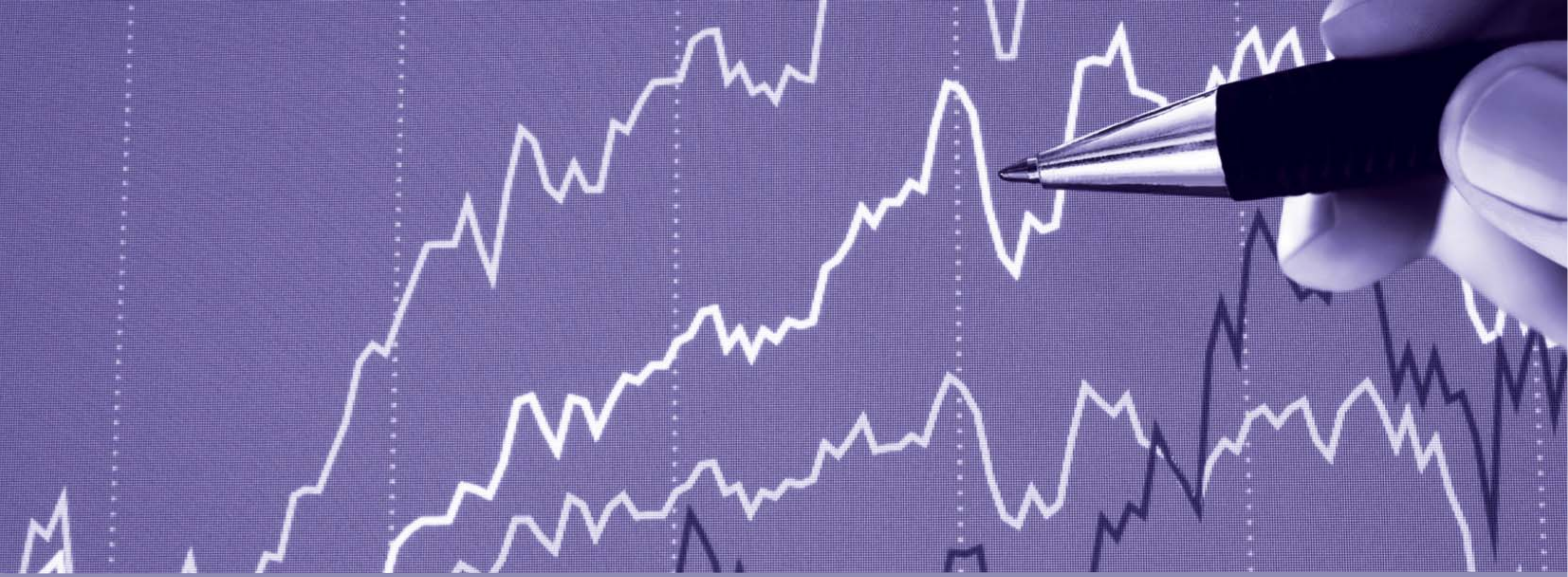

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Alternative Investment Funds 2014

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Engaging with the Regulation of Alternative Investment Fund Managers

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Only now is the true impact of implementation of the Alternative Investment Fund Managers Directive (AIFMD) becoming clear. Certainly a much better understanding of the scope of Directive has developed – but things are still not as clear as we might like, especially when trying to apply AIFMD to *existing* funds or fund models.

Even for those fund managers – and fund advisers such as ourselves – who approach this topic with experience from the more regulated end of the funds market spectrum, AIFMD has thrown up curiosities. Indeed, perhaps the more so because one is trying to fit in new AIFMD regulation on top of an existing regulatory framework.

This chapter seeks to highlight some of the issues which have arisen over the last transitional year, suggest how to take an orderly approach for analysing the impact of AIFMD for any new fund manager or project, and then identify emerging positive consequences – and possible trends and further challenges on the horizon – for those who become authorised Alternative Investment Fund Managers (AIFMs).

Progress Over the First Transitional Year

Considerable efforts have been made to work towards pragmatic and proportionate ways of applying the AIFMD provisions.

