AIFM Directive – Implications for QIFs

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Directive on Alternative Investment Fund Managers – Implications for Irish QIFS

DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS - IMPLICATIONS FOR IRISH QIFS

Overview

Directive 2011/ 61/EU on Alternative Investment Fund Managers (the "Directive"), which was agreed by the European Parliament on 11 November, 2010 was finally adopted on 21 July, 2011. Member States have until 22 July 2013 to implement its provisions. Readers should note that at the date of publication, Level 2 Commission Regulation on implementing the Directive has not yet been published in final form, and all information in this document is subject to change, following such publication.

The Directive aims to provide for an internal market for Alternative Investment Fund Managers ("AIFMs") and a harmonised and stringent regulatory and supervisory framework for the activities within the EU of all AIFMs, including those which have their registered office in a Member State ("EU AIFMs") and those which have their registered office in a third country ("non-EU AIFMs").

The Directive is subject to a legislative process involving (i) the adoption of the framework Directive by the European Council of Ministers and European Parliament ("Level 1"), (ii) technical implementing measures adopted by the European Commission and approved by the European Securities Committee, in consultation with the European Parliament, on the basis of advice from the European Securities and Markets Authority ("ESMA") ("Level 2") and (iii) recommendations from ESMA on interpretation to ensure consistent implementation and application ("Level 3").

At the time of writing (April, 2012), ESMA has provided technical advice to the European Commission ("ESMA's Level 2 Advice") and we are awaiting the publication by the European Commission of a working document containing an initial view on the content of the draft implementing measures.

In the meantime, with the implementation of the Directive fast approaching, the question is being asked as to how the Directive will impact Irish domiciled Qualifying Investor Funds ("QIFs") and what steps needs to be taken to ensure compliance. The QIF is an Irish regulated fund vehicle which was developed as a regulated platform for alternative investments. The QIF may be marketed to sophisticated investors, has a minimum subscription level of €100,000 and is not subject to investment restrictions (other than the requirement for investment companies to spread risk). With assets of approximately €186 billon (as of January, 2012), the QIF accounts for almost 80% of assets under management of all non-UCITS in Ireland and has proven to be the vehicle of choice for most alternative investment fund managers to date.

This Memorandum sets out a broad summary of the relevant provisions of the Directive insofar as it affects Irish QIFs and examines what steps need to be taken in order to prepare for the implementation of the Directive. The comments set out herein take into account ESMA's Level 2 Advice, which may be subject to change in the implementing measures. The implications of the Directive for other non-UCITS, such as non-UCITS retail funds are beyond the scope of this Memorandum.

General Considerations

Scope of the Directive

The Directive applies to the below categories of AIFM regardless of the open/closed ended status of the alternative investment fund ("AIF"), the legal structure of the AIF or the AIFM:

1. EU AIFMs which manage and/or market one or more AIFs irrespective of whether they are EU or non EU;

2. Non-EU AIFMs which manage one or more EU AIFs; and

3. Non-EU AIFMs which market one or more AIFs in the EU irrespective of whether they are EU or non EU.

Certain types of entities are expressly excluded, including holding companies, institutions for occupational retirement provision, supranational institutions, central banks, governments and institutions which manage funds supporting social security and pension systems, employee participation schemes or employee saving schemes and securitisation special purpose entities.

Meaning of the AIFM/AIF

The Directive defines AIFMs as the legal person whose regular business is "managing" one or more "AIFs".

Under the Directive, AIFs are collective investment undertakings (excluding UCITS) which raise capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of investors. The phrase "collective investment undertaking" is not defined but the Directive provides that an entity may be an AIF whether it is open or closed and whether it is constituted under contract law, trust law, under statue or any other legal form. ESMA's discussion paper of 23 February, 2012 titled "Key concepts of the AIFM Directive and types of AIFM" ("ESMA's Discussion Paper") sets out proposed criteria in order to assist in identifying the AIF. The Discussion Paper elaborates on the key terms used in the definition of AIF which are conceived in the Directive. These include raising capital, collective investment, number of investors and a defined investment policy. ESMA also includes some criteria which are not expressly included in the Directive, for example the nature of ownership and control over the underlying assets. An examination of such criteria indicates that it is likely that in practise all existing Irish QIFs whether structured as a unit trust, corporate entity or otherwise will fall within the definition of AIF, however, this remains to be clarified. ESMA's Discussion Paper also states that a fund with a single investor representing a number of underlying beneficial owners (e.g. in the case of nominee arrangements) would fall within the definition of AIF for the purposes of the Directive.

"Managing" AIFs means performing at least investment management functions such as portfolio management or risk management. Although only one of these activities needs to be present in order to render an entity an AIFM, that AIFM cannot be authorised to carry out portfolio management without also providing risk management and vice versa.

It is important to note that Article 5 of the Directive recognises that, depending on the structure of the AIFM, there may be more than one legal entity which could be appointed as AIFM to the AIF. The Directive provides that the AIFM shall be either:

1. 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

2. the AIF itself, which shall then be authorised as AIFM, where the legal form of the AIF permits an internal management and where the AIF's governing body chooses not to appoint an external AIFM.

It is clear from the Directive that only one of the above entities can actually be appointed as AIFM and be subject to the requirements of the Directive. Further, there are no provisions in the Directive which impose conditions or criteria on the AIF for the appointment or selection of the AIFM. Accordingly, in its Discussion Paper, ESMA is of the view that the AIF is free to appoint any legal person as AIFM provided that this entity is authorised under the Directive.

Many Irish domiciled QIFs are structured as self-managed investment companies. It is possible, therefore, under point 2 above that an Irish QIF structured as a self-managed investment company could be appointed as the AIFM. This is important when it is considered that a significant proportion of the promoters / asset managers to Irish QIFs are non-EU entities who will not wish to be the appointed AIFM (unless they make a strategic decision to do so). It is likely, therefore, that a high percentage of Irish self-managed QIFs will opt to be the AIFM under the Directive to the same degree as self-managed investment companies do under the UCITS Directive.

This Memorandum examines the new requirements applicable to Irish QIFs in the following circumstances:

(i) Requirements at the level of the AIFM, where the QIF is self-managed and is authorised as the AIFM; and

(ii) Requirements at the level of the AIF, which apply to the QIF in its capacity as the AIF (regardless of whether the QIF is the AIFM or an external manager is the AIFM).

