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AIFMD – Initial Guidance and Advice



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A What is the AIFMD?

The Alternative Investment Fund Managers Directive (the “AIFMD”) is a piece of European legislation borne largely out of European politicians’ response to the financial crisis of 2008 to 2009. It entered into force throughout the EEA on 21 July 2011 and was required to be implemented by member states on 22 July 2013. The aim of the AIFMD is to bring a harmonised regulatory framework across the EEA for alternative investment fund managers (AIFMs) in the EEA and to enhance investor protection. To this end, it covers a large number of areas, including:

- conduct of business
- remuneration
- delegation
- reporting and transparency
- risk
- liquidity
- depositary duties and liabilities

By nature of its EEA application, it provides a passport for managing and distributing alternative investment funds (AIFs) to professional investors throughout the EEA.

As indicated by its name, the AIFMD hinges on the investment manager and it is this entity which is regulated, which then impacts upon the fund.

B Who is affected by the AIFMD?

The triggers for the AIFMD to apply are the actions and location of the AIFM and, as described above, its impact falls largely on the AIFM, but also to an extent on the fund (the “AIF”).

This leads to ask who is an AIFM and what is an AIF? Looking directly at the definitions in the legislation:

1. “AIFs” are 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 Article 5 of Directive 2009/65/EC (i.e. are not UCITS funds).
2. “AIFMs” are legal persons whose regular business is managing one or more AIFs; and
3. “managing AIFs” means performing at least the investment management functions of portfolio management and/or risk management of an AIF.

The AIFMD itself states that it applies to:

- (a) EU AIFMs which manage one or more AIFs irrespective of whether such AIFs are EU AIFs or non-EU AIFs;
- (b) non-EU AIFMs which manage one or more EU AIFs; and
- (c) non-EU AIFMs which market one or more AIFs in the European Union irrespective of whether such AIFs are EU AIFs or non-EU AIFs.

Thus, the definitions of each are broad. The AIFMD covers funds which are open and closed ended, in and outside the EEA, regardless of their legal structure, and the EEA managers (i.e. those who are at least the portfolio manager and/or risk manager) of all those funds as well as non-EEA managers marketing funds in the EU.

To summarise, an AIF is any fund which is not covered by the UCITS IV Directive (thus including hedge funds, private equity funds, commodity funds, venture capital funds, real estate funds and investment trusts) and an AIFM is the entity which is appointed to be the portfolio and/or risk



manager of such an AIF. Each AIF must have one AIFM, with delegation of either risk management or portfolio management (but not both) being permissible, subject to AIFMD rules.

Please note that it is possible for the internal management of an AIF not to appoint an AIFM, but in this case, the AIF will be deemed self-managed for AIFMD purposes and itself considered the AIFM. It will therefore be required to act as such in accordance with the AIFMD.

The impact of the AIFMD on AIFMs depends on the size of the assets under management of the AIFM. Those whose assets under management in AIFs (thus not including “true” managed accounts which have a single investor) of under €100 million will fall into the category of small AIFM and be regulated as such (though it may elect to be regulated as a full-scope AIFM). This can be described as falling under a “register and report” regime.

Those AIFMs whose assets under management in AIFs are €100 million or over will fall into the category of a full-scope AIFM and be regulated as such. This requires compliance with all aspects of the AIFMD.

C Key Features of the AIFMD

1 Calculation of thresholds and regulatory capital requirements

As explained above, AIFMs whose assets under management in AIFs meet the threshold of €100 million or above will fall into the category of a full-scope AIFM and be regulated as such. When calculating assets for this threshold, the assets under management of every AIF managed by the AIFM must be included and derivative instruments should be converted into their equivalent position in the underlying asset. This calculation must be completed at least annually.

Where an AIFM is full-scope, its capital requirements are: (i) the higher of either €125,000 or one quarter of the AIFM’s fixed overheads in the previous year; and (ii) 0.02% of the value of the AIFs in excess of €250 million, subject to a cap of €10 million. Up to 50% of this

second amount may be met by a guarantee from a bank or insurer. For the purposes of the AIFMD, fixed overheads would include (amongst other things) salaries, guaranteed bonuses and rent.

A self-managed AIF must have a fixed amount of capital equal to at least €300,000.

In addition, each AIFM must also either take out professional indemnity insurance or have additional own funds available. Where using insurance, cover must meet 0.9% of assets under management for claims in aggregate per year and 0.7% of assets under management per individual claim. Where using own funds, the AIFMD must hold between 0.008% and 0.01% of the value of its AIFs. This amount is subject to on-going adjustments to reflect the AIFM’s risk profile. These funds must be held in liquid assets or assets which can be readily converted to cash, but may not include speculative positions. This prevents an AIFM from using own funds as working capital, but it appears that this restriction should be construed as applying only to balance sheet assets held as a result of the subscription of own funds in order to meet capital requirements imposed by the AIFMD, as opposed to all of an AIFM’s own funds.

