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# Preparing for AIFMD: Some Practical Tips, Part 1

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## Introduction

- A general round-up of key provisions in the AIFMD level 2 implementing regulations
- Scope of the AIFMD
- Timetable and transitional relief
- Cross-border marketing
- Delegation and letter-box entities
- Enhanced disclosure and reporting requirements

## Delegation and letter-box entities

- AIFM's obligations to investors survive delegation – e.g. acting in investors' best interests
- AIFM cannot circumvent responsibility or liability
- AIFM must retain decision-making functions that are its primary business role – at least risk or portfolio management
- Considered a letter-box entity if the delegate's investment management functions exceed those of the AIFM “by a substantial margin”
  - consider the type of assets invested in, their importance for the AIF's risk profile and for achieving its investment objective
  - ESMA may produce additional guidance for consistency
  - to be reviewed after two years

## Depositories

- All financial instruments which can be registered in a financial instruments account and belong to an AIF must be held in custody
- Do not exclude simply because of collateral arrangements – must be kept in custody while AIF retains ownership
  - either earmark or have the depository appoint a sub-custodian
- Can only discharge liability to a third party if the depository can demonstrate it had no other option – e.g.:
  - third country law requires it; or
  - AIFM insists held in that jurisdiction, despite warnings from depository as to increased risk

## Leverage

- Obligations on AIFM:
  - set maximum level
  - report to investors and regulators
  - provide policy when applying for authorisation
- Two compulsory calculation methods
  - Gross method: absolute value of all AIF's positions
  - Commitment method: allows for netting/ hedging
- Defined as ratio between AIF's exposure and NAV
- When using the commitment method, leverage is considered substantial when the AIF's exposure is more than 3x NAV
- Commission to review by 21 July 2015
  - Commission permitted to develop “additional and optional method” – e.g. advanced method

## Valuations

- AIFM must have written policies and procedures for each AIF
  - when using models for valuations, that model must be approved by senior management and be included in the AIF's policy
- AIFM must have written policies and procedures explaining the methodology used for different types of assets
  - may use different methodologies for different AIF
  - can differ within asset base to cover alternative scenarios

## Third countries

- Cooperation agreements
  - more flexible than the first draft
  - required for national private placement regimes and delegation to third country entities
- Use of non-EU OTC derivative counterparties and prime brokers
  - not required to be subject to regulation equivalent to EU law

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## Own funds and professional indemnity insurance (“PII”)

- AIFM must retain additional own funds or PII to cover professional negligence
- Indicative non-exhaustive list provided:
  - loss of documents evidencing ownership of assets
  - misleading statements made to AIF/ its investors
  - improper valuations
- Qualitative requirements to monitor operational risks
- Value of funds
  - 0.01% of AIF’s NAV, adjusted for the AIFM’s risk exposure.
- PII value
  - 0.7% of AUM for individual claims
  - 0.9% of AUM for annual aggregate claims

## Operating conditions

- Conflicts of interest
- Duty to act in best interests of AIF or investors, and the integrity of the market
- General scope of due diligence for more illiquid investments and in appointing prime brokers and counterparties
- Inducements, handling orders
- Reporting obligations re subscriptions and redemptions, and execution and allocation of orders for other entities' AIF
- Risk and liquidity management
- Transparency requirements and exchange of information

## Scope of the AIFMD

- What is an AIF?
- ESMA Consultation Paper-Guidelines on key concepts of the AIFMD, 19 December 2012
- Status of those guidelines
- Selected exclusions: holding companies (excl. private equity funds); employee participation schemes; securitisation special purpose entities; family office vehicles which invest the private wealth of investors without raising external capital (Recital 7); joint ventures

## Scope of the AIFMD

- Clarification of most concepts largely left to national regulators – e.g. joint ventures, family office vehicles – “more commercial terms”, according to ESMA – but does not help legal certainty
- FSA comment on joint ventures (CP12/32) – where investors in a given joint venture structure have substantial management control over strategic decisions, there is likely to be a contrast with the governance of typical AIFs

## Scope of the AIFMD

- FSA looking to ESMA on ‘joint ventures’ and ‘family office vehicles’
- One investor, no AIF? Not necessarily!
  - fund must be 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
  - Master Fund – needs to look through to investors of sole feeder; similar logic for funds of funds

## Scope of the AIFMD

- Don't forget separately managed accounts – no “pooled return” here but beware “single investor” funds where different legal entities connected with the single investor invest
- Also likely to be excluded
  - “ordinary company with general commercial purpose”
  - “entity acting for its own account and whose purpose is to manage the underlying assets as part of a commercial or entrepreneurial activity”

## Scope of the AIFMD

- FSA example: entity whose main purpose is to construct a building; REITS?
- Also not “raising capital”, probably, if investors in an undertaking are:
  - a member of the governing body of the fund
  - an employee of the fund or its manager whose professional activities have a material impact on the risk profiles of the fund (side-by-side employee investment vehicles?)
  - persons in a “close familial relationship that pre-dates the establishment of the fund”