Exemptions

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

Further, an AIFM that manages an AIF, whose assets under management do not exceed specified thresholds, are exempt from the requirement to seek authorisation and are exempt from most of the provisions of the Directive. Consequently, the Directive does not require the authorisation of an AIFM who, together with any affiliates, manage:-

(i) AIFs with assets under management, including those acquired through the use of leverage, of less than €100 million; or

(ii) AIFs with assets under management of less than €500 million, provided that the AIF are unleveraged and are subject to redemption lock-up periods of at least five years from the date of initial investment in each AIF.

If the Irish self-managed QIF is the AIFM, it will need to consider if it can avail of one of the above exemptions. In practise, the exemption may be helpful for some smaller QIFs structured as hedge or private equity funds. However, any AIFMs proposing to rely on such exemptions should be aware that unless they choose to “opt in” to the Directive, they will not be able to avail of the passporting provisions of the Directive.

AIFMs who choose to avail of the exemption will nonetheless have to comply with certain minimum registration and reporting requirements, such as registration with a national regulator, notification of the investment strategies employed, periodic updates with regard to main instruments held and notification of any breaches of the de minimis thresholds.

Conditions for taking up activities as AIFM

An external AIFM and an internally managed Irish QIF (which acts as the AIFM) is only permitted to engage in the activities listed in Annex I of the Directive i.e. portfolio management, risk management, marketing, administration services and activities related to the assets of the AIF.

It is important to note that Article 6(5)(d) of the Directive provides that AIFMs cannot be authorised under the Directive to provide portfolio management without also providing risk management. According to ESMA’s Discussion Paper, this provision should be interpreted as requiring an AIFM to be capable of providing, and take responsibility for, both portfolio management and risk management functions in order to obtain an AIFM authorisation in accordance with the Directive. If ESMA’s interpretation is implemented, it will be necessary for a self-managed QIF to demonstrate that it is capable of providing and taking responsibility for these functions in order to be appointed as the AIFM. In this regard, ESMA provides that notwithstanding that the AIFM must be able to provide both functions in order to be authorised, it may choose to delegate the portfolio management and/or the risk management function, subject to the delegation requirements set out in Article 20 of the Directive (see further below under “Delegation”).

It is important to note that ESMA’s Discussion Paper provides that while an AIFM may delegate the two functions (i.e. portfolio management or risk management) either in whole or in part, it may not delegate both functions in whole at the same time. This interpretation is considered to be unduly restrictive on the basis that (i) is it not supported by the wording of Article 20 of the AIFMD, which clearly contemplates the ability of AIFMs to delegate *both* portfolio management and risk management functions and (ii) it is contrary to the well established operating model of many funds whereby they delegate portfolio management and risk management to regulated third parties, but retain ultimate responsibility for such functions and retain sufficient resources to exercise day-to-day oversight over the delegates discharging such functions. However, if ESMA's position is adopted in the implementing measures, this would imply that the AIFM must be able to "perform" either part of the portfolio management function or part of the risk management function itself. It will be interesting to see what the requirements will be in order for the AIFM to demonstrate that it can perform part of the portfolio management and/or risk management function itself and whether there will be any minimum staffing requirements or whether the delegate could, for example, demonstrate performance of part of the risk management function by reviewing reports from its delegates. This will need to be clarified in the implementing measures.

It is worth noting that Article 6(2) of the Directive provides that an AIFM may also act as a UCITS management company. In this regard, a UCITS management company which manages AIF will not be subject to the UCITS Directive for that activity and will instead be required to obtain an additional authorisation under the Directive. It will also be possible for a UCITS management company to provide services such as portfolio management to AIFs but not to be appointed as the AIFM, i.e. under a delegation arrangement. In this regard, the UCITS management company would not be authorised under the Directive but would continue to be authorised under the UCITS Directive.

Significantly, Article 6(8) of the Directive states that MiFID firms and credit institutions are not required to obtain authorisation under the Directive in order to provide investment services such as individual portfolio management in respect of AIFs. This allows MiFID firms and credit institutions to continue to provide services to AIFs under delegation arrangements, subject to the rules on delegation (however, such MiFID firms may only offer/place units/shares of an AIF with investors in the EU only to the extent that such units/shares can be marketed in accordance with the Directive). In this regard, it should be noted that per ESMA's Discussion Paper, MiFID firms and credit institutions cannot be the appointed AIFM for an AIF or obtain authorisation under the AIFMD. A dual authorisation is only permitted in the case of a UCITS management company, which can be authorised both as a UCITS manager and an AIFM. If ESMA's interpretation of this provision of the Directive is implemented, the likely consequence is that the self-managed QIF will be appointed as the AIFM and that this will become the most common regulatory structure in Ireland.

Requirements at the Level of the AIFM

Conditions for Authorisation

Documentation /Information Requirements

AIFMs required to be authorised under the Directive must be authorised by its home Member State regulator. Accordingly, where an Irish self-managed QIF is the AIFM, it will be required to seek approval from the Central Bank of Ireland (the "Central Bank"). In summary, the authorisation process will be broadly similar to that for UCITS management companies and will involve, inter alia, the submission of the following to the Central Bank:

(a) information on the persons effectively conducting the business of the AIFM;

(b) details of the direct and indirect shareholders of the AIFM;

(c) submission of a programme of activity (Business Plan) setting out the organisational structure of the AIFM and including information on compliance with the operating conditions, transparency, leverage and delegation arrangements;

(d) information on the remuneration policies and practices pursuant to Article 13 of the Directive; and

(e) information on arrangements for delegation and sub-delegation to third parties.

The following details will also be required to be submitted to the Central Bank in relation to the AIF to be managed by the AIFM:

- information regarding the AIF's investment strategies, types of underlying funds, policy on leverage, risk profiles and location (including the location of any underlying master fund);
- constitutional documents;
- details with regard to the appointment of the depositary; and
- the prospectus / investor disclosure document.

Approval will be subject to compliance with the conditions of the Directive and will only be granted if:

- the AIFM has sufficient initial capital, which is EUR 300,000 for an internally managed QIF (similar to UCITS); it should be noted that where the AIFM is appointed as external manager of the AIF, the requirement is:

  (i) EUR 125,000; plus

  (ii) an additional amount of own funds equal to 0.02% of any assets of the AIFM under management exceeding EUR 250 million (up to a maximum of EUR10 million),

  provided (i) and (ii) above is not less than the amount required under the European Capital Adequacy Directive.