For most FCA authorised private equity and real estate managers who were historically outside the scope of any EU financial services directive, the AIFMD imposes significantly higher capital requirements. Some UK firms are both operators of collective investment schemes (CIS) and exempt CAD firms (adviser and arrangers), so have an own funds and initial capital requirement of €50,000, and these firms will see their capital requirements increase significantly.

For AIFMs which were MiFID investment firms classified as BIPRU limited licence firms, there is not such an obvious change in their capital requirements. These AIFMs must continue to hold one quarter of fixed annual overheads as regulatory capital and will also be faced with new requirements for professional indemnity insurance and new restrictions on their use of own funds. However, the AIFMD requirements apply only at the level of the AIFM itself (CRD



requirements also apply to the group). A further potential benefit is that an AIFM is not required to perform an internal capital adequacy assessment process (ICAAP), or calculate capital requirements with reference to credit risk or market risk requirements.

2 Organisational requirements

Under the AIFMD, AIFMs are subject to appropriate governance and conduct of business standards and must have in place robust systems which manage risks, liquidity and conflicts of interest. These must include a well-documented organisation structure with clearly delineated roles and responsibilities, controls and necessary hierarchy.

The principle of proportionality will apply, with those AIFMs who manage large sums of money expected to be organised and structured in accordance with their size.

Other organisational requirements state that the AIFM must establish a permanent and effective compliance function, establish and maintain a separate internal audit function and set up a proper and independent valuation process. This valuation process is commonly performed externally with valuation procedures performed and review when necessary, but at least annually.

3 Conflicts of interest

Each AIFM must put in place administrative and operational structures which will minimise conflicts of interest and allow it to respond promptly and appropriately when any are identified. This is often achieved by setting out internal procedures and segregating tasks and responsibilities. There should be a conflicts of interest policy, which should be appropriate for the size and characteristics of the AIFM.

Conflicts must be recorded by the AIFM and disclosed to investors by website or by durable means, for example by an offering memorandum stating that the AIFM may act in the same capacity for other AIFs or investment vehicles.

While not wholly comprehensive, a list of possible conflicts of interest is set out in the legislation.

4 Liquidity

Where the AIF is leveraged and open-ended, the AIFM must put in place procedures to ensure that the liquidity profile of the AIF complies with its obligations. These obligations include:

- (i) maintaining an appropriate level of liquidity;
- (ii) considering the type of investors and investments and monitoring the liquidity profile when considering these characteristics;
- (iii) assessing the risks of all investments, including future investments on the liquidity profile; and
- (iv) dealing with conflicts of interest between redeeming investors and those who remain in the AIF.

In addition, certain matters must be disclosed to investors, for example any redemption rights granted under side letters. Investors must be aware of redemption policies, which are commonly set out in the offering memorandum.

The AIFM must test its liquidity management system at least annually and be able to foresee future liquidity issues.

5 Leverage

Each AIFM is required to set out the maximum leverage which each of its AIFs may employ and may be required to report more information to its regulator (for example where systemic leverage is employed), which may impose leverage restrictions.

Leverage is defined as “any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash securities or leverage embedded in derivative positions or by other means”.

Leverage is expressed as a ratio between the exposure of an AIF and its net asset value and AIFMs are required to calculate exposure by both “gross” method and “commitment” method. Information on these methods of calculation are found in the AIFMD and are both lengthy and complicated.



6 Remuneration

Remuneration policies and practices must be put in place and applied to those members of staff whose activities have a material impact on the risk profile of the AIFs. The principles behind these are laid out in the legislation and deal with the promotion of sound and effective risk taking.

The remuneration rules apply to remuneration of any type paid by the AIFM and any amount paid directly by the AIF, including carried interest, as well as to any transfer of shares or units of the AIF. Remuneration requirements include the following:

- (i) requirements for fixed remuneration (salary) and variable remuneration (bonus) to be appropriately balanced;
- (ii) restrictions on the amount of variable remuneration that can be paid without deferral (at least 40%, and in some cases 60%, must be deferred over at least 3 years);
- (iii) provisions on the payment and vesting of deferred amounts;
- (iv) provision for contraction (or non-payment) of variable remuneration for poor performance and clawback for amounts already paid;
- (v) at least 50% of variable remuneration to be paid in units or shares of the relevant AIF;
- (vi) restrictions on guaranteed variable remuneration; and
- (vii) requirements for staff in control functions to be paid by reference to objectives linked to those functions and not on the performance of the AIF and AIFM.

