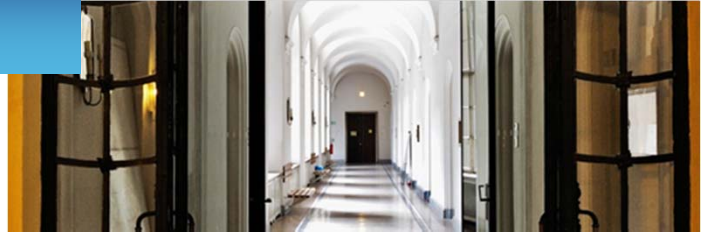


Alternative Investment Fund Managers Directive (“AIFMD”): An Overview and Analysis



Introduction

The Alternative Investment Fund Managers Directive (“AIFMD” or “Directive”) is the most radical reshaping of fund management and marketing regulation in the European Union (“EU”) since the UCITS directive changed the landscape for retail investment funds. Implementation of the AIFMD comes amid a spate of new legislative developments that will impact the European asset management industry in the wake of the financial crisis in 2008 and 2009.

The final text of the AIFMD greatly improves the European Commission’s (the “Commission”) original proposal which would have severely restricted the ability of European investors to invest in products managed or structured outside the EU. Crucially, the revised text permits professional investors to continue to invest in best-in-class products whilst promoting greater transparency, investor protection and the monitoring of systemic risk. However, there will still be an increase in costs for complying with the Directive and increased complexity for Alternative Investment Fund Managers (“AIFM”).

In this *ViewPoint*, we address the main provisions of the Directive, assess the impact on investors and on the European alternative fund industry, and consider forthcoming regulation that will govern AIFMD implementation. Finally, we discuss our intention to further engage with trade associations and regulators and continue to represent our clients’ interests.

The *ViewPoint* will follow the outline below:

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Legislative process

The European Parliament (the “Parliament”) and European Council (the “Council”) issued final approval of the AIFMD in November 2010, and the main or “Level 1” text of the Directive is expected to be available by June 2011, with EU member states required to implement the Directive in their individual countries two years from the date the text is released (i.e., June 2013).

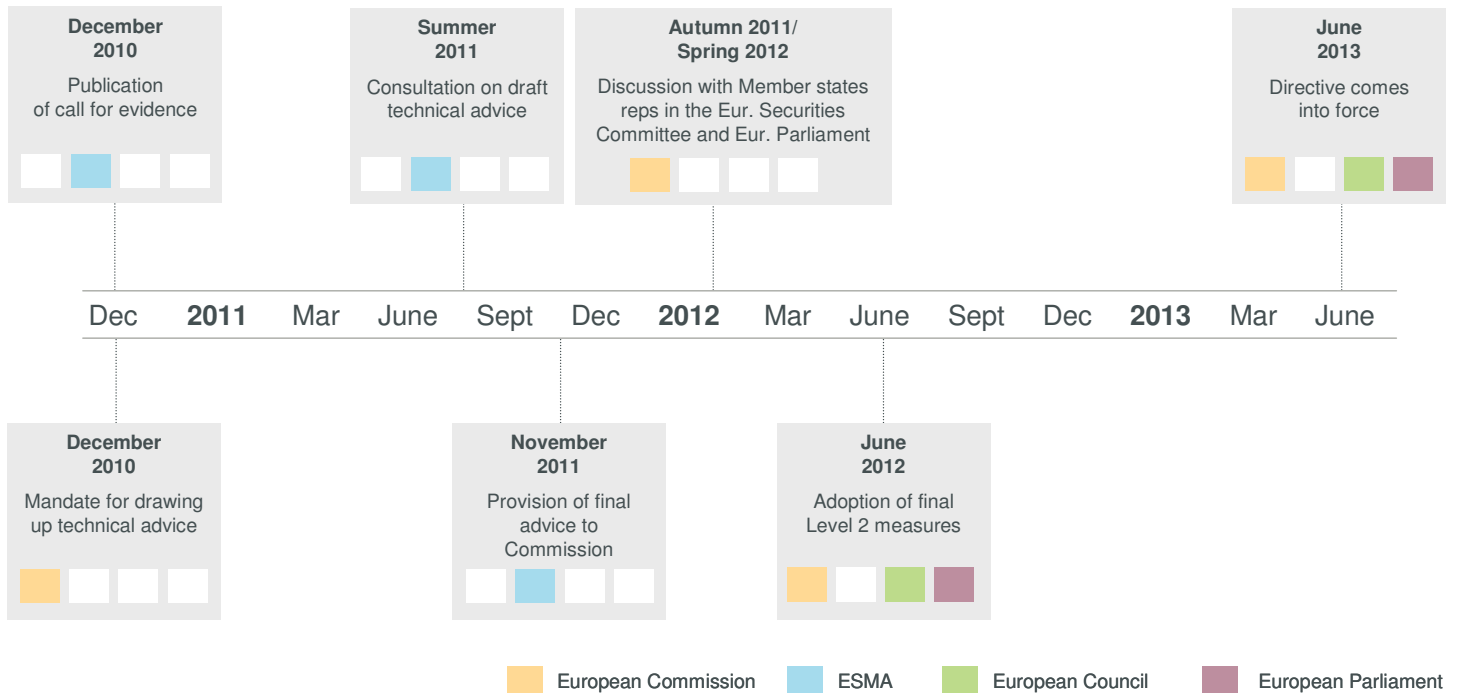
Currently, only the Level 1 text of AIFMD has been finalised. The Level 1 text contains extensive provisions authorizing the Commission and the newly-created European Securities Markets Authority (“ESMA”) to draft Level 2 subordinate legislation and technical guidelines, many of which will be fundamental to assessing the ultimate impact of the Directive. The next two years will therefore see further industry consultation and deliberation on essential details.

