THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

THRESHOLD CALCULATIONS AND REGULATORY CAPITAL REQUIREMENTS FOR PRIVATE FUND MANAGERS

INTRODUCTION

This briefing note analyses the key threshold exemption from the scope of the Alternative Investment Fund Managers Directive (the Directive) and the regulatory capital requirements for those private fund managers which will be subject to the Directive, such as private equity, real estate, debt and hedge fund managers.

A) THRESHOLD EXEMPTION FOR PRIVATE FUND MANAGERS

A number of private fund managers will be able to rely on an important size-based threshold exemption from the scope of the Directive. The FSA's (now FCA) second consultation paper on UK implementation (CP 13/9) confirmed that private fund managers who are able to rely on this exemption will also be outside the scope of the Directive's regulatory capital requirements (see Regulatory Capital below). Broadly, this exemption applies to managers of closed ended funds whose assets under management do not exceed €500m.

Specifically, the Directive provides an exemption for AIFMs which "either directly or indirectly through a company with which the AIFM is linked by common management or control" manage portfolios of funds whose assets under management do not in total exceed €500m (where the relevant funds are (i) unleveraged and (ii) have no redemption rights within five years from subscription).

The Level 2 measures provide further guidance / rules on how to calculate assets under management. This will be undertaken by reference to the value of assets in the relevant funds by using the valuation rules set out in the fund's constitutional documents. It is clear that uncalled capital commitments are therefore excluded from the calculation, so only cash and actual investments will be included. To the extent that any funds have borrowing or financing arrangements or facilities in place for capital calls or other short term funding then these will need to be reviewed to determine whether the funds are unleveraged (if leveraged the threshold drops to €100m). Particular rules are included in Level 2 to determine what happens if the threshold is exceeded, particularly if on a temporary basis. Generally if the assets are above the threshold for more than three months, steps will need to be taken to be authorised under the Directive.

In addition, the transitional provisions of the Directive also provide that if an AIFM manages:

- closed ended funds established before 22 July 2013 and which do not make any additional investments after 22 July 2013; or
- closed ended funds whose subscription period has ended prior to the Directive entering into force and are constituted for a period of time which expires no later than 22 July 2016,

then it may continue to manage these funds without requiring authorisation under the Directive.

If a fund manager is only managing funds that fall within the above two criteria then it will be fully outside the Directive, even if assets under management exceed €500m.

Where a fund manager manages one or more funds that meet the above criteria and other funds (e.g. funds which are still investing or whose life expires after 22 July 2016) then it is expected that:

- the Directive will not apply to the funds which meet the criteria (e.g. no need to appoint a depositary, no need to comply with reporting requirements); and
- the assets of those funds will not count towards calculation of the €500m threshold. (This view/interpretation is taken by the European Commission in its published Questions and Answers on the Directive).

In its second implementation consultation paper (CP 13/9), the FCA clarified that funds under management is to be calculated as the sum of the absolute value of all assets of all funds managed by the firm, including assets acquired through the use of leverage. Derivative instruments must be valued at their market value for these purposes.

If a fund manager has assets above the relevant threshold, then the full Directive will apply, including the regulatory capital requirements.

B) REGULATORY CAPITAL

Recital 23 of the Directive states that a firm must hold capital because:

"It is necessary to provide for the application of minimum capital requirements to ensure the continuity and the regularity of the management of AIFs provided by an AIFM and to cover the potential exposure of AIFMs to professional liability in respect of all their activities, including the management of AIFs under a delegated mandate. …"

The Directive requires an AIFM to:

- have a minimum amount of initial capital plus an additional own funds capital requirement;
- maintain qualifying professional indemnity insurance or additional own funds to cover professional negligence liability; and
- hold own funds in liquid assets or assets readily convertible into cash and not in speculative positions.

An AIFM must perform its regulatory capital calculations on a quarterly basis. The regulatory capital requirements in the Directive do not vary for different legal structures: a body corporate is subject to the same requirements as an LLP, although how the capital is held within, and contributed to, the regulated entity will vary accordingly to its legal structure.