Categories of staff whose professional activities have a material impact on the risk profile of the AIF, include senior management, risk takers, employees whose remuneration takes them into the same bracket as senior management or risk takers and those performing control functions (such as legal, compliance, human resources and risk management staff).

An AIFM that is significant in terms of its size or the size of the AIF it manages is also required to

have a remuneration committee, the members of which must be non-executives.

How the rules will be implemented in the UK is not certain but there is a view that HM Treasury will try to be benign in its interpretation.

7 Valuation

The independent valuation of AIF assets is required and, to ensure this independence, consistent and appropriate procedures and a valuation policy must be put in place. Valuations must be made at least once a year, the frequency within that period depending on specific circumstances.

An AIFM may perform valuations itself, or arrange for an independent external valuer to perform this function. An AIFM that carries out its own valuations must ensure independence between the valuation and portfolio management functions. This may be particularly difficult for a small AIFM. The AIFM must also put in place measures to mitigate conflicts of interest arising in connection with in-house valuation (for example, arising from its remuneration policy) and to prevent undue influence on staff. An AIFM which carries out its own valuations may be required to have them or its valuation procedures verified by an external valuer or, where appropriate, an auditor. It is important to note that an AIFM will be responsible for valuations to the AIF and its investors, whether or not an external valuer is appointed.

All valuations must be performed impartially and with all due skill, care and diligence. The NAV calculation must be performed and disclosed in accordance with the AIF rules and applicable national law and there are additional criteria in the AIFMD implementing measures. Furthermore, details of the valuation procedures for an AIF (including pricing methodology and methods for valuing hard-to-value assets) must be made available to investors before they invest. This information must also be provided to an AIFM's regulator when the AIFM applies for authorisation.



8 *Risk management and portfolio management*

AIFMs perform the portfolio management and/or risk management of an AIF. An AIFM may delegate one of these actions, but not both. Where both are retained, there must be functional and hierarchical segregation between the two. This will mean employing sufficient staff for each role, and ensuring that staff are suitably qualified and able to comply with the hierarchy imposed by the AIFM. The risk management policy must be set out in a specific document.

Risk management systems must be adequate for each AIFM and suitable for each AIF, considering the AIF's characteristics along with market, credit, liquidity, counterparty and operational risks. The systems must be reviewed and, if needed, adapted, at least annually. On an ongoing basis they must be tested by stress testing, back testing and scenario analyses.

As noted above, if the internal management of an AIF decides not to appoint an AIFM, then that AIF will be self-managed and itself considered the AIFM and must act as such in accordance with the AIFMD.

9 *Delegation*

An AIFM may delegate one of either portfolio management or risk management, but not both. Restrictions on the delegation of AIFM functions are imposed to ensure that investors and regulators are notified, and that the AIFM does not become a mere letterbox entity. Thus, it must have a reasonable substance.

The AIFM must be able to justify any delegation by use of objective reasons such as economics, expertise and access to global trading capability. It must then conduct an evaluation of the delegate and its skills, structure and staff. An AIFM may only delegate to an appropriately authorised entity. An entity which has portfolio management delegated to it by an AIFM will be a delegated portfolio manager and not the AIF's AIFM and will still need to be authorised to carry on its actions.

When using delegation, the AIFM must remain liable and carry out ongoing reviews of the services provided by the delegate.

10 *Passporting*

Compliance with the AIFMD provides a European "passport" under which AIFMs can manage and market EU AIFs to professional investors throughout the EU, subject to compliance with demanding regulatory standards.

Under the "management passport", an authorised full scope AIFM may be appointed an investment manager of an AIF which is incorporated in any EEA member state.

11 *Securitisation investments*

The AIFMD plans to remove any misalignment between the interest of those who repackage loans into securities and those AIFs which invest in securities. To achieve this, before an investment is made, the AIFM must ensure that the original lender meets sound credit requirements. In addition, the AIFMD sets out certain rules on investment in securitisation instruments. For example, AIFs may only invest in such instruments if the original lender holds a net economic interest which amounts no less than 5% of the AIF's position. Where this 5% limit is breached, the AIFM must hedge or sell the AIF's position.

12 *Investing in equity*

Anti-asset stripping measures apply, along with specific rules on the reporting of holdings. These are designed for private equity funds and other illiquid strategies holding stock.