- the persons who conduct the business of the AIFM are of sufficiently good repute and are sufficiently experienced and the conduct of the business of the AIFM is decided by at least two persons meeting such conditions;

- the suitability of the AIFM's shareholders (presumably, this will not be a consideration in the case of a self-managed QIF acting as the AIFM); and

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

Whilst the minimum capital requirements under the Directive are broadly consistent with the thresholds and calculation methods under the UCITS IV Directive, the Directive goes further as it requires all AIFM to provide additional funds which are appropriate to cover the potential liability associated with risks arising from professional negligence or alternatively, to hold professional indemnity insurance against liability arising from professional negligence which is appropriate to the risks covered.

Applicants will be notified within 3 months of the submission of a complete application of whether authorization is granted, which period can be extended for a further 3 months in certain circumstances.

Operating Conditions/Organisation Requirements

Chapter III of the Directive sets down new organisational internal control and code of conduct requirements that are designed to align the rules governing the AIFM to a significant extent with the UCITS and MiFID regimes. In this regard, the recital to the Directive provides that it is necessary to ensure that AIFMs operate subject to robust governance controls.

AIFMs should be managed and organised so as to minimise conflicts of interest. A key theme in Chapter III of the Directive in respect of operating conditions for AIFMs is the principle obligation on the AIFM of promoting the best interest of the AIF investors and the integrity of the market.

There is no distinction in Chapter III of the Directive between externally managed AIFM and self-managed AIFMs, nor is there any such distinction in ESMA's Level 2 Advices. In the absence of any further clarification, the likely assumption is that the conditions would appear to apply equally to both categories of AIFM.

General Principles

*A*n AIFM must at all times: (i) act honestly, with due skill, care and diligence and fairly in conducting its activities; (ii) act in the best interests of the AIFs /its investors and the integrity of the market; (iii) employ the necessary resources and procedures for the proper performance of its business activities; (iv) take all reasonable steps to avoid, manage and monitor conflicts of interests; (v) comply with all regulatory requirements applicable to the conduct of its business activities; and (vi) treat all investors fairly.

Importantly, no investor in an AIF shall obtain preferential treatment, unless such treatment is disclosed in the relevant AIF's constitutional documents.

In terms of the above general principles, the approach taken by ESMA in its Level 2 Advice is to seek to achieve an appropriate level of consistency with the UCITS and MiFID Directives as far as possible. However, ESMA does appear to take account of the diversity of AIFs and different types of assets in which they are invested. For example, throughout its advices, ESMA does provide certain distinctions and adjustments or exemptions for certain closed-ended AIFs and/or AIFs that invest in property or are structured as private equity funds. It would appear that, like the approach taken in the UCITS Level 2 Directive, many provisions of the Directive will be based on the principle of proportionality, i.e. consideration of the nature, scale and complexity of the AIFM.

Remuneration

In response to political pressure, the Directive contains various remuneration "principles" applying to senior management, risk takers and others having a material impact on the AIF they manage. The Directive provides that AIFMs must have remuneration policies and practices for those categories of staff 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. AIFMs must determine the remuneration policies and practices in accordance with Annex II of the Directive. The intent of the Directive is to match the risk to investors with the financial incentives of key staff members. A key proportionality principle has been included in the remuneration policy so that an AIFM is obliged to follow the remuneration policy "in a way and to the extent that it is appropriate".

Conflicts of Interest

Under Article 14 of the Directive, AIFMs must take all reasonable measures to identify conflicts of interest that arise in the course of managing AIFs and must maintain effective arrangements in order 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. Further, AIFMs will be required to 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. Where organisational arrangements to identify, prevent, manage and monitor conflicts of interest are not sufficient to ensure, with reasonable confidence, that the risk of damage to investors' interests will be prevented, the AIFM is required to clearly disclose the general nature of and sources of conflicts of interest to the investor before undertaking business.

The key impact of Article 14 on Irish self-managed QIFs acting as the AIFM is the requirement to adopt a written conflicts of interest policy. This policy will be required to (a) identify when potential conflicts will arise; and (b) set out procedures to be followed and measures to be adopted in order to manage such conflicts. Like UCITS, ESMA's Level 2 Advice recognises the principle of proportionality and that an AIFM's conflict policy will be appropriate to the nature, scale and complexity of its business. It is also worth noting that ESMA's Level 2 Advice provides that the AIFM's conflicts policy is required not only to take into account the activity of collective portfolio management but all other activities of the AIFM (for example, distribution and marketing). In addition, the policy needs to consider activities carried out by a delegate, external valuer or a counterparty and identify circumstances which would constitute conflicts of interest. This is more far reaching than the UCITS requirements.

Another important aspect of Article 14 is the requirement on AIFMs to exercise due skill, care and diligence in the selection and appointment of prime brokers. In ESMA's Level 2 Advices, ESMA recommends that all counterparties and prime brokers are to be subject to ongoing supervision by a public authority, be of financial soundness and have the necessary organisational structure for the services provided and further places an obligation on AIFMs to maintain a list of approved prime brokers.

Resources and General Organisation

Article 18 (1) of the Directive requires AIFMs to use at all times adequate and appropriate human and technical resources that are necessary for the proper management of AIFs. This is broadly similar to Article 5 of the UCITS Implementing Directive.

ESMA's Level 2 Advice sets out guidelines in respect of control by senior management and the supervisory function of the AIFM. In particular, ESMA recommends that senior management receive on a frequent basis and at least annually written reports on all matters relating to compliance, internal audit and risk management, stating whether remedial measures have been taken in the event of any deficiencies, and regular reports on the implementation of investment strategies and investment decisions. In this regard, it would appear that AIFMs will be required to establish reporting policies and procedures and reporting lines which are broadly similar with those in place for UCITS management companies.

Under Article 18, AIFMs will also be required to have sound and administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms. Further, in line with the UCITS approach, it would appear that AIFMs will be required to establish:

- a permanent compliance and permanent internal audit function, which operate independently;
- rules for personal transactions by relevant persons that are involved in activities carrying potential conflicts;
- procedures and arrangements for the recording of portfolio transactions;
- procedures for the recording of subscription and redemption orders; and
- procedures for record keeping / retention of records.

