

## **The Irish Hedge Fund Sector and the Impact of the AIFM Directive**

By Paul Farrell, Partner, Head of Investment Funds Group, and Gayle Bowen, Senior Associate, Walkers Ireland (01/04/2011)

Ireland is ready and extremely well positioned for the implementation of the European Union's Alternative Investment Fund Managers Directive ('the Directive'), which is expected to provide a significant boost to Ireland's successful investment funds industry.

As a leading centre for alternative investment funds, Ireland services over 40 per cent of all hedge fund assets globally, with €183billion of assets in Irish domiciled non-UCITS funds, €133billion of which is in Irish qualifying investor funds (QIFs). It is therefore unsurprising that the Irish regulatory regime is already aligned with many of the requirements of the Directive.

### **The Alternative Investment Fund Managers Directive**

The Directive will apply to all EU alternative investment fund managers (AIFM) that manage alternative investment funds (AIFs) and non-EU AIFM that manage AIFs domiciled in or marketed in the EU.

It will introduce a European passport under which authorised AIFM can, subject to a notification procedure, market AIFs to professional investors throughout the EU. It is also expected to enhance investor protection through increased transparency and more robust regulation of the EU's alternative investment fund industry.

The passport for EU AIFM managed EU domiciled funds will come into effect with the Directive in early 2013, allowing Irish QIFs managed by EU investment managers to take advantage of the passport from that date upon notification under the Directive.

For non-EU based AIFM there will be, at a minimum, a two-year time lag before the passport is available to these managers to market their AIFs. This time lag will also apply to EU AIFM marketing non-EU domiciled AIFs in Europe. The length of the lag will depend on the European Securities and Markets Authority (ESMA) and its recommendation but it is proposed that this regime will transition in 2015 to allow full access to an EU passport on the same terms as EU AIFs with EU asset managers.

Until then the Directive provides that non-EU based AIFM and their AIFs and non-EU domiciled AIFs can continue to be marketed to professional investors in the EU through traditional private placement regimes provided that the AIFM satisfy conditions specified within the Directive, in particular that there are cooperation agreements between the regulator of the EU member state in which an AIF is being marketed and the regulator of both the AIFM and the AIF being marketed.

To improve investor protection, the Directive provides for a number of requirements to enhance transparency which include specific disclosure requirements to potential investors ahead of investment, including performance data and net asset values, ongoing disclosure on areas such as liquidity, risk management and leverage to existing investors and the provision of annual audited accounts to investors and the AIF regulator.

In addition to enhance the regulation of AIFs, the Directive specifically provides for independence in the valuation of AIF and the appointment of a depository to the AIF.

Under the Directive the valuation function must be carried out by an independent external valuer or the AIFM itself provided that function is separated from portfolio management and other potential areas of conflict within the asset manager. In Ireland this is already provided for in the requirement for an independent administrator to Irish domiciled funds.

It should be noted that from an Irish perspective there are key questions as to the role under the Directive of the governing body of the AIF, as having the AIFM take responsibility for the valuation function does not correspond with current industry practice. In this regard the level 2 measures implementing the Directive, and to be provided by ESMA following industry consultation, will be key in determining how this will work in practice.

There are also requirements imposed by the Directive regarding depositories to AIFs. The Directive requires that AIFM appoint depositories to each of their AIFs. Again Ireland already provides for the appointment of a depository to Irish domiciled funds.

In the context of depositories and prime brokers, the Directive provides that a prime broker acting as counterparty to an AIF is not allowed to act as depository until it has separated its prime broker and depository functions. The prime broker can, however, carry out custody tasks as a delegate of the depository.

### **The Irish QIF**

The QIF is already the vehicle of choice for European domiciled hedge funds, with latest industry figures showing that 63 per cent of European hedge funds are constituted as QIFs. The QIFs have many characteristics of traditional offshore products, including tax neutrality, no restrictions on investments or leverage and speed to market (24 hours, subject to certain conditions). They also have a number of comparative advantages including potential access to Ireland's substantial network of double tax treaties as well as being able to benefit from the passporting opportunity under the Directive once in place.

The fact that QIFs already address most of the requirements of the Directive and upon the Directive's implementation will immediately have the benefit of the passport, provides a strong incentive for the EU's AIFMs to establish QIFs and to take advantage of the two-year period with the passport before it is opened up and becomes available to non-EU AIFM.

This has been recognised by the Irish Funds Industry, the Irish Central Bank and the Irish legislature. Indeed recent regulatory enhancements to Irish QIFs have been geared towards the implementation of the Directive. These include the convergence of the investor criteria for QIFs to those of the proposed Directive and the Market in Financial Investments Directive (MFID), the reduction of the minimum initial subscription amount for QIFs from €250,000 to €100,000 and clearer guidance with regard to promoter approval for promoters of QIFs.

Legislative updates have also improved the attractiveness of the QIF product. In terms of using the QIF as an investment product it is possible not only to establish it as a new product but also to convert an existing fund domiciled in a range of offshore jurisdictions, including Bermuda, BVI and the Cayman Islands, to a QIF pursuant to redomiciliation legislation passed in Ireland in 2009. This allows asset managers to redomicile an existing fund to Ireland in a seamless manner and without triggering a taxable event. It also allows established asset managers to maintain their track record.

### **Conclusion**

While many issues remain to be addressed through ESMA's level 2 implementing measures and while these measures must be clear and concise, thus avoiding conflicting interpretations or applications of the rules in different EU jurisdictions, the Irish Funds Industry has welcomed the Directive.

Ireland is ready for the Directive. As an onshore, European, fully regulated product, the QIF automatically meets the material requirements of the Directive and with the ongoing actions of the Irish Central Bank and the Irish legislature to ensure the QIF remains Directive ready it will prove a particularly appealing product to EUAIFM wishing to avail of the passport in 2013. The Directive will prove to be a significant and further boost to Ireland's alternative investment fund industry.