to the AIFM

3 Operational issues

Sub-delegation

Condition displayed for the delegation shall apply mutatis mutandis where the delegate sub-delegates any of its functions

The AIFM shall demonstrate its approval for the sub-delegation in writing

Criteria for a wrongful delegation

Delegation preventing the AIFM from being effectively supervised:

- AIFM, auditors or authorities do not have access to data related to the delegated functions or the business premises of the delegate
- Delegate does not cooperate with competent authorities

Delegation preventing the AIFM from acting, preventing the AIF from being managed in the best interest of investors:

- Conflict between the interest of delegate and those of investors/AIFM
- Such conflict of interest is not properly identified, managed, and monitored

Form and content of notification

Notification shall contain:

- Details on the delegate and the sub-delegate
- Name of the competent authority (in the case the sub-delegate is authorised or registered)
- Delegated tasks
- AIF affected by the sub-delegation
- Copy of written consent by the AIFM
- Intended effective date of the delegation

Depositary - Level 1



> **Depositary must**

- > monitor the reception of all investors' subscriptions and hold in custody all financial instruments of the AIF
- > ensure that AIF's **cash flows** are properly monitored, in particular booking of subscription monies on appropriate cash accounts
- > safekeep the assets:
 - > custody of **financial instruments** that can be physically delivered or registered in a financial instruments account, segregation being required
 - > verification of ownership of all **other assets** on basis of information provided by the AIF or the AIFM or - where available - external evidence

> **An AIFM must** appoint a single depositary in respect of each AIF it manages. The depositary must be a credit institution, an investment firm or other entity permitted under the AIFM Directive

> **Location of depositary:**

- > EU AIF: in the home member state of the AIF
- > Non-EU AIF: in the third country where the AIF is established, in the home member state of the AIFM or in the member state of reference of the AIFM

Depository - Level 1



> **Double liability:**

- > A strict (no fault) liability for losses of **financial instruments held in custody**

Obligation to return without undue delay identical financial instruments or the corresponding amount to the AIF

Exception: no liability if depository can prove that the loss has arisen as a result of an external event beyond its reasonable control (concept to be defined by Level 2 measures)

- > A fault-based liability for **all other losses** caused by the depository's negligent or intentional failure to comply with its obligations under the AIFMD

> **Possibility for contracting out of liability where the assets are delegated to a sub-depository if:**

- > Written contract between the depository and the AIF or the AIFM acting on behalf of AIF
- > Discharge explicitly provided in such contract
- > Objective reason to contract such a discharge

Operating conditions

Depositary - Level 2 Appointment



The agreement between the AIFM and the Depositary

Alignment with the particulars required in the contract between the depositary and the management company in the UCITS Directive

ESMA provided a list of 14 elements to be included in the agreement signed between the AIFM and the depositary, and several precisions to be brought

There is the possibility to enter a framework agreement in order to avoid the obligation for a specific written agreement for each AIF

ESMA chose not to provide a model agreement because it would have limited commercial freedom and not covered every situations.

The depositary regimes of UCITS and AIFMD are different! Several elements were added to the UCITS requirements (eligible assets, right of re-use, cash accounts, escalation procedure) and other were amended (termination of contract, liability, flow of information)

Difference in liability regime is consequent: for UCITS, a simple recall of the fact that the depositary's liability is not altered by delegation is sufficient. For AIFM, ESMA requires the parties to detail in which conditions a transfer can occur.

1

Appointment

Third country Depositary

Article 21 of the Directive provides with the conditions to be met so that an AIFM can appoint a third country depositary. (we recall that it only concerns non-EU AIF)

ESMA provided a list of criteria to assess that the regulation and supervision of the third country depositary is effective enough

→ a third depositary can be appointed only if the supervision/regulation of the third country imposes requirements identical to EU ones (credit institution or investment firm) on the following points:

- Independence of authority
- Eligibility criteria for depositary function
- Capital requirements
- Operating conditions
- Requirements on performance

Further requirements are added (sufficiently dissuasive enforcement actions in case of breach, possibility for the investor to invoke directly the liability of the depositary)

The equivalence to EU requirements is a very hard condition that may not be fulfilled by some host member state of AIFs

