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Authorization for US Managers under the AIFMD

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In our article appearing in the February 2012 issue of *The Investment Lawyer*, we reviewed the Alternative Investment Fund Managers Directive (AIFMD)[1] with an eye to identifying how a US investment adviser might determine the best strategy for adapting to the AIFMD.[2] In this Article, we assume that the investment adviser has decided to jump in with both feet, and make AIFMD a platform to raise money under management in Europe. This second article addresses how to do that.

By way of reminder, AIFMD establishes a comprehensive scheme for the marketing and distribution of Alternative Investment Funds (AIFs) by Alternative Investment Fund Managers (AIFMs) within the European Union (EU). On December 2, 2010, the European Commission sent a provisional request to the Committee of the European Securities Regulators, the precursor to the European Securities Market Authority (ESMA), seeking advice on implementing measures for the AIFMD. The provisional request was divided into four parts: Part I covers general provisions, authorization and operating conditions. Part II covers implementing measures regarding the depositary. Part III covers transparency requirements and leverage, and Part IV covers implementing measures regarding supervision. On November 16, 2011, ESMA issued its technical guidance to the European commission in the form of a "Final Report."[3] An analysis of this Final Report offers a clear view into what the Commission's regulations relating to AIFMD will look like.

There are three primary reasons why US money managers (US Managers) who manage non-EU alternative funds may want to prepare for authorization under and become compliant with the AIFMD. First, it is likely that national private placements will come to an end quite soon. That is, it is increasingly likely that the sale of Cayman funds (for example) to Europe will soon be precluded on a national private placement basis. There are two forces at work here; first current national private

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placement regimes will become unavailable to US Managers altogether in 2018 or 2019 (depending on whether the implementation calendar continues to slip). Second, it seems likely that country by country, national private placement regimes will be restricted, or precluded, either by regulation or market forces even before 2018/19.[4] The net result will be that US Managers who desire to market non-EU AIFs in the EU will simply have to do so under the AIFMD passporting regime, assuming, as we do, that the EU marketing passport is extended to non-EU AIFM after 2015. As such, many US Managers may want to anticipate the practical implications of authorization in order to be prepared to take advantage of the passporting regime as soon as it becomes available.[5]

With these considerations in mind, this article will focus on the conditions precedent to US Managers becoming authorized to market non-EU AIFs in the EU under the AIFMD, as illuminated by the Final Report.[6]

Conditions Precedent to the Application

In order to become authorized to manage EU AIFs, or market non-EU AIFs in the EU under the passporting regime, a US Manager must (1) apply to an appropriate Member State of Reference (MSR) and become authorized; and (2) comply with the substantive provisions of the AIFMD in their entirety (excluding Chapter VI, which is specifically applicable to EU AIFMs).[7] As such, US Managers considering authorization must be aware of the substantive requirements of the AIFMD.

Determining the Appropriate Member State of Reference

Article 37(1) of the AIFMD requires a manager to be authorized by its MSR. This is quite straightforward at one level: a Luxembourg AIFM will be regulated by Luxembourg, of course. The MSR is not so obvious, however, for a US Manager. Article 37(4) provides the process for determining the MSR. A US Manager's MSR is determined as Set forth in the table below.

Box 113 of the Final Report[8] specifies a detailed procedure for determining Member State of Reference in cases of potential conflict between the competent authorities of several member states. It provides that the MSR is the "Member State where [an AIFM] intends to develop effective marketing for most of those AIFs," meaning the Member State where the AIFM intends to target investors by promoting and offering, including through third party distributors, most of its AIFs. Selection of the MSR will be based upon a non-exhaustive list of factors that should be considered:

(1) The member state where the distributors are going to promote the most units;
(2) The member state where most of the targeted investors are domiciled;
(3) The language of the offering/promotional documents; and
(4) Where the advertisements are most visible/frequent.

In the authors' experience, non-EU AIFs with institutional investment strategies have sold well in the Netherlands to pension schemes. Were a manager to market several of its funds exclusively in this way, then the Netherlands would be the US Manager's MSR.