The regulatory capital requirements should not apply to sub-threshold private fund managers (i.e. firms able to rely on the exemption discussed in section A) or firms which are otherwise exempt from the Directive or outside the EU. The Treasury has confirmed that the existing regulatory regime will continue to apply to sub-threshold firms although confirmation is still awaited from the FCA that the existing capital requirements (primarily the £5,000 "own funds" capital for most private fund managers) will remain in place for such firms.

PRIVATE FUND MANAGERS WITHIN THE DIRECTIVE

For most UK FCA authorised private fund managers which are currently outside the scope of any EU financial services directive, the AIFMD will (if they are in scope) impose significantly higher capital requirements than the existing domestic regime.

Most UK private fund managers (other than hedge funds managers) are either operators of collective investment schemes (CIS) or exempt Capital Adequacy Directive (CAD) firms (advisers and arrangers), so either have an own funds and initial capital requirement of €50,000 (exempt CAD firms) or a £5,000 "own funds" capital requirement for fund operators/ managers. These firms will see their capital requirements increase significantly under the AIFMD.

For those existing UK private fund managers which are currently Markets in Financial Instruments Directive (MiFID) investment firms and are classified as BIPRU[1] limited-licence firms, there will be little material change to their capital requirements. They must continue to hold one quarter of fixed annual overheads as regulatory capital but they will also be faced with new requirements for capital to cover professional liability risks (as detailed in Appendix 3) and restrictions on their use of own funds, as explained further below.

SUMMARY OF CAPITAL REQUIREMENTS FOR PRIVATE FUND MANAGERS

Under the Directive the regulatory capital requirements are as follows:

- an initial capital requirement of at least €125,000; and
- if the value of assets under management exceeds €250m then an additional amount of "own funds" equal to 0.02 per cent of the excess over €250m (subject to a cap of €10m).

However, the "own funds" requirement must not be less than one quarter of annual expenditure and, in addition:

- up to 50 per cent of the "own funds" requirement may be disapplied if the AIFM benefits from a bank guarantee (or equivalent) for the relevant amount; and
- Level 2 contains a requirement for additional "own funds" regulatory capital of 0.01 per cent of the value of assets under management to cover professional liability risks (as set out in Appendix 3). Alternatively, a firm may take out professional indemnity insurance to cover this amount. However, we believe take-up of this option amongst impacted firms is likely to be limited.

For most private fund managers the one quarter of annual expenditure calculation (see worked examples below) is likely to exceed by some margin the 0.02 per cent calculation. Consequently the basic regulatory capital requirement will be:

- "own funds" of one quarter of annual expenditure; plus
- additional "own funds" of 0.01 per cent of assets under management.

The Directive also requires that "own funds" must be invested in liquid assets or assets readily convertible to cash in the short term.

[1] Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU).

DEFINITION OF INITIAL CAPITAL AND OWN FUNDS

"Initial capital" and "own funds" are defined in the Directive by cross reference to their meanings in the Capital Requirements Directive (CRD). These are two ways of measuring what are essentially shareholder or members' funds (for example, after deducting adjustments for losses). Generally there are methods of calculating/measuring financial resources but they refer to different combinations of certain capital items (e.g. paid-up share capital).

As mentioned above, own funds must be invested in liquid assets or assets readily convertible into cash in the short term and not in speculative positions. This restriction will therefore generally prevent an AIFM from using own funds as working capital.

PROPOSED FSA RULES FOR IMPLEMENTATION OF THE DIRECTIVE

The first FSA (now FCA) consultation paper on implementation of the Directive (CP12/32) set out the FCA's core proposals for the implementation of the regulatory capital provisions. The FSA's (now FCA) second consultation paper (CP 13/9) confirms the basic approach outlined in CP 12/32 and clarifies certain technical details. Importantly, these include confirmation that private fund managers that are able to rely on the size-based threshold exemption (outlined in section A above) will be outside the scope of the regulatory capital requirements imposed by the Directive. The FCA also confirms that non-AIF operators of collective investment schemes will not be subject to the Directive's regulatory capital regime. However, sub-threshold firms that act as AIFMs of authorised AIFs (such as non-UCITS retail schemes) will be caught by the requirements.