Other Operating Conditions / Organisational Requirements

The Directive also sets down certain requirements relating to Risk Management / Leverage, Liquidity Management and Valuation. An analysis of these requirements indicates that they apply at the level of the AIF rather than the AIFM. Accordingly, these requirements are dealt with below under the heading "Requirements at the level of the AIF".

Delegation

Article 20 of the Directive permits AIFMs to delegate to third parties provided they notify the regulator of their home Member State in advance of the delegation and satisfy certain conditions. The delegation requirements apply to each of the management functions set out set out in Annex 1 of the AIFMD i.e. portfolio management, risk management, administration, marketing and other activities related to the assets of AIFs. It should be noted that the delegation of 'supporting tasks' such as administrative or technical functions performed by the AIFM as part of its management tasks are not subject to the specific delegation requirements of the Directive. In this regard, drawing from MiFID, ESMA has advised that an AIFM must comply with the provisions of Article 20 in respect of the delegation of a task which is "critical or important for the proper performance of the functions it provides to an AIF". MiFID investment firms will therefore be already familiar with this "material outsourcing" concept.

Any delegation will be subject to the following conditions:

- the AIFM must be able to justify its entire delegation structure on objective reasons (for example, if the AIFM can demonstrate that the delegation is done for the purpose of a more efficient conduct of the AIFM's management of the AIF such as cost saving or expertise of the delegate);
- the delegate must have sufficient resources to perform the respective tasks and the persons who conduct the business of the delegate must be of sufficiently good repute and sufficiently experienced;
- the delegation must not prevent the effectiveness of supervision of the AIFM and must not prevent the AIFM from acting, or the AIF from being managed, in the best interests of its investors;
- the AIFM must be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question, that it was selected with all due care and that the AIFM is in a position to monitor effectively at any time the delegated activity, to give at any time further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interest of investors;
- the services provided by each delegate must be reviewed by the AIFM on an ongoing basis.

Where the delegation concerns portfolio or risk management, the following additional conditions apply:

(i) such delegation can only be to undertakings which are authorised or registered for the purpose of asset management and subject to supervision or, where that condition cannot be met, only subject to prior approval by the regulator of the home Member State of the AIFM; responding to the European Commission's request for guidance on the categories of eligible institutions which should be considered as authorised for the purpose of asset management and subject to supervision, ESMA listed the following entities: (i) UCITS management companies (ii) MiFID investment firms authorised to perform portfolio management, (iii) certain authorised credit institutions and (iv) externally-appointed AIFM authorised under the AIFMD;

(ii) where such delegation is conferred on a third-country undertaking, cooperation between the regulator of the home Member State of the AIFM and the supervisory authority of the undertaking must be ensured. ESMA has advised that the third country undertaking should be deemed to satisfy this requirement when it is authorised or registered for the purpose of asset management based on "local criteria" and is effectively supervised by an "independent" competent authority. This is a marked move away from ESMA's earlier proposals which incorporated "equivalence" assessments in relation to the delegate's home jurisdiction; and

(iii) no delegation of portfolio or risk management shall be given to (i) the depositary or its delegate or (ii) any other undertaking whose interests may conflict with those of the AIFM or the investors unless such entity has functionally and hierarchically separated the portfolio or risk management tasks from its other potentially conflicting tasks and the potential conflicts are properly identified, managed, monitored and disclosed to the investors of the AIF; ESMA advises that the functional and hierarchical separation of portfolio or risk management tasks from any other potentially conflicting tasks within the delegate should be calibrated to the nature, scale and complexity of the delegate's business and to the nature and range of activities undertaken in the course of that business.

The delegate may in turn sub-delegate its functions subject to the consent of the AIFM, prior notification to the regulator and the general requirements applicable to any delegation by the AIFM above.

It is important to be aware that the AIFM's liability towards the AIF and its investors will not be affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation.

Further, similar to UCITS management companies, an AIFM is not permitted to delegate its functions (which term, according to ESMA, specifically relates to portfolio management and risk management functions) to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity. ESMA has identified the following two circumstances under which an AIFM would become a letter-box entity and could no longer be considered to be a manager of the AIF: (i) the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation; and (ii) the AIFM no longer has the power to (a) take decisions in key areas which fall under the responsibility of the senior management or (b) perform senior management functions in particular in relation to implementation of the general investment policy and investment strategies.

The possibility of delegation has interesting implications for an Irish QIF authorized as an AIFM as it may be possible for an internally managed QIF to delegate certain activities to a US investment manager who would not have to be authorized under the Directive. In this regard, it is envisaged that a significant proportion of non-EU investment managers will take the option of continuing to be regulated under the local laws of their domiciles and seek to perform portfolio / risk management functions under a delegation agreement with the AIFM in accordance with Article 20 of the Directive. However, as mentioned earlier in this paper, it is important to bear in mind that ESMA is of the view that while an AIFM may delegate the two functions (i.e. portfolio management or risk management) either in whole or in part, it may not delegate both functions in whole at the same time, which would mean that a self-managed QIF must be able to "perform" either part of the portfolio management function or part of the risk management function itself.

Reporting Obligations

An AIFM is required to report regularly to its home Member State regulator on the principal markets and instruments in which it trades on behalf of the AIFs it manages, the main instruments in which it is trading, the markets of which it is a member or where it actively trades and the principal exposures and most important concentrations of each of the AIFs it manages.

An AIFM must, for each of the EU AIFs it manages and for each of the AIFs it markets in the EU, provide the following to its home Member State regulator:

(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 the market risk, liquidity risk, counterparty risk and other risks including operational risk;

(d) information on the main categories of assets in which the AIF is invested; and

(e) the results of stress testing required under the Directive.

The risk management system referenced under (c) above is analogous to that required by UCITS IV, though extends content requirements such that all risks of the AIF should be covered.

The AIFM must, on request, provide the following documents to the regulator of its home Member State:

- an annual report of each EU AIF managed by the AIFM and of each AIF marketed by it in the Union, for each financial year, in accordance with Article 22(1);
- for the end of each quarter a detailed list of all AIFs which the AIFM manages.

In relation to AIFs which employ leverage on a substantial basis, the AIFM is required to provide information to its home Member State regulator about the overall level of leverage employed, a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives and the extent to which the AIF's assets have been reused under leveraging arrangements. This information must include the identity of the five largest sources of borrowed cash or securities and the amounts of leverage received from each of those sources.