Practice Note: For US Managers marketing non-EU AIFs, the MSR will be where the marketing of those funds is the most intensive. This effectively means that the more familiar fund domiciles of Ireland and Luxembourg are unlikely to serve as the MSR for US Managers.

Applying for Authorization and Becoming Authorized

NOTE—Each member state is likely to adopt its own specific application process for becoming authorized as an AIFM and for authorizing specific AIFs under the AIFMD, within the parameters set forth therein. As such, the following discussion attempts to outline the authorization process to the extent it is discussed in the AIFMD.

Pursuant to Articles 37(5) and (7) of the AIFMD, the MSR will require the US Manager to submit an application for authorization and

US Manager Marketing:	Determining MSR:
Only one non-EU AIF in only one Member State.	The MSR in which the fund is marketed is that Member State (Article 37(4)(d)).
Only one non-EU AIF, but in different Member States.	The MSR is one of those Member States (Article 37(4)(f)).
Several non-EU AIFs.	The MSR is the Member State where the US Manager intends to develop effective marketing for most of the AIFs (Article 37(4)(h)).

determine that the proposed MSR is the appropriate MSR based on the application. The MSR will also review the AIFM's marketing strategy and will notify ESMA to the effect that the MSR is the correct MSR. Further, certain administrative hurdles must be met. The US Manager must have appointed a legal representative in the MSR to serve as the contact person for the investors and authorities and to carry out compliance functions. Additionally, cooperation agreements must be in place between the MSR's authorities and the US Securities and Exchange Commission (SEC), and the United States must not be listed as a Non-Cooperative Country and Territory by the Financial Action Task Force. Last, the United States must have an agreement on the exchange of tax information with the MSR that fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters.

The US Manager will also have to apply for authorization from its MSR to manage or market a particular AIF to professional investors within the EU. The administrative conditions, *supra*, with respect to the Manager's country must also be met with respect to the AIF's country (if the AIF is based in a third country). Also, Article 37(8) would require a US Manager to provide its MSR with detailed information (as required by Article 7(2) (the rules applicable to EU AIFMs) in addition to supplemental information specifically required by Article 37(8)).

The US Manager will be required to provide: information on the persons effectively conducting the business of the Manager; identification of the Manager's shareholders or members (whether direct or indirect, natural persons or entities) and the amounts of their holdings; a business plan setting out the Manager's organizational structure and how the Manager intends to comply with its obligations under the AIFMD; information on the Manager's remuneration policies and practices; and information on arrangements for delegation and/or sub-delegation to sub-advisers. In addition, Article 37(8) will require US Managers to provide the following: a justification as to why the Manager's selection of the MSR is appropriate, the name of the legal representative of the AIFM in its home state, and a list of all of the provisions of the AIFMD for which compliance is impossible due to conflicting provisions of another mandatory law (and evidence that the AIFM is subject to an equivalent standard of regulation in the United States with the same regulatory purposes and level of investor protection as that of the MSR).

Further, the US Manager must provide detailed fund-related information about the investment strategies of each fund marketed in the EU, the types of underlying funds if the AIF is a fund of funds, the AIFM's policy as regards the use of leverage, the risk profiles and other characteristics of the AIFs it manages or intends to manage, information about the Member States or third countries in which such AIFs are established or are expected to be established, information on where the master AIF is established if the AIF is a feeder AIF, the rules or instruments of incorporation of each AIF the AIFM intends to manage, and information on the arrangements made for the appointment of the depositary (that meets the requirements of the AIFMD) for each AIF the AIFM intends to manage.

Practice Note: Development of an AIFMD "business plan" can be expected to be a highly detailed process that will reach far beyond legal and regulatory requirements. The business plan

will need to address, in detail, ongoing compliance with the AIFMD's substantive requirements.

Substantive Requirements of the AIFMD

Certain substantive requirements (Capital Requirements, Organizational Requirements, Risk Management, Securitizations and Cooperation Agreements) were discussed in detail in our prior article. Capital Requirements, Organizational Requirements and Risk Management are briefly summarized below, along with a more in-depth discussion of the other substantive requirements that the AIFMD imposes on US Managers (Operating Conditions, Portfolio Management Conditions and Leverage, Liquidity Management Conditions, Conflicts of Interest and Remuneration Conditions, Valuation, and Delegation).

