

THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

ISSUES FOR OPERATORS OF REGULATED FUNDS

INTRODUCTION

Operators of alternative funds have for some time been anxious about how their business will need to change in order to operate under the heavy regulatory burden imposed by the forthcoming implementation in the UK of the Alternative Investment Fund Managers Directive (AIFMD or the Directive).

UCITS schemes will not constitute alternative investment funds (AIFs) for the purposes of the Directive; but non-UCITS retail schemes (NURSSs) (which include property authorised investment funds and funds of alternative investment funds) and qualified investor schemes (QISs) will be firmly within scope and will constitute AIFs.

Operators of regulated funds are used to carrying on their business and operating their funds in a heavily regulated environment and therefore is it simply business as usual for such firms?

Largely the answer is yes, as many of the Directive provisions are based on those set out in the Undertaking for Collective Investment in Transferable Securities Directive (UCITS Directive); although as this note explains, there are still a number of matters that fund managers need to consider.

SCOPE OF AIFMD

The scope analysis for UK operators of UK regulated funds is relatively straightforward.

It is clear that all UK NURSSs and UK QISs will be EU AIFs for the purposes of the Directive. It is also clear that UK UCITS are not EU AIFs.

Each AIF must have a single alternative investment fund manager (AIFM) which is responsible for managing the AIF. Managing means performing at least portfolio management or risk management functions in relation to an AIF.

An entity appointed as investment manager of a NURSS or QIS will not automatically be the AIFM. In the context of NURSSs and QISs the authorised corporate director (ACD)/manager almost always appoints an in-house or external investment manager to manage the relevant portfolios. It will therefore usually be the ACD/manager which will be the AIFM as it is that entity that has legal responsibility for investment management and risk management (and will therefore have the responsibility for complying with the Directive). Usually the ACD/manager will have delegated portfolio management to the investment manager.

On the face of it, the Directive therefore applies to the ACD/manager of UK NURSSs/QISs which will be deemed to be the AIFM. However, an AIFM will need to calculate its aggregate assets under management (excluding assets of UCITS funds) in order to establish whether it either: (i) meets the threshold to be in the scope of the Directive and therefore needs to comply with its provisions in full; or (ii) does not meet the threshold to be in the scope of the Directive, but nonetheless as a sub-threshold manager of regulated (NURSS/QIS) funds needs to comply with the majority of the provisions of the Directive. In either case, the AIFM will need to seek FSA (which will by then be the FCA) approval to act as an AIFM.

An AIFM whose assets under management:

- ◆ do not exceed €100m (including assets acquired through leverage at the level of the AIF); or
- ◆ do not exceed €500m (where there is no leverage at the level of the AIF and investors have no redemption rights from the AIF for at least five years from the date of their initial investment);

will be sub-threshold. HM Treasury is proposing that for sub-threshold AIFMs managing FSA authorised funds, the full requirements of the Directive will be applied except for the following requirements:

- ◆ letter box entity provisions;
- ◆ remuneration provisions (and therefore disclosure requirements in relation to remuneration); and
- ◆ certain of the transparency requirements (i.e. disclosure to investors).

We are expecting to hear more on this sub-threshold regime following the closing of the HM Treasury consultation at the end of February 2013.

DUAL AUTHORISATION AND SCOPE OF PERMISSION

Given that:

- ◆ the Directive will apply to operators of NURSSs and QIFs (even if aggregate assets under management are sub-threshold); and
- ◆ the UCITS Directive applies to the operators of UCITS funds;

what does this mean for operators of both types of regulated funds?

The UCITS Directive currently permits UCITS management companies to manage NURs and QISs as well as UCITS.

The AIFMD provides that an AIFM may also act as a manager of a UCITS provided that the AIFM is authorised in accordance with the UCITS Directive for that activity. After the entry into force of the AIFMD, a UCITS management company which manages AIFs and which is appointed as the AIFM for the purposes of the AIFMD will no longer be subject to the UCITS Directive for that activity and will instead be required to obtain an additional authorisation under the AIFMD.