Leveraged AIFs

While there is no leverage limit set out in the Directive, the AIFM must demonstrate that the leverage limits set by it for each AIF it manages are reasonable and that it complies with those limits at all times.

Where deemed necessary in order to ensure the stability and integrity of the financial system, the home Member State regulator of the AIFM can impose limits on the level of leverage that an AIFM may employ or other restrictions on the management of the AIF to limit the extent to which the use of leverage contributes to the build up of systemic risk in the financial system or risk of disorderly markets.

Private Equity Funds

Irish QIFs structured as private equity funds will need to consider the new onerous disclosure and notification obligations which apply to private equity houses within the scope of the Directive i.e. AIFMs which manage one or more AIFs which (either individually or jointly) acquire “control” of a non-listed company and AIFMs which cooperate with one or more other AIFMs on the basis of an agreement pursuant to which the AIFs managed by those AIFMs jointly, acquire “control” of a non-listed company. “Control” is defined to mean more than 50% of the voting rights of the company and must take into account any voting rights held directly by the AIF and any undertaking controlled by the AIF or an entity acting on behalf of the AIF.

Requirements at the Level of the AIF

Regardless of whether the Irish QIF is internally managed (where the QIF is the AIFM) or managed by an external manager (where the external manager is the AIFM), certain requirements of the Directive will apply at the level of the QIF itself (as the AIF). In fact, an analysis of the Directive shows that most of the regulatory requirements applicable to the AIFM arise at the level of the AIF.

Risk Management / Leverage

AIFMs are required to implement adequate risk management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each AIF, which systems must be reviewed annually. The risk management function must be “functionally and hierarchically separate” from operating units, including portfolio management. At a minimum, AIFMs must:

- implement a due diligence process when investing on behalf of the AIF, according to the investment strategy, the objectives and risk profile of the AIF;
- ensure that the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be properly identified, measured, managed and monitored (including through stress testing procedures);
- ensure that the risk profile of the AIF shall correspond to the size, portfolio structure and investment strategies and objectives of the AIF.

The issue of a functional and hierarchical separation was a controversial issue which was raised in the consultation papers to ESMA's Level 2 Advice and many respondents commented that the requirement would be difficult for small AIFMs and also for private equity and venture capital managers to meet. ESMA's Level 2 Advice provides further guidance in respect of the issue of the functional and hierarchical separation of the risk management function. It is worth noting that ESMA's advises that the competent authorities in each Member State should apply the principle of proportionality taking into account the operational structure of the AIFM and particular corporate government arrangements which should give some comfort to less complex and/or smaller AIFMs and self-managed AIFMs, such as Irish QIFs.

As part of its risk management, AIFMs must set a maximum level of leverage for each AIF they manage as well as the extent of any rights to reuse collateral or guarantees under the leveraging arrangements, taking into account the type of the AIF, its investment strategy and sources of leverage as well as:

- any other interlinkage or relevant relationships with other financial services institutions, which could pose systemic risk;
- the need to limit the exposure to any single counterparty;
- the extent to which the leverage is collateralised;
- the asset-liability ratio; and
- the scale, nature and extent of the activity of the AIFM on the markets concerned.

This will be straightforward for Irish QIFs as they are already required to disclose maximum leverage limits in the relevant fund prospectus.

It is clear that the Directive will require AIFM to adopt formal policies and procedures with regard to risk management. This will also involve setting qualitative and quantitative restrictions in respect of risk measurement. However, it is likely that the Member States may adopt a flexible approach with regard to the requirement to have functional separation of the risk management process. The Directive will most likely require all AIFMs to adopt a formal risk management policy, unless Member States take the view that the risk management procedures can be covered in the business plan of an AIFM.

Liquidity Management

Article 16 of the Directive provides that, unless the AIF is unleveraged and closed-ended, the AIFM must employ an appropriate liquidity management system for each AIF they manage and adopt procedures which enable them to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the AIF's investments comply with its underlying obligation. Stress testing is required in order to assess and monitor the liquidity risk. Further, the investment strategy, the liquidity profile and the redemption policy of the AIF must be consistent.

From ESMA's Level 2 Advices, it would appear that the provisions of Article 16 of the Directive will have the following implications for AIFMs:-

(i) AIFMs will have to adopt liquidity management policies and procedures which enable them to monitor the liquidity risk of each AIF and comply with the underlying obligations to investors, counterparties, creditors and other parties;

(ii) Measures will need to be put in place to access the quantitative and qualitative risks of positions which would have a material impact on liquidity profile of the AIFs;

(iii) Adoption of stress tests in both exceptional and normal circumstances will be conducted at a frequency appropriate to the nature of the AIF, the type of investor and redemption policy but at a minimum annually;

(iv) A liquidity management policy to be put in place which is subject to an annual review;

(v) Adoption of procedures at board level to ensure escalation measures of anticipated or actual liquidity shortages or other distress situations;

(vi) Full disclosure of redemption policies to investors and in the event of material changes (this will tie in with the transparency obligations under Article 23). Irish QIFs (and other Non-UCITS) are already required to comply with this obligation in terms of disclosure in offering documents and notification to investors of any material changes;

(vii) Management and monitoring of conflicts of interest between investors wishing to redeem their shares and those investors wishing to maintain their investments in the portfolio, conflicts between the AIFMs incentive to invest in illiquid assets and the AIFs redemption policy;

(viii) The adoption of what ESMA terms as necessary tools and arrangements to manage liquidity risk. This covers both management of asset liquidity, illiquid assets and related valuation problems and also the management of redemption requests. It recognises that such tools and arrangements may include where allowed under national law, redemption gates, partial redemptions, temporary borrowing, side pockets, notice periods, pools of illiquid assets and suspension.

Valuation

The Directive provides that it is the AIFM who is responsible for the proper valuation of the AIF. Appropriate and consistent procedures must be established in respect of each AIF managed by the AIFM so that a proper, consistent and independent valuation of the assets of the AIF can be performed in accordance with the Directive and applicable national AIF rules.

The frequency of valuations must be appropriate to the assets held by the AIF and its issuance and redemption frequency (in the case of open ended AIF). Valuations are also required in case of an increase or decrease of the capital by the relevant AIF (in the case of closed ended AIFs). Valuations are required at least annually in all cases.

The valuation of assets of an AIF that are financial instruments has to take place every time the NAV is calculated. The valuation of assets of an AIF that are not financial instruments has to take place at least once a year.