Capital Requirements. Article 9 of the AIFMD requires minimum initial capital (€125k for externally managed AIF), additional capital funds ("own funds") for funds exceeding €250m under management (0.02 percent of the amount exceeding €250m, up to but not greater than €10m in own funds), and "additional own funds" and/or indemnity insurance to cover the risks arising from professional negligence, taking into account the risks and quantitative requirements articulated in Boxes 5 and 7 of the Final Report, respectively. US Managers should calculate their capital requirements and accumulate capital as necessary before submitting an application for authorization to the relevant regulators in their MSR.

Organizational Requirements. The general organizational requirements for managers are set forth in Article 18 of the AIFMD, including administrative and accounting procedures, procedures for the protection of data, and rules related to personal trading and recordkeeping. In Boxes 44-52, ESMA's Final Report provides a comprehensive checklist of compliance responsibilities and a framework for administering a compliance program designed to minimize the risk of non-compliance. Most notably for US Managers, the Final Report holds senior management personally responsibility for administration of an effective compliance program.

Risk Management. Managers must have a functionally and hierarchically separate risk management function, including proper identification, measurement, management and monitoring of risks associated with each investment position. The risk profile of the AIF must correspond to the AIF's rules and its "size," including qualitative risk limits. Box 25 requires a manager to monitor risk limits and notify investors if an AIF's risk limits are exceeded. Further the manager must report to the board and senior management regarding any actual or foreseeable breaches of risk limits. Deciding to seek authorization will require some advisers to develop a risk function that is independent of operational areas and business units. Reporting lines and compensation arrangements should be revisited.

Practice Note: For senior management, the AIFMD is not a "set it and forget it" regime; the US Manager's senior management will be personally responsible for ongoing compliance in addition to their duties to supervise.

Operating Conditions (Implementing Measures on General Principles)

AIFMD Provisions on Operating Conditions. Article 12(1) of the AIFMD sets out general "conduct of business" principles, requiring that the US Manager (a) act with due care, diligence and fairly in the conduct of its affairs, (b) act in the best interests of the AIF, (c) have and employ necessary resources, (d) take all reasonable steps to avoid or address conflicts of interest that cannot be avoided (e) comply with "all regulatory requirements," and (f) treat all AIF investors fairly (that is, disclose all side letters).[9]

ESMA Technical Guidance on Operating Conditions. Box 10 contemplates that managers treat all AIF investors as "professional investors," similar to the approach taken in the Markets in Financial Instruments Directive (MiFID), when preparing conduct of business principles.[10] US Managers must have policies and procedures in place that are appropriate to prevent malpractices that might reasonably be expected to affect *the market's* stability and integrity. ESMA did not offer detailed examples of AIF malpractices that adversely affect the market, but cited late trading and market

timing (associated with UCITS funds) as examples. Further, managers are responsible for ensuring that undue costs (such as excessive trading costs) are not charged to investors or to the AIF. Thus, it would appear that AIFs that follow very aggressive trading strategies may struggle to obtain authorization.

Portfolio Management Conditions

ESMA Technical Guidance on Due Diligence - Box 11 of ESMA's Technical Guidance requires managers to conduct "a high level of" investment due diligence and to preserve due diligence records for a period of four years. Specifically, this means that a manager must perform due diligence prior to acquisition of an asset, assessing all relevant legal, fiscal, financial or other "value-affecting factors," including exit strategies, and must monitor its investments. Further a manager must have an AIF-specific "business plan" for *each* AIF that it manages that is consistent with the duration of the AIF's investments. Box 13 extends due diligence and prudence principles to counterparties and prime brokers, requiring senior management to prudently select and approve such parties prior to entering into an agreement and implying a duty to negotiate terms with the prime broker.

With respect to counterparties and prime brokers, Article 13 specifically mandates additional due diligence. Due diligence includes assuring that the prime broker is subject to "ongoing supervision" by a regulator. In addition, the US Manager will have to assess the prime broker's and counterparty's "financial soundness" and whether or not the firm has the "necessary organizational structure to supply the relevant services. Senior management of the AIFM must approve counterparties and prime brokers, and the AIFM must be able to demonstrate to its MSR regulator the basis for the selection of its counterparties and prime brokers.