Therefore a single firm may act as a UCITS operator and an AIFM provided it is authorised by the FSA to operate under both Directives.

The Directive is clear that a single firm will not be permitted to be a MiFID firm and an AIFMD firm so, as is currently the case, if your business requires a MiFID firm, for example for portfolio management activities which are not permitted under the UCITS Directive, then such a separate MiFID firm will continue to be required.

The Treasury and the FSA have proposed new regulated activities which are:

- ◆ managing a UCITS;
- ◆ managing an AIF;
- ◆ acting as depositary of a UCITS; and
- ◆ acting as depositary of an AIF.

The Treasury is proposing that the scope of permission for all UCITS management companies which currently hold permissions to carry on the regulated activity of “establishing, operating or winding up a collective investment scheme” or “acting as sole director of an open-ended company” will automatically switch to “managing a UCITS” so no change will be required in relation to UCITS business.

However if the firm is also operating NURs/QISs and therefore needs to obtain approval to act as an AIFM, a variation of permission application will need to be submitted to the FSA in order to achieve the required dual authorisation. The FSA has said that it will not accept variation of permission applications until 22 July 2013 at the earliest (although it is possible that this position may be altered as a result of the consultation process on implementation). Firms will have 12 months within which to apply for and receive approval for the variation of permission.

FSA HANDBOOK

The FSA has stated that it is not going to “gold plate” (i.e. make rules more stringent than those required) the Directive in its implementation in order to align the UCITS Directive and AIFMD.

The FSA will replace the COLL sourcebook with the new FUNDS sourcebook which will cover AIFs, UCITS and their managers. The FSA is expecting to issue a consultation paper in the coming weeks to deal with the transitional provisions for moving from COLL to FUNDS. The consultation paper will also contain more details on how NURs and QISs will be regulated. It is not expected that there will be much change.

The format of the new FUNDS sourcebook is expected to be as set out below and therefore it should be reasonably straightforward to identify which chapter firms will need to refer to in respect of the different kinds of funds they operate:

Chapter	Subject	Scope
1	Introduction	all firms managing AIFs and UCITS, all AIFs and UCITS
2	Authorisation	all firms managing AIFs and UCITS, all authorised AIFs and UCITS
3	Requirements for managers of AIFs	all AIFMs and AIFs
4	Common requirements for all retail funds	all AIFMs managing NURS and QIS, all UCITS management companies and UCITS schemes
5	Additional requirements for retail alternative investment funds	all AIFMs managing NURS
6	Additional requirements for qualified investor alternative investment funds	all AIFMs managing QIS
7	Additional requirement for UCITS funds	all UCITS management companies and UCITS schemes
8	Additional requirements for UCITS and AIF master-feeder arrangements	all AIFMs and UCITS management companies that manage UCITS/NURS/QIS feeder funds or master funds
9	Suspension of dealings and termination of authorised funds	all AIFMs managing NURS and QIS, all UCITS management companies and UCITS schemes
10	Operating on a cross-border basis	all UK AIFMs and UCITS management companies passporting into another EEA State, all EEA firms passporting into the UK under an AIFMD or UCITS Directive right
11	Recognised funds	all s.264 (UCITS) recognised schemes and all s.270 and s.272 recognised schemes

REGULATORY CAPITAL

The regulatory capital provisions under the Directive are largely based on the UCITS Directive. Both are based on a combination of funds under management and expenditure based requirements for calculating regulatory capital and the same types of capital instrument are allowed in determining what qualifies for these purposes.

Given that a firm that is authorised to manage an AIF may also manage UCITS (if it has permission to do so), the FSA has decided to apply the new capital and professional indemnity insurance (PII) requirements of AIFMD to UCITS operators too (whether or not they are AIFMs). This means that the regulatory capital for an operator of regulated funds will increase, albeit not substantially.

