



# Alternative Investment Fund Managers Directive: Impact on real estate funds - update and practical application

## Summary and implications

The European Commission published its first draft of the Directive on Alternative Investment Fund Managers (AIFMs) on 30 April 2009. Since then, the Swedish Presidency of the Council of the European Union has produced three further drafts (the last dated 15 December 2009), Jean-Paul Gauzes, a French MEP, has produced a report for the European Parliament (dated 23 November 2009) and the Spanish, who assumed the Presidency of the Council of the European Union at the beginning of 2010, published the fifth draft of the Directive on 3 February 2010. Significant press and industry comment continues, and over 1,000 amendments have been tabled to the Gauzes report.

Thankfully, the Spanish draft of the Directive (the Spanish Draft) is based on the last Swedish draft rather than the Gauzes report (which was considerably less friendly to alternative investment funds (AIFs)), and contains a number of helpful clarifications, for instance in relation to remuneration.

Unfortunately, the Spanish have not addressed various substantive difficulties with the Directive, and have resurrected the spectre of protectionism by introducing new restrictions on the marketing by non-EU AIFMs of non-EU AIFs and by imposing transparency and disclosure obligations on those non-EU AIFMs.

It is expected that the text will be settled in Europe in July 2010, with implementation to follow in the Member States in the middle of 2012 at the earliest.

The Directive will apply to most real estate fund managers unless they fall within an exemption (e.g. an AIFM which manages an AIF all of whose investors are in the same group as the AIFM) or can take advantage of an exclusion (e.g. for pension funds, sovereign wealth funds and parallel discretionary management arrangements). The Directive will also not apply to an AIFM which does not meet the prescribed thresholds for gross assets under management (being €100m or less, or €500m where the AIFs it manages are not leveraged and investors have no redemption rights for five years).

## Ask a question

If you have any questions please contact Amanda Howard, Partner  
T +44 (0)20 7524 6342  
[a.howard@nabarro.com](mailto:a.howard@nabarro.com) or your usual Nabarro contact

## The Indirect Investment team

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## Further information

We will provide regular updates on the AIFM Directive as it passes through the EU legislative process

## Headline issues for real estate fund managers

### *a) Scope: Broad definition of an AIF – No change*

The definition of an AIF is very broad and captures closed-ended, open-ended and listed funds and other vehicles, including limited partnerships. It looks as though ordinary property investment and trading companies and REITs could be caught, despite previous indications that they would not be.

Unfortunately, the Spanish Draft has not narrowed or clarified the definition of an AIF.

### *b) Scope: The AIFM and its ability to delegate – No change*

There will be a single authorised AIFM for each AIF. The AIFM has responsibility for all the AIF's investment and risk management functions. An AIFM is entitled to delegate those functions, but only to a person authorised by a regulator. An AIFM may delegate any other functions (including marketing, administrative and property management functions) to a person who is not authorised. The AIFM remains strictly liable for **all** acts of its delegates.

Unsurprisingly, the Spanish Draft has left these provisions untouched.

### *c) Scope: Where no external manager appointed – No change*

The Directive treats an "internally managed" AIF which does not appoint an external AIFM as an AIFM. In our view, this would include the general partner of a limited partnership or the trustee of a trust and could include an ordinary property trading or investment company managed by its board of directors. The application to such companies is unexpected and is an unwelcome extension of the scope of the Directive.

Unfortunately, the Spanish Draft has not excluded "internally managed" AIFs from the scope of the Directive.

### *d) Marketing rules - Spectre of protectionism*

The Directive still includes a passport to market EU AIFs throughout the EU to professional investors. Non-EU AIFs which have an EU AIFM can still be marketed under existing national laws. With 'investor protection' in mind, the Directive does not apply the passport to an EU feeder vehicle with at least 85% of assets invested in a non-EU fund.

The Spanish Draft introduces new provisions to the effect that a non-EU AIFM which manages a non-EU AIF will only be entitled to market interests in that non-EU AIF to professional investors within an EU member state if there is an "appropriate" co-operation agreement in place between the regulatory authorities of that EU member state and the jurisdiction of that non-EU AIFM. This will give the European Commission considerable scope to restrict the ability of property funds established in certain non-EU countries to market interests in those funds within the EU.

Furthermore, any such non-EU AIFM will be treated as an EU AIFM for certain purposes, in particular the requirements to publish an annual report in relation to any non-EU AIF which it manages, to make certain disclosures to actual and potential investors in that AIF and to EU regulators. Non-EU AIFs would include Jersey property unit trusts and

other funds established in the Channel Islands. These provisions are obviously extra-territorial in scope and it is unclear how they will work in practice.

*e) Depositaries – Enhanced disclosure obligations*

An AIFM is responsible for ensuring that it, or any EU AIF which it manages, appoints an independent depositary for that AIF (which must be established in the home member state of that AIF). An AIFM can not be a depositary.