The vast majority of fund managers have (somewhat predictably) delayed transitioning until the last moment – taking advantage of the transitional year so far as is practicable. Indeed the AIFM application process may continue for some post 22 July 2014 (at the time of writing the UK is indeed changing its regulations so as to contemplate application processes continuing post 22 July).

Looking at the "post-AIFMD world" from 22 July 2014 or another end date to the transitional period for an established AIFM with a range of AIFs, what are the main consequences?

- **Updating the documentation**

  Obviously there is to be an AIFM appointment. In many cases, for existing funds, this is adapted from an existing Investment Management Agreement, whereby the identified AIFM takes responsibility for portfolio management and now possibly more formalised risk management responsibilities, and possibly a number of the additional AIFM fund management activities identified in Annex 1 to the Directive. It is not, however, simply a case of deciding on the extent of the AIFM's roles but also how it might perform such roles – and dealing with specific issues which are contained in Chapter III of the Directive; for example, take valuation issues in Article 19: how does the AIFM interact with other parties, notably the administrator and any external valuer?

  The Directive makes references to the terms of the Alternative Investment Fund (AIF)'s "rules or instrument of incorporation" (limited partnership agreement, memorandum and articles of association, instrument or other constitutive document). Although in many cases no specific change might be required, some revisions might for example be required:

  - to include the power to give preferential treatment (the terms of Article 12(1) require the AIF's rules or instrument to facilitate this);
  - to allow the depositary to discharge itself of liability where the law of a third country requires that certain financial instruments are held in custody by a local entity and there are no local entities that satisfy the delegation requirements (Article 21(14)(a)).

  In addition to these two key documents, there needs to be a review of the entire waterfall of a fund's contractual arrangements to make sure that the waterfall still works – and works in compliance with the AIFMD expectations, notably the delegation requirements.

- **Reviewing control and influences – and so the balance of power – of the parties involved**

  It is not simply a case of putting the relevant references in the relevant documents, however. The consequence of updating the documentation is inevitably that there are changes. Some are quite subtle but others are more major and might affect the basic powers and influences of the various parties involved in running a fund structure.

  If one is considering the relationships between entities within a single corporate group of a fund manager/promoter, this may not cause any difficulty. However, it is causing pause for thought in various fund structures where the position is more complex and includes parties outside of a group.

  Take the position of a corporate fund with an (independent) board of directors. If it wishes to operate on a self-managed basis and so there is an internal AIFM – it can keep its traditional investment management agreement for appointment of an investment manager. If, however, it decides it wishes to appoint an external AIFM, it may now be "giving up" some of its key responsibilities. If the board is to purport to retain controls on some aspects of them and yet the AIFM is to assume its appropriate responsibilities, there is some tension in the AIFM appointment contract. This issue has, for example, been acutely felt by members of boards of UK investment trusts who are conscious of their obligations as directors of a UK listed investment company.

  From the external AIFM's viewpoint, it must be concerned to ensure that it is assuming a greater role than simply that of an investment manager. The Directive imposes on it certain, and detailed, obligations and responsibilities, not just in relation to specific topics such as setting the maximum level of leverage but also in relation to all general operational issues, including to all manner of risk management and liquidity policy monitoring and liaison with regulators. The AIFM is the key entity which needs to comply with the regulatory framework and interface with the relevant regulator, and it will be the first port of call for any regulator which perceives any difficulty in relation to the AIFs it manages. It is somewhat inevitable that it will generally fall to the AIFM to ensure that it resolves AIFMD compliance matters because it is the party which is assuming responsibility from the regulator's perspective in most key respects. And remember that this Directive purports to focus on AIFMs rather than the AIFs themselves.

- **Formulating revised policies**

  A key focus has been reorganising to comply with the new organisational requirements expected of an AIFM, and in particular to document the risk management and liquidity management policies, upgrade conflicts of interest policies and introduce policies for complying with the AIFM Remuneration Code.