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Operating conditions

Depositary - Level 2 Duties



Safekeeping

3-criteria definition of financial instruments to be held in custody:
-Transferable securities
-Not provided as collateral
-Registered or held in an account in the name of the depositary

Minimum safekeeping duties:

- Ensure proper booking
- Maintain records
- Conduct reconciliation (regular)
- Due care + high level of protection
- Assess /monitor all custody risks
- Introduce organisational arrangements to minimise the risks

A contrario approach to define the « other assets »

Minimum safekeeping duties:

- Ensure timely access to relevant information → ownership verification
- Sufficient and reliable information → ownership verification
- Record keeping

Related duties defined by ESMA

AIFM must ensure the prime broker provides depositary with a report, the details of which are imposed by ESMA

Oversight function

The depositary should:

- Assess the risks associated with the nature scale and complexity of an AIF and set up appropriate schedules
- Perform ex post verifications of procedures which are under the responsibility of the AIF, the AIFM or a third party

The AIFM must ensure that the depositary dispose of all information necessary to exercise its mission
Clarifications on specific duties are provided by ESMA

Due diligence duties

ESMA details the methodology to be followed to ensure an appropriate due diligence before delegating functions

Based on best market practice. Depositary takes into consideration all elements relevant to the consequences of the insolvency of the sub-custodian

Cash Monitoring

The depositary's obligations consist in verifying that there are procedures in place to appropriately monitor the AIF's cash flow (+periodical review)

This includes to ensure:

- Cash is properly booked
- There are proper reconciliation procedures
- Appropriate cash flow identification procedures are implemented
- Monitoring & consistency check

Regarding the interpretation of Level 1 provision imposing "cash has been booked in proper account", ESMA adopted a conservative approach → application to all the AIF's cash and not only in the context of subscription

Segregation

Article 21 (11) (d) (iii) requires a depositary to impose a segregation requirement on a third party before delegation

The depositary must check that the distinction between assets of its AIF and assets of another AIF are efficiently ensured
ESMA provides with the methodology to perform this check

The segregation is supposed to mitigate the consequences of the insolvency of the sub-custodian

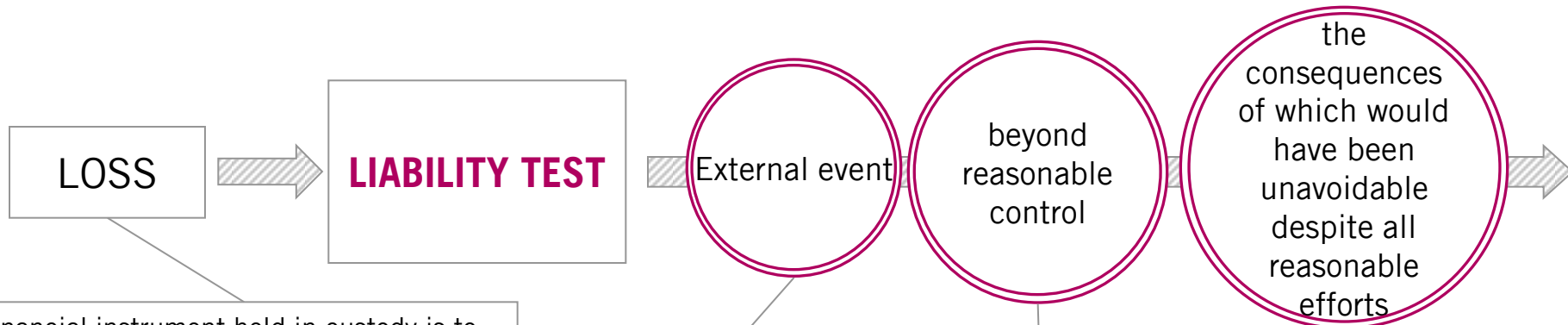
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Duties

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Operating conditions

Depository - Level 2 Liability



Financial instrument held in custody is to be considered lost when one of the following conditions is met:

- 1) financial instrument no longer exists or never did
- 2) financial instrument still exists but AIF has lost ownership over it **permanently**
- 3) AIF has ownership of the instrument but cannot dispose of it **permanently**

The permanence factor is very important. Although it is not officially defined, explanatory notes provide indications. There should be no prospect of recovery which excludes situations where the assets are unavailable or frozen

