

UK FSA Issues First Consultation on AIFMD Implementation

November 16, 2012

On 14 November 2012, the UK Financial Services Authority (FSA) published Part I (CP1) of its two-part consultation paper series on implementation of the Alternative Investment Fund Managers Directive (AIFMD) in the UK. The consultation period for CPI closes on 1 February 2013.

CP1 covers the following topics:

- the prudential regime for all types of alternative investment fund manager (AIFM);
- matters relating to depositaries; and
- the requirements on AIFMs contained within the AIFMD, including organisational matters, duties in relation to management of alternative investment funds (AIFs) and transparency obligations towards investors and regulators.

Part II of the consultation (CP2) will cover remaining topics relating to the AIFMD's implementation (see further below).

Context of Consultation and Implementation

The FSA's consultation is taking place in the context of significant reform of UK financial regulation due in the first part of 2013, when it is expected that the FSA will be split into, and succeeded by, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Under the draft reform legislation, the FCA will be both the conduct and prudential regulator for AIFMs. Transposition of the final rules implementing the AIFMD is intended to be located primarily in a new FCA rule sourcebook, "FUND".

In addition, HM Treasury will be consulting on legislative measures covering particular AIFMD matters, including options to apply differentiated regimes to certain smaller firms under the AIFMD, changes to the scope of activities which are regulated in the UK and the marketing requirements to be applied to AIFMs established outside the European Economic Area (non-EEA AIFMs) marketing AIFs into the UK by private placement.

Implementing measures also are being developed currently at the European level. Because the provisions in the European Commission's forthcoming implementing regulation (the Level 2 Regulation) will be directly applicable in each EU member state, the FSA will not be consulting on it once it is published, and will incorporate the Level 2 Regulation into the FCA's rules in large part by reference rather than strict copy out. Firms therefore will be responsible for ensuring that they are complying with the detailed provisions of both the FCA's rules and the Level 2 Regulation, and should familiarise themselves with the Level 2 Regulation detail when it is published.

Additionally, the European Securities and Markets Authority (ESMA) also is tasked with developing certain implementing measures; for firms, the two most important will be:

- draft regulatory technical standards (RTS) and related material on key concepts and types of AIFMs, following ESMA's discussion paper of February 2012; and
- final guidelines on remuneration policies and practices, following ESMA's consultation paper of June 2012.

Provided that the various consultations and drafts are published as expected, the FSA intends that CP2 will cover issues arising from the forthcoming Treasury and European consultations.

Scope and Types of AIFM

While matters concerning the scope and regulatory perimeter of the AIFMD are still the subject of continuing work at the European level and therefore not covered in great detail in the FSA's consultation, the FSA has set out its views on a few notable issues.

- Asset managers structured as English limited partnerships will not be able to become AIFMs because they do not have separate legal personality under English law, as the AIFMD requires an AIFM to be a "legal person".
- An entity may be out of scope of the definition of an AIF if its main business is a commercial activity, such as manufacturing goods or constructing buildings, or providing services to customers, although it is possible that an AIF may own such businesses without participating directly in the commercial activity being carried on. The presence of a substantial number of employees carrying on commercial activities might place an entity out of scope, whereas an AIF generally would employ relatively few people to manage its assets. This may be useful to

some types of REITS, for example.

- An example of a UK internally-managed AIF would be an investment company whose board retains control of all investment management functions, where no external manager has been appointed, and where the investment company employs staff to assist with investment management decisions.
- The FSA expects ESMA's draft RTS to address the difference between a closed-ended AIF and an open-ended AIF, and therefore will not be proposing its own definitions.

Authorisation Issues

The FSA has indicated that the Treasury will be proposing the following new regulated activities:

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

Establishing and operating a collective investment scheme (CIS) will remain a regulated activity but only in relation to CISs that are not AIFs or UCITS, which in practice will be very narrow in reach. This means that firms authorised to carry out the new regulated activities of managing an AIF or UCITS will not need permission to establish and operate a CIS in relation to the AIF or UCITS managed.

The FSA also has clarified its position on the transitional provisions. Firms currently not authorised by the FSA but which anticipate becoming AIFMs may wish to consider becoming authorised to operate a CIS before 22 July 2013 so as to take advantage of the transitional provisions in the AIFMD allowing up to a year to apply for authorisation as an AIFM, as these are not available to firms that will not be managing or marketing AIFs before that date. Firms that currently carry on business as an AIFM without needing to be authorised by the FSA – such as internally managed investment companies – also will be able to benefit from the transitional period.