The Directive provides that the valuation must be performed impartially and with all due skill, care and diligence. AIFMs shall ensure that the valuation function is either performed by an external valuer or the AIFM itself as follows:

External Valuer

The external valuer must be a legal or natural person independent from the AIF, the AIFM and any other persons with close links to the AIF or the AIFM. Where an external valuer performs the valuation function:

- the external valuer must be subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct; and

- the external valuer must provide sufficient professional guarantees to be able to perform effectively the relevant valuation function.

The valuation function described above is separate and distinct from the role of the calculation of NAV of an AIF. A third party, whose appointment must be notified by the AIFM to is home Member State regulator, which carries out the calculation of the NAV for an AIF is not considered to be an external valuer pursuant to the Directive, so long as this entity does not provide valuations for individual assets, including those requiring subjective judgement, but incorporates value which are obtained from the AIFM, pricing sources or the external valuer(s) into the calculation process.

In Ireland, QIFs are required to appoint an independent administrator to calculate the NAV of the fund, and must account for how each of the fund's assets are valued. Administrators are required to be authorized and regulated by the Central Bank of Ireland and may, therefore, be an appropriate "fit" for the role of external valuer. One issue that will need to be clarified, however, is the nature of the "professional guarantee" that will be required.

In its consideration of such professional guarantee, ESMA notes that the key objective of the guarantees should be to ensure that the valuer has the appropriate expertise to carry out the valuation function according to the types of assets invested in by the AIF.

An external valuer is not permitted to delegate the valuation function to a third party.

AIFM as Valuer

The AIFM may perform the valuation provided that:

- the valuation task is functionally independent from the portfolio management; and
- its remuneration policy and other measures ensure that conflicts of interest are mitigated and that undue influence of employees is prevented.

The regulator of the home Member State of the AIFM may require the AIFM to have its valuation procedures and/or valuations verified by an external valuer or, where appropriate, by an auditor.

Responsibility and Liability for Valuation

AIFMs shall be responsible for the proper valuation of AIF's assets, the calculation of NAV, and the publication of NAV. The AIFM's liability to the AIF will not be affected by the appointment of an external valuer. However, the external valuer will be liable to the AIFM for any losses suffered by the AIFM as a result of the external valuer's negligence or intentional failure to perform its tasks.

Annual report

An AIFM must make available an annual audited report for each EU AIF it manages and for each AIF it markets in the EU. The annual report must be available within six months following each financial year and be provided to investors on request and made available to the home Member State regulator of the AIF and the AIFM.

The annual report must contain the following minimum information:

(i) a balance sheet or statement of assets and liabilities;
(ii) an income and expenditure account;
(iii) a report on the activities for the financial year;
(iv) any material changes to the prospectus/offering document/risk management procedures/other items required to be disclosed to investors pursuant to Article 23 of the Directive during the financial year;
(v) the total amount of remuneration paid by the AIFM to its staff, and number of beneficiaries, and any carried interest paid by the AIF;
(vi) the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

Where the AIF is already required to publish an annual report under the EU Transparency Directive, then only the additional information set out at (i) and (ii) above will be required to be provided to investors.

Given that Irish QIFs are already required to produce annual reports, within tighter timeframes than those required by the Directive, this requirement should not impose any additional burdens, with the exception of the remuneration disclosure, which will need to be considered.

Prospectus Disclosure

An AIFM must make available certain information (and any material changes thereto) in respect of each EU AIF they manage and for each AIF that they market in the EU to investors before they can invest in the AIF.

It would appear that Irish QIFs are already subject to most of the disclosure requirements (for example, disclosure in relation to investment objectives, strategies, restrictions, type of underlying assets, details with regard to leverage, identity of service providers, valuation procedures / pricing methodologies, fees, procedures for issue and redemption of shares, provisions relating to appointment of prime brokers and their rights of use of fund assets etc). However, certain additional information will be required to be disclosed as follows:

- a description of the main legal implications of the contractual relationship entered into for the purpose of investment, including information on jurisdiction, on the applicable law and on the existence or not of any legal instruments providing for the recognition and enforcement of judgments in the territory where the AIF is established;
- a description of how the AIFM is complying with its own funds and professional indemnity insurance to cover liability risks;
- a description of any delegated management function by the AIFM and of any safe-keeping function delegated by the depositary, the identification of the delegate and any conflicts of interest that may arise from such delegations;
- a description of the AIF’s liquidity risk management, including the redemption rights both in normal and in exceptional circumstances, and the existing redemption arrangements with investors;
- a description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment and, where relevant, their legal or economic links with the AIF or AIFM;
- where available, the historical performance of the AIF;
- a description of any conflicts of interest in relation to the appointment of prime brokers and how they are managed are managed;
- a description of how and when the information required under “Periodic Disclosure” below will be disclosed.

In addition to the above, the AIFM must inform investors of any arrangements made for the depositary of the AIF to discharge itself of liability and any changes to the liability of the depositary towards the AIF.

Periodic Disclosure

On a periodic basis, the AIFM must disclose the following:

- the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature;
- any new arrangements for managing the liquidity of the AIF;
- the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks.

In addition, AIFMs managing leveraged AIFs must disclose the following on a regular basis:

- any changes to the maximum level of leverage which the AIFM may employ on behalf of the AIF as well as any right of the reuse of collateral or any guarantee granted under the leveraging arrangement;
- the total amount of leverage employed by that AIF.

Depositary

Article 21 of the Directive requires that an AIFM must ensure the appointment of a single depositary for each AIF it manages. The depositary can not be the AIFM and must be an EU credit institution, a MiFID investment firm authorized to provide custodial services and which meet certain capital requirements or other authorized entities which are eligible to be UCITS depositaries.

In the case of EU AIFs, the depositary must be established in the home Member State of the AIF. In the case of non-EU AIFs, the depositary must be established in the third country where the AIF is established or the relevant AIMF's home Member State or reference Member State and may be a non EU bank or custodian, subject to certain conditions as set out in the Directive to include co-operation arrangements being in place between the relevant regulators.

Irish authorized QIFs are currently subject to the requirement to appoint an independent regulated depositary in compliance with the Central Bank's requirements and, accordingly, will meet the Directive's criteria for the appointment of depositaries.