The event which led to the loss is not a result of an act or omission of the depository or one of its sub-custodian to meet its obligations

The event which led to the loss was beyond reasonable control, ie the depository could not have prevented its occurrence by reasonable efforts

Despite rigorous and comprehensive due diligence, the depository could not have prevented the loss

To avoid interpretation differences regarding "best efforts", ESMA provides with minimum actions to be taken by the depository to comply with the criteria

Other provisions: Transparency

Annual report - Level 1

- > Annual report re. AIF to be made available by AIFM to investors / competent regulator within 6 months of year end
- > Exception: annual report to be provided to the competent regulator within 4 months of year end if AIF is required to make it public
- > Content of the annual report:
 - > Balance sheet
 - > Report on the activities of the financial year
 - > Total amount of remuneration of AIFM staff members
 - > Balance sheet to be prepared in accordance with the accounting standards of the country of the AIF



Annual Report - Level 2

- > **Precise definition of content and format requirements for:**
 - > Primary financial Statements (Balance Sheet, Income and Expenditure Account)
 - > Report on Activities of the Year
 - > Remuneration disclosure: 3 options
 - > Total remuneration of the entire staff of the AIFM
 - > Total remuneration of those staff of the AIFM who in part or in full are involved in the activities of the AIF
 - > Proportion of the total remuneration of the staff of the AIFM attributable to the AIF

- > **Definition of material change:**

“change in information if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF, including for reasons that such information could impact an investor’s ability to exercise its rights in relation to its investments, or otherwise prejudice the interest of one or more investors of the AIF”

Disclosure to investors - Level 1

- > Information to be disclosed by the AIFM to investors before they invest:
 - > Description of investment strategy, investment policy and objectives of the AIF
 - > Description of main legal implications of the contractual relationship entered into
 - > Identity of AIFM, AIF's depositary, auditor and any other service providers
 - > Description of delegation of investment management functions
 - > Description of AIF's valuation procedure
 - > Description of AIF's liquidity risk management
 - > Description of all fees, charges and expenses
 - > How the AIFM ensures a fair treatment of investors + Preferential treatments
 - > Latest annual report
 - > Procedure and conditions of issue and redemption of units / shares
 - > Latest NAV of AIF and historical performance of AIF
- > Investors must be informed by the AIFM of any arrangement made by the depositary to contractually discharge itself from liability
- > Certain Information are to be disclosed by the AIFM to investors on a periodic basis
- > Certain Information to be disclosed by the AIFM to investors on a regular basis

Disclosure to investors - Level 2

- > Periodic disclosure to investors
 - > Percentage of assets subject to special arrangements
 - > New arrangements for managing the liquidity of the AIF
 - > Risk profile of the AIF
 - > Risk management systems employed by the AIFM
 - information to be disclosed as part of the periodic report to the investors, as required by the AIF rules or offering documents, or at least once a year
- > Regular disclosure to investors → whenever a material change occurs
 - > Maximum level of leverage
 - > Right of re-use of the collateral
 - > Nature of guarantee granted

Reporting to competent authority - Level 1

No restrictions on AIF's investment policy. However, AIFM required to report on:

- > Principal markets and instruments in which it trades on behalf of the AIF it manages
- > Principal exposures and most important concentrations of each of the AIF it manages
- > Actual risk profile of each AIF managed
- > Assets in which the AIF invested
- > Risk and liquidity management arrangements
- > Results of stress tests re: liquidity risk of AIF / risks associated to each investment position of AIF
- > Use of leverage on a substantial basis

Reporting to competent authority - Level 2

- > Format and content of the reporting to competent authorities
- > Use of leverage on a substantial basis
 - > Criteria to assess whether there is a use of leverage on a substantial basis:
 - > Type of AIF (incl: nature, scale, complexity)
 - > Investment strategy
 - > Market conditions
 - > Potentiality of market risk induced by the exposure of the AIF
 - > Potentiality of the contribution to a downward spiral of price due to the use of certain techniques
 - > Potential contribution to the build-up of systemic risk, or risk of disorderly markets through the degree of leverage employed.
 - > Monitoring on on-going basis + new assessment when there is a material change

