Financial Services and Markets

Countdown to AIFMD – Level 2 Regulation

On 19 December 2012, the European Commission published its long-awaited "Level 2" implementing measures for the Alternative Investment Fund Managers Directive ("**AIFMD**" or "the **Directive**"), considerably later than first expected. These measures take the legal form of a Regulation and so will be directly applicable in Member States, leaving Member States with no discretion as to how they are implemented.

The Regulation can be found here.

How we got here

The process by which the Regulation has been made, as with the AIFMD itself, has been highly unsatisfactory. There has been very little transparency as to the debates on key issues, many have been the subject of politically-charged negotiation. There are a number of aspects which are difficult if not impossible to reconcile with the Directive (particularly on delegation), which reveals a worrying tendency on the part of the European Commission to ignore elements of the law with which it does not agree.

The law which is now enshrined in the AIFMD and the Regulation suffers from many of the same defects as the original draft Directive. They reflect a lack of understanding (or unwillingness to understand) the vast range of different AIFM and AIF that will be affected. The result is that many of the provisions, when applied to certain types of AIF and AIFM, will produce unnecessary cost and/or bureaucracy with no corresponding investor benefit, in some cases they may even be impossible to apply.

The fact that the Directive was not subject to a proper pre-consultation process and that its text was the subject of fierce and political debate resulted in a Directive that is even more poorly drafted than usual. Important provisions are therefore open to more than one interpretation and it is only now that Member States and the Commission are focussing on these issues in implementation workshops. It seems likely that at some point the Commission will issue its views and there is a real risk that some of these will be surprising in an unpleasant way, including to national regulators. The ambiguous provisions include those which are critical to scope, such as the interpretation of the transitional/grandfathering articles, which even on a wide reading are very limited. Firms which hope to be out of scope or which are hoping to rely on any of the transitional/grandfathering provisions need to keep a close eye on developments.

We explain below that despite the fact that it will be some time before firms have the full picture, they will not be given additional time to comply.

Is this it?

No, there is still more to come. In particular:

- The Council of Ministers and the European Parliament have three months in which to raise any objections to the Regulation. In the (likely) absence of any objection, the Regulation will come into force shortly thereafter (when it is published in the Official Journal).

- Member States each have to implement the Directive; this opens up the possibility of various interpretations of some provisions, for example, what is meant by "marketing". There will be a period of uncertainty during which competing views on some core issues will be expressed. (See our previous note on the recent FSA consultation on implementation here).

- There are some provisions where the Directive confers express discretions on Member States, for example, whether or not to require their AIFM to appoint a third party valuer, whether to permit venture capital and private equity firms to appoint a depositary that is not a bank, and whether, and if so on what terms, to permit private placement regimes for funds outside the scope of the Directive. It is not yet clear what the final position will be in each Member State, although some (e.g. the UK and Germany) have published some proposals.

- There is some guidance to come, including remuneration guidelines.

- The key dates table below highlights some of the main items outstanding and their stated delivery dates. Some items, including important guidance on the intended application of the Directive, will not be available until after the implementation date.

Key dates

HMT consultation on implementation	Q4 2012
FSA consultation on implementation (Part 2)	February 2012
UK policy statements on implementation	June 2013
Remuneration guidelines	Q1 2013
UK FCA ready to receive authorisation applications	Q3 2013
Finalisation of co-operation agreements with non-EU supervisors	Q3 2013
Technical Standards, advice, guidelines and Q&A	Q4 2013

Timing

The AIFMD and the Regulation will become law in Member States on 22 July 2013 – seven months away. This is despite the fact that some important supporting elements of the law will not be known for some time. There is no expectation that there will be a delay in bringing the laws into force, and it seems likely that, as with the Short Selling Regulation, firms will not be excused from compliance simply because the authorities have not given them much time to make what may be significant changes to their operations.

Whilst there are some uncertainties, firms that know they will be within the scope of the Directive now have enough detail to start drafting their policies and procedures. The FSA published its first consultation on implementation on 14 November 2012. Firms who have not yet started their preparations need to do so now.

Although the position is not yet clear, it would be prudent for in-scope UK AIFM to be planning to be compliant with the national laws implementing the Directive by 22 July 2013, although they may not need to be authorised as an AIFM until 22 July 2014 unless they wish to be able to market into other EEA States before that date. It may not be possible for EU AIFM to carry on marketing after 22 July 2013 without being authorised. So all in-scope firms are likely to have work to do, but some will also have the additional work involved in making an authorisation application.

Non-EU AIFM who want to market their funds in European jurisdictions which have private placement regimes will have to wait and see if the necessary co-operation arrangements between EU and non-EU supervisors will be in place by 22 July 2013. If not, there may be disruption to their marketing plans.