The FCA is proposing two types of regulated firms within the scope of the Directive that will be relevant for private fund managers.

The first is a Collective Portfolio Management (CPM) firm, which will be a firm that undertakes external collective portfolio management of AIFs but does not provide any MiFID services (such as segregated investment management activities). The second type is a Collective Portfolio Management Investment (CPMI) firm, which will be a firm that provides collective portfolio management services to AIFs and MiFID services, such as segregated investment management/activities. While a firm cannot be authorised under both AIFMD and MiFID, the AIFMD does allow an AIFM to perform certain MiFID activities, including segregated investment management, investment advice and the reception and transmission of orders in financial instruments.

FCA HANDBOOK

The FCA has proposed a reorganisation of its handbook such that CPM firms (which will be the majority of private fund managers within the Directive (i.e. those who only manage/operate funds)) will be covered by a new Chapter 11 in IPRU(INV). CPMI firms will be covered by the existing General Prudential Sourcebook (GENPRU) and Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) (as amended), which currently apply to them.

REGULATORY CAPITAL REQUIREMENTS FOR CPM FIRMS

As mentioned above, private fund managers will be subject to an initial capital requirement set out under the Directive of €125,000 and this will need to be met out of "own funds" on an ongoing basis. Thereafter to calculate the overall capital for a CPM firm the following elements will be relevant: (i) initial capital requirement; (ii) a percentage of assets under management; (iii) an expenditure based minimum; and (iv) an additional own funds capital requirement in respect of risks arising from professional negligence.

Pulling these together, the FCA's interpretation is therefore that a CPM firm is required to maintain own funds of:

(a) the greater of:

- (i) €125,000 plus 0.02 per cent of the portfolio of relevant AIFs under management over €250m; and
- (ii) one quarter of the firm's relevant annual expenditure; and

(b) an additional amount equal to 0.01 per cent of the value of assets under management in AIFs.

The own funds (other than the initial €125,000 initial capital) must be invested in liquid assets (see further below).

REGULATORY CAPITAL REQUIREMENTS FOR CPMI FIRMS

As mentioned above CPMI firms will be AIFMD firms which also provide MiFID services, such as segregated portfolio management activities. The FCA's view (as set out in CP12/32) is that such a firm will generally be treated as a BIPRU limited licence firm, but only subject to the Pillar 1 requirements. Importantly, this will mean that such firms will not be required to prepare an Internal Capital Adequacy Assessment Process (ICAAP). These firms are currently subject to GENPRU/BIPRU regulatory capital rules so their regulatory capital is unlikely to materially alter as a result of becoming an AIFM.

CPMI firms must hold own funds equal to the higher of the GENPRU and BIPRU requirement for a limited licence firm (which is, in effect, the existing regulatory capital treatment for such firms) and the following own funds requirement:

- the higher of (i) €125,000 plus 0.02 per cent of the portfolio of relevant AIFs under management over €250m and (ii) one quarter of the firm's relevant fixed expenditure; and
- an additional amount equal to 0.01 per cent of the value of assets under management in AIFs.

FCA IMPLEMENTATION OF "INITIAL CAPITAL" AND "OWN FUNDS" REQUIREMENTS

The FCA's view is that whilst the initial capital requirement (that is, €125,000) must be in place once a firm is first authorised it must be met out of "own funds" on an ongoing basis, as in its view this better reflects the continuing obligations of the regulated firm.

LIQUID ASSETS

Own funds will be required to be invested in liquid assets or assets readily convertible to cash in the short term. This will apply to all regulatory capital, except the €125,000 initial capital requirement.

The FCA is proposing a "proportionate" interpretation of the term "assets readily convertible to cash in the short term" such that it will include assets which could be realised for cash within one month and this will therefore include cash, readily realisable investments that are not held for short term resale and also debtors.