ESMA Technical Guidance on Order Execution and Trade Allocation - ESMA sets forth criteria on order execution on a "best interest of the AIF" basis in Boxes 14-16, proposing a very detailed and prescriptive list of order execution criteria (that does not address soft dollars). Procedures are required for order handling, and to prevent misuse of information in all orders (for example, front running). Such criteria must be required to be reviewed annually on a "best execution" basis. The trade allocation rules start from a presumption against aggregation (Box 17). Aggregation is permitted if detailed conditions are met regarding measures to assure that aggregation will be "unlikely" to work to the disadvantage of any client "whose order is to be aggregated." Proprietary trades may be aggregated, but not in a way that "is detrimental to the AIF." This suggests that proprietary accounts may need to drop out of a block that is not a full order of all client demand for a security, and client accounts must have priority in getting filled. However, proportionate allocation across a block that includes proprietary accounts is permitted if necessary to get the trade done.[11]

AIFMD Provisions on Leverage. Article 25(3) of the AIFMD gives the Member State regulator the power to impose leverage limits on managers and other restrictions on the management of AIF to limit systemic risk. Article 4(1)(v) of the AIFMD defines leverage as any method by which AIFM increase exposure of a managed AIF (whether through cash or securities), or any leverage embedded through derivative positions. The Commission requested advice on the appropriate methods for calculating leverage and on methods by which an AIFM may increase the exposure of an AIF through leverage. AIFMs are also obliged to set maximum levels of leverage and make proper leverage disclosures to investors.

ESMA Implementing Measures on Leverage. Boxes 94-101 of the Final Report generally provide the methods for calculating leverage and for measuring the leverage associated with derivatives. Leverage must be calculated as a ratio of "exposure" to NAV, with "exposure" being calculated in accordance with either a "gross" method or a "commitment" method (unless the MSR permits an alternative to the commitment method, referred to as the advanced method). Under any method of calculation, exposure to third party collateral structures must be included to the extent that such exposure is specifically set up to increase the AIFs level of exposure. "Bridge" loans or other temporary borrowing arrangements may be excluded to the extent that such borrowings are "covered" by capital commitments

(as defined in Box 94).

The gross method (Box 95) looks to the value of the AIF's assets and requires conversion of derivatives to their equivalent physical position (with the formulas for such conversion set forth in Box 99 by derivative type). The gross method also requires exclusion of cash and highly liquid cash equivalents, excludes netting and hedging and permits adjustment for repos/reverse repos. The commitment method (Box 96) is similar to the gross method except that it allows the AIFM to take into account netting and hedging arrangements that reduce exposure. The advanced method provides a highly-flexible alternative method for calculating leverage provided that the AIFM notifies its MSR and complies with the requirements set forth in Box 97, including the requirement that such method of calculation is "fair, conservative and not underestimate or give a misleading view," and is applied consistently. Although ESMA expressly rejected calculation using the Value-at-Risk method, which was proposed in many responses to ESMA's draft technical advice and will be familiar to many US Managers, the flexibility afforded to AIFM in the advanced method may permit such calculation if the requirements in Box 97 are met, and if the MSR regulator is persuaded.

Box 101 of ESMA's Final Report provides the circumstances under which leverage limits may be imposed by the MSR regulator. Perhaps the key requirement is that the AIFM must demonstrate that the AIF's use of leverage is "reasonable" to the MSR regulator. Thus, the choice to passport within Europe may affect an AIF's leverage, and will put in the hands of the MSR regulator the ultimate authority to restrict leverage used by the AIF. Box 101 also provides that the MSR regulator is required to asses the risks of the use of leverage by an AIFM and the extent such use poses a systemic risk or could create disorderly markets. The regulator has the authority to intervene and impose leverage limits in the event of a downward spiral in prices of financial instruments.

