SHEARMAN & STERLING LLP

INVESTMENT FUNDS

CLIENT PUBLICATION

January 14, 2013

AIFMD "Level 2" Published – Time to Get Moving!

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

John Adams
London
+44.20.7655.5740
john.adams@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Lorna Xin Chen
Hong Kong
+852.2978.8001
lorna.chen@shearman.com

Thomas Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

John W. Finley III
New York
+1.212.848.4346
sean.finley@shearman.com

Laura S. Friedrich
New York
+1.212.848.7411
laura.friedrich@shearman.com

Etienne Gelencsér
Tokyo
+81.3.5251.0209
etienne.gelencser@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

The long-awaited Implementing Regulations for the AIFM Directive (so-called "Level 2") were published by the European Commission on December 19, 2012. Completing a winding legislative road that commenced with the publication of the first draft of the AIFM Directive in mid-2009, the Regulations will affect fund managers of almost all types worldwide.

The Implementing Regulations do not answer all the questions asked of – or solve all the problems created by – the AIFM Directive itself. Nevertheless, fund managers now have enough information to analyse the impact of the AIFM Directive on their structures and businesses, and to take appropriate action in advance of the implementation deadline of July 22, 2013.

Introduction

Relevant for all EU-based fund managers and advisers, and also relevant in practice for any non-EU manager or adviser whose business touches the EU in some way (either because a fund is marketed into the EU, or a fund is domiciled in the EU, or the non-EU adviser delegates to – or is delegated to by – an EU-based manager or adviser), the Directive[1] will have far-reaching consequences for fund managers globally, regardless of fund type or strategy. The Implementing Regulations[2] (the "**Regulations**") are intended to supplement, clarify and add colour to the provisions

[1] Directive 2011/61/EU.

[2] http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf.

of the Directive.[3] They impart detail in a number of key areas including depositary duties and liability, delegation, international cooperation agreements, and transparency requirements.

Leaked drafts of the Regulations that circulated within the fund management industry during 2012 suggested that the European Commission (the "**Commission**") intended to depart, in a number of crucial ways, from the advice of the European Securities and Markets Authority ("**ESMA**").[4] The final version of the Regulations confirms that approach.

This note addresses some of the key aspects of the Regulations, and analyses their implications for fund managers (referred to in the Directive as "Alternative Investment Fund Managers" or "AIFMs"), their counterparties, and the funds managed by AIFMs (funds are referred to in the Directive as "Alternative Investment Funds" or "AIFs"). We discuss in turn:

Registration Only – Lighter Regime for Smaller EU-Based Managers

A smaller, EU-based Alternative Investment Fund Manager is entitled to "register" with national regulators in the EU, rather than seek and submit to full authorisation. This 'registration-only' regime avoids most of the burden of the Directive and is available to those managers that have:

- assets under management ("**AUM**") of no more than €100 million; or
- AUM of no more than €500 million, but only where its funds are unleveraged and investors are not permitted to redeem their investments for at least five years.[5]

The Regulations provide guidance on how to calculate AUM for this purpose – and what to do in the case of a temporary breach of the limits.

[3] The provisions of the Directive were examined in detail in a previous publication, available at: http://www.shearman.com/european-regulation-of-fund-managers-aifm-directive-agreed-and-adopted-11-12-2010.

[4] ESMA's final advice was analysed in detail in a previous publication, available at: http://www.shearman.com/european-regulation-of-fund-managers--esmas-final-level--2-advice-published-12-12-2011/.

[5] Directive, Article 3(2).

Contacts (cont.)

Bill Murdie
London
+44.20.7655.5149
bill.murdie@shearman.com

Donna M. Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

Iain Scoon
London
+44.20.7655.5936
iain.scoon@shearman.com

Bertrand Sénéchal
Paris
+33.1.53.89.70.95
bsenechal@shearman.com

Azad Ali
London
+44.20.7655.5659
azad.ali@shearman.com

Jesse P. Kanach
Washington, DC
+1.202.508.8026
jesse.kanach@shearman.com

Pang Lee
Hong Kong
+852.2978.8005
pang.lee@shearman.com

Richard Metsch
Hong Kong
+852.2978.8010
rmetsch@shearman.com

Christine Ballantyne
London
+44.20.7655.5750
christine.ballantyne@shearman.com

Nina Garnham
London
+44.20.7655.5118
nina.garnham@shearman.com

SHEARMAN.COM

What Assets are Included in the Calculation?

