Proskauer

The European Commission Adopts AIFMD Implementing Regulation

December 20, 2012

On 19 December 2012, the European Commission (the Commission) adopted implementing rules (the Regulation) for the Directive on Alternative Investment Fund Managers (the AIFMD or Directive). The Regulation supplements certain elements of the Directive and contains implementing rules which will have direct effect in EU member states on application without the need for national implementing legislation. The rules in the Regulation concern the following topics:

- the calculations of assets under management (AuM), leverage and capital requirements in relation to professional liability risks applicable to alternative investment fund managers (AIFMs);
- operating conditions for AIFMs, including general principles, conflicts of interest, risk management, liquidity management, investment in securitisation positions, organisational requirements, and rules on valuation;
- conditions for delegation;
- rules on depositaries, including the depositary's tasks and liability;
- transparency, reporting and disclosure requirements; and
- rules for cooperation arrangements.

The Regulation is subject to a three-month scrutiny period by the European Parliament and the Council and will enter into force, provided that neither of these European co-legislators objects, the day following publication in the Official Journal at the end of the three-month period. It is not expected that the Parliament or Council will object to the Regulation.

While the published rules are extensive, the following summary highlights some of the key points of the Regulation.

Calculating assets under management

The Regulation establishes the procedure to be followed by an AIFM when calculating its AuM and the methodology to be used for specific categories of assets. The AIFM must calculate total AuM by determining the value of all assets it manages, without deducting liabilities, and valuing financial derivative instruments at the value of an equivalent position in the underlying assets. The following applies to AuM calculation:

- UCITS for which the AIFM acts as the designated management company are excluded;
- alternative investment funds (AIFs) managed by the AIFM for which the AIFM has delegated functions are included, but portfolios of AIFs managed by the AIFM under delegation are excluded;
- an investment by an AIF into another AIF managed by the same externally appointed AIFM is excluded;
- an investment by one compartment of an AIF into another compartment of that AIF is excluded; and
- AIFMs should take into account subscription and redemption activities, capital draw downs, capital distributions and the value of assets invested in for each AIF.

The Regulation also requires AuM to be constantly monitored by the AIFM and action to be taken when the AIFMD's scope thresholds are occasionally breached.

Additional own funds and professional indemnity insurance

Under the Directive, AIFMs must hold appropriate additional own funds or professional indemnity insurance (PII) to cover potential liability risks arising from professional negligence. The Regulation sets out the appropriate levels of such additional own funds or PII coverage.

Under the Regulation, if an AIFM chooses to hold additional own funds, they must represent at least 0.01% of the value of the portfolios of AIFs managed, subject to ongoing adjustments to reflect the risk profile of the AIFM. EU member state regulators may decide to lower this amount for particular AIFMs to 0.008% but only if they are satisfied, based on historical loss data covering at least three years prior to the assessment, that the AIFM provides sufficient additional own funds to appropriately cover professional liability risks. Member state regulators can also require an AIFM to provide additional own funds higher than 0.01% if it is considered necessary.

The Regulation requires that PII coverage, if chosen, must equal 0.7% of AuM per individual claim and 0.9% of AuM for claims in aggregate per year. If an AIFM chooses to use PII, it may be provided by an appropriately authorised EU or non-EU insurer.

Liquidity management

Under the Directive, an AIFM must employ, for each AIF it manages that is not an unleveraged closed-ended AIF, an appropriate liquidity management system, and to adopt procedures that enable it to monitor the AIF's liquidity risk and ensure that the liquidity profile of the AIF's investments complies with its underlying obligations.

The Regulation specifies that the liquidity management systems and procedures should allow AIFMs to apply tools and arrangements necessary to cope with illiquid assets, which may include "special arrangements" (such as "side pockets"). These tools and arrangements may be used only if the fair treatment of all AIF investors has been taken into account and appropriate disclosure to investors has been made.

Additionally, under the Regulation AIFMs should, where appropriate considering the nature, scale and complexity of each AIF they manage, set up suitable limits for the liquidity or illiquidity of the AIF consistent with its underlying obligations and redemption policy. AIFMs should conduct stress tests at least annually, and must act in the best interest of investors in relation to the outcome of any stress tests.

