

# THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

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## WHAT DO YOU NEED TO THINK ABOUT IN THE NEXT FEW MONTHS? - SOME PRACTICAL GUIDELINES

The Level 1 Alternative Investment Fund Managers Directive (AIFMD or the Directive) was passed on 22 July 2011, with a two year transposition period, meaning implementation by Member States must be achieved by 22 July 2013.

To date, the UK Government (HM Treasury) and the Financial Conduct Authority (FCA) have published two consultations each on the implementation of the AIFMD. HM Treasury has now published responses to both its consultations, which include final regulations to implement a large part of the AIFMD regime. It has also published separately questions and answers on common issues relating to HM Treasury's approach to implementation of the AIFMD. These documents, together with discussions at a recent HM Treasury and FCA "town hall" event on AIFMD implementation, shed further light on the options which are available to alternative investment fund managers (AIFM) following 22 July 2013. As the direction of travel is now more settled, implementation planning should now be started. Set out below are some of the high level issues that require more immediate consideration on which we would be happy to advise on a more detailed basis. The first part deals with UK/EU fund managers and the second with non-EU fund managers.

### UK/EU FUND MANAGERS

#### Scope and delegation

Each fund manager needs to consider the structures of its existing funds. This includes looking at each fund and deciding if it is an alternative investment fund (AIF) and determining which entity is the alternative investment fund manager (AIFM) – i.e. which entity is responsible for portfolio and risk management. This exercise will include considering whether any of these functions are delegated (either within a group or to a third party), since any entity which is considered to have delegated its functions to the extent that it is a "letterbox entity" will not be the AIFM. However, under Level 2 there is now a more qualitative approach (as opposed to the former approach which seemed partly quantitative) to be used when considering what constitutes a "letterbox entity". If a fund manager delegates investment management to an extent that "exceeds by a substantial margin" the investment management functions it performs then it will be a "letterbox" with the result that the delegate becomes the AIFM.

A UK fund manager which will be an AIFM will be required to apply to the FCA to amend its scope of permission to become an AIFM. The FCA will start accepting applications on 22 July 2013 and, where the application is complete, provide its determination within three months. UK fund managers which will be AIFMs will need to amend their scope of permission by 22 July 2014, at the latest.

#### Action points

- ◆ Identify all private funds (i.e. non-UCITS funds):
  - (1) Determine if they are AIFs, i.e. do they:
    - (i) raise capital;
      - from a number of investors with a view to investing it;
      - in accordance with a defined investment policy?

One of the recent ESMA technical papers has provided some guidance on the meaning of these elements of the definition. It will be important to look at all vehicles/structures (e.g. including co-investment or carried interest vehicles) to determine if they are AIFs.

- (2) Once the AIFs have been identified, their aggregate assets under management need to be calculated. An exemption will apply from most of the Directive's provisions if assets under management are sub-threshold, being either:
  - (i) under €100m; or
  - (ii) under €500m where the funds are closed ended, unleveraged and there are no redemption rights within five years.
- (3) Determine who is the AIFM of each AIF. Delegation arrangements will also need to be reviewed in light of the delegation criteria in the Directive and the Regulation.
- (4) Determine whether each AIF is an EU or non-EU AIF and whether each AIFM is an EU or non-EU AIFM.

In light of the answers to the above, determine the applicability of the Directive and whether FCA approval is required in order to manage and/or market the AIFs.

- ◆ If the fund manager carries on other activities in addition to pooled private fund management (e.g. managed/segregated accounts or investment advice) consider whether these activities can be undertaken under the AIFMD or whether a separate MiFID-regulated firm will also be needed. The AIFMD does allow a firm to be authorised under both the UCITS Directive and the AIFMD, so a single authorised firm could manage both UCITS funds and AIFs.

## MARKETING

From 22 July 2013 the marketing passport will, in theory, be available for an EU AIFM which is marketing an EU AIF in the EU. This means that the EU AIF can be marketed within the EU to "professional investors" without the need to comply with any local private placement rules. In order to benefit from the marketing passport, a UK AIFM will have to go through a registration process with the FCA. This will involve submitting details about the AIFM (such as controllers, structure, how it plans to comply with the Directive and delegation arrangements) and also providing details about each AIF (such as the constitutional documents and arrangements for the appointment of the depositary) as required by the Directive. For existing authorised firms it is likely that the FCA will have the bulk of this information already but changes to categorisation and scope of permission will be required. The marketing and constitutional documents for the AIF will need to contain a number of additional disclosures to investors. AIFMs will need to factor in time to compile the application as well as the potential three month approval time when considering the timing of marketing AIFs.