AUM is calculated by aggregating the value of the assets of all alternative investment funds managed, including where the manager delegates management to someone else. By contrast, assets managed under delegation should not be included in the calculation (which should, of course, avoid double-counting).

Similarly, in a master-feeder structure where the master and the feeder have the same manager, assets should not be counted twice. Derivative positions should generally be converted into the applicable underlying asset, and included in the calculation.[6]

Frequency of the Calculation and Temporary Breaches

An AIFM taking advantage of the lighter regime must conduct this calculation at least annually.[7] Where AUM exceed the applicable thresholds, the AIFM must decide whether or not that is a temporary situation (i.e., AUM is not likely to remain above the threshold for more than three months[8]). If it is temporary, the AIFM is able to maintain its registration-only status. If it is not temporary, the AIFM must seek full authorisation within 30 calendar days.

Delegation

Generally speaking, the Directive requires that an AIFM seeking to delegate some its functions to another entity must notify its national regulator before the delegation, be able to objectively justify its entire delegation structure, and comply with numerous additional conditions.[9] In addition, an AIFM must never delegate to such a degree that the AIFM becomes a "letter-box entity." The Regulations also impact upon the content of delegation agreements.

Delegation – Content of Agreements

Delegations by an AIFM will need to take the form of a written agreement.[10] The AIFM must in particular "contractually ensure" (i.e., the written agreement will need to detail):

- the AIFM's "instruction" and termination rights;
- the AIFM's rights to receive information;
- the AIFM's right to inspections and access to books and premises; and
- that sub-delegation can only take place with the consent of the AIFM.[11]

It is expressly provided that the delegating AIFM's consent to sub-delegation must be in writing, and that a general consent in advance will <u>not</u> be sufficient. That may rule out the continued use of, for example, the common provision that allows a delegate to sub-delegate to its affiliates without consent.

[6] Regulations, Article 2(3).

[7] Regulations, Article 2(6).

[8] Regulations, Article 4(4).

[9] Directive, Article 20(1).

[10] Regulations, Article 75(d).

[11] Regulations, Article 75(h).

The Regulations also impose numerous requirements on delegating AIFMs that, in practice, likely will end up being dealt with in the written agreement documenting the delegation. For example, the AIFM is required (among other things) to ensure that the delegate:

- discloses to the AIFM any development that may have a material impact on the delegate's ability to carry out its delegated functions;
- protects confidential information relating to AIFM and the relevant AIF and its investors;
- creates and maintains a disaster recovery plan and periodically tests backup facilities; and
- performs its functions effectively and in compliance with law and regulations.[12]

Delegation agreements will need to be revisited to ensure they meet these requirements in advance of either the delegation becoming effective, or the relevant AIFM becoming regulated under the Directive (whichever is the later).

Delegation – Must be Objectively Justifiable

The Directive requires that an AIFM be able to justify its delegation structure.[13] According to the Regulations, an AIFM that wants to delegate functions must provide its national regulator with a set of objective reasons for the delegation. Those reasons should be based on:

- optimisation of business functions;
- cost saving;
- expertise of the delegate in administration or specific markets; and
- access of the delegate to global trading capabilities.[14]

In reality, many delegations will be for one or more of these reasons. How individual national regulators will wield their power (i.e., will particular reasons be considered objectively justifiable in the circumstances?) is likely to become known only over the coming months and during the first phase of authorisations later in 2013.

Letter-box Entities

Disagreements over the content of the "letter-box entity" provisions of the Regulations were a principal reason for the delay in the publication of the Regulations. And the delay has not helped to create a polished set of provisions; they are riddled with uncertainty.

The basic principle set out in the Directive is that an AIFM cannot delegate to such an extent that "it becomes a letter-box entity."[15] Since that phrase was not defined in the Directive itself, the Commission was tasked with explaining what a "letter-box entity" was. Departing from ESMA's advice, the Commission decided in the Regulations that a delegating AIFM actually should be conducting some management functions itself (i.e., mere monitoring and supervisions of a delegate's activities is not enough) in order to avoid being a "letter-box entity."

[12] Regulations, Article 75.

[13] Directive, Article 20(1)(a).

[14] Regulations, Article 76(1).

[15] Directive, Article 20(7)(b).

