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## Impending Regulatory Changes for the Investment Trust Industry

This note is intended to provide a broad summary of the main provisions of the Alternative Investment Funds Managers Directive ('AIFMD') which is hoped to be of interest to BNY Mellon clients and prospective clients. This note is not intended to be a detailed description of every provision of AIFMD.

### Background

The recent events surrounding Madoff and Lehman created a perceived need for greater protection for investors in alternative investment funds. Investment trusts will be considered "Alternative Investment Funds" ("AIFs") under the Directive and, as such, will be subjected to the requirements of AIFMD.

The impetus behind the Directive therefore was to prevent hedge funds posing a risk to the stability of the EU's financial system. In addition to applying to investment trusts, the directive will apply to many hedge funds, real estate funds, private equity funds and even "traditional" funds that would not seem to pose any systemic risk. Another notable feature of the Directive is the amount of information that needs to be supplied to regulators by AIFs

The AIFMD came into force on 21 July 2011 and will bring a wide range of currently unregulated funds into the regulatory framework of the European Union ('EU'). Each EU member state will be required to transpose the AIFMD into national law by 22 July 2013.

### Regulatory Framework

The AIFMD creates a comprehensive EU-wide regulatory and supervisory framework for the management of AIFs. It sets down rules for the authorisation, ongoing operation and transparency of managers of AIFs. An AIF is defined as any collective investment undertaking (which is not an undertaking for collective investment in transferable securities ('UCITS')) which raises capital from a number of investors for investment in accordance with a defined investment objective and policy for the benefit of those investors.

All non-UCITS open and closed-ended funds will be caught by the AIFMD unless they can rely on a specific exemption provision. A wide range of AIFs are captured by the AIFMD including real estate funds, hedge funds, private equity funds, commodity funds, debt funds, energy and carbon funds, infrastructure funds, investment trusts and real estate investment trusts.

## Scope of AIFMD

The scope of the AIFMD's regulation of managers is wide, applying to any legal person appointed by or on behalf of the AIF who will be responsible for managing one or more AIFs. It will also apply to "internally managed" AIFs, where the governing body elects not to appoint an external fund manager. It will therefore be important for external fund managers to understand their position and identify whether they are appointed by or on behalf of the AIF, or as a delegate of the person appointed. 'Managing' means providing risk management or portfolio management services to the AIF. This distinction will need to be made in order for fund managers to understand how and when the AIFMD applies to them.

## To Summarise

- Authorisations: To operate in the EU, Alternative Investment Fund Managers ('AIFMs') need to be authorised by a member state. Once authorised, a fund manager may market funds to investors in any member state under the new AIFMD "passport" regime.
- Risk management and prudential oversight: AIFMs will need to satisfy their supervising authority of the robustness of their risk management arrangements, and will need to disclose information on a regular basis to the supervising authority.
- Treatment of investors: AIFMs must provide clear descriptions of their investment objectives and policy, including descriptions of the types of assets and the use of gearing, if applicable, to potential investors.
- Leveraged funds: Supervising authorities have power to set limits to leverage in order to ensure the stability of the financial system. AIFMs using more than a certain amount of leverage will need to report to the authorities on a regular basis.
- Controlling stakes in companies: AIFMs whose funds hold controlling stakes in companies will need to report certain information to other shareholders and their regulator.
- Marketing: A passport allowing AIFMs (whether based in or outside the EU) to market funds to investors in the EU will come in to force at a future date, likely to be in 2015.
- Depositaries: Every investment trust must have a depositary. Depositaries will be subject to a new liability standard by which they will have to return any "lost" financial instruments held in custody unless they can "prove" the loss was due to an "external event beyond [their] reasonable control the consequences of which would have been unavoidable despite all reasonable efforts to the contrary". This liability standard will extend to financial instruments held through third parties such as sub-custodians (as "delegation" arrangements).

- ESMA: The new European Securities and Markets Authority (“ESMA”), the successor to the Committee of European Securities Regulators (“CESR”) will have increased control over the policies and decisions of local regulators, including potential enforcement authority.

## The Depositary

Each AIF must have a single depositary, appointed in writing.

The depositary must generally be a credit institution or firm authorised under MiFID, in either case with its registered office in the EU, or some other institution eligible to be the depositary of a UCITS fund.

If the AIF is registered outside the EU the depositary may, alternatively, be an equivalent institution outside the EU as long as it is subject to equivalent prudential regulation.

The AIFM may not act as depositary and neither may a prime broker to the AIF, unless its depositary functions are “functionally and hierarchically separated” from those of the prime broker and potential conflicts of interest are properly investigated and monitored.

If the AIF is established in the EU, the depositary must be in the same member state as the AIF.

The depositary has a duty to monitor cash flows. The AIF’s cash held with third-party banks may be kept in an account in the depositary’s name (in which case none of the depositary’s own money may be paid into the account) but accounts may also be kept in the name of the AIF or the AIFM.

In the case of other assets, financial instruments that can be held in custody must be registered in the name of the depositary. For other assets, such as financial instruments that cannot be held in custody (e.g., derivatives or private equity shares which are registered directly with the issuer or its agent) or land, the assets may be registered in the name of the AIF or the AIFM.

*\* The depositary may delegate the safe-keeping of financial instruments to third parties (such as sub-custodians) where “objectively” required, but it may not delegate its other functions, which may be broadly described as a general duty of oversight.*

## And finally

The role of the depositary is to protect the interests of the investors and to ensure the safekeeping of assets. For UCITS schemes in the UK this function has been in existence for a considerable time under the auspices of a Trustee for Unit Trusts and a Depositary for OEICs.

The Depositary has oversight responsibilities for the AIFM's activities in a number of key areas such as dealing, valuation of assets and pricing and adherence to investment and borrowing powers restrictions. The Depositary is also responsible for the safekeeping of assets which entails the separation of the assets from the ownership of the AIFM (one of the most fundamental elements of investor protection).

The Depositary also has a responsibility for protecting the interests of incoming, outgoing and continuing investors in an investment trust. Whilst not taking direct responsibility for the activities of an AIFM, the Depositary must take reasonable care to ensure that the AIFM properly discharges its responsibilities.



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