

## Investment Funds Alert

### AIFMD Level 2 Measures: New Year's Resolutions for Alternative Asset Managers

January 3, 2013

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#### Introduction

As our client update of [19 December](#) identified, the European Commission (the “Commission”) has published the text of a proposed delegated regulation (the “Regulation”) that sets out the “Level 2” implementation rules in respect of the Alternative Investment Fund Managers Directive (the “AIFMD”). This alert will be relevant to and of interest to the following categories of alternative investment fund managers, all of whom may be affected by the implementation of the AIFMD during 2013:

- EU-based managers of alternative investment funds (“AIFs”)
- non-EU-based managers of AIFs, who either
  - have investment professionals based in the EU
  - who market their funds to investors in the EU
- managers and sponsors of investment products that allocate assets to EU-based alternative investment fund managers.

The text of the Regulation is complex and covers a significant number of areas in great detail. Rather than summarising the entire contents of the Regulation, this alert identifies five priority areas that should be considered by managers affected by the AIFMD as early in 2013 as possible. All managers affected by the AIFMD should, however, familiarise themselves with the full scope of the Regulation urgently given the short time remaining for managers to prepare for the implementation of the AIFMD across Europe in July 2013. This is particularly important since the rules in the Regulation will take effect across Europe, without any transposition by national governments or regulators.

#### Identifying the AIFM

One of the key impediments that have prevented adequate preparation for the implementation of the AIFMD during 2012 has been uncertainty over how to identify which entity within any given group should be regarded as the Alternative Investment Fund Manager (the “AIFM”) of any given AIF. Since the majority of alternative investment fund management businesses are structured in a way that involves multiple group entities being engaged in the management of each AIF in some way, ascertaining which entity is the AIFM for each AIF is vital, in order to identify whether or not there is an EU-based AIFM that will be subject to the AIFMD.



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The Regulation does not contain a straightforward test to explicitly address this issue. However, there are provisions which give a clear indication of how the Commission expects the industry to approach this point. In broad terms, an entity appointed to manage the assets of an AIF will be regarded as the AIFM unless it is a “letter-box entity.” Some groups may wish to establish that the AIFM for each AIF that they manage is located outside the EU, or is located under a particular EU jurisdiction. To be able to do so, they will need to be able to show that the entity that they identify as the AIFM is not regarded as a letter-box entity.

Article 82 of the Regulation sets out the test for establishing this. The criteria for the test are broadly drafted. The criteria will need to be assessed subjectively in respect of each AIF and each entity involved in the management of the AIF. The greatest focus is likely to fall on consideration of the extent of delegation by any entity seeking to be treated as the AIFM. If the delegation of “investment management functions” exceeds by a “substantial margin” the investment management functions actually performed by the relevant entity, the relevant entity will be regarded as a letter-box entity and will not be regarded as the AIFM. Neither the term “investment management functions,” nor “substantial margin” are defined in the Regulation, so any views expressed by national regulators on how these tests should be applied will be significant in assessing how to apply the test in practice.

There are some potentially undesirable consequences of this test:

- Groups that maintain an EU-based investment team may be regarded as having an EU-based AIFM, even in cases where the group’s headquarters are located outside the EU (e.g. US-based investment managers). This could lead to an outcome where some funds managed by a group will need to be “AIFMD-compliant” in due course, even though the EU operations of the group are relatively small.
- Some EU-based managers may be treated as being the AIFM of products that they do not sponsor. There is a particularly pronounced risk of this in relation to a number of “managed account platform” structures, where managers are appointed to manage a portfolio of assets relating to another fund or pooled investment vehicle of some sort. It is unclear in many of these structures who the AIFM will be.

#### *January 2013: Action Items*

- Analyse each AIF “sponsored” by the group and identify which entity is the AIFM.
- Consider restructuring products where the result of analysis is that an EU-based AIFM is the AIFM of the product.
- Analyse all “managed account” products to identify any that pose the risk of your being regarded as the AIFM of an AIF that you do not sponsor.

## **Managing Delegations**

The AIFMD sets out a number of conditions regarding the delegation of tasks by an AIFM. These conditions have been expanded upon considerably by the Regulation, with detailed obligations being created in respect of the basis on which delegations are permissible, the terms on which delegates must be appointed and the ongoing supervision of the performance by delegates of their functions.

The Explanatory Memorandum that accompanies the Regulation seeks to clarify what sorts of delegations the relevant provisions of the AIFMD and the Regulation apply to. The AIFMD applies the delegation rules to any delegation by the AIFM of its “functions” to a third party. The Commission believes that, for these purposes, those functions should be “. . . the management functions set out in Annex I . . .” of the AIFMD. This construction means that, not only do the delegation rules apply to delegation of investment management functions, but also to a variety of “administrative” functions that the AIFM is appointed to carry out and also to the appointment of marketing intermediaries by the AIFM.

The practical impact of these rules in relation to existing delegations could be significant, particularly where the terms on which any relevant delegate is appointed may be inadequate for the purposes of the Regulation.

There are additional, more detailed rules regarding delegations of portfolio or risk management outside the EU, which require there to be in place cooperation arrangements with the state in which the delegate carries on its activities. These functions cannot be delegated to a third-country undertaking if those cooperation arrangements are not in place.