To explain in more detail: the Regulations set out four situations where a delegating AIFM will be a letter-box entity:[16]

- the AIFM does not retain the expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- the AIFM does not have the power to exercise certain senior management functions;
- the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or can no longer exercise these rights in practice; and
- the AIFM delegates the performance of "investment management functions" to an extent that "exceeds by a substantial margin" the investment management functions performed by the AIFM itself."

The first three of those situations are manageable. The primary regulated entity should have the capacity to supervise delegates, should retain the ability to take senior management decisions (e.g., changes to a fund's investment strategy), and should in practice be able to monitor the delegate. Taken together, these three requirements have a very similar effect to the UK's current "central management and control" requirements for FSA-regulated firms. The fourth situation, though, contemplates that the AIFM will not delegate all investment management functions and, indeed, must retain sufficient functions so that those delegated do not "exceed by a substantial margin" those retained. The questions, then, are what functions need to be retained - and how much?

Letter-box Entities: Investment Management

The Regulations speak in the context of being a letter-box entity of delegating "investment management" functions - a phrase that is used sparingly in the Directive, but that encompasses both portfolio management and risk management.[17]

In the explanatory memorandum that accompanies the Regulations, it is said in the context of the delegation provisions in the Regulations that the AIFM must perform "at least functions relating to either risk or portfolio management".[18] That does raise the possibility of an AIFM delegating all portfolio management functions, yet not being considered a "letter-box entity" because the AIFM retains all, or some, risk management functions. That may be a more palatable option for some managers with existing delegation structures affected by these provisions. Certainly, the reference to "investment management" makes the test less troublesome than earlier drafts of the Regulations.

Letter-box Entities: Substantial Margin

The AIFM cannot delegate to an extent that exceeds by a "substantial margin" the functions performed by the AIFM. There is no guidance as to what a "substantial margin" might be. Instead, the Regulations decide to leave that to national regulators in the EU that are looking at an AIFM's delegation structure. The Regulations set out a number of criteria that national regulators should consider when deciding if an AIFM is a letter-box entity. They include the risk profile of the AIF in question, the types of strategies pursued, the geographical spread of assets, and what has been delegated.

In reality, the criteria set out in the Regulations do not give much guidance to national regulators – or, indeed, to managers looking to organise themselves in advance of the Directive's implementation. The guidance that ESMA is now

[16] Regulations, Article 82(1)(a).

[17] Directive, Annex 1(1).

[18] Regulations, Explanatory Note 3.2.10.

empowered to issue on these provisions[19] will be awaited eagerly. Almost with a sigh, the Regulations acknowledge that the Commission will have to revisit this issue by reviewing the application of the letter-box entity provisions in 2015 (whether they are working?).[20]

Co-operation Agreements

The Directive requires co-operation agreements to be in place between EU regulators and non-EU regulators in numerous scenarios. This will be of particular importance for non-EU managers and managers of non-EU funds since, without appropriate cooperation agreements in place by 22 July 2013, many funds simply would not be capable of being marketed into the EU at all.

At the time of writing, only Switzerland has been reported to have agreed a cooperation agreement with ESMA, which is negotiating with non-EU regulators on behalf of all EU national regulators. In their final form, the Regulations make it marginally more likely that co-operation agreements will be completed than had been the case with the earlier leaked draft of the Regulations. That had suggested that cooperation agreements might have to legally bind the non-EU regulators, requiring them to assist EU regulators in, for example, enforcing EU legislation in the relevant non-EU country. The final Regulations do not use any such definitive language.[21]

Transparency Requirements

The Directive requires that AIFMs comply with various disclosure and reporting requirements. Those requirements include the filing of an annual report, and making ongoing disclosures to both investors and regulators.[22] This note will focus on annual reports and disclosures to regulators.

These transparency requirements apply not only to fully-authorised AIFMs, but also to non-EU managers that market into the EU on and from 22 July 2013.

Annual Reports

The annual report (one per AIF) that must be filed with regulators by AIFMs (or by non-EU managers marketing into the EU) must contain details relating to the AIF's financial performance and remuneration of the AIFM.[23] The Regulations provide a huge amount of detail in relation to the contents of the annual report – including as to how the financial statements must be prepared and presented.

The Regulations also say, in the context of the remuneration disclosure, that the AIFM will need to be clear in the annual report when disclosing the remuneration of the AIFM, whether the figure given for "total remuneration" relates to either the entire staff of the AIFM or only those staff involved in the relevant AIF's activities. Breakdowns of remuneration attributable to each AIF should be provided where possible.[24]

[19] Regulations, Article 82(3).

