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Regulation of Alternative Investment Fund Managers: The End of the Beginning?

Field Fisher Waterhouse LLP

Kirstene Baillie

Introduction

In force now for some time, one might think that the basis for implementation of the Alternative Investment Fund Managers Directive (AIFMD) should now be settled and so there may be little to say in a keynote introductory chapter. More likely, though, the evolvement of the regulation of AIFMs is only just beginning.

In this chapter, approaching this topic with experience from a particularly wide-ranging field of view of what is a diverse fund marketplace acting for a broad range of fund managers (remembering that the vast majority of the EU-based fund managers are UK-based), we seek to highlight first where there is now a positive impact, or at least a clear impact – and secondly where we are now seeing unintended consequences. Finally, we look at the major work which remains to be done or where further change is on the horizon.

Most notably, implementation of AIFMD is, as yet, incomplete. At the time of writing, we await papers on the third country provisions, the key issue to look at once the European Securities and Markets Authority's (ESMA) July 2015 Opinion is published. Also, AIFMD is only one of a wider set of regulatory initiatives which will likely result in increasing intervention and constraints which may affect AIFs and AIFMs operating within the EU – and how EU-based investors can access AIF investments.

Positive Impacts

Both for established AIFMs which have now adjusted their arrangements for management of their existing non-UCITS fund ranges to AIFMD, and for new AIFMs now becoming established, there are some positive impacts which can be identified:

- **Better management of ManCos**

  With the raft of requirements for the authorisation and operation of fund management companies, and with AIFMD for AIFMs, arrangements for systems and controls and management of conflicts of interest, to name but two areas, have likely markedly improved.

  One could argue, particularly in the UK where there is long-established regulation of the operation of collective investment schemes, that sound management of fund managers already existed but, on a Europe-wide basis, we can certainly say that with AIFMD there is a comprehensive framework now in place. Also, given that many mainstream managers run both UCITS and AIFs, it makes sense that there are appropriate standards for management of AIFMs alongside those which already exist for UCITS management companies.

- **Improved disclosure to investors**

  A key aim of AIFMD was to ensure better transparency – with information flows improved for both investors and regulators.

  Improved disclosure to investors should aid investor comprehension and consequently assist investor protection because investors are better aware of the product and the investment exposure which they have as a result of investing in it. Having said that, some AIFMD disclosure documents we have seen have been a little more of the "tick the box" approach to satisfy requirements than one might have wished. Some are not overly communicative. Maybe there is still some further work to be done in this area.

- **Passports are now available**

  There is now scope for the AIFMD management and marketing passports to work for those now authorised as full-scope AIFMs. The differences in the passporting arrangements for various EU countries is unhelpful but nonetheless, overall, the passport position should now be viewed as a positive.

Positive impacts are also now arising from clarification of various issues which were previously on the list of "uncertainties".

- **Article 6(4) MiFID type of activities can be passported**

  The passport for management obviously relates to acting as an AIFM. However, the Commission Q&As confirmed, when updated in June 2014, that the Markets in Financial Instruments Directive II (MiFID II) provisions would modify AIFMD in order to establish that an AIFM authorised to provide the MiFID investment services mentioned in Article 6(4) of AIFMD would have the right to provide these services on a cross-border basis under the authorisation to manage an AIF granted by its home Member State. Member States are required to apply such measures arising from MiFID II from 3 July 2015. It was expected though, in the interests of cooperation, that this would be facilitated before that date. Indeed, the UK Financial Conduct Authority (FCA), by way of example, has always taken the view that Article 6(4) ancillary activities could be passported and, pursuant to its March 2015 Consultation Paper 15/8, is expecting to formalise this previously confirmed approach in its FUND Sourcebook.

- **Workable valuation arrangements**

  To take one initially problematic area, the position on valuation responsibilities is becoming clearer. The somewhat attractively simple wording of AIFMD proved challenging when applied to fund structures, but there is now a clearer delineation developing between the responsibility for valuation under Article 19 of AIFMD and services of third parties supporting those performing such responsibility. There are some signs of pragmatic approaches being taken.