Liquidity Management Conditions

Liquidity and redemption features. The AIFMD requires that managers "employ an appropriate liquidity management system and adopt procedures which enable them to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations." Liquidity management does not apply to closed-end AIFs. Article 16 of AIFMD requires stress testing to allow assessment of liquidity risk, in proportion to the AIF's redemption policy, management and investment strategy—all of which must be consistent. Further, pursuant to Article 23(4)(a), managers must periodically disclose to investors the percentage of AIF assets subject to "special arrangements" arising from their illiquid nature (defined in Box 31 of the ESMA's Final Report to include assets that have to be held in a side-pocket and other similar arrangements which achieve similar outcomes).

ESMA Technical Guidance on Liquidity Management. Pursuant to Box 32, a manager must be able to demonstrate to the relevant regulator that it has in place "appropriate and effective" liquidity management procedures.[12] Managers must monitor the liquidity of each AIF and adopt appropriate liquidity management policies that align investment strategy, liquidity profile and redemption policy.[13] Prospective investments must be analyzed using liquidity criteria and that prospective investment's contribution to the AIF's liquidity position. Qualitative and quantitative liquidity analysis is to be implemented and AIFMs are responsible for ensuring adequate disclosure of liquidity risk. Managers are further responsible for considering conflicts of interest between investors seeking to redeem, as well as any conflict associated with making an illiquid investment. Such liquidity management procedures must account for risk monitoring of liquidity and periodic stress testing that simulates a shortage of liquidity and atypical redemption requests, as well as valuation sensitivities, margin calls and other factors (Box 33). This testing should be as frequent as suggested by the redemption policy, strategy and holdings of the AIF (and at a minimum, annually).

Conflicts of Interest and Remuneration Conditions

To be in compliance, managers must have procedures in place designed to "identify, prevent,

manage, monitor and disclose conflicts of interest." To the extent that the installed procedures are not sufficient to provide a reasonable degree of confidence in the prevention of any risk of damage to the investor's interest, the managers should disclose the general nature of the conflict to the investors.

Remuneration is a central tenet of the AIFMD, which contemplates controls applicable to remuneration paid to senior management, risk takers and control functions. A manager's remuneration policies should discourage risk-taking which is inconsistent with the risk profiles, fund rules, or instruments of incorporation of the AIF it manages. Further, a manager's remuneration policy should observe a multitude of requirements. Specific requirements include: (i) setting performance awards in a multi-year framework suitable to the fund managed; (ii) limiting payment on early termination so as to not reward failure; (iii) risk adjusting performance awards to reflect all forms of current and future risks, and (iv) providing variable equity in line with long term interests.

AIFMD Provisions on Conflicts of Interest and Remuneration. Article 14 of the AIFMD requires managers to maintain and operate effective organizational controls "with a view to taking all reasonable steps" to identify, prevent, manage and monitor conflicts of interest so as to ensure no risk of damage to investors. All other conflicts must be disclosed.

ESMA Technical Guidance on Conflicts of Interest. Box 20 contemplates five inquiries a manager should undertake to identify possible conflicts: (a) any potential for gain/loss avoidance at an AIF's expense, (b) any interest in a service, activity or transaction distinct from that of AIF (for example, affiliated brokerage/underwriting), (c) any incentive to favor one client over another, (d) multiple clients receiving the same service, (e) receipt of any inducement in relation to managing the AIF from a third party other than standard fee for that service (for example, soft dollars).[14] Boxes 20-24 set forth ESMA's technical guidance on implementing conflict controls.

Box 21 requires a manager to have an effective, written, conflicts of interest policy. The key criterion is a process that identifies possible conflicts.

Box 22 sets out a series of steps designed to "wall off" fund management from other business interests of the manager and its relevant persons, including information barriers, separate supervision, removal of remuneration links, prevention of inappropriate influence, or sequential involvement in portfolio management, risk management or administration.

Box 23 calls for record keeping of types of activities and material conflicts arising from those activities, which must be disclosed, and which may be disclosed via a website, under certain circumstances.

Box 24 requires managers to have adequate strategies to ensure voting rights are exercised in the best interests of the AIF and investors (monitoring relevant corporate actions, consistency with investment objectives, preventing or managing conflicts) and to make those strategies available to investors on request.