[20] Regulations, Article 82(2).

[21] Regulations, Article 114.

[22] The Directive also requires that AIFMs make pre-investment disclosures to investors, but the Regulations do not deal with those disclosures.

[23] Directive, Article 22.

[24] Regulations, Article 107(1).

Disclosures to Regulators

An AIFM must periodically provide its national regulator with a great deal of information regarding matters such as the primary markets and instruments in which it trades, the principal exposures of each AIF, and details of the liquidity of each AIF's assets.[25]

A template form is provided in the Annex to the Regulations. It is intended that this template be used by AIFMs when making the required disclosures to any EU regulator – something that will be particularly pleasing to non-EU managers, who otherwise may have faced numerous different filings with different EU regulators.

As expected, the required frequency of reporting for an AIFM of the various AIFs it manages generally will depend on the AUM of that AIFM:[26]

- AIFMs with AUM of more than €100m or €500m (unleveraged) but less than €1bn - report required <u>every 6 months</u>; and
- AIFMs with AUM of more than €1bn - report required <u>quarterly</u>.

Additionally, where an AIFM manages an individual AIF with assets of more than €500m, reporting in relation to that AIF in particular will be required quarterly, regardless of the total AUM of the AIFM. By contrast, where an AIFM manages an unleveraged AIF that primarily seeks to acquire control of companies (e.g., some types of private equity fund), reporting in relation to those AIFs will be required only annually – regardless of the size of that AIF.

Additional disclosures are required where an AIFM manages an AIF that employs leverage "on a substantial basis." The Regulations essentially define a "substantial basis"[27] as being where the total exposure of an AIF is over three times NAV.[28] This is, at least, a more realistic definition than the suggestion of 2:1 that was contemplated by an earlier leaked draft of the Regulations.

Depositaries

As well as introducing a near strict-liability regime for depositaries safeguarding assets, the Directive imposes multiple cash-monitoring and other supervisory obligations on depositaries. The Regulations provide extensive detail to flesh out the liability regime and those obligations.[29]

Depositary Liability

The depositary liability provisions remain, unfortunately, largely the same as those contained in the previous leaked drafts of the Regulation.

Where a depositary is taken to have "lost" a financial instrument in its custody (or in the custody of the depositary's delegate), the depositary will be liable to return an equivalent financial instrument – except where:

[25] Regulations, Article 110(1). Fewer disclosures are required in relation to non-EU AIFs that are not marketed into the EU.

[26] Regulations, Article 110(3). National regulators are empowered to require information to be reported more regularly than the Regulations dictate.

[27] Directive, Article 24(4). This was discussed in more detail in our previous publication entitled "AIFM Directive: Agreed and Adopted", available at: http://www.shearman.com/european-regulation-of-fund-managers-aifm-directive-agreed-and-adopted-11-12-2010.

[28] Regulations, Article 111(1).

[29] Directive, Article 21.

- the loss is caused by an event that is outside the depositary's, or a third party who held custody of the assets, control; and
- the depositary could not have reasonably prevented the event from occurring, despite taking all "precautions incumbent on a diligent depositary;" and
- despite rigorous and comprehensive due diligence the depositary could not have prevented the loss.[30]

The effect of the content of the Regulations is that this test likely will be satisfied only in the case of true "force majeure"-type events, such as acts of God, war, and the adoption of local laws that impact upon the assets held in custody.

The Directive does allow a depositary, theoretically, to transfer its liability "down the chain", if a delegate is directly liable to the AIFM or the AIF for the loss of assets held in the delegate's custody.[31] However, the value of this get-out is limited by the Regulations. They provide that a depositary wishing to discharge liability would need to demonstrate that it was "forced by the specific circumstances" to delegate in the first place.[32] This may limit significantly the circumstances in which a depositary can transfer its liability – for example to a situation where local law requires a local custodian, and the depositary does not have a branch in that jurisdiction and is thus "forced" to delegate to a local custodian.

Instruments to be Held in Custody

A depositary is only liable, though, for the loss of assets held in its custody (or in the custody of a delegate). Where assets are not capable of being held in custody, then, the depositary will escape liability. One particular issue that has caused consternation for fund managers and depositaries during the drafting of the Regulations has been that relating to collateral.

ESMA's advice to the Commission had specifically recommended that assets posted as collateral by an AIF (whether effected by way of title transfer or by way of security, such as a pledge) not be treated as assets held in custody by the depositary. That was for the simple reason that, once posted as collateral, the AIF would not own or control those assets.