In summary, an AIFM is subject to:

- ♦ an own funds requirement of at least €125,000 for an AIFM; and

- ♦ where the value of the portfolios managed by that AIFM (or self-managed AIF) exceeds €250m, an additional own funds requirement of 0.02 per cent of the amount which exceeds €250m (subject to a cap of €10m). At its discretion, a Member State may authorise an AIFM to reduce this additional own funds requirement by up to 50 per cent where the AIFM benefits from a guarantee of the same amount provided by an EU credit institution (such as a bank) or an EU insurance firm;

provided that the own funds requirement of the AIFM must always be at least equal to one quarter of its annual expenditure.

The new provision is that in addition, to cover potential professional liability risks, an AIFM is required to hold either:

- ♦ (further) additional own funds; or
- ♦ appropriate professional indemnity insurance (PII) cover.

Additional own funds to cover professional liability risks should be at least equal to 0.01 per cent of the value of portfolios of AIFs managed (excluding UCITS). The value of the portfolios of AIFs managed shall be the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through the use of leverage, with derivatives being valued at their market value.

All categories of own funds must be invested in liquid assets or assets readily convertible into cash in the short term and must not include speculative positions.

DELEGATION

The delegation rules under the Directive are broadly similar to those under the UCITS Directive in that if the AIFM wishes to delegate any of its functions such as portfolio management or risk management, it is permitted to do so provided that the AIFM will remain liable for the performance of such functions and the delegation must not affect effective supervision of that function. The AIFM will need to notify the FSA of any delegation. If investment or risk management is delegated then the delegate must be authorised by its local regulator for those activities. Additional rules apply if the delegate is outside of the EU.

The AIFMD provides that an AIFM must not delegate its functions to such an extent that it becomes a "letter box entity" and can no longer properly be considered to be the manager. An AIFM is considered a "letter box entity" if it:

- ◆ no longer has the expertise or resources to supervise delegated tasks effectively and manage the risks of delegation;
- ◆ no longer has the power to take decisions in key areas or perform senior management roles, including implementing general investment policies and strategies;
- ◆ cannot inspect the books and records of the delegate; or
- ◆ delegates out more of its portfolio management function than it retains itself.

In relation to this last test, regulators will not just look at the size of assets under management kept by the AIFM relative to the delegate, but also the types of assets an AIFM is invested in, the geographical and sectoral spread of investments, risk profiles, investment strategies, the types of delegated tasks and those tasks which are retained in-house by the AIFM, and the configuration of delegates and their sub-delegates. The FSA

has noted, in its consultation paper on AIFMD implementation, that it expects judgements of the AIFM on the core activities of portfolio and risk management to be genuine rather than a mere show of compliance.

Operators of NURSSs/QISs will need to consider these provisions carefully to ensure that they have not delegated the investment management and risk management functions to such an extent that they have become a letter-box entity and no longer properly the manager of the AIF. This may therefore mean additional resources within an ACD (e.g. new directors) to ensure compliance.

Operators of regulated funds are familiar with ensuring they are able effectively to monitor any delegate, however procedures should be reviewed in light of these Directive provisions. Delegation must be by way of a written agreement and all such agreements need to comply with the provisions of the AIFMD. This will require a review of any investment management/sub-management agreements currently in place.

A delegate is allowed to sub-delegate, provided that the AIFM has consented to such sub-delegation in writing and the sub-delegation has been notified to the FSA prior to its effective date together with appropriate details and a copy of the AIFM's written consent. The AIFM cannot give a general consent to sub-delegation in its written agreement with its delegate. The procedures in place for sub-delegating will need to take this into account.

DEPOSITARIES

There will be no major differences in relation to depositaries. The general position on liability is that the depositary is liable to an AIF or to the investors of an AIF, for loss of assets by the depositary (or a third party custodian to whom the depositary has delegated custody). However, the depositary may, in certain circumstances and provided it has complied with the provisions in the Directive, transfer liability to the custodian. The depositary is also not generally liable for the loss of assets broadly where this has been caused by an event beyond the depositary's reasonable control. There are detailed provisions in the Directive on this point.

Depositaries may look to update existing depositary agreements in order to cover off some of the Directive requirements however it is expected that UCITS V will, in due course, bring the UCITS depositary regime in line with the AIFMD regime.