Difficulties had been encountered when considering whether there is an external valuer or the AIFM itself providing the task. The UK is currently in the process of formalising some FCA Perimeter Guidance which will "clarify" the position in a pragmatic way, such that:

- input of third party advisers or price providers on the valuation of assets should not be considered to be performing the valuation function, so they should not need to be formally appointed as external valuers. The person performing the valuation function who seeks their input can retain responsibility for making the final determination of value;
- where a board of directors or trustees of some AIFs retains a right (contractual or otherwise) to override the valuation figure approved by the person who on a day-to-day basis makes a determination of the individual asset values (whether the AIFM or external valuer), this does not necessarily mean that it is viewed as undertaking the valuation function provided that the right of override is only exercised on an exceptional basis. This will be of assistance, for example, to the position of UK investment trusts where the valuation will be one of those issues where the board of directors will have retained such an override.

Such signs of developing a pragmatic interpretation are to be welcomed.

- **Pragmatic approaches, e.g. on remuneration codes**

  Further pragmatism has become evident in the proportionality which is being applied in various areas, most notably in relation to the way in which remuneration codes are being applied. This is also helpful.

Many of the "issues" which have been considered over the last two years since transposition of the Directive have now thankfully been clarified by much of the guidance which has been issued. We are therefore much further forward in understanding how to accommodate AIFMD than we were. There are however various challenges remaining, and detailed work is often involved in finding the appropriate way through the provisions when considering any new AIF project.

The Required Analytical Approach

When assessing the AIFMD implications for any fund proposition which might be managed from, or marketed in, the EU, my first recommendation is that the first and the most important step should be to adopt a careful and analytical approach. Key topics include:

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

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

  The ESMA AIFMD Key Concepts Guidelines are very helpful and the Commission's Q&As also assist and are regularly updated, clarifying issues which have emerged as unclear. Q&As of key regulators, notably the UK FCA, Luxembourg's *Commission de Surveillance du Secteur Financier* (CSSF) and the Irish Central Bank, are also useful. However, the published documents may not answer all of the questions all of the time.

  Remember also that ESMA's initial guidance on the open- and closed-ended AIF definition aspects was rejected by the Commission, and so the boundaries of the AIF definition have always been contentious from the regulators' perspective. One cannot assume that there is a single agreed view – there are grey areas.

  For example:

  - Must there be more than one investor? The FCA's Perimeter Guidance now reflects the ESMA AIFMD Key Concepts Guidelines indicating that an undertaking which 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, should be regarded as an undertaking which raises capital from a number of investors even if it in fact only has one investor.
  - Does the final version of the ESMA Guidance on Key Concepts really exclude all types of commercial product from AIFMD's scope? When we have tried to look at the boundary of the commercial undertaking area, it has proved problematic.
  - Although rightly widely defined, should AIFs encompass what are in truth separate portfolio management agreements which are managed on a common basis? Generally, the answer will be "no" but there are some instances, notably for UK Enterprise Investment Scheme (EIS) funds, where the opposite view is being taken.

- **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 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 as 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 manager, a key question is whether that UK-based manager will in fact have a role sufficient to make it the AIFM. Some might take the view purposefully to ensure that there is a non-EEA AIFM and construct arrangements accordingly. Now that AIFMD implementation initial issues are more settled, more are taking the view purposefully to construct matters so that there is an EU AIFM and benefit from the management and marketing passports.

- **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 need not mean that the Directive is inapplicable.

  For sub-threshold entities, there must be: registration with the home state regulator; identification of the AIFMs and the AIFs they manage to that regulator at the time of registration; provision of information on the investment and 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 – and also to notify the regulators in the event that they no longer meet the sub-threshold conditions. Small 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.

  Some difficulties have emerged in identifying whether or not the thresholds are met in certain circumstances because there are two, and concerns as to which one applies:

  - 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 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 firms to review their leverage arrangements and possibly decide to remove leverage in order to become within the higher threshold test and so remain sub-threshold. In order that the threshold applies per fund, it has also encouraged some funds to construct matters so that there is internal management considered per AIF rather than assets under management 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 in 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 collective management of an AIF concerning administration, marketing and certain activities relating to the assets of the AIF.

  Once the scope of the AIFM's function is identified, it should be made clear in the AIFM appointment contract to ensure that its services are clearly expressed by reference to the AIFMD-expected services.

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

  As for any fund structure, the contractual arrangements should be cogent and there is a particular need to demonstrate compliance with the AIFMD provisions, notably regarding delegation and for valuation.

