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## AIFMD and the Impact on Investment Trusts

The Alternative Investment Fund Managers Directive ('AIFMD') looms amongst an avalanche of financial services regulation facing an alternative investment funds industry that includes the investment trust community in the UK. The AIFMD timetable rumbles towards its scheduled transposition into domestic legislation by July 2013 with an investment manager authorisation deadline by July 2014.

AIFMD will not only affect how alternative investment managers market and distribute their funds within the EU, but also how they operate their business and how managers are remunerated. In order to continue to market non-UCITS funds in the EU, managers will need to register with an EU-based regulator, comply with various disclosure-based obligations - such as the provision of investor information and reporting to a national regulator - and appoint a Depositary.

The European Commission's latest proposed measures implementing AIFMD, which will be issued in the form of a regulation taking direct effect in member states, has created significant controversy. Despite much lobbying from interested industry groups, the Commission has shown little inclination to deviate from its proposed measures, despite the fact that they deviate from those recommended by the European Securities and Markets Authority in its "Final Report" issued in November of 2011. If the Commission's measures remain as proposed, alternative fund managers will need to consider carefully the consequences of the AIFMD's requirements and how these fit within their existing organisational and operating structures. Investment trusts have already commenced detailed analysis of the impact on their business and operational models.

## **What are investment Trusts and why are they different from OEICS/Unit Trusts?**

Unlike other fund structures currently falling under the scope of the proposed AIFMD, investment trusts have been around for a long time. The first investment trust company, Foreign & Colonial, was founded in the UK in 1868. Currently, investment trusts have assets totalling some £100 billion and have approximately one million private investors, which are overwhelmingly based in the UK and EU. The objective of investment trusts is simple and straightforward: which is to make money for investors through diversification of assets.

Investment trusts have several special features which set them apart from other types of funds which the AIFMD is seeking to regulate. Firstly, investment trusts trade on regulated markets. Secondly, an investment trust is governed by an independent board, is subject to Company Law and London Stock Exchange Listing Rules and every investor becomes a shareholder in the company with voting rights and a share in the company's profit. These features make investment trusts similar to publicly traded companies rather than true alternative investment funds such as hedge funds and private equity structures – which are the main targets of the AIFMD.

### **Investment trusts have a fundamentally different structure to other funds**

The AIFMD has been designed and written with the typical Alternative Investment Fund ('AIF') structure in mind and therefore does not fit neatly with the traditional structure used by UK investment trusts. This, in turn, has led to a number of unintended consequences (see below). The organisation and activities of investment trusts differ from other AIFs in several ways:

A board of non-executive directors is collectively responsible for the management of the investment trust. As with all public limited companies, the board of directors is appointed by the company's shareholders and each non-executive director is legally obliged under company law to look after the interests of the shareholders. Again, this is radically different from other AIFs where no board exists, and therefore does not have the same structure of legal accountability and responsibility.

### **There are two types of investment trusts:**

- **Internally-managed** investment trust companies, in which investment decisions are made by fund managers of the investment trust company under guidance of the non-executive board of directors and no external investment manager is employed.
- **Externally-managed** investment trust companies, in which the board outsources investment decisions to one or several external managers. The external fund manager is still accountable to the board and can be replaced at any time.

Both of these models differ from the typical AIF structure in which the investment manager bears the ultimate responsibility for investment decisions. This difference is key to understanding why the AIFMD, as currently drafted, isn't appropriate for investment trusts (see below).

There are also a number of other important differences between investment trusts and other AIFs:

For example, investment trust companies are closed-ended as opposed to open-ended in the case of OEICS and Unit Trusts and so their shareholders have no rights to require redemption. The shares are subject to the London Stock Exchange listing requirements and are traded on the stock market.

Unlike most hedge funds, investment trusts very rarely borrow large amounts of money to buy additional assets. Since these companies are not as 'geared' as hedge funds, they don't pose the same risk to market stability.

## Summary

The investment trust industry is currently assessing and considering the implications of complying with the AIFMD. The dilemma as to which entity should be the AIFM requires a detailed understanding and assessment of the consequences of the decision that is taken in this regard. If the non-executive directors take the decision that they, rather than the investment manager, will undertake to act as the AIFM, they will face increased responsibilities such as being required to become Approved Persons under the FSA regime, which may be a step too far for some Non-Executive Directors.

In the Autumn of 2012 the FSA will issue a Consultation Paper, followed by definitive regulations early in 2013, on their interpretation of AIFMD which will impact alternative investment funds in the UK. At present OEICS and Unit Trusts are governed under specific regulations known as the COLL Sourcebook: it is expected that regulations based on COLL will be introduced for investments trusts under the banner of a "FUND" Sourcebook.

Until greater clarity is provided by both the EU and the FSA, the industry will require direction and advice from prospective Depositaries. BNY Mellon Trust & Depositary (UK) is working closely with existing custody clients in the UK to ensure that they fully understand the challenges ahead in complying with these new regulations.



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