THE REGULATION

We highlight below some of the most significant issues covered by the Regulation.

Calculating assets under management

The AIFMD contains a partial exemption for AIFM whose total assets under management do not exceed certain thresholds. Whilst Member States must apply a registration regime to such AIFM, they will not have to comply with the full provisions of the Directive. The thresholds are:

- €500 million, provided the AIF are not leveraged and investors have no redemption rights for the first five years;

- €100 million (including assets acquired through leverage).

The Regulation prescribes the basis on which the value of assets under management must be calculated, in essence requiring the portfolio to be valued in accordance with the valuation rules provided for in the law of the country where the AIF is established (if any) and the fund documentation. Specific provision is made for valuing derivative positions.

These rules matter to firms who hope to stay outside the AIFMD. But Member States may choose to "gold-plate" and apply the AIFMD to all their firms, regardless of the exemption. It appears that UK firms will be able to use the AIFMD exemption because it seems likely that the UK will maintain its existing authorisation regime for them.

Delegation of AIFM functions – the "letterbox" issue

Impact

This provision has been highly controversial and is one of the main reasons for the delay in the agreement of the Regulation. It has a direct and an indirect effect.

It directly affects AIFM because it operates as a constraint on the extent to which they may delegate investment management and risk management. It has an indirect effect because it may mean in some cases that the entity which is designated as the "manager" of an AIF under fund documentation is not regarded as the AIFM for the purposes of the Directive. So, for example, where an offshore fund has a "manager" in the offshore jurisdiction and a single UK sub-manager, the sub-manager is currently treated as a discretionary asset manager and not a fund operator. Under the AIFMD there is a risk that if the offshore manager is only a "letterbox", then the UK sub-manager may be treated as the AIFM under the Directive.

The letterbox provision will also be relevant to non-EU AIFM intending to market in the EU from July 2013, as it may affect the identification of the entity which is to be regarded as the AIFM and which must comply with the various disclosure provisions which apply to AIFM who market under national private placement regimes.

Thus the provision has implications for existing and future fund structures. The exact analysis applicable to any situation will be very fact specific.

What is a "letterbox" entity?

The Regulation lists four cases in which the apparent AIFM will be deemed to be a letterbox entity. Three of these are relatively straightforward situations which ought not to cause major issues for most firms, although they may need to take some steps to ensure that they can show that the situations are not applicable to them. However there is one case which is controversial, on the final drafting of which there has been no public consultation and which will be challenging to apply in practice to some structures. This provides that the AIFM will be deemed a letter box entity and not the manager of the AIF if:

> "The AIFM delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself."

Investment management refers to portfolio and risk management, as defined in the AIFMD.

In assessing the extent of delegation, national regulators are required to take into account:

- the assets managed under delegation (the drafting leans towards this being a quantitative rest, but it is unclear); and
- specified qualitative criteria, including the importance of the assets managed under delegation for the risk and return profile of the AIF and the types of tasks delegated in relation to those retained and whether the AIFM and delegate are in the same corporate group.

Although the qualitative criteria provide some moderation to a test which at its crudest interpretation may be based solely on value of assets whose management is delegated, the clear message is that to avoid the risk of being categorised as a letterbox entity an AIFM must perform a significant degree of day-to-day investment management itself, without delegation, and that, proportionally, this should not be significantly outweighed by the amount of day-to-day investment management that it has delegated.

This raises significant concerns that any substantial delegation of day-to-day investment management and risk management functions to a third party might render an AIFM a "letter-box" even in circumstances where it nonetheless retains the necessary powers, contractual rights, expertise and resources to supervise the delegate and is compliant with the strict requirements of Article 20 of the Directive on delegation.

Following a last-minute drafting change, the Regulation confers new powers on the Commission and ESMA in relation to the letterbox test. ESMA is empowered to issue guidelines to ensure consistent assessment of delegation structures across the European Union. The Commission has power to make further provisions on the letterbox test after two years and is tasked with monitoring the application of the letterbox provisions. This raises the unwelcome possibility that firms may need to revisit their analysis of whether their manager is a "letterbox" in light of policy announcements made after the Directive comes into force.

The calculation of leverage

Leverage has a wide meaning under the Directive, it is defined as "any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means". It includes any "financial and/or legal structures involving third parties controlled by the relevant AIF".

The Regulation provides further definition of what is meant by leverage and the basis on which firms must calculate leverage. This matters because:

- the meaning of leverage is important for those firms seeking to rely on the partial exemption for AIFM managing small AIF, since if the AIF it manages is/are leveraged the exemption will only be available if the assets under management (including those acquired through leverage) do not exceed €100 million.