ESMA has been tasked with providing guidance to the Commission by November 2011 on how best to implement the AIFMD. It has delegated its consultative work among four Task Forces, each of which is headed by different member state regulators.

- ▶ Task Force 1, led by the Central Bank of Ireland, will map the population of managers and investment strategies that fall within the scope of AIFMD.
- ▶ Task Force 2, led by BaFin, the German regulator, will advise on authorisation and general operating conditions, including delegation.
- ▶ Task Force 3, led by AMF, the French regulator, will advise on depositaries.
- ▶ Task Force 4 led by FSA, the UK regulator, will advise on transparency requirements, leverage, risk and liquidity management.

In order to prepare further ESMA consultation documents, each Task Force is holding regular meetings with other member state regulators and workshops with the asset management industry. Investors will be able to assess these further ESMA consultations in Q2/Q3 2011, and it should be noted that ESMA has stated publicly that it is open to further comment from interested participants at any time.

Level 2 - Approximate Timeline



The four Task Forces are currently being prioritised, and as a result, Level 2 consideration of third-country issues, such as the marketing of alternative investment funds domiciled outside the EU (“non-EU AIF”), has been delayed. It is not clear when Level 2 work on third-country issues will begin. Whilst this will not have an impact on the date of implementation of third country issues, we are highlighting to regulators potential implications of decisions, for example valuation and transparency, on third country managers.

Scope

The scope of the Directive is extremely broad. Alternative Investment Funds (“AIF”) covers all non-UCITS funds, wherever domiciled, which are either managed within the EU or marketed to investors within the EU. In spite of the Directive’s name, it covers not only hedge funds and private equity funds, but also the following:

- ▶ Real estate funds,
- ▶ Luxembourg SIFs (Specialised Investment Funds),
- ▶ Irish QIFs (Qualifying Investor Funds),
- ▶ Dutch FGRs (Fonds voor de Gemene Rekening),
- ▶ German Spezialfonds,
- ▶ UK Investment Trusts,
- ▶ UK charity funds,
- ▶ UK NURS (Non-UCITS Retail schemes), and
- ▶ UK unauthorized unit trusts.

The AIFMD also captures US bank collective trusts and US ‘40 Act funds marketed within the EU.

Investors who currently invest in AIF therefore include:

- ▶ retail investors,
- ▶ high net worth individuals,
- ▶ charities,
- ▶ distributors,
- ▶ fund of funds,
- ▶ pension funds,
- ▶ insurance companies,
- ▶ corporations,
- ▶ institutions and
- ▶ government entities.

Improvement on original proposals

BlackRock has engaged intensively in the legislative process over the past 18 months to communicate the views of its investors. BlackRock’s key message is that European professional clients must continue to have access to best-in-class funds regardless of where they are domiciled or managed.