The depositary of an EU AIF which holds “financial instruments” (which would include shares in property owning SPVs and units in unit trusts) must be an EU bank, a MiFID firm or authorised by a regulator established in the home state of the AIF. A depositary’s functions include:

- holding “financial instruments” (including share and unit certificates) in segregated accounts;
- verifying title to and keeping records of other assets (including underlying real estate assets); and
- fund administration, in particular calculating NAV and processing subscription and redemption applications.

The Directive does not require a non-EU AIF to appoint a depositary.

The Spanish Draft introduces an obligation on the depositary to ensure that the AIFM complies with its obligations in relation to valuation.

The Spanish Draft imposes greater disclosure obligations on AIFM about the liability of delegates of the depositary. The Spanish Draft does not, however, address in a concrete fashion the concerns of depositaries about their potential liability for the acts of delegates in non-EU countries, particularly in emerging markets.

*f) Valuation – More rules*

The Spanish Draft has clarified that, almost invariably, an independent person will need to carry out the valuation of the assets of an AIF.

The Spanish Draft also introduces a new requirement for independent valuers to be regulated and to have professional indemnity insurance. The appointment of the external valuer must also be notified to the regulator in the home state of the AIFM.

*g) Remuneration – Limited clarification*

The Swedish draft of the Directive introduced onerous restrictions on the remuneration paid by both AIFs and AIFMs, which is likely to be at the level imposed on large banks. The purpose is to ensure that the remuneration which AIFs and AIFMs pay is linked to the long-term performance of the AIF.

For example, highly paid managers will need to have at least 40-60% of their bonuses or carried interest deferred over an “appropriate” period (taking into account the AIF’s life-cycle and redemption policy).

### Depositaries – Real estate funds

Real estate funds typically hold shares in SPVs or units in unit trusts which hold property. The depositary will hold the share or unit certificates, and will verify title and maintain records for other assets of the real estate fund. The depositary is entitled to delegate its duties other than fund administration (which includes the calculation of NAV and the processing of subscription and redemption applications). The depositary will remain liable for all of the actions of its delegates unless it can show it acted properly in the “selection, appointment and periodic review” of delegates, it has contracted out of liability and it was reasonable for it to do so.

The Directive allows Member States to require that all valuations are overseen by the depositary.

This is likely to be unattractive to open-ended and trading funds, although possibly less troublesome for fixed life investment funds where carried interest is often paid towards the end of the life of the fund. The Directive requires the Committee of European Banking Supervisors (CESR) to publish guidelines on remuneration policies which reflect the Directive.

The Spanish Draft clarifies that the restrictions on remuneration will be limited to staff whose professional activities have a material impact on the risk profile of the relevant AIF. The Spanish Draft does not make any other changes to those restrictions, but expect further changes to these provisions in the coming months.

#### *h) Leverage and transparency requirements – Widening of scope*

An AIFM which manages an AIF which uses leverage on a “systematic basis” must still disclose to the FSA information about the leverage employed by that AIF, and if that AIF reaches a position to control a non-listed company or certain listed vehicles, the AIF must notify the FSA and the investors of the AIF about the debt supported by that entity. The Directive contemplates allowing regulators to impose limits on the amount of leverage that an AIFM may employ on behalf of an AIF, and empowers the European Commission to adopt measures to clarify what amounts to use of leverage on a “systematic basis” and how to calculate leverage. This therefore hands considerable discretion to the European Commission in this area. The Directive also imposes onerous obligations on AIFMs to report information to regulators, which is unwelcome.

As mentioned above, the Spanish Draft provides that a non-EU AIFM which manages a non-EU AIF will be now subject to many of these requirements. This is an unexpected and unwelcome development.

#### **Practical advice**

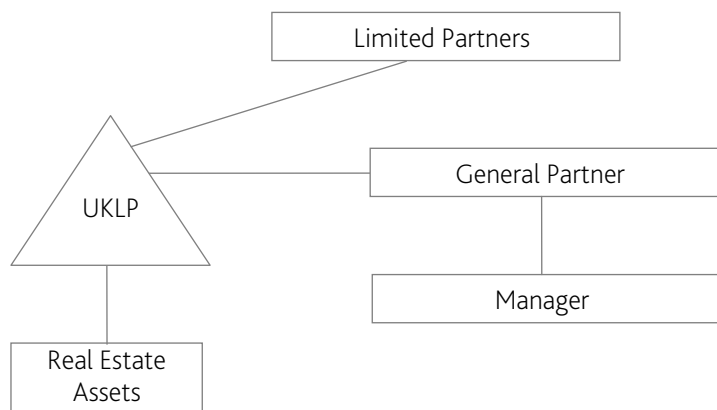
The public consultation period is over and the Directive is likely to be implemented into law in the Member States, including the UK, in the middle of 2012 at the earliest. Changes to the form of the Directive (specifically on scope and remuneration) are expected in the next few months. There will be transitional measures. For instance, closed-ended AIFs that are fully invested by the end of 2011 (and possibly later) will fall outside the Directive. We would be happy to come and talk to you further about issues raised by this briefing. We will be in touch with further updates as the Directive progresses.