  Updating compliance and risk policies is particularly challenging for those AIFMs which are part of a group which manages a wide range of funds, not just AIFs. For those which also manage Undertakings for Collective Investment in Transferable Securities (UCITS funds), updating policies has specific challenges because there may be subtle differences between the requirements for the two product ranges. Note that UCITS V has just been settled in April 2014, and its implementation is just around the corner (by 2016) for those which also manage UCITS funds, with its new provisions relating to UCITS management company staff remuneration.

  To take the Remuneration Code issue, there are tricky decisions to be made on apportioning the relevant staff member's remuneration between the different types of business (AIFMD, UCITS and MiFID) in order to apply the relevant provisions.

- **Agreeing terms for the depositary appointments**

  This is new for some. Those operating in the more regulated end of the spectrum are adjusting existing arrangements – there has typically been an external appointed custodian. For UCITS funds this custodian has depositary roles which are quite specific, but the AIFMD provisions do take the depositary's roles and obligations and consequent liabilities somewhat further. For some structures though, such as many of the limited partnership private fund structures, there has never been an appointed custodian, with the general partner instead simply holding assets in its name or in a nominee's name.

  Depositaries have had to adjust their service offerings to encompass the extended AIFMD roles, re-price their services to reflect the assumption of such liabilities, and in some way address even the compromise text reached as to what happens if they need to replace "lost assets".

  Flexibility and choice are, however, offered if the concession in Article 21(3) of AIFMD to appoint a wider range of depositaries can be utilised. It assists many closed-ended AIFs which invest in property and private equity (in UK Financial Conduct Authority (FCA) provisions described as the "PE AIF Depositary").

  For the present, the new depositary agreements being put in place simply reflect the words of the text of the Directive and the Level 2 measures. It will be interesting to see how this works through once the boundaries of the new depositary roles are tested in practice.

- **Ensure compliance with the transparency requirements**

  All the above work then needs to be reflected in explanatory documents provided to investors – whether a prospectus or a private placement memorandum (PPM) or other offering document – and a document which provides the ongoing summary information is required to be available to investors. For some this is easy; say, for a non-UCITS retail scheme where there are existing prospectus document requirements and these simply need to be updated for AIFMD requirements. For others, though, such as a listed fund which may not have a current prospectus, there is a need to ensure that a current information document is made available.

  An important point to note is that transparency is not just *vis-à-vis* investors but also ongoing transparency to regulators. The necessary systems need to be put in place in order to comply with the detailed reporting formats required by the regulators.

When reduced to a series of bullet points, the process might seem suspiciously simple – and indeed various clients have thought that their AIFMD project might at first glance be one which should be relatively straightforward. However, the experience in practice is that much of the devil is in the detail, and AIFMD implementation projects are time-consuming.

Emerging Issues

Exploring just three examples of issues emerging from AIFMD transitioning projects might illuminate some of the difficulties.

First, there has been a temptation for some existing funds to do as little as possible in order to comply. To some extent this is understandable because, if a closed-ended fund – say a fixed-term limited partnership private equity or property fund – has already completed its fund-raising, it has presented a package to investors on the basis of which they have invested and so there is sound commercial reason for trying not to alter the position. Going forward, however, for new funds this argument will no longer be the case and a more positive embracing of AIFMD's approach might be be preferred.

The "minimal change approach" has been most evident from those who are least used to regulation. Ironically, those entities which are already (relatively speaking) more heavily regulated, are those ones which demonstrate the greatest wish to embrace the AIFMD regulation.

It will be interesting to see how the relevant regulators approach their supervision role once they start to receive reporting from AIFMs and investigate how AIFMs have adapted their contractual arrangements and organisational arrangements, and whether they think that they suffice.

Secondly, for various offshore fund structures, uncertainty from both the regulatory and tax perspectives has meant that, for the present, some of the fund structures have worked under what we would call "the old basis" so as to ensure offshore management and control, and no onshore AIFM.

We are seeing some new start-ups where ideally they would embrace the UK-authorised firm approach and so establish a UK AIFM but decide to take a lower level starting point, leaving the AIFM offshore (whether there is an offshore management company or a self-managed fund structure) and consequently limiting the scope of the UK FCA-authorised firm's mandate.