We consider the Directive agreed upon by the Council, Parliament and Commission a significant improvement upon the original, more restrictive Commission proposals. Contrary to the original proposal, the final Directive allows for continued marketing of non-EU AIF to European investors without the need for extensive fund redomiciliation, restructuring or changing of global fund management platforms. Overall, the Directive offers a more proportionate solution to a wide variety of AIF governance structures, and AIFMs can continue to delegate

investment, risk management functions and expertise wherever they are located. Delivering a level playing field in terms of investor disclosure and regulatory oversight may, however, require significant enhancement to existing structures and governance.

Overview and Analysis

Authorisation

To operate in the EU, all AIFM with assets under management (“AUM”) exceeding €100 million (or €500 million for closed-ended unleveraged funds) must obtain initial authorisation from their member state regulators by providing information on themselves and their AIFs. AIFM whose AUM do not reach these thresholds may also opt in to the full regime. Member states’ regulators have three months to grant approval and up to six months in specific circumstances.

Once authorised, AIFM will need to give one month’s advance notice to their regulators before making any material changes to the way an AIF is managed. Regulators have an extra month in specific circumstances to approve material circumstances.

BlackRock supports the authorization of AIFM. We believe that this contributes to investor confidence that all our AIFM are regulated entities. However, the UCITS-style approval process under AIFMD is likely to result in longer lead-times for new AIF products and strategies which may prevent investors from being able to take advantage of rapidly changing investment opportunities.

Marketing, passport and third-country provisions

The new marketing regime for AIF is highly complex but importantly, European investors, either at their own initiative or through private placements, will continue to be able to invest in best-in-class funds wherever such funds are domiciled.

Marketing

Under the new legislation, beginning in 2013, AIFM domiciled in the EU (‘EU AIFM’) can actively market EU AIF to professional investors in all EU member states using the new marketing passport. In contrast, AIFM marketing non-EU AIF may only market by way of private placement to those EU member states which permit private placement and even then, additional conditions will apply.

Crucially, the Level 1 text permits reverse solicitation, and therefore an AIFM can allow an investor to invest in its AIF if the investor, on its own initiative, contacts the AIFM. Restricting such unsolicited approaches would have substantially removed professional investors’ ability to choose the best-in-class product most suitable for their investment needs. The Commission, has retained the ability to review existing legislation and assess whether to impose tighter due diligence requirements on EU investors who invest on their own initiative.

Application of the new marketing regime

Location of Manager / Fund	National Private Placement Regimes	EU Passport
EU AIFM / EU AIF	Cease to exist	Comply with full Directive
EU AIFM / non-EU AIF	Comply with full Directive excluding Article 21, which relates to depositories Plus comply with a condition relating to supervisory co-operation arrangements	Comply with full Directive, plus conditions
Non-EU AIFM / EU AIF	Comply with a condition relating to supervisory co-operation arrangements	Comply with full Directive
Non-EU AIFM / non-EU AIF	Transparency requirements <ul style="list-style-type: none"> • Annual Report • Disclosure to Investors • Reporting Obligations to competent authorities Plus comply with a condition relating to supervisory co-operation arrangements	Comply with full Directive, plus conditions*

The three items below comprise the conditions referred to in the asterisk in the table above.

1. Co-operation arrangements between the regulator of the AIFM and supervisory authority where the non-EU AIF is established;
2. The third country where the non-EU AIF is established is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing;
3. The third country where the AIF is established has signed tax information sharing agreement with each of the competent tax authorities of the AIFM and the competent authority of the country where the fund is marketed.

Passport and third country provisions from 2015

EU AIFM with EU AIF will have access to a passport from the date of transposition of the AIFMD in 2013. This means that they can proactively market their funds throughout the EU instead of only in those countries allowing private placement. Non-EU AIF and non-EU AIFM can also actively market funds within the EU, but they must operate under national private placement schemes for the first two years (2013-2015) and comply with enhanced disclosure requirements.