### Action Points

- ◆ For marketing which has finished prior to 22 July 2013 by existing FCA authorised fund managers – there is a transitional 12 month period within which to apply for authorisation and comply with the Directive.
- ◆ For marketing under the passport between 22 July 2013 and 22 July 2014 by existing FCA authorised fund managers – it is likely that compliance in full with the terms of the Directive will be required, although as indicated above, this could be problematic.
- ◆ For marketing by new (i.e. unauthorised) fund managers prior to 22 July 2014 – they will need to go through the authorisation process and comply in full with the Directive.
- ◆ For marketing by existing managers only after July 2014 - it is likely that full compliance will not be required until 22 July 2014.

## REGULATORY CAPITAL

The Directive sets out some fairly onerous restrictive regulatory capital provisions for AIFMs.

For asset managers/hedge fund managers which are currently subject to expenditure-based capital requirements, not much

change will be required. If however fund managers decide they need separate MiFID and AIFMD firms then both will need to meet their regulatory capital obligations. For those private fund managers which currently only have a £5,000 own funds capital requirement, regulatory capital will increase significantly.

As a reminder, under the AIFMD, regulatory capital requirements will generally be:

- ◆ an initial regulatory capital requirement of €125,000;
- ◆ where assets under management exceed €250m, an additional amount of "own funds" regulatory capital equal to 0.02 per cent of assets under management, over such excess (subject to a cap of €10m);
- ◆ provided that such "own funds" requirement is not less than one quarter of annual expenditure of the authorised firm; and
- ◆ under Level 2, an additional "own funds" requirement of 0.01 per cent of the value of funds managed (to cover for professional liability risks).

The FSA has clarified in its consultation paper what will be treated as "expenditure" for regulatory capital requirements.

### Action points

- ◆ Take steps to calculate the amount of regulatory capital required by an AIFM and how it will be met.
- ◆ Consider steps to reduce expenditure (e.g. use of profit shares or guaranteed bonuses).

## DEPOSITARIES

Under the Directive, each AIF will be required to appoint a depositary which will be responsible for safekeeping of assets as well as cash monitoring, oversight, due diligence and segregation. Currently, a number of depositaries provide services to UCITS funds and it may be assumed that they will also do so for AIFs. Some existing private fund administrators have indicated that they will be prepared to act as a depositary in relation to AIFs. Nevertheless, there is concern that there will be insufficient providers of these services and that the costs charged will be high. Consequently, we are advising clients to think about this issue immediately and to begin discussions with potential depositaries as soon as possible.

### **Action points**

- ◆ If the AIFM wishes to market under the Directive prior to 22 July 2014, a depositary needs to be appointed in respect of the relevant AIF. In any event, a depositary for each AIF must be appointed by 22 July 2014.
- ◆ Start discussing arrangements with potential depositaries and negotiating a depositary agreement.
- ◆ Depositaries to review/draw up procedures for safekeeping of assets, cash monitoring etc.

### **POLICIES AND PROCEDURES**

The Directive requires AIFMs to have a number of policies and procedures in place, some of which will already be familiar to UK fund managers, others will be new. Certain internal or external appointments will need to be made to ensure that the compliance arrangements are robust.

### **Action points**

Start considering (or revisiting) the following organisational policies:

- ◆ risk management;
- ◆ liquidity management;
- ◆ conflicts of interest;
- ◆ valuation procedures; and
- ◆ use and calculation of leverage.

Review the adequacy of compliance arrangements to ensure the following functions are covered (as proportionate to the business of the UK fund manager):

- ◆ permanent compliance function – establish and maintain procedures to ensure compliance with the Directive;
- ◆ permanent internal audit function – establish and maintain an audit plan to evaluate the effectiveness of systems and controls; and
- ◆ permanent risk management function – implement risk management procedures to monitor the risks to which each AIF is exposed.

### **REMUNERATION CODE**

ESMA has now published the final remuneration code. Whilst the FSA still needs to implement the code into the FSA rules, UK fund managers should review and analyse the provisions.