The Commission chose not to adopt ESMA's approach in relation to collateral. The Regulations are essentially silent on the subject. The only reference to collateral is in a Recital to the Regulations, which hints that collateral will not be treated as within the depositary's custody obligation if the AIF does not "own" the collateral.

In the absence of any further explanation, it is not at all clear whether collateral posted by way of security (where the AIF may technically continue to "own" the collateral even if it has no control over it) is still within the depositary liability regime. If it is, that could result in depositaries of AIFs that post collateral by way of pledge (as is common in the US when clearing through a Futures Commission Merchant) having more significant liability exposure than depositaries of AIFs that post collateral by way of title transfer (as is more common in the EU). A greater liability exposure for a depositary could naturally translate into higher fees for fund managers.

[30] Regulations, Article 101(1)(c).

[31] Directive, Article 21(13).

[32] Regulations, Recital 122.

Cash Monitoring

A depositary must also monitor an AIF's cash flows. According to the Regulations, that means that a depositary must:

- ensure that the AIF's cash is booked in accounts with appropriate entities;
- create effective procedures for reconciling cash flow movements and perform reconciliations daily;
- create procedures that identify significant close of business day cash flows;
- periodically (at least annually) review the adequacy of these procedures;
- monitor the outcomes and actions taken as a result of discrepancies identified in the reconciliations procedure, notifying the AIFM if it cannot be rectified and regulator if it cannot be clarified; and
- check its cash position records against the AIFM's for consistency, with the AIFM providing the depositary with instructions and information relating to any cash account it opens with a third party.[33]

Although these obligations are placed on depositaries, it is incumbent on the AIFM to ensure that the depositary is provided with all necessary information to enable it to perform its duties.

Some of the duties imposed on depositaries may in practice, for some types of funds, be capable of being allocated to other service providers by way of delegation. So, for example, prime brokers could act as delegates in respect of assets held by them and administrators could perform ownership verification and potentially some oversight functions.

Non-EU Managers –Action Points

Although not facing imminent authorisation under the Directive, non-EU managers should be urgently considering the impact of the Directive on their businesses and structures. Some general action points are:

- Consider which funds are likely to be marketed into the EU from 22 July 2013, and into which EU countries
- Cross-check marketing materials with the required pre-investment disclosures listed in the Directive
- Seek counsel on implementing legislation in EU countries likely to be targeted for marketing (individual countries' rules are likely to change between now and July 2013)
- Begin to implement systems for annual and other required reporting under the Directive
- If operating under delegation, revisit existing arrangements to determine whether those arrangements are Directive-compliant
- If any funds are EU-domiciled, consider whether the fund itself (or a local management company or similar) might be an AIFM, and thus subject to the Directive in full

[33] Regulations, Article 86.

Conclusion

The Directive has now been gestating for nearly four years. And despite being only six months away from implementation, some of the most basic questions – what is an AIFM in particular structures? What is and is not an AIF? Can an AIFM delegate all portfolio management or not? – have been, at best, only partially answered by EU legislators. While the Regulations do provide a great deal of useful detail in many areas, its provisions relating to letter-box entities, in particular, depart from ESMA's advice in an extremely unwelcome manner. Other key important issues arising from the Directive are not touched upon in the Regulations – issues such as the apparent requirement that an AIFM be restricted in the activities that it can perform, which could result in institutions being forced to hive out their asset management divisions.

As well as the Directive, and the Regulations, the funds industry needs to keep abreast of the numerous consultation papers still circulating in relation to the Directive. That is both at a European level (even on the same day as the Regulations were released, two separate consultation papers were published by ESMA in relation to the AIFMD) and at a national level.

Indeed, it is at a national level that many of the fundamental consequences of the Directive for non-EU managers will take form. Some European countries (notably Germany – with Spain and France expected to follow) clearly intend to restrict further the ability of non-EU managers and funds to access investors in their market. Others (such as the UK) will likely maintain the *status quo*, so far as possible.

In terms of timing, the release of the Regulations with an effective date of 22 July 2013 indicates that there is little appetite, at least at the date of writing, for extending the implementation deadline. As a result, any managers – whether domiciled inside or outside of the EU – that have not yet analysed the full impact of the Directive on their fund structures, and considered whether and to what extent fund documentation will need to be revised before July 22, 2013, would be well-advised to do that over the coming weeks and months.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069