  Also, 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 respective obligations under AIFMD, whether, for example, as an AIFM or a Depositary.

- **Devise an appropriate marketing strategy**

  "Marketing" is defined for AIFMD purposes as a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares it manages to, or with, investors domiciled or with a registered office in the EU.

  The consequence of looking at whether an AIF is authorised or registered in a particular country or, if not, has its registered office there, leads to interesting conclusions for certain fund propositions. For example, an English limited partnership requirement to register its principal place of business with Companies House is regarded as the equivalent of a registered office for this type of AIF, and so an English limited partnership with a principal place of business in Guernsey would be a non-EEA AIF. However, a Guernsey limited partnership with a registered office in Guernsey and with a principal place of business in the UK would, in the FCA's view, also be a non-EEA AIF because, unlike the English limited partnership, it has a registered office. Detailed consideration of the status of "establishment" is important before looking at the relevant marketing provisions.

  In looking at the marketing provisions, of course, there is a core distinction between an EU-based AIFM marketing funds and a non-EU AIFM with a non-EU AIF marketing funds, and the latter being under a temporary national private placement regime approach. The particular ways of utilising the private placement regimes do need to be reviewed individually per country, at least for the present.

Assuming a thorough analysis of the position, one can generally apply the AIFMD provisions to most scenarios. Despite the diversity of their form and their investment strategies, we have workable approaches available for most forms of AIF. So what remains to be done?

Emerging (Unintended?) Consequences

Although various positive impacts are identified above, there are various, probably unintended, consequences which are now coming to the fore. Some are driven by commercial motivations; others result from AIFMD regulation; and some perhaps from a combination of the two. Some of these may develop into new trends, and we should now consider whether these would be welcome developments.

Of course we may not yet have seen many of the potential consequences. Whilst new documentation has been put in place, such as AIFM appointments and depositary contracts, most of these simply record the relevant requirements. The real test will be when the new contractual provisions are tested and the practical application of the AIFM's policies are reviewed. That is when the real challenge will come so we can see whether or not the revisions operate successfully.

That being said, consequences which are already evident include:

- **Impact on depositaries**

  Key AIFMD protections should result from the requirement for AIFs to appoint a depositary and from the consequent arrangements for custody of an AIF's assets. The challenges in this area, though, should not be underestimated, particularly in respect of the consequent liability issues and possible cost implications.

  For some of the more esoteric forms of AIF, however, there have been challenges in selecting a suitable depositary who is willing to perform the relevant functions. This is in part due to the wide scope of AIFMD. Some structures are not entirely predisposed to the convenient appointment of a depositary to take on an AIF depositary's functions. We have come across certain fund propositions which really do not suit well the anticipated depositary obligations and functions. (The result, in some instances, ironically has been a redesigning of those products in order to fall outside of the AIFMD's scope and so offer investors perhaps a lower, or certainly different, level of protection.)

  As might be expected, various new depositary offerings are now being made available.

- **Host AIFM services**

  One of the perhaps more unexpected consequences is the growth in host AIFM services. These might, in particular, be popular in helping new start-ups.

  The idea of AIFM services being promoted by numerous firms with suitable authorisation, notably in Luxembourg and Dublin, is now being heavily promoted but the idea is far from new. The UK has long experience of UK-authorised fund manager services being made available and the experience has not been an entirely satisfactory one. Take for example the redress process for investors in the Arch Cru UK authorised funds with a host manager, which is still ongoing. So, although attractive in theory, there are practical challenges of putting essentially an administrator function in the central role with the real manager sitting behind.

  Such models may not strictly fail the letterbox test as such but, from a commercial viewpoint, they do alter entirely the dynamics of the interrelationship between the parties involved, with the real promoter/product provider one stage removed from being at the core of the product. It is not inevitable that such models are flawed but the particular nature of an AIF with a host AIFM does inevitably introduce some points of tension, with the result that it may not work as efficiently as a mainstream model under which the main investment management entity would seek authorisation from the AIFM itself as efficiently as a mainstream model under which the asset manager would itself have an authorised AIFM within its group.

- **Influence on choice of domicile**

  Some think that EU-based funds may become more popular and that Dublin and Luxembourg will benefit as the two

EU main fund domiciles but, thankfully, we are also seeing evidence of UK-based funds being utilised for some propositions (although the UK fund range is still arguably insufficiently extensive to win through).