The Commission may introduce an EU passport for non-EU AIFM or non-EU AIF following qualified majority support from ESMA in 2015. If this occurs, a dual system of an EU passport and private placement will operate from 2015 to at least 2018. In 2017, ESMA will review the functioning of the EU passport and the private placement schemes. If the review is positive for a number of criteria, including the ability of EU investors to access non-EU AIF, national private placement schemes will be eliminated altogether in 2018. Although the conditions that a non-EU AIFM has to meet to market funds under a passport will be far more burdensome than those under private placement

schemes, the passport will offer the advantage of allowing non-EU AIFMs to market to investors in all EU markets. If private placement schemes are eliminated in 2018, the key concerns for European investors will be whether (i) a restrictive passport is adopted for non-EU AIFM and non-EU AIF and (ii) limitations are imposed on reverse solicitation (e.g., due diligence requirements for European clients investing in non-EU AIF). This would effectively prevent European investors from selecting best-in-class AIF outside the EU.

Private placement conditions

Certain conditions must be met for AIFM to market funds via a private placement. A cooperation agreement to share systemic information must exist between the regulator of the EU member state and the non-EU regulator of the AIF. EU AIFM marketing non-EU AIF must comply with all Directive terms, except for the depositary requirements (see below). Non-EU AIFM marketing non-EU AIF must comply with AIFMD requirements such as transparency on annual reports, disclosure to investors and reporting to EU competent authorities.

In the event that the Commission introduces a passport for non-EU AIF in 2015, non-EU AIFM looking to market a fund via a passport rather than by private placement must comply with AIFMD in full, unless this would require a breach of its national law. In this case, ESMA would judge whether the third country national law has the same regulatory purpose and the same level of investor protection as in the AIFMD. In addition, a cooperation agreement must exist between the EU and non-EU supervisor to ensure full compliance with AIFMD and the non-EU supervisor must comply with international anti-money laundering (“AML”) and tax information sharing agreements.

Flexibility in fund governance structures

The original Commission proposal did not fully account for the multiplicity of fund structures covered by the AIFMD. However, the Level 1 text recognises and provides for the wide range of commonly used AIF structures and their governance models. This avoids the extensive restructuring that would have resulted from adoption of just a single model. It is important that this flexibility is maintained in the Level 2 implementing measures as ESMA considers individual fund structures in more detail. Any compromise could be costly without providing significant benefits for investors.

The Level 1 text enables appropriate identification for the AIFM. For any AIF, the Directive provides for a single AIFM to be the entity responsible for compliance with AIFMD, avoiding confusion and potential double authorisations. It also allows for both externally-managed and, where legal form permits, internally-managed AIFs, which is a helpful provision for self-managed vehicles such as UK Investment Trusts or self-managed Irish or Luxembourg funds.

Delegation

Portfolio and risk management mandates can be delegated to supervised non-AIFM entities both inside and outside the EU

The original Commission proposal created concern about the extent to which portfolio management could be delegated outside the EU. The Level 1 text is significantly better for investors. It allows existing portfolio and risk management delegation models for AIF to continue provided that UCITS-style conditions, such as prior regulatory notification, are met. There are no limits on the length of the sub-delegation chain, thereby accommodating the heterogeneous nature of AIF structures. This is fundamental to maximizing the expertise of global investment management groups for the benefit of clients. It reduces costs and avoids duplication of delegated functions.

AIFM that wish to delegate do not need to gain regulatory approval. Instead, they must provide prior notification to their regulator that their delegate has met the Directive’s suitability and supervision requirements. Delegation to non-EU AIFM is permitted, subject to the same conditions as EU AIFM and to a cooperation agreement being in place between the home Member State of the AIFM and the supervisor of third country manager. Sub-delegation is allowed subject also to the same conditions.

Depositaries

Pool of eligible depositaries has been expanded beyond EU credit institutions

The Level 1 text defines depositary functions as extending beyond mere holding of assets and custodial services to include the wider fiduciary duty of safekeeping. It prohibits depositaries from performing portfolio or risk management functions.

The original proposal restricted eligible depositaries to a small pool of EU credit institutions, which we believe would have increased counterparty and systemic risk. The Level 1 text mitigates these risks by also allowing MiFID firms or other UCITS depositaries to act for EU AIF. Non-EU AIF may appoint other entities subject to equivalent regulation for non-EU AIF. The original proposal did not recognise prime brokers but under the Level 1 text, prime brokers can now act as depositaries if they operate separate prime broker and depositary functions.