CALCULATION OF ANNUAL EXPENDITURE

Annual expenditure will generally only include fixed expenditure, and not variable or discretionary expenditure and will therefore cover (amongst other things) salaries; guaranteed bonuses; rent; and insurance premiums. AIFMs will be required to provide income statements (Form FSA 030) to the FSA on a quarterly basis, which will contain the expenditure figure used as the basis for the fixed overheads requirement calculation. Form FSA 030 sets out the lines of expenditure that are included and these are set out in Appendix 1. The draft FSA rules also provide that certain items of expenditure are not deemed to be fixed and will therefore be deducted. This includes staff bonuses (provided they are not guaranteed) and employees'/ directors' shares in profits. These are also set out in Appendix 1.

CALCULATION AND REPORTING OF CAPITAL REQUIREMENTS

Each CPM Firm will be required to complete a new reporting form (FCA 066), which will demonstrate whether it meets its ongoing capital requirements. These will be required to be submitted on a quarterly basis, alongside Form FSA 030 and a balance sheet (Form FSA 029). In addition a CPMI Firm will also be required to submit Form FSA 067 which will contain supplementary information. Each firm will also be required to submit an annual report and accounts and a solvency statement within 80 days of their accounting reference date.

CPM firms will be required to calculate their initial capital and own funds on the basis of Table 7.4 in IPRU(Inv) 11, with a distinction between Tier 1 and Tier 2 capital, as set out in Appendix 2.

EXAMPLE CALCULATIONS

Example 1

In the example below it is assumed that the private fund manager has €750m of assets under management and annual expenditure of €4m.

Own Funds Requirement

(1) Higher of:	
(a) €125,000 + 0.02 per cent of AUM in excess of €250 million =	€225,000
(b) ¼ of annual expenditure =	€1,000,000
PLUS	
(2) 0.01% of AUM	€75,000
Total own funds requirement	€1,075,000

Represented by

€1,000,000 of eligible LLP members' capital

€75,000 interim profits (independently verified by auditor)

Liquid Assets Requirement

(1) Higher of:	
(a) 0.02 per cent of AUM in excess of €250m	€100,000
(b) ¼ of annual expenditure =	€1,000,000
PLUS	
(2) 0.01 per cent of AUM	€75,000
Total Liquid Assets Requirement	€1,075,000

Represented by

≥ €1,075,000 of liquid assets or assets readily convertible to cash in the short term

In this example, ¼ of annual expenditure results in a higher figure for stage (1) of both the own funds requirement and the liquid assets requirement calculations. As noted above, this is likely to be the case for most UK private fund managers as a firm would need to have very low expenditure relative to assets under management for ¼ of annual expenditure to be a lesser sum than 0.02 per cent of AUM (even adding €125,000 in the case of the own funds requirement). This is illustrated in example 2 below.

Example 2

In this example, it is assumed that the private fund manager has €5bn of assets under management and annual expenditure of €3m.

Own Funds Requirement

(1) Higher of:	
(a) €125,000 + 0.02 per cent of AUM in excess of €250 million =	€1,075,000
(b) ¼ of annual expenditure =	€750,000
PLUS	
(2) 0.01% of AUM	€500,000
Total own funds requirement	€1,575,000

Represented by

€1,575,000 of eligible LLP members' capital

Liquid Assets Requirement

(1) Higher of:	
(a) 0.02 per cent of AUM in excess of €250m	€950,000
(b) ¼ of annual expenditure =	€750,000
PLUS	
(2) 0.01 per cent of AUM	€500,000
Total Liquid Assets Requirement	€1,450,000

Represented by

≥ €1,450,000 of liquid assets or assets readily convertible to cash in the short term

CONCLUSION

Private fund managers should now determine whether or not they will be able to rely on the threshold exemption and/or transitional provisions discussed in Section A. Those private fund managers who will be required to comply with the regulatory capital requirements of the Directive from implementation should calculate their regulatory capital requirements under the Directive based on their current balance sheet and expenditure. Clearly many firms will face significant increases in regulatory capital and while expenditure can be managed to an extent (for example switching guaranteed remuneration/salaries to bonuses or allocation of profits) most expenditure is relatively stable. In addition the requirement to hold the bulk of regulatory capital as liquid assets will decrease the ability to use such resources for other purposes.