Box 18 prohibits a manager from making any payment or receiving any monetary or non-monetary benefit related to portfolio management other than: (a) fees paid to the AIF, (b)(i) fees paid by the AIF that are fully disclosed and (b)(ii) the fee/payment is designed to enhance service quality,[15] or (c) proper fees to non-conflicted service providers. Fee disclosure may (initially) be summary. Box 18 is intended to address AIF marketing, and preclude inducements.

ESMA Technical Guidance on Remuneration. ESMA's Technical Guidance provides the required content and format of remuneration disclosures relating to aggregate compensation of senior management and staff that have a material impact on a fund's "risk profile" as part of an AIFM's annual reporting obligations. Essentially, the disclosure is limited to aggregate amounts paid in salary, and the amounts of variable compensation. It should be noted that the AIFMD has detailed substantive proscriptions regarding bonuses, requiring (in very general terms) that compensation of investment professionals be deferred, subject to claw backs, and convertible to stock in the manager at the manager's discretion.[16]

Valuation

The AIFMD focuses on independent valuation. Valuation can be performed either internally or externally, but the assurance of

independence is key. If the valuation is performed internally, the valuation task must be "functionally independent" from the portfolio manager, remuneration policy, and anything else that might pose a conflict of interest. If valuation is performed externally, the manager maintains ultimate responsibility.

Practice Note: US Managers will need detailed due diligence files on investments and counter parties sufficient to satisfy the MSR regulator. In addition, the US Manager will have to test and report leverage and liquidity using methodologies acceptable to its MSR regulator.

AIFMD Provisions on Valuation. Article 19 of the AIFMD mandates that managers have "appropriate and consistent" valuation procedures that produce a "proper and independent valuation." Further, Article 19(3) requires disclosure of NAV in accordance with AIF's rules (including redemption/sales cycles) and no less than yearly.

ESMA Technical Guidance on Valuation. Box 55 of ESMA's Final Report addresses the appropriate policies and procedures for asset valuation. These valuation policies and procedures must be in writing. They must address organizational structure, roles and responsibilities, including those of senior management, internal valuation independence safeguards, and coordination with external valuators. Importantly, a manager may not invest in a particular type of asset for the first time unless valuation methodologies have been identified for that asset. Boxes 56-61 provide detailed valuation models and methodology (which are beyond the scope of this article).

Delegation

The AIFMD puts into place certain procedures to be followed when a manager delegates one of its functions. The manager must notify the competent authorities of the MSR before delegating any function, and must be able to "objectively" justify the delegation. Risk and/or portfolio management functions may only be delegated to authorized and supervised "asset managers." Further, delegations to entities outside of the EU have additional requirements such as cooperation between the relevant supervisory authorities. Sub-delegation is also permitted with certain restrictions. The manager must consent prior to any sub-delegation and all conditions applicable to the initial delegation apply to the sub-delegate. Additionally, the relevant competent authority must be notified prior to the sub-delegation becoming effective.

AIFMD Provisions on Delegation. Article 20 of the AIFMD generally provides the rules for delegation of a manager's functions. It specifically requires the manager to notify their Member State authority prior to delegating tasks and sets out a series of conditions that must be met with respect to delegation of duties. Article 20(1)(a) requires an AIFM to be able to justify its entire delegation structure based on "objective reasons." Delegates must meet "resources" and "good repute" tests (set forth in Article 20(1)(b)), and delegation is only permissible to entities that are authorized/registered for "asset management" and subject to effective supervision (Article 20(1)(c)). Delegation is not permitted if it would prevent the effectiveness of supervision of the manager (Article 20(1)(e)), such as if it would prevent the manager from acting or AIF from being managed for the best interests of investors, and delegation may not be made to any entity whose interests are in conflict with the investors' interests unless there is functional and hierarchical segregation of the portfolio/risk tasks from the conflicting interests.