The Level 1 text moves away from strict depositary liability to a more reasonable negligence standard for loss caused to the AIF as a result of the depositary’s actions, although the definition of “loss” is still under considerable debate in Level 2. Depositaries can only discharge liability for an external event beyond the depositary’s reasonable control. The definition of an “external event” also requires further clarification. These liability standards

are being considered as the basis of the UCITS V review. Given that global custody will be provided by the same global custody networks, we believe that it is essential that the same regulatory base is provided for both UCITS and AIF.

The potential increase in the liability standard may increase costs or reduce the number of institutions willing to act as depositaries if uncertainties as to the liability standard persist. Depositary service providers will also need to consider changes to their operating models, and traditional prime brokers will need to review their model for managers wishing to use the passport from 2015. As a result, traditional custodian and administrator roles will change. We are monitoring the impact of the legislation on depositaries closely.

Leverage

AIFM shall set maximum level of leverage for AIF and demonstrate reasonableness to competent authority, which may impose limits

The AIFMD's provisions on leverage aim to increase transparency and to allow supervisors to monitor leverage in the financial system.

An AIFM must disclose to its investors the circumstances in which an AIF can use leverage, the types and sources of leverage and the maximum level of leverage which the AIFM may employ on behalf of the AIF. The exact methodology to calculate leverage will be finalized as part of the Level 2 text. The result may require AIFM to report leverage to investors using additional measures to those currently used.

An AIFM must set a maximum level of leverage for an AIF and demonstrate the reasonableness of the level to its regulator, who has the ability to reduce this level. Local regulators must also make information available to other regulators. ESMA and the European Systemic Risk Board ("ESRB") must facilitate EU wide monitoring of the impact of leverage.

ESMA cannot directly force reduction in leverage, as its powers are less than those that the Commission originally proposed, but it can recommend that national regulators institute additional reporting in exceptional circumstances or when required to ensure the integrity and stability of the system.

Portfolio Company Disclosure

AIFM on more even footing with other private equity investors regarding disclosure; and new "asset stripping" provisions limit distributions in the first two years

The Directive includes specific requirements for private equity AIFM. The original proposal would have created an unlevel playing field for private equity AIFM compared with other investors in private companies. The Level 1 text still requires

greater notification and disclosure requirements. However, the information required to be disclosed is no longer of a strategically sensitive nature. Additionally, the Directive invites the Commission to review disclosure requirements applicable to all investor groups in addition to private equity investors.

An AIFM must inform its regulator when the shares held by one of its AIF in an EU company that is not listed on an EU regulated exchange (a "non-listed company") exceeds or falls below the following increments: 10%, 20%, 30%, 50%, 75%. It should be noted that these obligations also apply in respect to companies listed on London's Alternative Investment Market (AIM) as AIM is not an EU regulated market.

Where an AIF acquires over 50% of a non-listed company or acquires "control" as defined by national regulations of a listed company, the AIFM must make certain information available to the controlled company, its shareholders and the AIFM's regulator, including the identity of the AIFM, the resultant voting rights, conditions under which control was reached, the AIFM's policy on conflicts of interest and the AIFM's policy for communication with employees. The AIFM must also inform the non-listed company and shareholders of its intentions with respect to the future business of the non-listed company and any repercussions on employment. The AIFMD does not require the AIFM to communicate directly with employees of the non-listed company, which would have usurped the position of the board.

A new provision attempts to resolve Parliament's concerns over "asset-stripping". The Article prohibits an AIFM controlling a portfolio company (listed or not) from paying out dividends or paying out to shareholders for 24 months if doing so would prejudice the capital adequacy of the portfolio company. This reflects the status quo for listed companies but not, for example, for non-listed companies in the UK.

Transparency

BlackRock is very supportive of the greater transparency that the Directive provides for investors, such as liquidity management, valuation procedures and the appointment of any sub-custodians.

The Level 1 text provides for a number of different disclosures to be made to investors and regulators. For example, AIFM must disclose when certain investors receive preferential treatment but are not required to reveal such investors' identities. AIFM must also disclose to regulators their policies on liquidity management, including gating, portfolio stress testing and risk management. The Level 2 text will define the type of disclosure required in report accounts. BlackRock believes that it is essential that the Level 2 text does not force AIFM to adopt additional accounting standards or require AIF to adopt the same year-end across Europe as this would duplicate the accounting processes and be very impractical to implement given the current practice of AIFM to stagger AIF year-ends across the financial year.

