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Financial Services and Markets

Countdown to AIFMD – two ESMA papers on scope

On 19 December 2012, the European Securities and Markets Authority published two consultation papers on the Alternative Investment Fund Managers Directive. They expand on the themes covered in ESMA's discussion paper of February 2012 concerning key concepts. The first new paper takes forward ESMA's thinking on **"key concepts" used in the Directive**, with a view to the publication by ESMA of formal guidelines applicable to EU Member State regulators on a "comply or explain" basis. It gives some important guidance on the scope of the Directive and clarifies many, but not all, points of uncertainty about scope. There is broadly good news for most firms, for example UK REITs, real estate joint ventures and potentially private equity acquisition special purpose vehicles. The second new paper is a consultation on **regulatory technical standards concerning "types of AIFM"**. It clarifies when a fund will be deemed "open-ended". In this briefing note, we summarise and comment on some of the more interesting points in both papers.

Taken together with the Level 2 Regulation adopted on the same day by the European Commission, and summarised in our separate briefing note, firms should be in a position to advance their planning for the Directive substantially immediately after the holidays.

The consultation paper on key concepts is available HERE .

The consultation paper on types of AIFM is available HERE .

The deadline for responses to both consultations is 1 February 2013. ESMA plans to finalise the guidelines and present draft regulatory technical standards to the European Commission in the first half of 2013.

Consultation paper on key concepts

Overview

The paper sets out draft guidelines in Annex V (beginning on page 50). They cover only four pages. The consultation paper itself has only six pages of substantive material.

The draft guidelines expand on the elements of the definition of "AIF" in the Level 1 Directive. The definition is as follows:

> *"AIFs" means collective investment undertakings, including investment compartments thereof, which (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) [are not UCITS].*

The elements of the definition ESMA picks out are:

- collective investment undertaking;
- raising capital;
- from a number of investors; and
- defined investment policy.

We comment on the elements of the definition below. ESMA makes clear that all elements must be present for an undertaking (or cell of an undertaking such as an umbrella fund or protected cell company) to constitute an AIF.

Helpfully, ESMA has dropped the idea that the legal arrangements relating to ownership of underlying assets (for example whether investors have legal or beneficial proprietary interests in the underlying assets) should be one of the criteria for identifying an AIF. That idea had been criticised by respondents to the earlier discussion paper.

The bulk of the paper summarises feedback to the discussion paper and provides a cost-benefit analysis. ESMA barely comments on the feedback received, so the summary does not shed much light on the merits of the positions taken by respondents. For example, ESMA notes that some respondents asked whether a carried interest vehicle should constitute an AIF or not. It gives no specific guidance on that point but elements of its guidance on co-investment schemes tends to point to a conclusion that at least some carried interest vehicles will not be AIFs.

ESMA considers its work to be relevant only to the definition of "AIF" for the purposes of the AIFM Directive. For example, it suggests that its elaboration on the concept of "collective investment undertaking" is not relevant to the same term used in the Prospectus Directive. It is to be hoped, however, that ESMA will accept that its guidance is relevant to the application of the European Market Infrastructure Regulation, which applies differently as between "financial counterparties", including "AIF" as defined in the AIFM Directive, and "non-financial counterparties".

Collective investment undertaking

ESMA suggests that an undertaking will be a collective investment undertaking if all the following characteristics (in summary) are present:

- it is not "an ordinary company with general commercial purposes";
- it pools capital with a view to a *pooled return* (as defined below) (albeit different investors may receive different returns on different bases); and
- the investors do not have day-to-day discretion or control over the management of the undertaking's assets.

"*Pooled return*" is defined as "the return generated by the pooled risk arising from acquiring, holding or selling investment assets as opposed to the activity of an entity acting for its own account and whose purpose is to manage the underlying assets as part of a commercial or entrepreneurial activity, irrespective of whether different returns to investors, such as under a tailored dividend policy, are generated".

In introducing these criteria (not all of which were in the earlier discussion paper) and elaborating on them in the body of the consultation paper ESMA appears to have borrowed heavily from jurisprudence concerning the definition of "collective investment scheme" in section 235 UK Financial Services and Markets Act 2000 and regulations made under it, albeit the test is not identical.