Whilst a number of existing fund managers are subject to the current FSA remuneration code, the one required by the AIFMD is different and, in addition, current non-MiFID fund managers will be subject to a remuneration code for the first time.

### **Action point**

- ◆ Review existing remuneration structures for compliance. Particular issues arise around deferral and vesting requirements for “variable” remuneration, which includes remuneration related to carried interest and performance fees.

### **UK TRANSITIONAL PROVISIONS**

The AIFMD requires that AIFM performing activities which fall under the AIFMD before 22 July 2013 should take all necessary measures to comply with the national law stemming from the AIFMD and, in any event, should submit an application for authorisation before 22 July 2014.

The helpful view of the HM Treasury is that the AIFMD provisions do not apply until a UK AIFM (i.e. an existing manager of alternative funds) is duly authorised as such by the FCA. In addition, the transitional provisions in the AIFMD which apply to UK AIFM are being extended to benefit both EEA and third country AIFMs. This, combined with HM Treasury’s intention to continue existing private placement regimes, gives a clear message that the UK remains open for business for as long as it is able to within the constraints of the AIFMD.

Unless an AIFM wishes to utilise the AIFMD managing or marketing passport prior to 22 July 2014, it is likely that many AIFMs will take full advantage of this transitional period in order to manage or market into the UK, whether in relation to existing alternative investment funds (AIF) or new launches, without needing to become fully AIFMD compliant. Therefore, the main reason an AIFM would need to be AIFMD compliant and authorised by the FCA as an AIFM, is if it needed a marketing passport to market funds in other EU jurisdictions to avoid existing uncertainties around transitional provisions and private placement in other EU jurisdictions. This means that AIFM do not need to change their reporting arrangements or marketing documentation until 22 July 2014 at the latest.

The extension of the transitional period also provides comfort in relation to the potential for delay in the signing of third country co-operation agreements since HM Treasury is clear that these need only be in place once the AIFM is authorised. However, it is not yet known if other Member States will follow the lead of the UK in extending the transitional period to EEA and third country AIFM.

## NON-EU FUND MANAGERS

The applicability of the Directive to those fund managers based outside the EU will depend on a number of factors including:

- i) whether they are managing any EU AIFs;
- ii) whether they are marketing any AIFs (whether EU or not) into the EU; or
- iii) whether they have been delegated portfolio management by an EU AIFM.

Whilst the marketing passport is not available for non-EU fund managers, they must still comply with local private placement regimes (as possibly amended as a result of the Directive) and also comply with the Directive provisions relating to reporting/transparency, control of non-listed companies and the "asset-stripping" provisions.

In addition, in order to market an AIF within the EU, a non-EU AIFM will need to comply with its local laws and the home regulator of such AIFM will need to have entered into a co-operation agreement with each EU member state in which marketing is proposed to take place. The Level 2 provisions on co-operation agreements are less restrictive than was previously the case but there is still uncertainty as to whether important fund jurisdictions such as the US, Cayman and BVI will be able or willing to do so.

### Action point

- ◆ A non-EU AIFM should find out the current indications (if any) as to the likelihood of its home regulator entering into co-operation agreements.

## CONCLUSION

We are looking closely at the final Level 2 provisions and advising many clients operating in different asset management areas and in various jurisdictions on their position. We will be circulating a fuller note shortly.

We are holding a number of seminars to examine the detailed provisions of the Directive and the Level 2 provisions for private equity, credit and real estate fund managers, regulated funds and for hedge fund managers.

In addition we would be delighted to have a meeting to discuss any specific issues or questions.

## CONTACT DETAILS

If you require any further information on these issues, please do not hesitate to contact:

### BRIDGET BARKER

DD: +44 (0)20 7849 2495  
bridget.barker@macfarlanes.com

### ALEX AMOS

DD: +44 (0)20 7849 2554  
alex.amos@macfarlanes.com

### STEPHEN ROBINSON

DD: +44 (0)20 7849 2280  
stephen.robinson@macfarlanes.com

### TIM CORNICK

DD: +44 (0)20 7849 2510  
tim.cornick@macfarlanes.com

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## MACFARLANES LLP

20 CURSITOR STREET LONDON EC4A 1LT

T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

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