Other provisions: Controlling stakes

Controlling stakes - Level 1

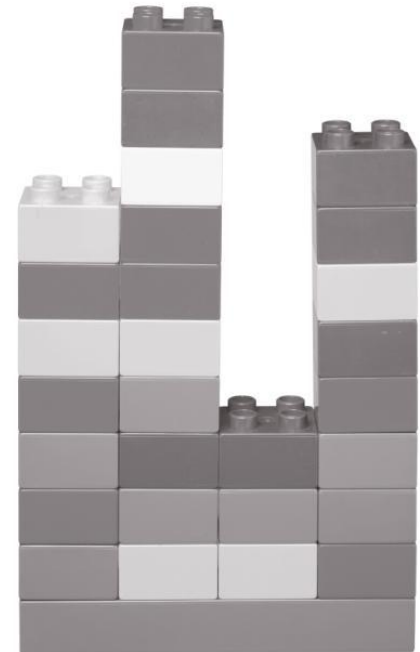
- > Mandatory notification to competent regulator of acquisition by AIF of major holdings OR control (i.e. more than 50% of voting rights) of non-listed companies (exclusion of SMEs)
- > Disclosure to the company concerned, its shareholders and regulator of the AIFM
- > Disclosure of the policy for preventing and managing conflicts of interests
- > Specific annual report requirements
- > Limitation on asset stripping for 24 months following the acquisition of control



Other provisions: Leverage

Leverage - Level 1

- > Disclosure to investors and reporting to regulator in case of use of leverage
- > Leverage limits set up by the AIFM to be disclosed to investors
- > Leverage limits to be set up by the regulator of the AIFM if such use contributed to the build-up of systemic risk



Leverage - Level 2 Exposure

Specific inclusion / exclusion of the calculation

Any financial/legal structure involving third parties controlled by the relevant AIF is included if created specifically to increase directly or indirectly the exposure at the level of the AIF

→ Exclusion of the leverage in an acquired non-listed company

Borrowing arrangement entered into by AIF is excluded if temporary in nature and fully covered by capital commitments from investors

Exposure of the AIF with Gross Method

Exposure = sum of absolute values of all positions, according to the following criteria:

- Value of cash and cash equivalent
- Financial derivative instruments, as converted in their position in the underlying asset
- Cash borrowings remain cash and cash equivalent
- Exposure relating to the reinvestment of cash borrowings should be included → maximum between market value of investment and total borrowed
- Position in repurchase agreement or reverse repurchase agreement

Leverage
-
Exposure

Exposure of AIF with Commitment Method

Exposure = sum of:

- Each financial derivative instrument position converted into an equivalent position in the underlying asset (conversion methodologies provided for each type of derivative instrument)
- Apply netting and hedging arrangements
- Calculate the exposure created through the reinvestment of borrowings where such reinvestment increases the exposure of the AIF

Exposure of AIF with Advanced Method

Exposure to financial derivative instrument with Commitment method

In all other cases, AIFM can use the method it considered the most adapted, provided that:

- Methodology is fair
- Approach is constantly applied
- There is consistency with how the AIFM manages the risk within the AIF

Leverage - Level 2 Limits

- > The competent authorities have been given the right to limit the level of leverage used by an AIFM, after having performed the following assessment:
 - > Assessment of the risk entailed by the use of leverage with regards of information provided under articles 7 (3) (application for authorisation), 15 (4) (maximum level of leverage set by AIFM), 24 (4) and 24 (5) (reporting to competent authorities)
 - > Assessment of the potential contribution to the build-up of systemic risk in the financial system
- > Various illustrative circumstances are given by ESMA, e.g :
 - > leverage → important source of market, liquidity, counterparty risk to a financial institution
 - > leverage → contribution to downward spiral of price

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Specific Level 2 provisions: Supervision and cooperation between authorities

Supervision & cooperation between entities - Level 2

Cooperation arrangement between EU & Non-EU authorities

Cooperation arrangement in writing, and shall provide for:

- Exchange of information for supervisory and enforcement purposes
- Right to obtain all information necessary
- Right to request an on-site inspection (to perform directly or to be performed)

Third country competent authority shall assist the EU competent authority in the enforcement of EU legislation

Member State of reference: in case of multiple choices

Procedure in case of multiple possibilities for MSR:

