

## The Alternative Investment Fund Managers Directive: A Brief Guide for Real Estate Investment Businesses

The Alternative Investment Fund Managers Directive will establish an EU-wide regulatory and supervisory framework for alternative investment funds. Although primarily aimed at hedge funds, the broad scope and “one size fits all” approach of the Directive mean that it will also impose onerous compliance obligations on many other businesses, including real estate investment businesses. Lengthy negotiation and much lobbying on behalf of the property industry have secured valuable exemptions which should take many traditional real estate investment structures outside the scope of the Directive, but much of the detail of the new regime, and the extent to which it will affect real estate businesses, will not become clear until secondary legislation and guidance are settled.

### Alternative Investment Fund Managers

The Directive regulates Alternative Investment Fund Managers (“AIFM”) rather than the funds themselves. Subject to certain exceptions mentioned below, an AIFM is any entity whose regular business is managing or marketing an Alternative Investment Fund (“AIF”). For this purpose “managing” means providing portfolio management or risk management services; simply giving management advice, which the AIF may decide to accept or reject, would probably not amount to managing.

The Directive applies if the AIFM has its registered office in the EU, if the AIF which it manages is authorised or registered or has its registered office or head office in the EU, or if the AIFM markets the AIF in the EU.

Where an AIF does not have a separate manager, it is itself treated as an “internal manager” and it must be authorised and comply with the other obligations of an AIFM.

### Alternative Investment Funds

An AIF is any collective investment undertaking, no matter what its legal structure (other than an UCITS fund), which raises capital from a number of investors to invest in accordance with a defined investment policy for the benefit of those investors. It therefore includes both open-ended and closed-ended funds, listed funds, companies, limited partnerships, trusts and limited liability partnerships.

Managers of real estate funds will generally be covered by the Directive. However, initial drafts were so widely worded that they would also have caught many traditional property companies, which caused alarm in the property industry. Intensive lobbying has resulted in the exclusion of certain holding companies, corporate groups and joint ventures from the scope of the Directive. Nevertheless, the precise extent of these exceptions will depend on the terms of the secondary legislation which has yet to be drafted, and in the meantime concern remains that the reach of the Directive might still go beyond the funds to which it was designed to apply.

The Directive also excludes:

- pension funds, employee participation schemes and employee saving schemes;
- undertakings which invest the private wealth of investors without raising external capital;
- supranational institutions, national central banks, national, regional and local government and bodies which manage funds supporting social security and pension systems;
- securitisation special purpose vehicles; and
- insurance contracts.

A lighter regulatory regime applies to managers of funds with assets of less than €100 million and to managers of unleveraged funds with assets of less than €500 million where investors have no redemption rights for five years. Those managers will not be subject to full authorisation but will need to be registered and to provide certain information about the funds they manage.

## Duties Imposed

### Authorisation

The AIFM will have to be authorised. To obtain authorisation the AIFM must have its head office and registered office in the same member state and it will have to supply information on:

- the persons effectively conducting its business, who must be of sufficiently good repute and sufficiently experienced in the investment strategy of the AIF;
- the shareholders or members of the AIFM who hold, directly or indirectly, 10 per cent or more of its capital or voting rights, who must be "suitable taking into account the need to ensure the sound and prudent management of the AIFM";
- how it intends to comply with its obligations under the Directive; and
- various information about the AIF, including its investment strategies, its policy on the use of leverage and its risk profile.

Authorisation in one member state will be valid for all member states.

### Minimum Capital Requirements

The AIFM will be required to have initial capital of at least €125,000, or €300,000 if it is an internal manager and to have its own funds equal to 0.02 per cent of the value of any assets of the AIF over €250 million, subject to a maximum requirement of €10 million. Up to half the funds may instead be guaranteed by a credit institution or insurance undertaking. The AIFM will also be required to have sufficient funds to cover potential liability for professional negligence or to have appropriate professional indemnity insurance.

### Leverage

The AIFM must set a maximum level of leverage for the AIF and demonstrate that the limit is reasonable and is complied with. There is provision for the authorities to impose limits on the level of leverage that may be employed, or other restrictions on the management of the AIF, if necessary to ensure the stability and integrity of the financial system.

### Appointment of a Depositary

The AIFM must ensure that a depositary is appointed for each AIF it manages. The depositary is responsible for the safe keeping of the fund's assets. It is required to have custody of financial instruments, such as the share certificates of property owning subsidiaries, and it must verify and record ownership of all other assets, such as properties. The depositary is also responsible for ensuring that investments are carried out properly and that assets are properly valued, that consideration for the sale of assets is remitted to the AIF within usual time limits and that income is properly applied.