The FSA also is considering establishing a "grandfathering" process to applications for variations of permission for firms currently holding permission to establish and operate a CIS, and will notify firms in due course of its intentions.

Finally, contrary to its previous publications, the FSA now does not expect that the FCA will be in a position to accept applications for authorisation (or variations of permission) until 23 July 2013.

Regulatory Capital Requirements

The FSA has noted the following changes in relation to the AIFMD's prudential requirements:

- Three new prudential categories will be created: collective portfolio management firm; internally managed AIF; and collective portfolio management investment firm (i.e., an AIFM that also undertakes certain services under the Markets in Financial Instruments Directive (MiFID) as permitted by the AIFMD).
- In the FSA's view, the AIFMD's initial capital requirements for AIFMs should be met out of own funds on an ongoing basis.
- Internally managed AIFs will need to meet the initial capital requirements out of their own funds on an ongoing basis as well as professional indemnity insurance requirements, but will not need to meet prudential requirements relating to funds under management and expenditure.
- Collective portfolio management investment firms will need to hold the higher of the AIFMD's own funds requirements and the capital requirements currently set out for firms undertaking the relevant MiFID-scope business.

Disclosure, Transparency and Reporting Requirements

Much of the detail regarding the disclosure, transparency and reporting requirements in the AIFMD will be supplemented by the Level 2 Regulation. In particular, disclosure requirements relating to portfolio company holdings, which will be of interest principally to private equity fund managers, will be discussed in CP2.

The following is noted in CP1:

- Where a fund's constitution currently does not require the disclosure of information to investors at least on request, it will need to be amended.
- AIFMs marketing non-EEA AIFs into the UK will be permitted to have the AIF's annual report audited in the country where it is established, provided the process meets international accounting standards.
- The FSA expects the first regulatory reporting deadline to be October 2013 for certain very large AIFMs that are not operating under the transitional provisions relating to authorisation.

Depositories

The FSA has proposed, in conjunction with the Treasury, a "private equity AIF depository" model applicable to particular types of closed-ended AIFs, which will typically be private equity funds. The FSA proposes that firms other than just professional firms (such as lawyers and accountants) should be allowed to perform depository activities. These depositories would be authorised to act as depository of an AIF with a limitation to private equity AIFs, and would generally not hold assets in custody but would be permitted to do so if necessary. The FSA intends for these depositories to have lower regulatory capital requirements than depositories acting for other AIFs, recognising their more limited role under the AIFMD and the need for such limited depositories to provide competitive pricing to smaller fund managers. Taken together, the FSA proposals potentially open the way to new entrants into the custody/depository market.

Next Steps and Timing

For both private equity fund managers and managers outside the EEA, most of the detail is still to come in CP2. The FSA currently expects to publish CP2 in February 2013 but the precise timing will depend on the timing of the Treasury's consultation, expected in January 2013, as well as further European progress on AIFMD measures. According to the FSA, the European process for the adoption and agreement of Level 2 had not yet begun by 14 November 2012, and so a delay to the publication of the Level 2 Regulation is anticipated, possibly into December 2012 or early 2013. ESMA's draft RTS and related material on key concepts and types of AIFMs is expected to be published in Q4 2012, with final guidelines on remuneration policies expected to follow in Q1 2013.

Provided the timing of these various publications proceeds as expected, the FSA intends to cover additional topics relating to AIFMD implementation in CP2, including the following:

- Further clarification on scope issues and supervisory regimes for smaller AIFMs.
- The retail regime, including the integration of current retail fund schemes and marketing to retail investors;
- Marketing to professional investors, including non-EEA AIFs;
- Further clarification on the Level 2 Regulation delegation requirements, including supervisory assessment of "letterbox entities"; and
- AIFMD provisions applicable principally to private equity fund managers, including portfolio company disclosure requirements.

The FSA expects that a final policy statement covering both consultations will be published in June 2013.

In the interim, firms would be wise to consider their positions in relation to the FSA's first set of articulated views. Firms currently authorised to operate a CIS may want, for example, to examine their current funds in light of the FSA's proposed regulatory capital rules and revisit their fund documents to ensure that investor disclosure is properly addressed. Firms not currently authorised but which anticipate becoming AIFMs should consider in particular whether they want to become authorised as CIS operators before 22 July 2013 to take advantage of the AIFMD's transitional provisions.

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