The AIFMD imposes significant monitoring and oversight obligations on depositaries, and these will necessitate significant co-operation from AIFMs.

OPERATIONAL REQUIREMENTS

The organisational requirements in the AIFMD are designed to be broadly consistent with the principles and requirements in the UCITS and MiFID Directives, while at the same time seeking to take into account the particular characteristics of different types of AIFs and the diverse assets in which they may be invested. Most of the organisational requirements in the Directive are aligned with those in the UCITS Directive, so we believe that there will not be many significant differences for firms seeking dual authorisation. Relevant differences are highlighted below.

LEVERAGE

An AIFM must calculate leverage for each of its AIFs. This is a concept which operators of regulated funds are used to as the requirements are similar to those for calculating the global exposure of a UCITS. Whilst for UCITS funds, operators can select to use either the "commitment approach" or the "value at risk approach", for AIFs an AIFM must use the "gross method" and the "commitment method".

The gross method is simply the sum of the absolute values of all positions valued in accordance with the Directive. The commitment method, like the commitment approach, allows operators to take into account certain netting or hedging arrangements to reduce risk.

If an AIF employs leverage "on a substantial basis", the AIFM will be required to report on its use of leverage to the FSA, to enable it to assess whether the AIF might contribute to the build-up of systemic risk in the financial markets or risks of disorderly markets. Leverage will only be considered to be "employed on a substantial basis" when the exposure of an AIF, calculated according to the commitment method, exceeds three times the AIF's net asset value. The AIFMD gives new supervisory powers to the FSA, permitting it to impose leverage limits or other restrictions on an AIFM's management activity, where the AIFM's use of leverage, or its interaction with other AIFMs or financial institutions, may contribute to the build-up of systemic risk in the financial system, or risks creating disorderly markets.

CONFLICTS OF INTEREST

The AIFMD rules on conflicts of interest are intentionally similar to those from MiFID and the UCITS Directive.

The main change is that if an AIFM is using a prime broker on behalf of its AIF, the terms governing the AIF's relationship with the prime broker must be documented in a formal agreement. In particular, any possibility of transfer and re-use of AIF assets must be provided for in the formal agreement and must comply with the AIF's rules. The depositary must be informed of the existence of the formal agreement.

RISK MANAGEMENT

The sections of the Directive providing for risk management, in particular to require the adoption of a risk management policy, mirror the UCITS Directive.

LIQUIDITY MANAGEMENT AND VALUATION

These provisions do not provide any significant concern for the operators of regulated funds which currently operate with similar rules. However, AIFMD sets out more details on the liquidity management systems and procedures required and introduces specific liquidity stress testing and periodic disclosure requirements, which will be new for UCITS management companies becoming AIFMs. Indeed the FSA proposes to apply the liquid assets requirement to UCITS firms that do not manage any AIFs, even though they are not within the scope of the Directive.

ANNUAL REPORTING TO INVESTORS

Under the Directive, within the annual report an AIFM will need to report to investors on the total amount of its remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and provide details of the number of beneficiaries and the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

REMUNERATION

Whilst a number of existing fund managers are subject to the current FSA remuneration code, the one required by the AIFMD is different. ESMA has published the final code which will be implemented into the FSA rules.

Existing remuneration structures will need to be reviewed for compliance.

MARKETING

The FSA has indicated that NURSs will continue to be permitted to be marketed to retail investors in the UK. However if an AIFM wishes to market a NURS to EU investors, the AIFM will need to apply for a passport in order to do so. The FSA is going to cover this issue, together with the issue of non-UK recognised schemes, in its second consultation paper which is expected soon.

The UK marketing regime for QISs is subject to change, not because of the AIFMD, but because of the FSA's proposal to tighten (and almost prohibit) the marketing to retail investors of unregulated funds and similar products. The FSA deems QISs to be similar products even though they have been approved by the FSA.

CONCLUSION

Although the Directive does not substantially change the regulatory landscape for the operators of regulated funds in the same way that it does for operators of alternative funds, there are still a number of compliance and operational issues to address in the coming months.

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