Organisational requirements

AIFMs must use, at all times, adequate and appropriate human and technical resources necessary for the proper management of AIFs, including administrative and accounting procedures and adequate internal control mechanisms. The Regulation requires AIFMs to establish a well-documented organisational structure that clearly assigns responsibilities and reporting lines, defines control mechanisms and ensures effective internal reporting and communication of information among all parties involved within and external to the AIFM.

When allocating functions internally, the AIFM must ensure that the governing body, the senior management and, where relevant, the supervisory function are responsible for the AIFM's compliance with its obligations under the AIFMD. Under the Regulation, an AIFM's senior management is allocated a number of responsibilities and duties, including:

- implementing the general investment policy for each managed AIF;
- overseeing the approval of the investment strategies for each managed AIF;
- ensuring the establishment and implementation of AIFMD-compliant valuation policies and procedures;
- ensuring that the AIFM has a permanent and effective compliance function;
- approving and reviewing the risk management policy and arrangements for each AIF managed; and
- establishing and applying a remuneration policy in line with the requirements of the AIFMD.

The permanent compliance function and the permanent internal audit function should be separate and independent from other functions in order to be able to fulfill their tasks. When establishing the procedures and structures required under the Directive, AIFMs should take into account the principle of proportionality which allows procedures, mechanisms and the organisational structure to be calibrated to the nature, scale and complexity of the AIFM's business and to the nature and range of activities carried out in the course of its business.

This may require some internal reorganisation by AIFMs.

Valuation

Under the Directive, the AIFM must ensure that, for each AIF it manages, appropriate and consistent procedures are established so that a proper and independent valuation of the AIF's assets can be performed in accordance with the AIFMD and applicable national and AIF rules.

The Regulation requires an AIFM to establish, maintain and implement for each AIF policies and procedures for the valuation of assets, and sets out the main features of such valuation policies and procedures. If a model is adopted to value the assets of an AIF, the model and its main features must be explained and justified in the valuation policies and procedures, and the AIFM must document the reasons for choosing the model, the assumptions and their rationale, and the limits of the model-based valuation. The Regulation requires consistent application of valuation policies and procedures, and further sets out rules for the periodic review of valuation policies and procedures, the review of individual values of assets, the calculation of the net asset value per unit or share, the professional guarantees to be provided by an external valuer and the frequency of valuation of assets held by open-ended AIFs.

AIFMs should review their valuation models and processes with a view to ensuring compliance with these regulations.

Delegation of AIFM functions

The AIFMD permits AIFMs to delegate the performance of some of their functions, subject to the satisfaction of certain conditions and provided the AIFM is not deemed to be a "letter-box entity" as a result of the delegation. The Regulation sets out the conditions under which the AIFM is permitted to delegate, taking into account the fact that an AIFM should not be prevented from acting in the best interests of its investors and must retain responsibility for the delegated functions. Under the Regulation, an AIFM will be deemed to be a letter-box entity and no longer the manager of the AIF in at least any of the following circumstances:

- the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the implementation of the general investment policy and investment strategies;
- the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice; or
- 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.

When assessing the extent of delegation, member state regulators must assess the entire delegation structure taking into account not only the assets managed under delegation but also certain qualitative criteria (including, for example, whether the delegation is conferred on a group entity).

According to the Commission, the cumulative effect of these conditions is that the AIFM must, therefore, perform at least functions relating to either risk or portfolio management where delegation has occurred.

This section of the regulations is likely to significantly impact a number of firms which operate within the EU, operating as a delegate of an offshore manager, for example an adviser. This is because in order to avoid delegation of the investment management function "by a substantial margin", the operations of the offshore manager may need to be bolstered, so that the onshore adviser does not become the AIFM.

The reversion of the Commission to a qualitative, rather than a quantitative, assessment of when a letter-box entity is taken to exist, is to be welcomed.

Importantly, the Commission is to review the letter-box entity conditions in 2015 and may, if necessary, take further measures to specify additional conditions. The European Securities and Markets Authority (ESMA) is also empowered to issue guidelines to ensure consistent assessment of delegation structures across the EU member states.

Depositaries

The Regulation sets out detailed provisions about the obligations and rights of depositaries, including the scope of custody requirements. These provisions will require custodians significantly to review internal processes, risk assessments and policies as well as their documentation with clients and delegates.