Valuation

Can be independent entity or a functionally separate unit of AIFM

The AIFMD's provisions require the appointment of either an independent entity or a functionally separate unit of the AIFM to provide the valuation function. In cases where the valuation is carried out internally, the home state regulator may require that an external valuer or auditor verify the procedures used. BlackRock supports this as a fundamental part of investor protection.

If the AIFM uses an external valuer, the AIFM must demonstrate that it is capable of performing the function. In addition, the AIFM must meet conditions relating to suitability and supervision and give objective justification for delegating. A cooperation agreement must exist between supervisors if delegating to a third country. However, the AIFM is still responsible to the AIF and investors for proper valuation of fund assets.

Further clarification as to the precise duties of the valuer will be provided in the Level 2 text. This is crucial in ensuring that appropriate models are retained.

Risk Management

Must be functionally separate from portfolio management

We support the Directive's approach to risk management, which we believe is consistent with the best practices in the market.

Risk management must be functionally separate from portfolio management. However, the Directive recognises that there may be circumstances in which it may not be necessary for AIFM to separate such functions provided there are safeguards against conflicts. Further guidance on this is expected as part of ESMA's guidance to the Commission on the Level 2 implementing measures.

AIFM must review risk management systems at least annually and implement an investment due diligence process to identify, manage and monitor investment risk. They must also adopt an appropriate risk profile and a maximum level of leverage for each AIF they manage.

Liquidity Management

We believe that the Directive's approach to liquidity management is also beneficial for investors.

With the exception of unleveraged closed-ended funds, all AIFM must employ an appropriate liquidity management system and adopt procedures that enable liquidity risk monitoring of each AIF

and ensure that the liquidity profile of the AIF's investments complies with its underlying obligations. AIFM must also conduct regular stress tests on their portfolios.

Capital Requirements

Capital requirements capped in line with UCITS, dually-authorized AIFM/UCITS subject to single capital requirements test

Capital requirements depend on an AIFM's AUM. The minimum amount that managers must hold is €125,000 and AIFM must hold an additional 0.02% of any AUM (including leveraged assets) in excess of €250,000 with a total cap of €10 million in line with UCITS. Internally managed AIF such as UK investment trusts must retain assets of €300,000. Funds must also hold appropriate insurance policies to meet negligence liability.

Remuneration

Remuneration requirements are based on the principles in the Capital Requirements Directive III and are to be applied in a manner which is appropriate to the size and complexity of the AIFM. This is likely to mean that a proportion of compensation must be paid on a deferred basis. For more complex AIFM this may mean that a substantial portion (at least 40%) of variable remuneration must be deferred when paid to individuals exercising significant functions within the AIFM. In extreme cases this would be increased to 60% where variable remuneration represents a particularly large proportion of total remuneration.

Next Steps

The final text left a number of key areas such as leverage, risk management, delegation and depositary requirements subject to further clarification at Level 2. ESMA's wide-ranging initial consultation on Level 2 measures closed on 14 January 2011. Our detailed response to the consultation is available on BlackRock's Public Policy Website and ESMA's website. Further consultations on specific issues will be launched in the coming months. ESMA is due to deliver final advice to the Commission by November 2011 to allow the Commission time to draft appropriate implementing measures. The final implementation date of the Directive is still not certain and is dependent on the publication of the final text of the Level 1 Directive. If the final text of the Level 1 Directive is published as expected in June 2011, the implementation date will occur two years later in June 2013.

BlackRock will endeavor to continue to assist regulators' understanding of the diversity of asset classes and fund structures captured by AIFMD and emphasise that the flexibility

and proportionality incorporated into the Level 1 text be retained in the Level 2 guidance. Given the extremely diverse nature of AIF, we will communicate our preference for the use of flexibly-applied EU directives instead of rigidly-applied EU regulations to implement Level 2 legislation. Our efforts to represent the

interests of our clients in the Level 2 text are informed by our overarching message that investors should continue to have access to best-in-class funds wherever such funds are domiciled or managed.

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