The suggestion that an undertaking is not an AIF if it is "an ordinary company with general commercial purposes" will be warmly welcomed by many, for example by UK Real Estate Investment Trust companies listed under Chapter 6 of the Listing Rules, who are likely to argue that they are ordinary companies. It is also potentially good news for private equity, real estate and infrastructure fund managers who set up acquisition structures using what they will seek to argue are "ordinary companies".

The suggestion that an undertaking is not a collective investment undertaking if all investors have day-to-day discretion or control over the management of its assets will be good news for real estate joint ventures. Most UK joint ventures are structured so that the participants do have day-to-day control over major commercial decisions.

It is disappointing though that ESMA has stated that failure to meet one of the tests set out in the bullets above is not a guarantee that a vehicle is not an AIF.

Raising capital

ESMA suggests that either or both of the following things amount to an undertaking "raising capital":

- "taking direct or indirect steps to procure the transfer or commitment of capital by one or more investors to an undertaking for the purpose of investment with a view to generating a *pooled return* (as defined above) for the investors; and/or
- commercial communication between the undertaking seeking capital or a person or entity acting on its behalf (typically, the AIFM), and the prospective investors, which aims at procuring the transfer of investors' capital."

This guidance may leave room to argue that a special purpose acquisition vehicle owned by a fund does not take steps to *procure* the transfer or commitment of capital from a fund but rather takes steps to *agree to* and *facilitate* the injection of capital at the instance of the fund.

ESMA goes on specifically to clarify that seeking co-investment from members of the governing body or risk-taker employees of the undertaking or its manager (such as hedge fund portfolio managers or members of a private equity manager's investment committee), will not amount to capital raising, and an undertaking in which only such people invest "is not likely to" be an AIF. This will be welcome news for all alternative asset managers and their investors who require or encourage co-investment. Pure co-investment vehicles should not be considered AIFs in their own right (albeit the master or main fund likely will be). This could save firms some cost and administrative burden.

The co-investment undertaking may still be an AIF if the group invited to participate in the co-invest opportunity through that undertaking extends beyond "risk takers" to include: (a) the AIFM itself or an affiliate; (b) more junior staff; (c) friends of the firm; or (d) unconnected third parties, e.g. investors. What constitutes a "risk taker" is likely to be the same for these purposes as for the application of the remuneration rules under the Directive.

The idea that a co-investment undertaking is an AIF if any affiliate of the AIFM invests in it poses a technical problem for English or Scottish limited partnership co-investment schemes into which a general partner company (typically an affiliate of the AIFM) makes a nominal capital contribution.

ESMA also clarifies that an undertaking established exclusively for a group of people all of whom have a close familial relationship that pre-dates the establishment of the undertaking would be unlikely to be treated as capital raising. That will assist some vehicles operated by smaller or traditional family offices but by no means all family offices who may invest capital on behalf of a wider group of friends as well as core family. ESMA suggests that this guidance gives effect to the quasi-exemption in Recital 7 of the Directive for family office vehicles.

From a number of investors

ESMA suggests that an undertaking raises capital from a number of investors even if it in fact has only one investor. That is so unless national law applicable to it, or its rules or instruments of incorporation, or other provisions or arrangements of binding legal effect, prevent it from raising capital from a second investor.

However, some structures with a single investor may not involve "pooling" (see above) and may not therefore constitute AIFs on other grounds.

In this section of the paper, ESMA refers to nominee arrangements, feeder structures and fund of fund structures. It seems to be suggesting that, if a single nominee invests in an undertaking on behalf of a number of investors, the underlying undertaking may be deemed to raise capital from a number of investors. This seems to be the case unless national law applicable to it, or its rules or instruments of incorporation, or other provisions or arrangements of binding legal effect, prevent it from raising capital from a second investor. The precise implication of this section of the draft guidance is unclear.