## Scope of the AIFMD

where the fund is exclusively for managing their family wealth

- Practical tip: don't necessarily assume that a fund is an AIF under AIFMD

## Timetable and Transitional Relief

- 22 July 2013 or 22 July 2014?
- A.61(1) – 1 year transitional relief only applies to AIFMs performing activities under AIFMD before 22 July 2013
- In any event, nature of relief given appears to be a matter for decision at the EU Member State Level, save that there is no local discretion regarding the provision that the application to be an authorised AIFM is not required until 21 July 2014
- What is the UK proposing to do?
  - Applying this to AIFMs managing an AIF immediately before 22 July 2013

## Timetable and transitional relief

- No need to comply with AIFMD provisions regarding marketing of an AIF to which the relief applies (e.g. Article 36 register; depositary requirements) until 22 July 2014
- AIFMD effective on the earlier of (i) determination of an application to be an authorised AIFM and (ii) 22 July 2014
- PD Prospectus dated before 22 July 2013 in respect of an AIF not subject to additional marketing requirements in AIFMD
- No other transitional relief except in certain closed-end fund situations

## **Timetable and transitional relief**

- Practical tip: don't assume that if you have an FSA authorisation, AIFMD implementation is delayed until 22 July 2014 – e.g. firm with discretionary management permissions that is managing only separate accounts and/or acting as delegate of AIFM
- Practical tip: consider whether to restructure to turn an entity that is not an AIFM into an AIFM before 22 July 2013, in order to use the transitional relief
- Practical tip: don't assume that the approach to transitional relief will be the same in other EU Member States

## Cross-border marketing

- What is marketing? “a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM”
- FSA (CP12/32) – AIFMD marketing is different from “financial promotion” as currently understood
- “Indirect offering” is an opaque concept e.g.:
  - Pre-offering steps (e.g. to secure an offering at the investor’s initiative)?
  - Is offering of Fund A which is established to invest in Fund B an indirect offering of Fund B? Does it matter that it may not be on behalf of Fund B’s AIFM?

## Cross-border marketing

- Open-ended fund continuing to remain open to new subscription? Probably an “offering” to EU investors unless there is a process to exclude EU investors (e.g. internet click-through)
- Drawing down already committed money?
- Can you manufacture a reverse solicitation? Any merit in having existing investors write to you expressing interest in future funds?

## Cross-border marketing

- Practice on reverse solicitation may vary from EU Member State to EU Member State (UK approach – Directive copy-out but can only reverse solicit if marketer would be able to promote fund to potential investor under s.21/s.238 FSMA)
- UK approach – if fund not being marketed by AIFM or on its behalf, fund nevertheless needs to comply with AIFMD requirements re: marketing to EU investors (see e.g. AIFMD Article 6(8))

## Cross-border marketing

- UK approach – private placement exceptions, i.e. s.21 and s.238 FSMA (financial promotion) not being made any more restrictive, except in respect of marketing of unregulated CIS to individuals through IFAs/FSA authorised firms
- No guarantee that other jurisdictions will maintain existing private placement exceptions:
  - Germany has already implemented changes essentially removing all exceptions
  - we have heard existing exceptions are under threat in Holland (subject to verification)
  - in Italy, perhaps a minimum subscription of EUR 250,000

## Cross-border marketing

- If considering EU AIFM managing EU AIF to get passport, does not work if feeding into a non-EU fund (85% + investment)
- Also cannot invest in parallel masters with “identical investment strategies”
- Article 36/Article 42 – UK proposes pretty bureaucratic application process with 20 working day period for regulator determination for each fund

## Cross-border marketing

- We await approach in other EU Member States but State by State and fund by fund approach clearly onerous
- Articles 36 and 42 uncertain anyway – cooperation agreements; jurisdictions able to impose super-equivalent restrictions
- Practical tip: by far the most certain approach for marketing into the EU on a regular basis will be EU AIF/EU AIFM

## Cross-border marketing

- If an entity decides to become an authorised AIFM, MiFID covers permitted non-AIFMD services, e.g. separate account management; marketing investment advisory services in the EU (Note – extent of these activities is restricted by AIFMD)
- FSA notes in CP12/32 an uncertainty as to whether an AIFMD passport extends to these ‘MiFID services’. FSA thinks it does, some other Member States think MiFID authorisation limited to those specified activities will be needed as well (with passporting under MiFID)

## Cross-border marketing

- Practical tip: review the non-AIFMD services proposed to be carried on by an entity for which an AIFM authorisation is to be sought and ensure they are permitted. If not, consider hiving-off

## Delegation and letter-box entities

- AIFM “core” activities: portfolio management and risk management; AIFM cannot delegate responsibility to AIF and its investors for these things
- AIFM must be “closely involved” in the decision-making of its delegates
- Investment committees making final buy/sell decisions in group structures may need to be re-configured to give the AIFM the control required under AIFMD – emphasis on corporate governance at AIFM (in keeping with FSA’s approach to UK subsidiaries of non-EU managers)