Under the Regulation, all financial instruments which can be registered in an account (including transferable securities such as shares or bonds, money market instruments and units in collective investment undertakings) and which belong to an AIF must be held in custody. Financial instruments that in accordance with applicable national law are only registered in the name of the AIF with the issuer or its agent, such as investments in non-listed companies by private equity and venture capital funds, should not be held in custody. All financial instruments capable of being physically delivered to the depositary must be held in custody.

Assets belonging to an AIF which are subject to collateral arrangements must also be held in custody. The Commission suggests that custody can be arranged in several ways:

- the collateral taker is the depositary of the AIF or is appointed by the AIF's depositary as sub-custodian over the AIF's collateralised assets;
- the AIF's depositary appoints a sub-custodian that acts for the collateral taker; or
- the collateralised assets remain with the AIF's depositary and are "earmarked" in favour of the collateral taker.

The Regulation also contains particular requirements with respect to the oversight and control function of a depositary in order to enable it to properly assess and supervise the AIFM. The AIFM must provide the depositary with all instructions related to the AIF's assets and operations to facilitate the depositary's ex-post controls and verifications, and must also provide all other relevant information the depositary will need to carry out its oversight functions.

Loss of financial instrument, external event etc

Under the AIFMD, the depositary's liability is not affected by any permitted delegation of its functions. The depositary will be liable to return an instrument in custody if the loss of that instrument is caused by events in the operational sphere of a depositary or its appointed sub-custodians. The Regulation provides that a loss of a financial instrument is deemed to have taken place when, in relation to a financial instrument held in custody by the depositary or sub-custodian, any of the following conditions are met:

- a stated right of ownership of the AIF is demonstrated not to be valid because it either ceased to exist or never existed;

- the AIF has been definitively deprived of its right of ownership over the financial instrument; or
- the AIF is definitively unable to directly or indirectly dispose of the financial instrument.

Insolvency of a sub-custodian, accounting errors, fraud or operational failures on the part of the sub-custodian (such as a failure to apply segregation requirements) would also give rise to the return obligation on the part of the depositary while external events, such as natural disasters, acts of public authority or government measures, or major upheavals would not, unless it is proved that the loss could have been prevented.

Under the Directive, a depositary is permitted to contract a discharge of liability regarding a delegation to a third party provided certain conditions are satisfied, including that a written contract establishes the objective reasons for such a discharge. The Regulation provides that the objective reasons for contracting a discharge of liability must be:

- limited to precise and concrete circumstances characterising a given activity;
- consistent with the depositary's policies and practices; and
- established each time the depositary intends to discharge itself of liability.

A development is that the depositary is deemed to have objective reasons for contracting a discharge of its liability to third parties when it can demonstrate that the depositary had no other option but to delegate. This can be demonstrated when either (a) the third country laws of the delegate satisfy the requirements of delegation of depositary functions (Art 21 (11)) or (b) the AIFM insists on maintaining an investment in a particular jurisdiction despite warnings by the depositary as to the increased risk position that this represents. The earlier position of ESMA enabled a discharge if both (a) the depositary had no other option and (b) the AIF and AIFM acting on behalf of the AIF has notified the depositary in writing that it considers the delegation of custody to be in the best interests of the AIF and its investors.

So far as the selection of non-EU prime brokers and counterparties are concerned, these are not required to be subject to regulation equivalent to EU law.

Transparency

The AIFMD is heavily focused on transparency and disclosure issues in relation to investors and regulators, and the Regulation supplements these provisions with additional clarifications and requirements, including:

- minimum requirements for the content of the financial information and report on activities required to be included in the annual report under the Directive, reflecting recognised practices, accounting standards and rules;
- clarification on the disclosure requirements relating to remuneration, including that AIFMs must provide general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created, disclosing at least the information necessary to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interest;
- specification that periodic disclosure to investors takes place in accordance with the AIF's rules or instruments of incorporation, or at the same time as the offering memorandum, but as a minimum at the same time as the annual report is made available;
- the requirement that AIFMs must immediately notify investors where they activate gates, side pockets or similar special arrangements relating to liquidity management or where they decide to suspend redemptions; and
- the establishment of pro forma reporting templates, to be submitted to member state regulators on a half-yearly, quarterly or annual basis depending on AuM calculations and, if relevant, the investment policy of the AIF in question.