One potential development is that some of the offshore centres and – notably on the European business front – the Channel Islands, might be losing out as fund domiciles. As ever, there is no right or wrong answer, although some who promulgate standard fund models for particular sectors still purport to say so. In some instances, if there is, for example, to be a wide range of investors both EU- and non-EU-based, there is a logic to the Jersey or Guernsey fund structure being offered for the non-EU investors and for an EU-based fund being offered to the EU investors – and of course all the regulatory issues have to be worked out in conjunction with the tax issues involved to identify the most appropriate matrix for the particular circumstances. Certainly, though, AIFMD is having an influence on the choice of domicile and there is a new element of influence in this area.

- **Lack of true harmonisation**

  ESMA's Q&As on the application of AIFMD are intended to promote common supervisory approaches and practices in the application of AIFMD and its implementing measures, by providing responses to questions posed by the general public and competent authorities in relation to the practical application of AIFMD. The content is aimed at local regulators in the EU with the intention that their actions in supervisory activities should converge along the lines of the responses set out by ESMA. It is continually edited and updated so it ought to remain up to date.

  Nonetheless, different approaches to implementation in different Member States are already a bone of contention in relation to this relatively new Directive. To be fair, this does happen with most EU harmonisation initiatives. In relation to AIFMD, there is certainly hope expressed that some of the divergences, e.g. in relation to passport activation, can be smoothed out. ESMA's work stream most immediately is to focus on the functioning of the EU passport under AIFMD and the functioning of the marketing of non-EU AIFs by EU AIFMs in the EU and the management and/or marketing of AIFs by non-EU AIFMs in the EU – with its Call for Evidence in these areas being published on 7 November 2014.

  These concerns are aside from the wider concerns of lack of consistent international regulation. Fund managers frequently operate globally, and run one or more fund ranges which have to deal with different types of regulation in different parts of the world. Better coordination of regulation more widely than simply in the EU would likely be welcomed. Certainly, any risk that AIFMD encourages development of EU funds run by EU managers for the EU marketplace and non-EU funds run by non-EU-based managers for the non-EU marketplace, would best be avoided. This, if it occurs, might in itself be a retrograde step. One hopes that this isolationist approach does not in fact arise. The signs at the moment are that it might not; this does however require some resolution on the third country issues mentioned below.

Some of the dynamics giving rise to the above issues might of course always exist, and success of a regulatory initiative such as AIFMD should be assessed by reference to what is in fact achievable.

Future (Optimistic?) Prospects

Looking forwards, the key to whether AIFMD might be viewed as a success probably depends on the resolution of major strategic issues rather than some of the points highlighted above. AIFMD has been crafted to cover a broad range of funds and going forward there may be three key areas on which to focus:

- **Restoring logic?**

  We all understood that the UCITS Directive was supposed to set out the constraints for retail funds, looking at product regulation specifically and providing a product passport so that the funds could be marketed to retail investors. Not only did this work in the EU but UCITS has become a recognised global brand for retail funds. Then comes along AIFMD and logically this would sit alongside UCITS and be the brand for alternative funds to be marketed to professional investors more widely, looking at regulation of the fund manager rather than specific fund product regulation.

  One difficulty is that the European Commission has already complicated the AIF picture by introducing:

  - an EuVECA regime for venture capital funds;
  - an EuSIF regime for social investment funds;
  - and now, particularly confusingly, an ELTIF regime – a long-term closed-ended structure which is to be a packaged retail investment product (PRIIP) but which will be an AIF with a retail passport.

  On the UCITS side there are issues with structured UCITS to be classed as complex products and so which can only be capable of being sold to retail investors subject to an appropriateness test. UCITS VI is still on the horizon, although re-opening basic issues as to the scope of UCITS seems unlikely.

  Before AIFMD regulation develops further, it would be prudent, and indeed add to the strength of it, if some logic could be restored to the divide between UCITS and AIFs.

- **Helping to achieve a level playing field**

  The previous issue leads on to how to achieve a level playing field between what investors perceive as being comparable products.

  A variety of overlapping European regulatory initiatives, each seeking to improve protection for investors, may well lead to some challenges for distribution arrangements for product manufacturers. One cannot simplistically view AIFs and AIFMD as being targeted at professional investors and UCITS and the UCITS Directive as being aimed at retail investors.