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- Identify all delegations by an EU AIFM of “management functions” in accordance with the AIFMD.
- Review the provisions of contracts appointing such delegates to determine compliance with the requirements of the Regulation.
- Plan a project for assessing each delegation in accordance with the criteria set out in the Regulation.
- Identify any delegation of portfolio or risk management to a third-country undertaking and monitor the progress of the relevant co-operation agreement.
- Consider contingency plans for dealing with “non-compliant” delegations.

## **Calculation of Leverage**

Leverage, defined as “any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means”, is made subject to several obligations under the AIFMD. For example, an AIFM has to report leverage figures to investors and supervisory authorities, adopt a policy regarding the use of leverage and set a maximum level of leverage for the AIFs it manages.

The Commission was empowered to specify (i) the methods by which leverage is obtained and (ii) how leverage is to be calculated. The Regulation has confirmed the Commission’s initial opinion that a combination of two methods of leverage calculation should be used: the “gross” method and the “commitment” method. The Commission takes the view that the use of both methods will allow regulators and investors to gain a complete picture of the AIF. Specifically, the “gross” method will set out the overall exposure of the AIF, and the “commitment” method will give more insight to the hedging and netting techniques used by the AIFM.

The way in which AIFMs will need to calculate leverage under each method is set out in Articles 7 to 11 and Annexes I, II and III of the Regulation. The industry lobbied for an alternative, third, method of calculation (arguing that the proposed methods could give a distorted view of the leverage, and risk, inherent in an AIF), but the Commission has rejected this argument. The Commission has, however, opened the door for the European Securities and Markets Authority to review the calculation methods and decide whether an additional method for calculating leverage should be adopted in due course.

Finally, only AIFMs using “substantial” leverage need to make certain information available to their supervisory authorities. The Commission has clarified that “substantial” means exposure, calculated using the “commitment” method, of over three times net asset value.

#### *January 2013: Action Items*

- Identify resources for carrying out leverage calculations and undertake initial calculation.

- Undertake analysis of leverage calculations to determine whether or not leverage is “substantial” within the meaning of the Regulation

## Investment Processes

The AIFMD sets out conditions relating to how AIFMs are permitted to run AIFs where the investment strategy involves particular investment techniques. The provisions relate to:

- Investment in securitisation positions.
- Management of leveraged AIFs. Acquiring control of non-listed companies and issuers.

Although the Regulation does not seek to apply “investment restrictions” in any conventional sense to such AIFs, it does seek to prescribe the manner in which investment activities are carried on. This is most pronounced in relation to investment in assets that have “limited liquidity”.

There is no definition of how to ascertain whether an investment is to be regarded as having “limited liquidity”. Whilst conventional private equity, real estate and infrastructure assets will all clearly be in this category, it is also possible that investments in hedge funds by fund of fund managers will be caught, along with investments by hedge fund managers in assets that, whilst freely tradable, are subject to qualifications on their liquidity by virtue of the markets they are traded on (e.g., small cap stocks, where there is limited trading in the issuer).

Article 18 of the Regulation specifies standards of due diligence to be applied by AIFMs in relation to all of their investments. In addition, where the AIF invests in an asset which has “limited liquidity,” and where the investment has been subject to negotiation, further conditions are imposed by Article 19:

- A business plan must be set out and regularly updated.
- Transactions must be sought and selected in a consistent manner with the business plan.
- Due diligence should be performed prior to execution.
- Performance should be monitored having regard to the business plan.
- Transactions should be assessed by a number of factors, including human resources and exit strategies.

The Commission expects AIFMs to maintain minutes of all relevant meetings, preparatory documentation, and the economic and financial analysis conducted for a period of five years.

### *January 2013: Action Points*

- Review existing portfolios to determine whether there are any investments in limited liquidity assets.
- Engage investment professionals in discussions regarding investment processes to be adopted.

## Depositaries

The AIFMD imposes an obligation on AIFMs to ensure that each AIF that they manage appoints a single entity to act as a depositary. The depositary’s role is to ensure that the AIF’s cash flows are properly monitored, safe-keep the assets

of the AIF, and ensure that issues and redemptions of interests in the AIF, together with the valuation of the AIF's assets, are carried out properly.

AIFs established in the EU are subject to the whole of Article 21 of the AIFMD, whilst non-EU AIFs are subject to more limited obligations; specifically, that one or more entities perform the roles highlighted above. Non-EU funds therefore escape the balance of the more complex rules prescribing how the depositary's duties should be discharged and, in particular, rules regarding delegation and when the depositary should be liable for losses to the AIF and its investors (although it should be noted that the Directive allows individual Member States to impose stricter conditions on an AIF being marketed in their territory so they could provide for the full range of rules to apply).

AIFMD granted the Commission wide powers to specify the conditions for performing the depositary function and the duties of depositaries. Therefore, the Regulation contains lengthy provisions establishing, amongst other things:

- The criteria for monitoring the cash flows.
- The scope of instruments that should be held in custody (including rules on instruments held as collateral).
- Liability of depositaries for losses of instruments held in custody.
- Reporting obligations for prime brokers.
- The duties regarding subscriptions and redemptions.
- The duties regarding valuation of interests.

*January 2013: Action Points*

- Review documentation for EU AIFs and non-EU AIFs to be marketed in the EU to confirm that persons are appointed to carry out the appropriate depositary functions.
- Engage in discussion with administrators/prime brokers in respect of depositary offerings.

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