APPENDIX 1

EXPENDITURE FOR THE PURPOSES OF CALCULATING THE FIXED OVERHEADS REQUIREMENT

A firm's relevant fixed expenditure is the amount described as total expenditure in its final income statement (FSA030) for the previous financial year and is made up of the following items:

(1) Commissions and fees;	
(2) Staff costs – salary;	
(3) Staff costs – guaranteed bonus;	
(4) Foreign exchange losses;	
(5) Accommodation;	
(6) Interest expense; and	
(7) Other expenditure.	
= Total expenditure	

The following variable items should then be deducted from the total expenditure figure above (to the extent they are included within such expenditure):

(1) Staff bonuses, except to the extent that they are guaranteed;	
(2) Employees' and directors' shares in profits, except to the extent that they are guaranteed;	
(3) Other appropriations of profits;	
(4) Shared commissions and fees payable which are directly related to commissions and fees receivable, which are included within total revenue;	
(5) Interest charges in respect of borrowings made to finance the acquisition of the firm's readily realisable investments;	
(6) Interest paid to customers on client money;	
(7) Interest paid to counterparties;	
(8) Fees, brokerage and other charges paid to clearing houses, exchanges and intermediate brokers for the purposes of executing, registering or clearing transactions;	
(9) Foreign exchange losses; and	
(10) Other variable expenditure.	

APPENDIX 2

SUMMARY OF INITIAL CAPITAL AND OWN FUNDS CALCULATION

TIER 1:

1. paid-up share capital (excluding preference shares);
2. share premium account;
3. audited reserves and interim profits;
4. non-cumulative preference shares; and
5. eligible LLP members' capital.

The sum of items 1 to 5 constitutes **Initial capital**. **Tier 1 capital** is Initial Capital less each of the deductions in items 6 to 10 below:

6. investments in own shares;
7. intangible assets;
8. material current year losses;
9. excess LLP members' drawings; and
10. material holdings in credit and financial institutions.

TIER 2:
Tier 2 capital is the sum of items 11 to 15 below:

11. revaluation reserves;
12. fixed term cumulative preference share capital;
13. long-term qualifying subordinated loans;
14. other cumulative preference share capital and debt capital; and
15. qualifying arrangements.

Own funds is the sum of Tier 1 capital and Tier 2 capital. Tier 2 capital must not exceed 100 per cent of Tier 1 capital.

Eligible LLP members' capital (item 5) can only be included in Initial capital if specific and general conditions are met. The specific conditions are that the members' capital consists of the members' capital account. The members' capital account must meet the following conditions:

- it is an account into which capital paid by the members is contributed;
- a member may only withdraw capital if:
- he ceases to be a member and an equal amount of capital is contributed by existing or replacement members;
- the LLP is wound up or dissolved; or
- the LLP has ceased to be FCA authorised.

The general conditions for the members' capital are that:

- it is fully paid up and the proceeds are immediately and fully available to the firm;
- it cannot be redeemed, except in the circumstances set out in the specific conditions;
- any coupon is non-cumulative;
- it is loss absorbent;
- the amount of the item is net of any foreseeable tax charge;
- it is available to the firm for unrestricted and immediate use to cover risks and losses as soon as they occur;
- it ranks for repayment on a winding up of the firm no higher than a share of a Companies Act company would; and
- the firm is not obliged to pay a coupon on the capital at any time.

Once the calculation has been undertaken (and recalculated on a quarterly basis) the figure must exceed the initial capital and own funds requirement, also calculated on a quarterly basis.

APPENDIX 3

PROFESSIONAL LIABILITY RISKS (ARTICLE 12 LEVEL 2)

Professional liability risks include, without being limited to, risks of:

a. loss of documents evidencing title of assets of the AIF;

b. misrepresentations or misleading statements made to the AIF or its investors;

c. acts, errors or omissions resulting in a breach of:

   i. legal and regulatory obligations;

   ii. duty of skill and care towards the AIF and its investors;

   iii. fiduciary duties;

   iv. obligations of confidentiality;

   v. AIF rules or instruments of incorporation;

   vi. terms of appointment of the AIFM by the AIF;

d. failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts;

e. improperly carried out valuation of assets or calculation of unit/share prices; and

f. losses arising from business disruption, system failures, failure of transaction processing or process management.

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