Defined investment policy

In seeking to clarify what is a "defined investment policy", ESMA gives a non-exhaustive list of factors tending to indicate the existence of such a policy. Again, unhelpfully, ESMA has commented that the absence of all of these factors would not conclusively demonstrate no policy exists. The factors may be summarised as follows:

- some sort of policy exists about the management of the capital raised by the undertaking and pooled;
- that policy is not merely the business strategy followed by an ordinary commercial company with general commercial purposes;
- the investment policy is determined and fixed, at the latest by the time that investors' commitments to the undertaking become binding on them;
- the investment policy is set out in a document which becomes part of or is referenced in the rules or instruments of incorporation of the undertaking;
- the undertaking or the entity managing it has an obligation (however arising) to investors, which is legally enforceable by them, to follow the investment policy, including all changes to it;
- the investment policy specifies investment guidelines, with reference to criteria including the following:

  (a) to invest in certain categories of asset, or conform to restrictions on asset allocation;

  (b) to pursue certain strategies;

  (c) to invest in particular geographical regions;

  (d) to conform to restrictions on leverage;

(e) to conform to minimum holding periods; or

(f) to conform to other restrictions designed to provide risk diversification.

These tests may enable some companies, such as UK Real Estate Investment Trusts listed under Chapter 6 of the Listing Rules, to conclude that they do not have a defined investment policy.

Consultation paper on types of AIFM

Overview

The draft regulatory technical standards, taking the form of a Commission Delegated Regulation, are only three pages long. They are set out in Annex VI to the paper (beginning on page 47). The only topic covered is how to distinguish between an open-ended fund and a closed-ended fund.

Other characteristics of AIFs addressed in the earlier discussion paper are not addressed in any detail in this paper and are not covered in the draft regulatory technical standards. They are:

- whether an AIF is leveraged or employs "substantial leverage" – on this ESMA proposes to wait to see how the Level 2 Regulation is received before deciding whether additional clarification is needed;
- whether an AIF is significant in size – ESMA is taking this question as part of its work developing guidelines on remuneration under Annex II to the Directive;
- whether an AIF uses a prime broker or not (because it should consider conflicts if it does) – ESMA does not perceive any need for guidance on this;
- whether an AIF is internally or externally-managed – ESMA says nothing on this, presumably because the question is affected in large part by the Level 2 Regulation.

The bulk of the paper summarises feedback to the February 2012 discussion paper and provides a cost-benefit analysis.

ESMA reserves the right to consider developing further draft regulatory technical standards in future, for example it may develop a typology of AIFMs based on the investment strategies of the AIFs they manage.

Distinguishing between open-ended and closed-ended AIF

The draft regulatory technical standards provide that an AIF shall be considered to be open-ended if investors:

"have the right to redeem their units or shares out of the assets of the AIF where all of the following conditions are present:

- the right may be exercised at least once a year;
- the transaction is carried out at a price that does not vary significantly from the net asset value per unit/share of the AIF available at the time of the transaction; and
- no restriction or power provided for in the rules or instrument of incorporation of the AIF or any prospectus to apply special arrangements, such as side pockets, gates, suspensions, lock-up periods or other similar arrangements arising from the illiquid nature of the AIF's assets, is to be taken into account for this purpose."

This has the merit of being a relatively straightforward test. A small number of funds considered to be open-ended for the purposes of current domestic laws of EU Member States are likely to be deemed closed-ended based on this test.

Not every point of uncertainty is covered in the papers

ESMA has shied away from consulting on all of the topics covered in its February 2012 discussion paper. For example, the papers do not address:

- the extent to which AIFMs may delegate risk management or portfolio management functions, which is bound up with the "letter-box" test in the Level 2 Regulation;
- types of undertaking which are not AIFs because of the negative scope provisions of the Directive, including the exemptions for joint ventures and holding companies; or

- the interaction between the AIFM Directive, the UCITS Directives and MiFID and the extent to which AIFMs can be licensed also under either of those other Directives.

On these topics, ESMA will wait to see to what extent consensus emerges following publication of the Level 2 Regulation but floats the possibility of publishing Q&A on its website or using other "convergence tools" in due course. Q&A are not always the subject of prior consultation, so this approach poses risks for the industry.

For further information on how we can help you with questions arising out of the FSA letter and the structuring your contingency plans, please contact one of the partners in our Financial Services and Markets Department or your usual contact at Travers Smith.

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