*It is worth considering your current funds now, whether or not they fall into the regime and any structuring issues that may need to be addressed*

#### **Examples**

Set out below are three diagrams of common real estate fund structures. We have highlighted below each diagram the impact the Directive in its current form may have on certain areas (assuming that no exemption or exclusion from the Directive can be used).

## UK Limited Partnership



A UK LP acts through its GP, and the UK LP (acting through the GP) will need to appoint a third party manager with full responsibility for investment and risk management to be the AIFM to ensure that the GP is not the AIFM (which would require it to be authorised). If the GP were to retain approval and veto rights, the GP would risk being treated as the AIFM.

### Marketing and Managing

- The manager will need authorisation to continue to manage under the Directive. The manager can not start managing the AIF until one month has elapsed from its submission of all required authorisation information.
- The manager can then market to professional investors in other EU Member States using the passport.

### Capital

- The manager must maintain a minimum level of own funds (capped at €10m) of €125,000 plus 0.02% of the amount by which the total value of its gross assets under management (being all funds managed by the manager other than funds which it manages as a sub-manager) exceeds €250m.

### Remuneration

The UK LP and the Manager must defer for an “appropriate” period at least 40-60% of the bonuses and carried interest of high earning staff who have a material impact on the risk profile of the UK LP. This needs to be considered in the context of the UK LP’s life-cycle and redemption policy and be aligned with the nature of the risks of the AIF. The impact of this is unclear, for instance, whether or not closed-ended funds will need to wait until the end of their life before making any carried interest payments.

### Delegation

- The manager can delegate investment and risk management decisions to any person which is authorised by a regulator. For a non-EU delegate, a regulatory co-operation arrangement must also exist between the authorities of the Member State and the non-EU country in which the delegate is established. Naturally, no such agreements are yet in place.
- The manager can delegate certain administrative functions to appropriate persons (whom the Directive will not require to be authorised).
- The manager remains strictly liable for **all** acts of its delegates.

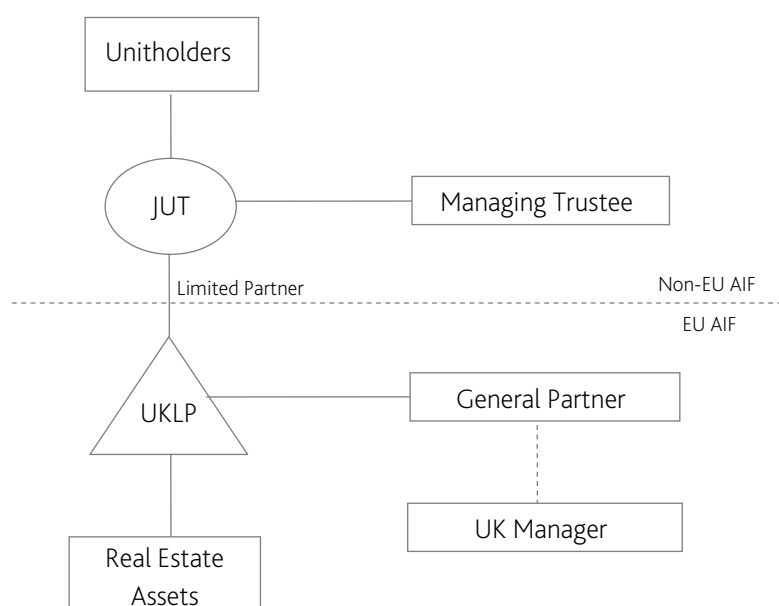
**Depositary**

- The manager must ensure that it or the AIF appoints an EU bank, MifID firm or a person authorised by the FSA (because the AIF is established in the UK) as its depositary.
- The depositary must be approved by the FSA prior to its appointment.

**Remuneration**

At least 40-60% of bonuses and carried interest payments must be deferred over an “appropriate period”.

**UK Limited Partnership with Jersey Unit Trust as Limited Partner**



The JUT and the UK LP are both AIFs. The managing trustee of the JUT (the Managing Trustee) is a non-EU AIFM and the UK manager of the UK LP is an EU AIF. The Directive will only apply to the Managing Trustee to a limited extent because the Channel Islands does not form part of the EU. The Managing Trustee will be subject to certain transparency and reporting obligations in relation to the JUT under the Directive.