Generally the depositary must be an EU credit institution, a MiFID investment firm or an institution eligible to be a depositary for UCITS. However, funds such as real estate funds, private equity funds and venture capital funds which do not generally invest in financial instruments and where investors have no redemption rights for five years may be allowed to appoint a qualifying professional adviser to carry out this function. The AIFM cannot be a depositary. The depositary for an EU AIF must be established in the member state of the AIF. For non-EU AIF, it must be established in the jurisdiction where the AIF is established or the member state where the AIFM is located or regulated.

The requirement to appoint a depositary is likely to add significantly to the overheads of the AIF.

## Valuations

Assets will have to be valued at least once a year and investors must be informed of the valuation. The valuation may be carried out by the AIFM, rather than an independent valuer, provided that the valuation function is independent from portfolio management and there are measures to prevent conflicts of interest and undue influence. The depositary may carry out the valuation provided the valuation and depositary functions are kept separate and potential conflicts of interest are monitored and disclosed.

## Remuneration

Controls will be imposed on the remuneration of staff of the AIFM who have a material impact on the risk profile of the AIF, including senior management and risk takers and others in the same pay bracket. The controls are similar to those applying to bankers and are intended to prevent the AIFM encouraging excessive risk-taking. For example:

- bonuses must be sustainable and justified according to the performance of the business unit, the AIF and the employee
- at least 40 per cent of bonuses must be deferred for at least three to five years, rising to 60 per cent where the bonus is particularly high
- at least 50 per cent of bonuses must be paid in units or shares of the AIF or equivalent instruments
- discretionary pension benefits must be retained for five years in the form of units or shares of the AIF or equivalent instruments

However remuneration policies may take into account the size of the AIFM and the AIF and the nature of their activities and this may provide some flexibility.

## Disclosure

The Directive requires a large amount of information about the AIF to be disclosed to investors such as its investment strategy, use of leverage, valuation procedure, fees and expenses, risk profile and risk management systems. There are also detailed requirements to report information to the authorities on matters such as the risk profile and risk management tools and details of leverage.

There are additional disclosure requirements where the AIF acquires control of a non-listed company

and a prohibition on asset stripping, but they do not apply to the acquisition of a special purpose vehicle with the purpose of purchasing or holding real estate or to companies falling within the definition of small and medium sized enterprises.

## Delegation

The AIFM may delegate its responsibilities subject to a number of conditions and provided the authorities are notified. In particular, prior approval is required if portfolio management or risk management are delegated to an undertaking which is not authorised or registered to carry out asset management and subject to supervision. Notwithstanding such delegation the AIFM will remain liable to the AIF and to the investors.

## Marketing

The main potential advantage of the new regime for managers is the introduction of a marketing “passport” which will enable an AIFM authorised in one EU member state to market an AIF to professional investors throughout the EU without needing any further authorisation or registration. Marketing for this purpose is direct or indirect offering or placement of units or shares in the AIF. The passport will not apply to marketing to retail investors, which will be dealt with by member states separately.

The passport will be available to EU AIFMs managing EU AIFs as soon as the rules are incorporated into national law (probably 2013). Two years later (probably 2015) it may also be available for non-EU AIFMs and the marketing of non-EU AIFs, provided the European Securities and Markets Authority is in favour of it and necessary secondary legislation is passed. In the meantime, member states will be permitted to retain their national private placement regimes, subject to certain conditions, until at least three years after the passport is extended to non-EU AIFMs (probably 2018).

The Directive does not affect passive marketing or reverse solicitation, so an EU investor will be able to approach a non-EU AIFM to invest in a non-EU AIF without the AIFM having to comply with the Directive.

## General Principles

The AIFM will also be subject to a number of general requirements such as acting with due skill, care and diligence, taking all reasonable steps to avoid

conflicts of interest and separating risk management functions from operating functions.

## Timetable

The Directive was adopted by the European Parliament in November 2010. It will enter into force twenty days after it has been published in the Official Journal of the EU; this is expected during summer 2011. There will then be a two year deadline for the Directive to be transposed into national law, at which time the passport for EU AIFMs to market EU AIFs will take effect (probably in July 2013). AIFMs operating at that time will then have a year to apply for authorisation (so probably until July 2014). The "Level 2" process, during which secondary legislation will be made, is underway; the new European Securities and Markets Authority will play a key role in this process and a number of consultations are expected.

## Steps to Take Now

Investment businesses should consider whether they fall within the definition of an AIF or AIFM and, if so, whether they will be affected by the Directive or whether one of the exclusions will apply. If the Directive will apply, it will be important to decide who the AIFM is and this is far from clear at present for many structures. Authorisation as an AIFM may limit the AIF's activities. Some restructuring may be necessary to prevent an entity inadvertently becoming an AIFM.

The fine tuning of the regime which will take place during Level 2 may result in significant changes to what is currently expected so it will be necessary to monitor that process closely.

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## Practice group contacts

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