ESMA Technical Guidance on Delegation. Boxes 63 through 74 of ESMA's Final Report provide ESMA's Technical Guidance on delegation and sub-delegation. Pursuant to Box 63, the conditions of Article 20 must be met to delegate any task which is "critical or important for the proper performance" of services provided to an AIF. Critical or important services subject to Article 20 are ones where a failure would materially affect compliance. In order to provide objective reasons for delegation, as required by Article 20 of the AIFMD, ESMA's Final Rule requires managers to demonstrate that the delegation serves efficiency purposes (Box 65).[17] Objective reasons for delegating tasks include, but are not limited to, optimizing business processes, cost savings, expertise, and scalability.

Box 66 sets forth an AIFM's due diligence obligations for examining a potential delegate.

This includes examination of resources, personnel (their theoretical knowledge and practical experience), and their "negative records" with respect to criminal, judicial or administrative proceedings.[18]

Box 69 discusses when a delegation would prevent the effective supervision of the AIFM so as to violate Article 20(1)(e). It mandates access to the delegate data by AIFM and authorities and delegate cooperation on inspection, and prohibits undisclosed conflicts between delegate and AIF.

Box 72 describes how the prohibition on delegating to an entity whose interests conflict with the investors' interests should work within an investment adviser: consideration of undue influence by members of a company group or by investors should be considered. Also portfolio management must not perform "control tasks," and conversely risk managers must not perform "operational tasks" or be supervised by those that do. Risk and portfolio management must be independent at the adviser's board level.

Box 74 of ESMA's Final Report provides ESMA's technical guidance for when a manager would have delegated to the point of becoming a "letter box entity" in violation of Article 20(7)(b) of the AIFMD as: (1) if the AIFM can no longer effectively supervise and manage the risks of the delegated function or (2) the AIFM no longer has the "power to make decisions" in the areas required to be taken by "senior management."

***Practice Note*:** US Managers (particularly those that operate as managers of managers) will recognize that their appointment of sub-advisers will be deemed "delegation" and that US Managers that use sub-advisers will have to follow the procedures described above, effectively subjecting their sub-adviser appointment to MSR regulatory review, and, assuming no objection from the regulator, to ongoing compliance with the "do's" and "don'ts" list set out below. But, equally, US Managers may, upon reflection, prefer to be "delegates" themselves rather than Alternative Investment Fund Managers. We anticipate that "rent-a-management company" solutions will emerge for AIFM as they have for UCITS. We note a term "Super ManCo" is coming into use to describe UCITS management companies that intend to be qualified under the AIFMD to serve as the management company for AIFs.

Conclusion

US Managers may seek to become authorized as alternative investment fund managers to market alternative investment funds within the EU. Further, institutional investors in the EU may use the AIFMD as a "best practices" risk-management device and may expect even those managers marketing under national private placement rules to comply with many, if

Do's and Don'ts of Delegation (Box 64)	
DO	**DO NOT**
Assure delegate complies and is effective.	Delegate senior management functions.
Retain resources to supervise delegate.	Alter management's obligations.
Assure for continuity in case delegation is terminated.	Undermine conditions for authorization.
Allocate responsibility clearly and in writing.	Contradict investment policy of AIF.
Instruct the delegated portfolio manager in implementation of investment policy.	
Assure delegate (i) keeps information confidential, (ii) discloses to AIFM any material adverse development, and (iii) has a business continuity plan.	

not all, of the substantive requirements of the AIFMD. As such, the AIFMD will affect any US Manager that seeks to manage money for EU clients in an alternative investment fund. The AIFMD's substantive requirements are formidable, turning a heretofore lightly regulated segment of the fund industry into arguably the most regulated of all kinds of collective investment vehicles. While the burdens of the AIFMD are not to be understated, authorized AIFMs will have a significant marketing advantage in Europe. Thus, access to Europe via the AIFMD may be an opportunity that is too significant not to embrace, even at the cost of the attendant regulation.

Notes

1. *European Parliament and Council Directive (EU) 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 105/2010.*

2. *See,* Stuart Fross and Michael Rohr, "AIFMD Implementing Regulations Update: ESMA's Final Report and Impacts for US Managers," *The Investment Lawyer,* Vol.19, No.2, Feb. 2012 (AIFMD Implementing Regulations Update). In our last article, six key themes were identified for US money managers seeking to adopt their current operations to AIFMD, focusing on (1) the AIFMD's "transparency" requirements for alternative investment funds (AIFs) organized outside the EU that will market in the EU on a national, private placement basis, and (2) certain of the AIFMD's most onerous requirements for US money managers.