Disclosure obligations apply where an AIF acquires major holdings (starting at 10% of voting rights) in non-listed EU companies, as well as imposing obligations on AIFMs whose AIFs acquire control of EU companies (whether or not listed). "EU companies" means those companies who have their registered office in the EU.

The disclosure obligations differ depending on whether the investee company's securities are traded on an EEA regulated market or whether



it is a non-listed company i.e. it either has no traded securities or might have securities on non-EEA regulated markets (such as AIM or on certain PLUS Markets).

Disclosure rules do not apply where the investee company is a small or medium-sized enterprise (meaning it employs under 250 people in the EU and has either or both of: (a) an annual net turnover not exceeding EUR50 million; or (b) a balance sheet total not exceeding EUR43 million).

On voting rights, reporting to the FCA is triggered for a non-listed company where the AIF's interest in the voting rights reach, exceed or fall below 10%, 20%, 30%, 50% or 75%. The voting interest must be reported precisely.

On reporting to the FCA where control is gained, different triggers apply to listed and non-listed companies. For a non-listed company, control means control of more than 50% of the non-listed company's voting rights, whereas for a listed company the AIFM must look at the threshold for a mandatory bid under the Takeovers Directive which applies in the company's member state. In the UK, this is 30% of voting rights. For both, specific information must be reported to the FCA, the company and other shareholders within 10 working days.

Details of the information to be supplied is set out in the AIFMD. In summary it includes voting rights, conditions under which control has been obtained and the date on which control was reached, and while some information is the same for listed and non-listed companies, there are variations between the two.

13 *Depositaries*

An AIFM must ensure that the AIF to which it is appointed has contracted with a depositary. The depositary has three main duties, these being:

1. the oversight of key tasks – the AIFMD imposes control/focussed obligations on the depositary. For example it must confirm the accuracy of subscriptions and share issues, distributions and dividend payments and

confirm that valuation policies are both appropriate and effectively implemented;

2. cash monitoring - the depositary must ensure that cash accounts of the AIF are only opened with banks or authorised credit institutions. It must then reconcile cash movements each day and identify any which appear inconsistent. On an ongoing basis, it must monitor reconciliations, check its own records against those of the AIFM and produce an annual review of reconciliation procedures. The AIFM must ensure that the depositary receives the information it requires in a timely and accurate manner; and
3. the safekeeping of assets – those financial instruments which can be held in custody (i.e. those which may be registered or held in a depositary's name) are subject to a duty of due care and protection by the depositary. For example the depositary must ensure segregation, prepare reconciliations, assess all relevant risks and ensure that the AIF's ownership is verified. Other assets which are not held in custody by the depositary are subject to ownership verification and record keeping procedures by the depositary.

The depositary has strict liability imposed upon it for the loss of financial instruments held in custody, while the loss of other assets extends only to liability for fault. This imposition of strict liability inevitably leads to increased fee charges by depositaries.

A depositary may sub-contract its duties, including, in a limited set of circumstances and under strict conditions and transparency requirements, contractually transferring its liability. However, a depositary may only delegate its safekeeping duties, not its monitoring or oversight tasks, and the AIFMD requires that the depositary ensures, on an on-going basis, that its delegate:

- (i) has appropriate structures and expertise;
- (ii) is subject to effective prudential regulation (including capital requirements) and



- supervision, and periodic external audit if it will have sub-custody of financial instruments;
- (iii) segregates the depositary's client assets from its own assets and those of the depositary;
 - (iv) does not re-use AIF assets without informing the depositary in advance and obtaining the prior consent of the AIF (or the AIFM acting on its behalf); and
 - (v) performs the delegated functions in compliance with the standard of care required by the AIFMD for depositaries.

These requirements are more onerous than those historically applying under FCA rules, as these recognised the reality of what could be achieved with custody arrangements in certain jurisdictions. Nevertheless, the AIFMD does make some provision in acceptance of this i.e. where the law of a non-EU country requires that a local entity holds certain financial instruments in custody and there are no local entities that satisfy the delegation requirements, a local entity may be appointed provided that AIF investors are informed prior to their investment and AIF (or the AIFM on its behalf) instructs the depositary to delegate to that sub-custodian.

The appointment of the depositary must be by way of a written agreement signed by the depositary, the AIF and the AIFM. Where the AIF is established in the EEA, the depositary must be established in the same jurisdiction as the AIF. Prime brokers may be appointed as an AIF's lead depositary, but only if the depositary tasks are functionally and hierarchically separated from prime broker tasks and any potential conflicts of interest are properly identified, managed, monitored and disclosed to AIF investors.