The Regulation also sets out when an AIFM is deemed to use leverage on a substantial basis. Under the Regulation, an AIF would be considered to be employing leverage on a substantial basis when its exposure, calculated using the "commitment method", exceeds three times its net asset value.

In relation to transparency, the disclosure requirements regarding remuneration that appear broader than the Directive (albeit continuing to focus on general disclosures) and the requirement that AIFMs must give immediate notification of gates, side pockets and similar special arrangements will continue to concern AIFMs.

Specific rules relating to third countries

There has been a relaxation of a former position regarding cooperation arrangements with non-EU countries and equivalence requirements for data protection in those countries. The equivalence requirement was a potentially serious impediment to the conclusion of cooperation agreements with third countries, with the potential consequence that AIFMs in those third countries may not be able to market funds under EU member state private placement regimes and third parties based in those countries may not act as delegates to EU AIFMs.

Conclusion

Much detail is added to the framework of the Directive through the Regulation and the Regulation provides significant technical detail to aid such matters as calculating assets under management and when a manager may be regarded as a letter-box entity, for example. However, much of the detail regarding matters outside of the areas of the Directive covered by the Regulation will require further interpretative guidance from ESMA and national regulators, such as that set out in the proposals put forward by ESMA below. In many ways, this guidance may prove to be more critical in the implementation of the Directive than the Regulation itself.

ESMA consults on key concepts relating to AIFs and AIFMs under the AIFMD

On 19 December 2012, the European Securities and Markets Authority (ESMA) published two consultation papers regarding the Directive on Alternative Investment Fund Managers (the AIFMD or Directive), with the purpose of ensuring common, uniform and consistent application of the Directive across the EU.

One consultation paper, entitled "Guidelines on key concepts of the AIFMD", sets out to provide guidelines on the definition of an alternative investment fund ("AIF"). The second consultation paper, entitled "Draft regulatory technical standards on types of AIFMs", provides draft regulatory technical standards (RTS) to determine the types of alternative investment fund managers (AIFMs) under the Directive, relating specifically to AIFMs of closed-ended or open-ended funds.

Both consultations are open until 1 February 2013, and ESMA aims to issue final guidelines and RTS in the first half of 2013.

ESMA's draft guidelines regarding the definition of an AIF

Under article 4(1)(a) of the Directive, "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) do not require authorisation pursuant to [the UCITS Directive]".

Importantly, under the draft guidelines all of the elements included in the definition of an AIF under the Directive must be present for an entity to be considered an AIF. For example, undertakings which do raise capital from a number of investors, but do not do so with a view to investing it in accordance with a defined investment policy, should not be considered AIFs for the purposes of the AIFMD.

Collective investment undertaking

ESMA proposes that the following characteristics, if all of them are exhibited by an undertaking (or an investment compartment of it), should show that the undertaking is a "collective investment undertaking":

- the undertaking is not an ordinary company with general commercial purpose;
- the undertaking pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors from investments (whether or not different investors receive returns on different bases); and
- the unitholders or shareholders of the undertaking have no day-to-day discretion or control over the management of the undertakings' assets.

ESMA defines a "pooled return" 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.

Raising capital

An activity with the following characteristics is considered to be "raising capital", regardless of whether it takes place only once, on several occasions or on an ongoing basis:

- 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 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.

It is not likely to be within the scope of "raising capital" when capital is invested in an undertaking by a natural or legal person or body of persons who is one of the following:

- a member of the governing body of that undertaking or the legal person managing that undertaking;
- an employee of the undertaking or of the legal person managing the undertaking whose professional activities have a material impact on the risk profiles of the undertakings they manage and into which he or she invests; or
- a member of a group of persons connected by a close familial relationship that pre-dates the establishment of the undertaking, for the investment of whose private wealth the undertaking has been exclusively established.

However, the criterion of "raising capital" is fulfilled if at least one investor who is not one of the persons mentioned above invests in an undertaking. The fact that an investor who is one of the persons above invests alongside an investor who is not does not bring the undertaking outside the scope of the definition of an AIF. Additionally, whenever such a situation does arise, and the undertaking qualifies as an AIF, all investors should enjoy full rights under the AIFMD.