It should be noted that a prime broker acting as counterparty to an AIF can only act as depositary if it has separated the performance of its depositary functions from its tasks as prime broker and the potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF. However, a prime broker may carry out custody tasks as a delegate of the depositary. This takes account of the fact that many AIFs, and, in particular, Irish QIFs structured as hedge funds currently make use of a prime broker and ensures that AIFs may continue to use the function of prime brokers (subject to the delegation requirements below).

Functions / Duties

The core obligations of the depositary will not change as a result of the Directive, however, the Directive is more prescriptive in terms of the duties and the standard of liability of the depositary. In addition to its general duty to act honestly, fairly and in the interest of the AIF and the investors of the AIF and the requirement to avoid conflicts of interest in carrying out its duties, the depositary has the following duties under the Directive:

1. Cash Monitoring

There are now additional depositary responsibilities surrounding monitoring cash flows, in particular, the duty to ensure that that the AIF's cash flows are properly monitored, that subscription payments 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.

2. Safe-keeping Responsibility

The Directive distinguishes between "financial instruments that can be held in custody" and "other assets" as follows:

Assets subject to custody function

For financial instruments that can be held in custody, the depositary is required to hold in its custody: (i) all financial instruments that can be registered in a financial instruments account opened in the depositary's books; these instruments must be registered in segregated accounts so that they can be clearly identified as belonging to the AIF at all times; and (ii) all financial instruments that can be physically delivered to the depositary.

ESMA's Level 2 Advices provide that assets should be included in the scope of the depositary's "custody function" when they meet all three of the criteria below:

1. they are transferable securities (including those which embed derivatives), money market instruments or units of collective investment undertakings;
2. they have not been provided as collateral under the terms of a title transfer financial collateral arrangement or under a security financial collateral arrangement by which the control or possession of the financial instruments has been transferred from the AIF or the depositary to the collateral taker; and
3. they are registered or held in an account directly or indirectly in the name of the depositary.

Other Assets

For "other assets", the Directive provides that the depositary's duty is to verify the ownership of the AIF of such assets and to maintain a record of those assets for which it is satisfied that the AIF (or the AIFM acting on behalf of the AIF) holds the ownership of such assets (the assessment of ownership must be based on information or documents provided by the AIF or the AIFM and, where available, on external evidence); further, the depositary must keep its record up-to-date.

As to the meaning of "other assets", ESMA's Level 2 Advices state that all financial instruments that do not comply with ESMA's criteria for "assets in custody" should be considered as 'other assets' and be subject to record keeping duties. ESMA comments that financial instruments would which fall under "other assets" would include but not be limited to:

- Physical assets that do not qualify as financial instruments or cannot be physically delivered to the depositary;
- Financial contracts (e.g. derivatives other than those embedded in transferable securities);
- All financial instruments, including units/shares of collective investment schemes, issued in a nominative form or registered directly with the issuer or through a registrar acting on behalf of the issuer, in the name of the AIF, provided that they cannot be physically delivered to the depositary or they are not registered or held in an account directly or indirectly in the name of the depositary;

- Cash deposits; and
- Investments in privately held companies and interests in partnerships.

Irish QIFs will need to carry out a review of the arrangements in place with their depositaries to ensure compliance with the above safe-keeping requirements.

3. Oversight Responsibility

The depositary's oversight function under the Directive is similar to that already required by custodians of Irish QIFs, such as the duty to 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 constitutional documents and to ensure that the value of the units or shares of the AIF is calculated in accordance with the applicable national law and the AIF constitutional documents.

Delegation

It is possible for the depositary to delegate its safe-keeping responsibilities provided a number of tests are satisfied, including that the depositary can demonstrate that there is an "objective reason" for the delegation and that it exercises all due skill, care and diligence in the selection and the appointment of any third party and in the periodic review and ongoing monitoring of such third party. Further, the depositary must ensure that the third party meets certain conditions, including the following:

- it must have the structures and the expertise that are adequate and proportionate to the nature and complexity of the assets of the AIF;
- for custody tasks in respect of instruments that can be held in custody, the third party must be subject to effective prudential regulation, including minimum capital requirements, and supervision in the jurisdiction concerned and subject to an external periodic audit to ensure that the financial instruments are in its possession; and
- the third party must segregate the assets of the depositary's clients from its own assets and from the assets of the depositary in such a way that they can at any time be clearly identified as belonging to clients of a particular depositary.

However, where the law of a third country requires that certain financial instruments be held in custody by a local entity and no local entities satisfy the delegation requirements laid down in the Directive, the depositary may delegate its functions to such a local entity only to the extent required by the law of the third country and only for as long as there are no local entities that satisfy the delegation requirements provided investors are duly informed of the situation and the AIF, or the AIFM on behalf of the AIF, has instructed the depositary to delegate the custody of such financial instruments to such local entity.

A third party may in turn sub-delegate its safe-keeping duties in which case the delegation rules set out in the Directive will apply.

The Directive clarifies that the provision of services by securities settlement systems shall not be considered a delegation of custody functions, however it is not clear what standard of liability applies where assets are lost as a result of the default of a securities settlement system.

Depositaries of Irish QIFs will need to review their delegation arrangements in order to ensure compliance with the above delegation requirements. In particular, it will be necessary to examine the delegation models in place with prime brokers, who are commonly appointed as sub-custodian for many hedge funds. While such prime brokers may carry out custody tasks as a delegate of the depositary, any such delegation will be subject to the delegation requirements above.

Liability

The depositary's liability regime is a central issue of the Directive and probably one of the most controversial. The Directive distinguishes between the "loss of financial instruments held in custody" (in which case, a near-strict liability standard is imposed) and any "other losses" (in which case a negligent / intentional failure standard applies).

The Directive provides that the depositary shall be liable to the AIF or to its investors for the "loss" by the depositary or a third party to whom the custody of financial instruments held in custody has been delegated, unless it can prove that the loss is a result of events beyond its reasonable control (see further below). In the case of "loss", the depositary must return a financial instrument of identical type or the corresponding amount to the AIF without undue delay. This is a significant reinforcement of the depositary's liability compared to the UCITS IV framework.

Importantly, the depositary will not be liable if it can prove that the loss of the financial instruments held in custody has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

As to the meaning of "loss", ESMA has put forward a suggestion which is designed to limit the loss to situations where the financial instruments are permanently lost as opposed to temporarily unavailable. The definition of loss thus covers situations where the AIF has been permanently deprived of its ownership right over the financial instrument or is permanently unable to dispose of them. It further ensures that "loss" resulting from fraudulent behaviour is within the scope of the depositary's liability.