From the UK tax perspective where there is to be UK investment management, once the Section 363A Taxation (International and Other Provisions) Act 2010 is finally widened to refer to AIFs as well as UCITS schemes being deemed non-resident, the incentive to maintain AIFM management roles offshore should be reduced. Note, though, that there are three caveats to this:

- even when Section 363A is widened, care will need to be taken, as underlying SPVs will not benefit from it;

- where a fund is trading, there is still the additional issue that, in order to prevent the UK manager constituting a taxable permanent establishment, it will be necessary to satisfy the Investment Management Exemption (IME); and
- it remains necessary to review access to any double tax treaty networks.

As a result of these current regulatory and tax concerns, there has been a reluctance to determine that both existing and new offshore fund structures have a European Union (EU) AIFM.

This second issue has, as a consequence, further encouraged the take-up, at least initially, of the Article 42 option. Assuming the national private placement regime still remains in place in each relevant EU jurisdiction, and the relevant notification procedures are followed both in the fund's jurisdiction and in the EU Member State(s) into which the fund wishes to market its units, there can be a relatively straightforward continuation of marketing. Article 42 facilitates promotion without a passport of AIFs managed by a non-EU AIFM where:

- the non-EU AIFM complies with Articles 22-34 (transparency requirements);
- appropriate co-operation arrangements are in place for the purpose of systemic risk oversight and in line with international standards in place between the relevant authorities; and
- the third country where the non-EU AIFM or the non-EU AIF is established, is not listed as a non-co-operative country or territory by the Financial Action Task Force (FATF).

Work on developing the range of co-operation arrangements has been relatively rapid, covering the mainstream jurisdictions concerned following the European Securities and Markets Authority (ESMA)'s Guidelines on the Model Memorandum of Understanding (MoU) concerning consultation, co-operation and the exchange of information related to the supervision of AIFMD entities (see Article 34). One avoids the need to select a depositary. One avoids the need to appoint an AIFM and all the consequent organisational and compliance issues which go with that. So, somewhat ironically, the short-term likelihood is that the more *alternative* Alternative Investment Fund Managers and new start-up businesses, about which the regulators might expect to be most concerned, are reducing their exposure to the AIFMD regulatory requirements, at least for now, and remaining, so far as they can, offshore. Any real benefits of AIFMD *ought* in fact to come from the true alternative investment fund managers seeking for the first time to embrace a more regulated environment for their AIF management activities, but this may not happen initially to the extent hoped.

Thirdly, and meanwhile, many established household name financial institutions with major EU-based organisations work to adjust to AIFMD. For those with funds at the most regulated end of the AIF spectrum, take for example UK non-UCITS retail schemes where there is a detailed regulation under the UK Collective Investment Schemes Sourcebook (COLL) on quite a prescriptive basis as to how they must operate – we are struggling to fit the AIFMD system now introduced on a copy-out basis under the new UK FUND Sourcebook with the existing and continuing COLL Sourcebook. (At the moment there is simply one sentence which indicates that, in the event of a conflict, FUND (and so AIFMD) prevails because it had been too difficult in the time available to adjust the COLL Sourcebook to fit and to complete the writing of the FUND Sourcebook.) But it seems that little advantage will in fact be achieved once the two regimes are rationalised: it will simply be a slightly different way of achieving a high level of detailed regulation. So, although there will likely be a cost in adjusting, there will probably be little if no commensurate benefit.

Required Analytical Approach to AIFMD Compliance

Our experience is that, even for those AIFMs which have relatively "straightforward" circumstances, matters are usually not as straightforward as they might at first appear. A key difficulty with the Directive from the start has been that it encompasses all non-UCITS funds, and one of the key problems with it remains that "one size does not fit all".

Differing approaches are now, as you might expect, starting to emerge for different sectors of the marketplace, whether for hedge fund managers, private equity fund managers or property fund managers. Even within particular sectors, distinctions are emerging depending on the precise nature of the strategy followed by a particular fund and its particular management arrangements. Bespoke alternative fund offerings need to devise their own appropriate route through the AIFMD requirements.