14 Transparency and reporting

The AIFMD is designed to enhance transparency. Transparency requirements apply to disclosures to investors prior to investment, while on an on-going basis reporting obligations to regulatory authorities, detailed disclosures in AIF annual reports and AIFM disclosures about investment in investee companies must all be met.

Audited annual reports of each AIF managed by an AIFM must be made available to investors (on request) and regulators within six months of year end. These reports must be prepared in accordance with the accounting standards of the relevant member state (the FCA for UK AIFMs) and must include information specifically required by the AIFMD, such as details on remuneration (as set out above) and, in relation to private equity funds, certain disclosures regarding each non-listed EU companies over which the AIF has control.

Investors must be given information before they invest (these are commonly set out in the offering memorandum for the AIF), plus updates after investment when appropriate. Information to be disclosed includes investment strategy, the identity of service providers (and any delegates), valuation policy, any preferred treatment which may be granted to an investor and arrangements in place with prime brokers and depositary.

In addition, AIFMs must make regular reports on issues such as side pockets, any assets which are subject to special arrangements, material changes to liquidity, risk profile and any action taken if risk limits are exceeded, risk management systems, material changes to leverage and a total leverage employed during the relevant period, showing both minimum and leverage employed.

Reports must also be made to the regulator. The AIFMD provides reporting templates. These explain the frequency of reporting and the information to be reported. The information to be reported is extensive and includes details of the types of instrument traded, the markets traded and portfolio diversification. Diversification reports look at such issues as assets held subject to special liquidity measures, redemption policies, gating, risk profiles and risk management systems, the results of stress tests, market values, turnover and performance.

15 Third Countries

The AIFMD imposes conditions on the management and marketing of non-EU AIFs, and this is commonly known as the "third country issue". Currently in the UK, non-EEA investment



managers may market under a specific private placement regime which requires registering with the FCA and making certain reports. This is expected to fall away in July 2018, when only fully registered AIFMs will be able to market (and a non-EEA AIFM must choose which jurisdiction is suitable for it to be regulated by).

16 Inspection and Authorisation

Regulators are given wide powers of inspection and intervention under the AIFMD.

D How to apply to be an AIFMD

The AIFMD had to be transposed into national law and implemented by member states by 22 July 2013. However, an EU AIFM already operating before that date has a further year, until 22 July 2014, to obtain authorisation and become compliant with the AIFMD's requirements as a result of the transitional provisions set out in the Directive.

A UK AIFM is required to be authorised by the FCA and the FCA is under a statutory obligation to determine a new full-scope AIFM application within three months of receiving the complete application. The FCA can extend this period by a further three months if it considers an extension necessary and notifies the applicant. The statutory timeframe for determination will only start once the FCA deems the application complete.

Thus, to be authorised as a full-scope AIFM by the end of the transitional period, a complete application would need to be submitted at the latest by 22 April 2014.

The application process involves the AIFM submitting a considerable volume of information to the FCA on the relevant forms. The information required includes details of:

- (i) the AIFM's remuneration policies, compliance procedures and arrangements in relation to delegation, valuation, liquidity risk management and depositaries;

- (ii) any fees, charges and expenses borne by investors; and
- (iii) any preferential treatment granted to investors (for example, in a side letter), although the investor's identity need not be disclosed.

Further details will be required in respect of the AIF, including the AIF rules or instruments of incorporation and details of the risk profile of the AIF, the policy on use of leverage and any arrangements for collateral or the re-use of assets.

For a full-scope AIFM application, the following forms are required:

- (i) a Part 4A application form for wholesale investment firms (which include forms dealing with staff, basic details of the proposed business, a business plan and financial forecasts);
- (ii) Variation of Permission form for full-scope AIFMs;
- (iii) Schedule of AIFs for full-scope UK AIFMs; and
- (iv) Passporting forms (as relevant).

As set out below, part of the application includes submitting application forms for those individuals performing controlled functions. The FCA recommends that an AIFM is comprised of at least three individuals, but the actual number required should be proportionate to the size and number of AIFs involved and the complexity and structure of the firm itself.

The preconditions for granting authorisation broadly reflect the MiFID provisions requiring assessment of the suitability of the persons who conduct the business, the controllers and any close links.

Upon receipt of the application, a triage team will determine whether the application contains enough information to be assigned to a case officer. If the application is deemed to be incomplete, the FCA will notify the applicant and ask for the necessary information. Applications that are complete but contain missing information are required to be updated with



that information at least one month before the date on which the applicant anticipates being authorised. The FCA is required to complete the process within three months.

**This document is for general guidance only. It does not constitute advice.
March 2014**



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