## **Delegation and letter-box entities**

- If delegate's interests may conflict, delegate needs to functionally and hierarchically separate the performance of the potentially conflicting tasks from the delegated activities
- A factor in determining whether there's a conflict is, in a group situation, "the extent to which the delegate controls the AIFM or has the ability to influence its actions"
- AIFM must have the expertise and resources to review delegate "on an ongoing basis". Level of AIFM resource required likely to depend on the nature of the investment management activity – e.g. private equity -v- hedge fund activities

## Delegation and letter-box entities

- Needs to be a plan if delegation terminates
- Where portfolio management delegated, delegate needs, unless regulator approval received, to be authorised or registered for the purpose of asset management and subject to effective supervision by the local regulator
- If delegate is in non-EU country need cooperation agreement between regulators: e.g. FCA needs to be able to carry out on-site inspections on premises of delegate outside the EU

## Delegation and letter-box entities

- AIFM loses that status if it “delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions of the AIFM itself”
- National regulators appear to have some residual discretion around this issue and are required to “assess the entire delegation structure”

## **Delegation and letter-box entities**

- Clear that AIFM must retain one of portfolio management or risk management; conversely AIFM can delegate all of portfolio management provided it retains an adequate oversight capability
- Practical tip: don't underestimate the extent of the substance required in the AIFM. In appropriate cases perhaps consider 'hosting' AIFMs
- Practical tip: take particular care where a subsidiary is delegating to its parent entity
- Practical tip: check whether delegates of AIFM are subject to appropriate regulation

## **Enhanced disclosure and reporting requirements**

- Operational Processes (Articles 12-19 AIFMD)
- Investor Disclosure and Annual Reporting (Articles 22 and 23 AIFMD)
- Regulatory Reporting (Article 24 AIFMD)

## Operational processes

- Conduct of Business (Article 12 AIFMD)
- Conflicts of Interest (Article 14 AIFMD; Articles 30-37 Level 2)
- Risk Management Policy (Article 15 AIFMD; Articles 38-45 Level 2)
- Others
  - Leverage (Article 4 AIFMD; Articles 6-11 Level 2)
  - Valuation Requirements (Article 19 AIFMD; Articles 67-74 Level 2)
  - Liquidity Management (Article 16 AIFMD; Articles 46-49 Level 2)
  - Remuneration Policies (Article 13 and Annex II AIFMD; ESMA Guidelines)

## **Operational processes: Conduct of business**

- Investment due diligence (Articles 18-19 Level 2)
- Counterparty selection (Articles 17, 20-21 Level 2)
- Fair Treatment of Investors (Articles 23 and 57 Level 2)
- Inducements (Article 24 Level 2)
- Order Allocation (Articles 25-29 Level 2)

## **Operational processes: Conflicts of interest**

- Procedures to be followed and measures to be adopted to prevent, manage and monitor conflicts
- Appropriate to the size and organisation of the AIFM and the nature, scale and complexity of its business
- Take into account other members of the AIFM's group, if applicable
- Separation of supervision
- Removal of any direct link with remuneration
- Measures to prevent or control involvement of a relevant person in activities that may impair the proper management of conflicts of interest
- Maintain records of material risk and disclosure

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## **Operational processes: Risk management policy**

- Identify the relevant risks for each AIF
- Set the risk limit for each AIF, along with a justification for the risk limits
- Set out the allocation of risk management responsibilities within an AIFM
- Describe the tools and techniques that will be used to identify, manage and monitor risk
- Set out any conflicts of interest identified, along with safeguards put in place, to ensure the risk function is independent

## Annual reporting

- Article 22 AIFMD, Articles 103-107 Level 2 - Annual report must be produced within six months of the end of the AIF's financial year
- Must include for the financial year:
  - balance sheet or statement of assets and liabilities
  - income and expenditure account
  - report on activities
  - material changes to information made available to investors pre-investment
  - information on remuneration

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## **Investor disclosure: Periodic (Article 108 Level 2)**

- Presented in a clear and understandable way
- Illiquid assets; use of side pockets and/or gates
- Changes in liquidity management
- Notify investors where they activate gates, side pockets or similar arrangements or where redemptions are suspended
- Risk management systems, including risk profile and risk limits

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## **Investor disclosure: Regular (Article 109 Level 2)**

- Changes to maximum level of leverage shall be provided without undue delay including:
  - original and revised maximum level of leverage
  - the nature of the rights granted for the reuse of collateral
  - the nature of guarantees granted and details of changes in any service providers related to the above
- Total amount of leverage

## Regulatory reporting

- Article 24 AIFMD; Articles 110-111 and Annex IV AIFMR

Frequency	AIFM's Assets Under Management
Quarterly	AIFMs managing AIFs with AUM in excess of EUR 1 billion
Quarterly	AIFMs managing AIFs which individually exceed, including use of leverage, EUR 500 million
Half-yearly	AIFMs managing AIFs with AUM in excess of the AIFMD thresholds but not in excess of EUR 1 billion
Annually	For every unleveraged AIF which invests in non-listed companies and issuers in order to acquire control

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