**Marketing and Managing**

- The Managing Trustee cannot benefit from the marketing passport since the JUT is a non-EU AIF. The national private placement regimes in each EU member state will apply provided that there is a regulatory cooperation agreement in place between that EU member state and Jersey.
- The principles set out under the previous diagram will apply to the manager of the UK LP.

**Capital**

- The Directive will not impose any capital requirements on the Managing Trustee.

- The principles set out in relation to the previous diagram will apply to the manager of the UK LP.

**Delegation**

- The Directive will not restrict the ability of the Managing Trustee to delegate any of its obligations.
- The principles set out in relation to the previous diagram will apply to the manager of the UK LP.

**Depositary**

Neither the JUT nor the managing trustee of the JUT will be required to appoint a depositary because the JUT is a non-EU AIF.

**Depositary**

- The Directive will not require the Managing Trustee to appoint a depositary (because the JUT is a non-EU AIF).
- The principles set out in relation to the previous diagram will apply to the manager of the UK LP.

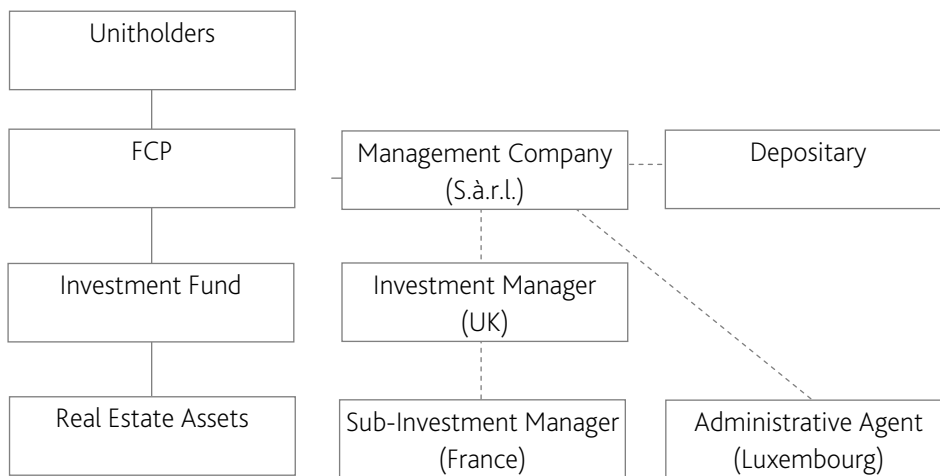
**Remuneration**

- The restrictions on remuneration under the Directive will not apply to the JUT or the Managing Trustee.
- The principles set out in relation to the previous diagram will apply to the UK LP and the manager of the UK LP.

**Practical Advice**

As long as current national private placement regimes do not become more restrictive, the non-EU JUT fund structure itself appears attractive, avoiding most of the restrictions imposed by the Directive at the level of the JUT. However, we believe it is likely that over time EU Member States will tighten their national private placement regimes in light of the Directive.

**Fonds Commun de Placement (FCP)**



The FCP is an EU AIF and the UK investment manager (the Manager) is the AIFM of the FCP (by virtue of its appointment by the management company).

### Marketing and managing

The principles set out in relation to the first diagram will apply to the Manager.

### Capital

The principles set out in relation to the first diagram will apply to the Manager.

### Delegation

- The principles set out in relation to the first diagram will apply to the Manager.
- Luxembourg law requires an administrative agent to carry out certain duties in relation to the FCP. Since the Manager has strict liability for all acts of its delegates we anticipate that the FCP will appoint that administrative agent directly.
- The Manager will require the approval of the FSA before delegating investment management functions to the French sub-investment manager unless it is authorised in France.

### Depositary

The Manager must ensure that the FCP appoints an independent depositary established in Luxembourg (because Luxembourg is the home state of the FCP).

### Remuneration

The principles set out under the first diagram will apply to the AIF and the Manager.

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#### London

Lacon House,  
84 Theobald's Road,  
London WC1X 8RW  
T +44 (0)20 7524 6000  
F +44 (0)20 7524 6524

#### Sheffield

1 South Quay,  
Victoria Quays,  
Sheffield S2 5SY  
T +44 (0)114 279 4000  
F +44 (0)114 278 6123

#### Brussels

209A Avenue Louise,  
1050 Brussels, Belgium  
T +32 2 626 0740  
F +32 2 626 0749

Alliance firms

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#### France

August & Debouzy  
Gilles August  
T +33 (0)1 45 61 51 80  
www.august-debouzy.com

#### Germany

GSK Stockmann + Kollegen  
Rainer Stockmann  
T +49 (30) 20 39 07 - 0  
www.gsk.de

#### Italy

Nunziante Magrone  
Gianmatteo Nunziante  
T +39 06 695181  
www.nunziantemagrone.it

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#### Nabarro LLP

Registered office: Lacon House, 84 Theobald's Road, London, WC1X 8RW.

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