The Directive provides that the depositary shall also be liable to the AIF, or to the investors of the AIF, for all other losses suffered by them as a result of the depositary's negligent or intentional failure to properly fulfil its obligations pursuant to the Directive.

The depositary's liability will not be affected by any delegation. However, in the case where the depositary delegates its custody tasks to a third party, if there is a loss of financial instruments held in custody by a third party, the depositary can discharge itself of liability if it can prove that:

- all requirements for the delegation of its custody tasks set out in the Directive are met;
- a written contract between the depositary and the third party expressly transfers the liability of the depositary to that third party and makes it possible for the AIF or the AIFM acting on behalf of the AIF to make a claim against the third party in respect of the loss of financial instruments or for the depositary to make such a claim on their behalf; and
- a written contract between the depositary and the AIF or the AIFM acting on behalf of the AIF, expressly allows a discharge of the depositary's liability and establishes the objective reason to contract such a discharge.

In addition, where a third country legally requires assets to be held by a local entity and there are no local entities which satisfy the delegation requirements of the Directive, the depositary can discharge itself of its liability for the loss of financial instruments provided that certain conditions are met.

EU Passport and Private Placement and Third Country Rules

The EU passport, private placement and third country rules contained in the Directive are complex and beyond the scope of this Article. However, the following provisions are relevant in the case of an Irish authorized QIF:

Where the internally managed QIF is the AIFM:

- From 2013, assuming an external manager is not appointed as the AIFM, an internally managed Irish QIF will be required to be authorized as an AIFM under the Directive, unless it can avail of the threshold exemption referred to below.

- An internally managed Irish QIF may not be required to seek authorization as an AIFM if the threshold exemption set out in Article 3 (2) of the Directive can be relied upon. If such exemption can be relied upon, it will not be possible for the Irish QIF to avail of the Directive's passporting provisions unless it chooses to "opt in". However, it can continue to privately place its units/shares into the EU, subject to certain requirements, including compliance with the Directive's transparency and private equity requirements.

- Once authorized as an AIFM under the Directive, the Irish QIF will be able to market its units/shares on a passported basis to professional investors (i.e. institutional and sophisticated investors, as described in Annex II to Directive 2004/39/EC (MiFID)) across the EU.

Where the QIF is externally managed:

- If the Irish authorized QIF is externally managed, its units / shares can only be marketed on a passported basis to professional investors across the EU provided its external manager has been authorized as an AIFM under the Directive.

- If the QIF is externally managed by an EU AIFM, then such EU AIFM must be authorised and can avail of the EU wide passport from 2013.

- If the QIF is externally managed by a Non- EU AIFM, such Non-EU AIFM must be authorised under the Directive and can avail of the EU wide passport from 2015; however, subject to further recommendations from the EU, there may be an option for such Non-EU AIFM to continue to sell under the private placement rules until 2018 (subject to certain conditions, to include co-operation arrangements being in place and subject to compliance with the Directive's transparency and private equity requirements).

The Directive envisages that no earlier than 2018 ESMA will issue an opinion on the functioning of the European passport for the marketing of non-EU AIF by EU AIFM and on the continuing functioning of the national private placement regimes and an advice on the termination of such national regimes. If ESMA considers that there are no significant obstacles regarding matters such as investor protection, market disruption, monitoring of systemic risk and distortion in competition impeding the termination of the national private placement regimes and to maintain the availability of the European passport for the marketing of non-EU AIF by EU AIFM or the management and/or marketing of AIF by non-EU AIFM in the Member States, then it will issue a positive advice. Based on this advice, the European Commission will adopt rules within three months specifying the date when the national regimes will terminate and the European passport will become the sole and mandatory regime applicable in all Member States.

Timings

The Directive provides that by 22 July, 2013, Member States must adopt and publish the laws, regulations and administrative provisions necessary to comply with the Directive and shall (subject to certain of the provisions regarding passporting) apply those laws from that date. However, in the meantime following ESMA's Level 2 Advice, Member States await the publication by the European Commission of the Level 2 regulations, which are expected to be published by end April 2012.

Article 61 of the Directive provides that AIFMs "performing activities under the Directive" before 22 July 2013 shall take all necessary measures to comply with national law stemming from the Directive and shall submit an application for authorisation within one year of that date. Assuming that this is given its natural interpretation, this means that AIFMs have a one year transitional period within which to make an application for authorisation under the Directive unless either of the following principal grandfathering provisions apply:

(a) AIFMs that manage closed-ended AIFs that make no additional investments and are not marketed after the Directive's transposition deadline are not required to apply for authorisation; or

(b) AIFMs that manage closed-ended AIFs that continue to make investments but whose subscription period ended prior to the entry into force of the Directive and have a fixed term life which expires at the latest three years from the Directive's transposition deadline may continue to manage such AIFs without authorisation, but these AIFMs must comply with the disclosure requirements of Article 22 and, in the case of private equity funds, Article 26 to 30.

Summary

Subject to ESMA's Level 2 Advices and the recommendations set out in ESMA's Discussion Paper being adopted, the Irish self-managed QIF represents the ideal vehicle for both:

(i) EU managers authorised under MiFID or as a credit institution who may not be appointed as the AIFM; and

(ii) non-EU managers who wish to assure themselves of continued access to EU markets and who do not wish to be appointed as the AIFM.

In such circumstances, the Directive allows for the self-managed QIF to be appointed as the AIFM and then to delegate performance of the portfolio management and / or risk management function to the EU or non-EU manager, although the self-managed QIF may be required to perform part of either of the foregoing functions itself. Any delegation arrangements must comply with the Directive and an AIFM must not delegate their functions to the extent that it can no longer be considered to be the manager and it becomes a letter-box entity.

In order to be appointed as the AIFM, the Irish self-managed QIF will need to comply with the Directive's general operating and organisational requirements, to include new UCITS/MiFID type internal control and code of conduct requirements. It will also be necessary to comply with the new risk management/leverage, liquidity management, valuation r, transparency and depositary requirements.

As an EU AIFM, the Irish QIF will benefit from the passport provisions immediately on the implementation of the Directive in June 2013 and will be able to market its units / shares on a passported basis to professional investors (i.e. institutional and sophisticated investors) across the EU.

Date: April 2012

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