3. *ESMA/2011/379, Final report: ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive* (Final Report). These implementing measures are either "delegated acts" or "implementing measures." The delegated acts will (when adopted by the Commission) supplement the AIFMD text and (after a three-month review period for potential challenges by the Council or European Parliament) will then be followed by national legislation in the member states as part of implementation of the AIFMD on a country by country basis. Implementing measures are adopted by the Commission, subject to an internal review procedure. The Commission has (initially) until July 21, 2015 to complete the process of exercising its delegated authority, pursuant to AIFMD, Article 56. Member states are then obliged to adopt measure of national law that implement in national law the Commission's implementing measures.

4. *Id.* The AIFMD establishes new, "best-practices" for investor protections. As a result, US Managers may begin to experience social pressure from buyers seeking, in their fiduciary capacity, to ensure their money managers comply with the best-practices standards as soon as practically possible

5. By way of reminder, as of the effective date of AIFMD in July 2013, non-EU AIFMs managing non-EU AIFs are not required to be authorized if marketing in the EU under local private placement rules. However, the AIFMD's preamble contemplates that ESMA "should issue advice on the termination of those national [private placement] regimes." Such advice is expected in 2018. AIFMD, 174/13 at (90). For further discussion, please refer to S. Fross and M. Rohr, AIFMD Implementing Regulations Update, *supra* n.2.

6. This article is not addressed to the depositary requirements under the AIFMD and the Final Report.

7. *See* Article 37(1). Article 37(2) provides an exception for complying with a provision of the AIFMD "if and to the extent that compliance" is incompatible with another law that the US Manager is subject to, provided the Manager can demonstrate that simultaneous compliance with the AIFMD and a mandatory provision of the other law is impossible, and the other law has an "equivalent rule having the same regulatory purpose and the same level of protection" for investors as the AIFMD.

8. By way of reminder, ESMA reported its technical advice to the Commission by segregating background information and interpretive guidance from the actual technical guidance by placing the guidance in numbered "boxes."

9. Note the similarities to UCITS 14(1).

10. MiFID, among other things, imposes an obligation to determine the suitability of a fund for a particular client. Professional investors under MiFID can be assumed to be able to accept investment risk associated with a particular fund and to understand investment risks of that fund. Thus, the MiFID firm's duties are reduced to assuring that the investment objective of the fund meets the client's investment objective.

11. It seems that proprietary money will never be needed in a block trade and that Box 17, as a practical matter requires proprietary money to trade last.

12. Interestingly, the AIFM must give consideration not only to liquidity needs of investors, but also to those of "counterparties, creditors and third parties." ESMA specifically considers suspension of redemption rights—something only to be used when in "the best interests of all AIF Investors."

13. Funds of funds (if underlying funds are unlisted) must monitor the liquidity of the investments made by the underlying managers and their redemption policies.

14. In addressing AIFM conflicts, ESMA made reference to the November 2010 IOSCO Report on Private Equity Conflicts of Interest. ESMA provided an example: a conflict would be buying real estate from the AIFM or

one of its relevant persons in a "bad location." Another interesting example of a conflict: AIF is long in an asset and a UCITS client shorts the same asset, particularly if the AIF is in a position to influence the price of that asset.

15. For example, where an investor pays subscription fees to an AIFM which are passed on to intermediaries for the marketing of the relevant AIF, the payment falls under paragraph (b) of Box 18. The inducement rules of Box 18 will be aligned with any future development of the MiFID rules.

16. For additional discussion of remuneration, see Stuart Fross and Philip Morgan, "The Advent of Investment Adviser Remuneration Regulation," *The Investment Lawyer,* Vol.18, No.7, July 2011, available at *www.klgates.com/files/...4049.../IL_0711_Fross_Morgan.pdf.*

17. The rule is based on the UCITS approach in Article 13 of the UCITS Directive.

18. Professional service providers established in the EU and authorized for the purposes of the delegated task are presumed to have no negative records unless facts suggest otherwise.

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