  The PRIIPs Regulation initiative should cover all packaged retail- and insurance-based investment products with effect from 31 December 2016 (subject to the exemption for UCITS funds until 31 December 2019). As finalised, it includes all investment funds, whether closed- or open-ended, including UCITS. It is now clear that whether or not there is a retail element may only be determined at the point of sale and the required disclosure will need to be produced whenever a product which falls within the Regulations' scope is to be sold to retail investors. It may therefore encompass not only UCITS but also AIFs which are promoted to the retail public.

  Another major European initiative which overlaps with AIFMD will be implementation of MiFID II and MiFIR with effect from 3 January 2017. Although we await ESMA's guidelines to help firms determine when a product is deemed complex, which are due to published in January 2016, the indication so far is that the outcome will be quite restrictive on what might be regarded as non-complex. It seems likely that the Commission will take a strict interpretation of the criteria for what would be considered complex and non-complex for MiFID II purposes (such that in future it is likely that structured UCITS and non-UCITS collective investment undertakings (including non-UCITS retail schemes) will be considered complex). Significantly fewer types of products (in respect of funds, being only non-structured UCITS funds) will be considered non-complex and so be able to be sold in the retail marketplace without an appropriateness test being satisfied.

- **Activating the third country provisions?**

  A key issue of immediate interest, of course, is the need to deal with third country challenges. In principle, AIFMD

anticipates that authorised EU AIFMs intending to market non-EU AIFs to professional investors in their home Member State and/or other Member States, should be allowed to do so with a passport subject to notification procedures and conditions in relation to the third country's non-EU AIF. On this, we await with interest ESMA's Opinion which is due in July 2015 and so, at the time of writing, is now imminent.

By July 2015, which will be two years after the AIFMD transposition date, ESMA should issue an opinion on the functioning of the passport then in force and on the functioning of the National Private Placement regimes, and issue advice on the extension of the passport for EU AIFMs marketing non-EU AIFs in the EU and to non-EU AIFMs managing and/or marketing AIFs in the EU. AIFMD is one of the first Directives to seek to have reach into applying to non-EU firms.

The Commission should adopt a delegated act within three months after the receipt of ESMA's July opinion and advice from ESMA, taking into account the criteria listed in, and the objectives of, the Directive (including regarding the internal market, investor protection and effective monitoring of systemic risk).

We should wait to see whether a delegated act is made later in 2015 under Article 67(6), assuming that ESMA gives positive advice and the Commission decides then to make such a delegated act within the anticipated three-month period. In theory, we should have an answer on some of these third country issues by September 2015.

So, within 2015, one should hopefully now be able to take a more positive view of AIFMD. Regardless of its (likely poor) cost-benefit analysis, certainly in its initial two years, this Directive is here to stay, and it is likely to develop as one major component of EU investment fund regulation – and potentially offer a new European brand which can sit alongside UCITS.

In February 2015, the European Commission launched a landmark project in its Green Paper "Building a Capital Markets Union", looking to unlock funding for European businesses and boost growth. It refers to the role for both the UCITS Directive and the AIFMD in relation to boosting institutional investment and recognises the need to reduce costs for setting up funds and cross-border marketing generally. The Commission is open to hearing views on what further policy measures could improve matters, including in relation to AIFMD which has now created the framework within which all European alternative investment managers are able to operate.

Certainly there are some major challenges to be addressed as to how the UCITS and AIFMD Directives should be aligned and what fund products should be offered and to which type of investors. With all the detailed new provisions coming in over the next couple of years, periodically regulators and those in the fund management industry should stand back and check if the intentions of all of this regulation are being met, and check on the desirability or otherwise of any consequences.

Most importantly though, regulation should not unduly prevent new fund managers from being set up or new products from being established in the marketplace, or prevent investors from having access to a wide range of products. Hopefully, whilst regulatory initiatives will inevitably continue to influence the way in which fund products are developed, they will influence but not stifle investor choice and product innovation.

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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 (recently including property, media and private equity funds), 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 in the areas of financial services non-contentious regulation; investment funds; and insurance. 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 Chair of the International Bar Association's Annual Globalisation of Investment Funds Conference (for its 26th year being held in Paris in June 2015). 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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