- for firms who are within the Directive the detail is relevant for a number of reasons including because:

    - an AIFM is required to set a maximum level of leverage in respect of each AIF it manages;

    - an AIFM will be required to demonstrate that the leverage limits set are reasonable and are complied with at all times;

    - an AIFM must comply with specific reporting requirements to its regulator where the AIF's exposure calculated using the commitment method (see below) exceeds three times its net asset value.

In outline, the Regulation provides the following in relation to the calculation of leverage:

- leverage of an AIF should be expressed as a ratio between the "exposure" of an AIF and its net asset value;

- the exposure of an AIF must be calculated in accordance with two methods, the "gross method" and the "commitment method". The exact method of performing these calculations is complex. The commitment method broadly involves calculating the exposure of the AIF by way of the absolute values of its positions in instruments, assets or liabilities but takes account of hedging arrangements and netting between derivatives in reducing the overall exposure. The gross method is similar, in terms of calculating the absolute values of positions, but does not allow for hedging or netting;

- temporary borrowing arrangements (for instance, by way of bridging finance) can be excluded from the calculation of leverage but only if they are fully covered by contractual capital commitments from investors. Revolving credit facilities are treated as not temporary for these purposes;

- exposure contained within financial and/or legal structures involving third parties controlled by the relevant AIF must be included in the overall calculation *where those structures are specifically set up to directly or indirectly increase the exposure at the level of the AIF*.

While the meaning of the words we have italicised is not particularly clear, the underlying political objective was to ensure that hedge funds could not invest through SPV structures and take the exposure in those structures out of their leverage calculation.

A recital in the Directive makes it clear that this anti-avoidance mechanism is not intended to capture leverage at the level of a venture capital/private equity portfolio company. This recital is partly but not fully recognised in the Regulation. It provides that for AIFs whose core investment policy is to acquire control of non-listed companies or issuers, any leverage existing at the level of those non-listed companies and issuers should not be included in the calculation of exposure provided neither the AIF nor the AIFM acting on behalf of the AIF has to bear potential losses beyond its capital share in the company or issuer. The exact application of this provision remains politically controversial.

Capital and insurance requirements

An external AIFM must satisfy the basic own funds requirements under the Directive to hold own funds at least equal to the higher of (i) a quarter of annual fixed overheads and (ii) €125,000 plus 0.02% of assets under management above €250 million (up to €10 million). In addition an AIFM must choose between having either (i) qualifying professional indemnity insurance, or (ii) additional own funds, in each case to cover potential liability for professional negligence. "Own funds" is essentially "shareholder funds" after deducting adjustments, e.g. for losses.

Qualifying professional indemnity insurance

Where insurance is to be used as a substitute for additional capital the Regulation:

- specifies the risks that must be covered;

- requires cover for certain delegates;

- requires any excess to be covered by additional own funds; and

- specifies the minimum coverage for individual claims and aggregate claims with reference to the value of the portfolios managed by the AIFM.

Additional capital

Where additional capital is to be used to cover professional liability risks it must be at least equal to 0.01% of the value of the portfolios of AIFs managed, although the AIFM's regulator may reduce this to 0.008% if it is satisfied that professional liability risks are adequately covered by the available own funds on the basis of three years' historical loss data.

PII vs Insurance: implications

AIFM will need to consider which of the two options produces the least expensive outcome. It is not at all clear that the insurance option will be viable for many firms. The FSA has proposed imposing an additional requirement that UK AIFM using insurance hold further own funds to cover policy exclusions.

Overall adequacy rule

Each AIFM will be required to maintain "financial resources adequate to its assessed risk profile". This is virtually identical to the requirement currently applied to all UK FSA authorised firms, which is set out in the FSA's fourth threshold condition: the requirement for resources of the firm to be "adequate in relation to the regulated activities it carries on".

Quantitative requirements

Each AIFM will be required to implement operational risk policies as part of its risk management framework. As part of this, they must establish an historical loss database which records operational failures, loss and damage. The AIFM must use this database when formulating its risk management framework and must make internal reports on operational risk exposures and losses.

The operational loss database concept is borrowed from the advanced operational risk requirements applied to the largest EU banks. Its application to all AIFM, no matter what their size, appears completely disproportionate and risks diverting resource away from meaningful compliance monitoring activities.

AIFM with a "top-up" permission/UCITS managers

AIFM who are authorised to perform any of the MiFID services listed in Article 6 of AIFMD will need to comply with both the AIFMD minimum capital requirements outlined above and the requirements of the Capital Requirements Directive. AIFMs which are UCITS managers need to comply with the qualifying professional indemnity insurance/additional own funds and liquid assets provisions of AIFMD in addition to the UCITS Directive requirements.