Number of investors

A collective investment undertaking should be regarded as one which raises capital from a number of investors if it is not prevented by its national law, the rules or instruments of incorporation, or any other provision or arrangement of binding legal effect, from raising capital from more than one investor. ESMA proposes that this should be the case even if:

- it has in fact only one investor; or
- if a sole investor invests funds which it has raised from more than one legal or natural person for the benefit of those persons as in the case of nominee arrangements, feeder structures or fund of fund structures that have more than one investor for the purposes of the AIFMD.

It is essential therefore that fund managers who wish to ensure that a single-investor fund falls outside the scope of the AIFMD draft or amend fund documents so as to provide for an enforceable obligation which restricts the sale of units or shares in the fund to a single investor.

Defined investment policy

Under ESMA's draft guidelines, an undertaking which has a policy about how the pooled capital in the undertaking is to be managed to generate a pooled return (as defined by ESMA) for the investors from whom it has been raised should be considered to have a defined investment policy for the purposes of the AIFMD.

ESMA sets out that the following factors could, singly or cumulatively, tend to indicate the existence of a defined investment policy:

- 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 (including any guidelines given for the management of an undertaking which determine investment criteria for purposes other than those set out in the business strategy followed by an ordinary company with general commercial purpose), with reference to criteria including the following:
    - to invest in certain categories of asset, or conform to restrictions on asset allocation;
    - to pursue certain strategies;
    - to invest in particular geographical regions;
    - to conform to restrictions on leverage;
    - to conform to minimum holding periods; or
    - to conform to other restrictions designed to provide risk diversification.

However, the absence of any or all of the factors above should not be considered as conclusive that no such defined investment policy exists.

Collectively, these proposals go some of the way to giving guidance on when a fund vehicle might be regarded as being an AIF. For example, the single investor fund guidance provides reasonable clarity on what must be done to take the fund outside of the AIFMD. For other types of structures, the position is less explicit. For example, does a permanent capital vehicle raise capital in the required sense? Do carried interest vehicles invest in accordance with a defined investment policy? The outcome may need to be inferred from the consultation and the precise characteristics of each structure, rather than any express guidance on the point.

ESMA's draft RTS on types of AIFMs

ESMA's current consultation regarding RTS on types of AIFMs focuses only on the characteristics that distinguish whether an AIFM manages an AIF of the open-ended or closed-ended type, which in turn affects the application of certain rules on liquidity management, valuation and transitional provisions in the AIFMD. ESMA may consider the development of further RTS addressing different types of AIFMs, where relevant to the application of the Directive.

Under ESMA's draft RTS, an open-ended AIF is one whose unitholders or shareholders have the right to redeem their units or shares out of the assets of the AIF where all 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 or 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.

The lock-up period referred to above is considered to cover any minimum holding period during which unitholders or shareholders do not have the right to exercise their redemption rights. For the purposes of the definition it is of no consequence whether that period is set at the AIF level, with reference to the date of creation of that AIF or the date of commencement of activities, or at each individual unitholder or shareholder level, with reference to his or her date of subscription.

According to the draft RTS, an AIFM managing an open-ended AIF is an AIFM of open-ended AIFs. An AIFM of closed-ended AIFs is an AIFM managing AIFs other than the open-ended AIFs described above.

It is useful to have some proposals clarifying the criteria that are applied to characterising an AIF as being either open- or closed-ended. The one year period in particular is generous in terms of characterising a fund as being open-ended, although this is not out of line with practices in some European countries. However, the existence of a side pocket or similar arrangement should not serve to recharacterise the entire fund as being closed-ended.

Related Professionals

- **Arnold P. May**
  Partner
- **Amanda H. Nussbaum**
  Partner
- **Scott S. Jones**
  Partner
- **Charles (Chip) Parsons**
  Partner
- **Jamiel E. Poindexter**
  Partner
- **Marc A. Persily**
  Partner
- **Ira G. Bogner**
  Managing Partner
- **Sarah K. Cherry**
  Partner
- **Bruce L. Lieb**
- **Nigel van Zyl**
  Partner
- **Mary B. Kuusisto**

Partner

- **Malcolm B. Nicholls III**
  Partner
- **David W. Tegeler**
- **Howard J. Beber**
  Partner
- **Robin A. Painter**
- **Christopher M. Wells**
- **Stephen T. Mears**
  Partner