In developing workable AIFMD-compliant models for various types of AIFs for the future, it is important to consider the fundamental considerations from first principles – and approach these logically. It is important not to jump into a specific detailed point.

To sketch out a generally workable approach to the analysis required, whether for an existing model or a new fund proposition:

- **Identify whether indeed there is an AIF**

  We are still dealing with basic questions around the identification of AIFs and their categorisation.

  Some of the Questions and Answers (Q&As) (from the Commission and some of the key regulators, notably the UK FCA, the Luxembourg *Commission de Surveillance du Secteur Financier* (CSSF) and the Irish Central Bank) have been helpful but they do not answer all of the questions all of the time. For example, the Special Purpose Vehicle (SPV) exemption should help underlying structures but is it really fair if one therefore effectively dodges regulation by not applying the AIFMD provisions on a look-through basis? Is it a requirement for an AIF that there should be more than one investor (as the UK has always maintained but which has not been quite the same in Ireland)? Does the final version of the ESMA Guidance on key concepts really exclude all types of commercial product rather than investment fund product?

  Remember that ESMA's initial guidance of the open- and closed-ended AIF definition aspects was rejected by the Commission and so the boundaries of the AIF definitions have been contentious from the regulators' perspective.

- **Identify the AIFM**

  Frequently there is a choice and it should be an informed choice.

  How does one deal with the general partner of a limited partnership – whatever that limited partnership's objectives might be? Under UK guidance, for example, it is indicated that, although the general partner (GP) is a partner of the limited partnership and should be acting as agent of the limited partnership, if it might be selected as the AIFM it would be viewed as an external AIFM (rather than following the internal management model, as would be the case with the board of directors of a company).

  If you are considering a fund established in an offshore jurisdiction – such as the Channel Islands or Cayman Islands – with an EU-based investment manager, a key question is whether that UK-based "manager" will in fact have a role sufficient to make it the AIFM. For the present, some are taking the approach purposefully to ensure that there is a non-EEA (European Economic Area) AIFM and constructing the arrangements accordingly.

- **Identify if the AIFM is exempt**

  If an AIFM is sub-threshold or is managing only group undertakings within the terms of Article 3, then the Directive does not apply and authorisation need not be obtained.

  However, this does not mean that the Directive is inapplicable. For sub-threshold entities there must be: registration with the home state regulator; identification of the AIFM and the AIFs they manage to that regulator at the time of registration; provision of information on the investment strategies of the AIFs that they manage at the time of registration; and regular provision to the competent authorities of information on the main instruments in which they are trading and on the principal exposures and most important concentrations of the AIFs that they manage, in order to enable those regulators to monitor systemic risk effectively. They must also notify the regulators in the event that they no longer meet the sub-threshold conditions.

  Small EEA AIFMs therefore do not escape, but they do benefit from a simpler registration arrangement, and yet one which enables regulators to have them on their radar screen. And small non-EEA AIFMs are outside the Article 42 scope, although there may be local marketing requirements. (For example in the UK there are requirements for marketing of AIFs by small third country AIFMs under Regulation 58 of the UK AIFMD Regulations.)

  Some difficulties have emerged in identifying whether or not the thresholds are met in certain circumstances, because there are two thresholds:

  - AIFMs which manage portfolios, including assets acquired through use of leverage, which in total do not exceed a threshold of EUR 100 million; or
  - AIFMs which manage portfolios of AIFs whose assets under management in total do not exceed a threshold of EUR 500 million when the portfolios of the AIFs consist of AIFs that are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF.

  This sub-threshold issue has led some funds to review their leverage arrangements and positively to decide to remove leverage in order to come within the higher threshold test and so remain sub-threshold. In order that the threshold applies per fund, it has also encouraged some to construct matters so that there is internal management considered per AIF rather than aggregate assets under management considered for an appointed AIFM managing a range of AIFs.