Operating conditions

There are detailed provisions in relation to "Operating conditions". These address matters such as acting in the best interests of the AIF/investors in the AIF, due diligence, inducements, conflicts of interest, placing orders with other entities for execution, risk and liquidity management and investment in securitisation positions. Many of the provisions are very similar to those found in the MiFID. For the most part they bring additional layers of detailed requirements to day to day operations, but there will be aspects, for example the provisions on inducements, which may present practical challenges.

Risk management – functional and hierarchical separation test

In this context risk management means managing the risks relevant to the investment strategy. Despite the fact that different types of AIF have very different investment risk profiles, the Regulation adopts a one size fits all approach, its provisions being driven by political concerns about hedge funds. The risk management provisions are excessive for many AIF strategies and smaller AIFMs and will present many AIFMs with unnecessary costs and bureaucracy.

The Regulation requires all AIFMs to have a permanent risk management function and specifies the conditions that must be met to ensure that risk management is "functionally and hierarchically" separated from operating units, including the portfolio management function. The Directive recognised the need for proportionality in applying such a concept. The Regulation pays lip service to proportionality, but the drafting does not give the flexibility allowed by the Directive. The impact on firms will vary widely depending on their investment strategies and existing structures.

Organisational requirements

These provisions lay down detailed requirements as to the organisational structures within the AIFM. Many AIFMs will need to introduce additional procedures and record keeping to show compliance with them. In addition, the Regulation provides further detail on what firms must do to have an independent permanent and effective compliance function and the circumstances in which they must have a permanent internal audit function.

Depositaries

The provisions relating to depositaries are another area where there has been a further tightening of the provisions beyond those suggested in the ESMA advice to the Commission. This will present significant liability issues for those wishing to provide depositary services. For AIFMs and AIF investors, the issues are likely to focus on the impact of these provisions on cost and the availability of depositaries, particularly in those sectors which are not widely serviced by custodians currently.

Key issues include:

- near strict liability on depositaries for loss of relevant instruments/assets, for themselves and their sub-custodians (whether or not affiliated);
- the exact meaning of "loss" is not clear, it is defined very broadly and could include cases where the AIF/AIFM did not have good title to the instruments in the first place;
- it will be difficult for depositaries to avoid liability for losses occurring because of external events (i.e. which do not result from the acts or omissions of the depositary or its sub-custodian). The depositary will have to show that despite rigorous and comprehensive due diligence, it could not have prevented the loss. These requirements will be deemed to be fulfilled if the loss arises due to certain "force majeure" type events (e.g. wars, laws and regulations);
- the circumstances in which a depositary can transfer its liability so that a sub-custodian is liable to the AIF instead of the depositary are more limited;
- the Directive envisages that only certain assets must be held "in custody" by the depositary, and the liability provisions attach in respect of these assets. Therefore it is key to identify whether an AIF invests in instruments that must be held in custody. Uncertainty remains in some areas;
- the depositary must implement effective and proper procedures to reconcile cash flow movements and *perform* daily reconciliations – less frequent reconciliations are permitted in the case of "infrequent cash movements";
- the depositary's safe-keeping duties will apply a "look-through" basis to the underlying assets held by entities controlled directly or indirectly by the AIF or AIFM (except in the case of fund of funds as master feeder structures where there is a separate depositary for the underlying fund).

The burdensome requirements imposed on depositaries will have a knock-on effect for AIFM/AIF and their investors. It is likely that they will find that there will be substantially fewer depositaries prepared to accept the heightened risks (and increased regulatory capital requirements) of operating in the new regime; and those which are prepared to operate in the new climate may well charge significant fees for doing so.

Other topics addressed by the Regulation

Other topics addressed by the Regulation include:

- Valuation procedures.
- Transparency requirements – including detailed requirements regarding the content and layout of annual reports and the content and format of required disclosures to investors including remuneration disclosure.
- Some limited and high level third country rules in relation to co-operation agreements between competent authorities and third country supervisors.

Comment

The law which will take effect in July 2013 and the process by which it developed are rightly subject to strong criticism. However, firms wanting to continue doing business in Europe will need to find ways of complying, and they do not have much time to do so.

For further information on how we may be able to help you these issues please contact one of the following partners in our Financial Services and Markets Department or your usual contact at Travers Smith.

Travers Smith LLP
10 Snow Hill
London EC1A 2AL

T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

Margaret Chamberlain
margaret.chamberlain@traverssmith.com
+44 (0)20 7295 3233

Jane Tuckley
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238

Tim Lewis
tim.lewis@traverssmith.com
+44 (0)20 7295 3321

Phil Bartram
phil.bartram@traverssmith.com
+44 (0)20 7295 3437