- Request sent by AIFM to all potential MSR
- All potential MSR contact each other and ESMA (within 3 business days)
- Research of other potential MSR by those already contacted (ESMA is in charge of contacting these other potential MSR)
- Discussion and joint decision for
tion of the appropriate
in 1 week (ESMA
should facilitate the process)

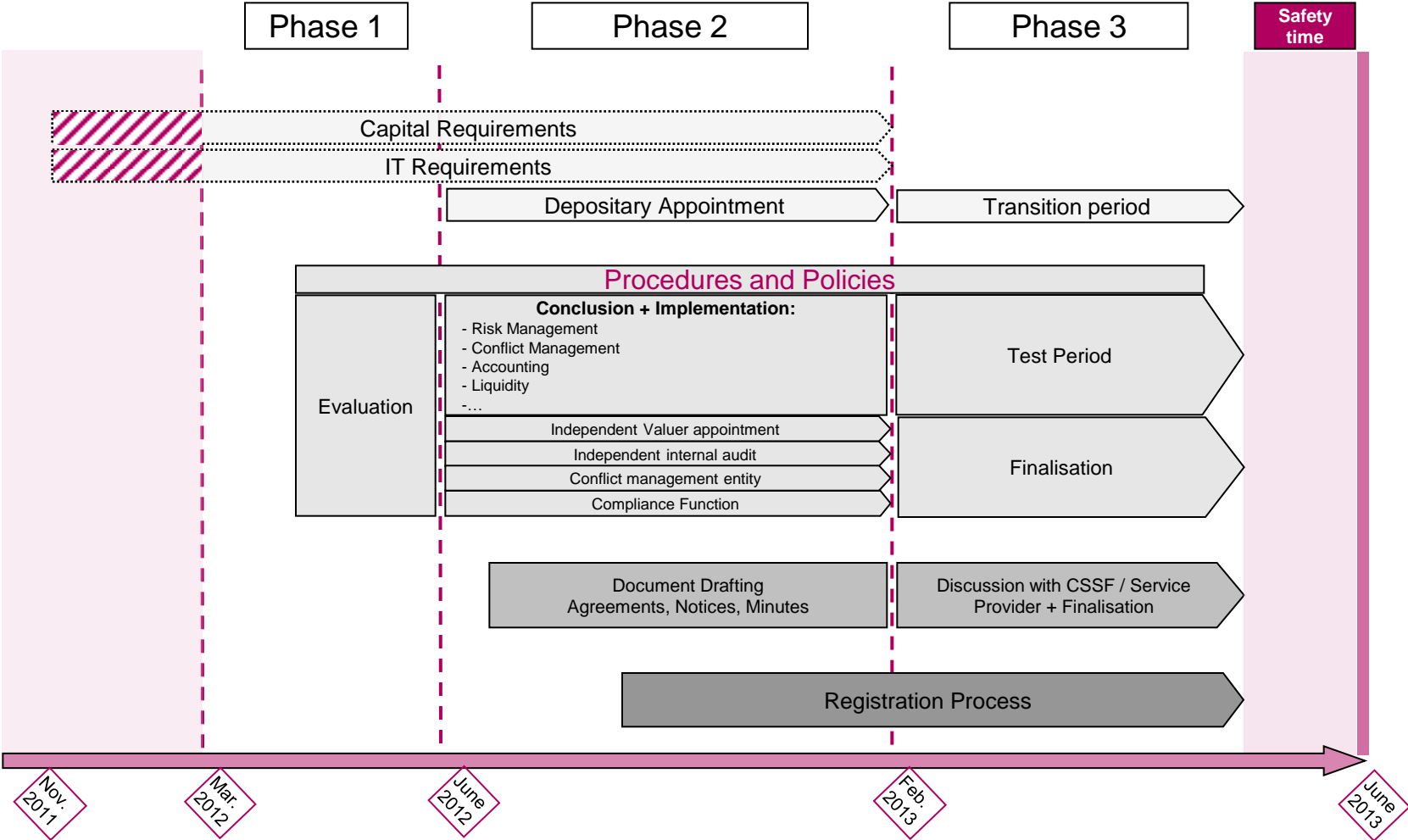
Supervision
&
Cooperation

Cooperation and exchange of information between EU authorities

ESMA provided a pro forma reporting template to facilitate the communication between the various national authorities

Time to act

Update timeline



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