- **Identify the scope of the AIFM's functions**

  According to Annex 1 AIFMD, "managing AIFs" means performing at least the investment management functions referred to at point 1(a) or (b) of Annex 1 for one or more AIFs. Consequently, the AIFM's services must comprise the investment management functions which an AIFM shall at least perform when managing an AIF of:

  (a) portfolio management; or

  (b) risk management.

  Paragraph 2 of Annex 1, however, provides that there are other functions that an AIFM may additionally perform in the course of the collective management of an AIF, concerning administration, marketing and certain activities related to the assets of the AIF.

  As mentioned above, once the scope of the AIFM's functions is identified, it should be made clear in the AIFM Appointment contract, and existing contracts should be amended to ensure the services are clearly expressed by reference to the services expected according to AIFMD.

- **Work out the waterfall of contractual arrangements for the fund including AIFM delegations**

  - The contractual arrangements must be cogent, as usual, and now in addition there needs to be compliance with the AIFMD provisions, notably on delegation and for valuation.
  - There should be the ability for each of the parties involved with an AIF to communicate with the other parties involved, so as to ensure that each can perform their relevant obligations under AIFMD whether as AIFM or depositary.

Following such a logical flow of questions should enable one to reach a considered view as to how to adapt an existing fund structure or set up a new business which involves managing AIFs. For various reasons, including those given in the three examples of emerging issues above, there has been much caution evident in the transitional year and so many potential AIFMs have shied away from complete engagement with the AIFMD regime. But hopefully this is a short-term hesitation.

Positive Consequences of AIFMD Implementation

Let us turn to look at the potential positives for fund managers of embracing AIFMD regulation:

- We are not sure whether and where a sensible and clear divide might be drawn between those funds which are UCITS funds regulated under the UCITS Directive which are available to retail investors, and Alternative Investment Funds which are managed by AIFMs under AIFMD and made available to professional investors. But there is the prospect of an AIF brand developing alongside the well-established global UCITS brand.
- Many in the Alternative Investment Funds community might still have preferred a harmonised private placement regime across Europe rather than the panoply of regulation we now have with AIFMD, but the availability of a marketing passport should be a positive.
- With the general increase in regulation applicable to the manager and so indirectly to the fund, it is likely that, once EU-based AIFMs obtain their authorisation, this might assist the marketability of alternative funds (as well as simply an activation of marketing passports).

From the regulators' perspective, consider the summary of the approach which ESMA is obliged to take in respect of any enforcement measures set out in Article 47(6), including: the threat to the orderly functioning and the integrity of the financial market or the stability of the whole or part of the financial system of the EU, or significantly improving the ability of competent authorities to monitor the threat; not creating a risk of regulatory arbitrage; and not having a detrimental effect on the efficiency of the financial markets, including reducing liquidity in those markets or creating uncertainty for market participants in a way that is disproportionate to the benefit of the measures. Regulators will have regular reporting to ensure that they can focus better on these issues.

Emerging Trends?

For those which are seeking authorisation as full-scope AIFMs and so embracing the AIFMD regime, some tentative trends are starting to emerge:

- As one might have expected – or at least hoped – some sense of proportionality and practicality is creeping in, both in regulator guidance and in the way in which funds' AIFMs are now implementing AIFMD. Proportionality was always contemplated in the Level 1 AIFMD text (regarding specific provisions: risk management functions; depositary concerns regarding third party delegations' tasks; and determination of administrative penalties). Our point here though is a much wider one in that proportionality and practicality should inform how the Directive generally should be implemented and applied. Take for example the Irish confirmation that Section 110 companies are viewed as SPVs. Or take the UK FCA's clear pronouncements on proportionality in its finalised General Guidance on the AIFM Remuneration Code.

- One consequence of the AIFMD which is likely encouraging the external AIFM ManCo approach now sitting alongside the UCITS Directive with its long-established UCITS management company approach, is that there may prospectively be some take-up of the management company passports – not just the marketing passports.

  A UCITS management company passport was introduced in respect of UCITS funds which are available to retail investors some time ago under UCITS III, but in practical terms only once implementation issues had been "clarified" in UCITS IV. In practice, however, due to the allocation of regulatory responsibilities between home and host jurisdictions, which is quite novel, and the circumstances of the management companies concerned, it has taken a little time for this to be an option which fund managers might consider utilising. But there is now a growing interest in this option.

- We are starting to see some mainstream financial institutions seeking to avoid running multiple fund ManCo entities. Issues regarding Article 6(4) as to whether an AIFM's additional services (of the management of portfolios of investments on a discretionary client-by-client basis, or non-core services comprising investment advice, safekeeping and administration in relation to shares or units of collective investment undertakings, and receipt and transmission of orders in relation to financial instruments) could be passported, caused difficulties at the outset. But, assuming that the proposed amendment to Article 33 is progressed and jurisdictions accept that this is effective, the additional services should be passportable. So there should be scope for a single firm to act as AIFM for ranges of AIFs, or a UCITS management company for a range of UCITS, and to provide some additional segregated portfolio management services. It is unlikely that a number of what are now commonly being termed "Super ManCos" will be established by established financial institution AIFMs.

Certain frustrations remain. Major financial institutions are on a journey to adapt and embrace AIFMD provisions at considerable cost and effort. As yet, they might argue that neither they nor their funds' investors can see much commensurate benefit. And those frustrations may be compounded when other regulatory initiatives are progressed, as seems likely across the broad spectrum of investment funds.

The political agenda moves on apace, notably with the publication of recent Financial Stability Board (FSB) and EU Commission papers regarding various aspects of shadow banking. This started with the Group of Twenty (G20) and FSB papers referring to issues for money market funds and exchange-traded funds (ETFs), yet the latest (third) FSB Global Shadow Banking Monitoring Report of November 2013 refers to "other investment funds" being the largest sub-sector of the entities under review (accounting for 35% of other financial intermediaries (OFIs)). The European Commission's Communication of 4 September 2013 set out a number of measures in the field of shadow banking which will affect the asset management sector, looking at AIFMD as being relevant to this, alongside work planned on the money market funds regulation proposal, and a planned review of UCITS investment techniques and strategies.

Implementation of AIFMD should not therefore be looked at in isolation. It is only part of a wider set of regulatory initiatives – and an evolving political agenda – which is likely to result in increasing intervention in, and constraints upon, the way in which Alternative Investment Fund Managers and Alternative Investment Funds can operate. So watch this space!

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Kirstene is best known for her advice on regulated funds but her practice has evolved with the globalisation of fund management businesses and covers a wide range of international funds and products including Alternative Investment Funds of a variety of descriptions, and insurance and pension products. Also she advises a wide range of clients on UK financial services regulation, including FSMA perimeter issues, insurance and pension products, conduct of business issues and the impact of the implementation of EU Directives.

With over 25 years' experience in this sector, her leading expertise is acknowledged by UK and international legal directories. (For example: Kirstene is ranked in Band 1 for Open and Closed-ended Funds by Chambers UK, 2014; Kirstene is endorsed as a leading individual in the PLC Which Lawyer Directory; and Kirstene is endorsed as a prominent practitioner in the Guide to the World's Leading Investment Funds Lawyers.)

Kirstene is an immediate past Co-Chair of the International Bar Association's LPD Investment Funds Committee. She is the current Co-Chair of the International Bar Association's Annual Globalisation of Investment Funds Conference (for its 25th year being held in Paris in June 2014). She is a member of the UK FCA's Legal Experts Group regarding implementation of the Alternative Investment Fund Managers Directive.

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Nicholas was a member of the ISDA Tax Committee dealing with the Credit Support Annex, and of the Financial Services Authority's Committee on the taxation of Funds of Alternative Investment Funds (or FINROFs). He is co-author of various Butterworths textbooks, including International Taxation of Financial Instruments and Transactions, and Company Reorganisations: Tax and Tax Planning. He also wrote the tax chapter on investment trusts in Butterworths Tax Planning Service. He is currently writing the tax chapters on what will be the standard book on stock loans and repos.

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- Lending & Secured Finance
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