

FSC Newsletter

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**Financial Services
Commission**

Alternative Investment Fund Managers Directive

Introduction

This Newsletter is directed at Alternative Investment Fund Managers (AIFMs). Alternative Investment Funds (including EIFs), depositaries and fund administrators should also familiarise themselves with this Newsletter and the Directive requirements.

The purpose of this Newsletter is to provide some initial detail on the upcoming Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD). Firms are advised to carry out an impact analysis and to ascertain if its existing resources and techniques remain adequate.

The Directive will have a material effect upon some EIFs and may require amendments to the current EIF Regulations. This will be consulted on once the new EU requirements are finalised.

Of particular note are the new depository requirements and licensing of EIF managers which are detailed below.

Background

Turmoil in the markets has encouraged the EU to establish common requirements governing the authorisation and supervision of AIFMs in order to provide a coherent approach to the related risks and their impact on investors and markets in the European Union.

The Directive lays down rules for the authorisation, ongoing operation and transparency of the managers of Alternative Investment Funds (AIFs), which manage/or market such funds to professional investors in the European Union. AIFMs will be able to market units or shares in AIFs to professional investors in any member state once it has notified the home regulator of where it intends to market.



Implementation timescale

The Directive requires transposition by July 2013 and firms will have a deadline of a year to comply with all the requirements of the AIFM. Further details on our expectations in this respect will be provided to firms over the course of the year.

The European Securities and Markets Authority (“ESMA”) will be issuing guidance on level two criteria and the EU Commission is to adopt level two measures by Summer/Autumn 2012. Following this the FSC will commence consultation on the necessary changes to the EIF Regulations.

Who the Directive affects

The Directive requires AIFMs to be authorised. AIFMs are any legal persons whose regular business is managing one or more Alternative Investment Funds (“AIFs”), whether external or self-managed.

Managing AIFs means providing at least the following investment management functions to AIFs:

- Portfolio management
- Risk management

Additionally, AIFMs may perform other functions, such as the administration and marketing of the AIFs throughout the EU.

AIFs include any non-UCITS collective investment undertaking which raises capital from a number of investors to invest in accordance with a defined investment policy for their benefit.

AIFMs includes some firms licensed under Financial Services (Markets in Financial Instruments) Act, which provide management services to AIFs, and potentially a small number of firms licensed under the Financial Services (Investment and Fiduciary Services) Act. This will also include firms managing Alternative Investment Funds as a regular business, for example, managers of private equity funds or AIFMs managing AIFs whose shares are admitted to trading on a regulated market. Some of these firms will not have previously required licensing under local Financial Services legislation.

As this Directive does not regulate AIFs, these funds should therefore be able to continue to be regulated and supervised as usual i.e. via the Experienced Investor Fund regime (as amended). However, AIFM will need to ensure that AIFs meet certain Directive requirements.



Lighter regime

The Directive provides a lighter regime for AIFMs which, directly or indirectly, do not manage portfolios of AIFs with aggregate assets under management (AuM) exceeding €100 million (including any assets acquired through use of leverage). Aggregate AuM may be increased to €500 million where:

- The AIF is not leveraged
- No redemption rights exercisable during 5 years from initial investment

AIFMs that fall beneath the threshold will still have to register with the Financial Services Commission and there will be certain requirements to comply with, such as reporting requirements.

These AIFMs will not be able to passport throughout the EU but may be able to opt up to the full regime if they choose to.

Exemptions

This Directive shall not apply to: holding companies; institutions for occupational retirement provision; supranational institutions such as the ECB; governments; employee participation schemes or employee savings schemes; or securitisation special purpose entities.

The Directive will not apply to any funds that have stopped making investments prior to the final transposition date. Any fund that stopped taking subscriptions from investors and then winds up within three years of that final transposition date will also be outside the scope.

MiFID Firms:

MiFID firms will not need to re-apply for an authorisation under AIFMD, however, they will need to be AIFMD compliant in order to provide services to AIFs. Nearer to the transposition of the Directive, the Commission will be liaising with firms directly.

Requirements

AIFMs will need to provide the Financial Services Commission with information on various areas particularly on:

- Managers, shareholders or members of the AIFM;
- Programme of activity and organisational structure of the AIFM;



- Remuneration policies and practices compatible with the Directive;
- Arrangements for delegation and sub-delegation;
- Investment strategies;
- Use of leverage and risk profiles;
- Fund rules;
- Custody arrangements

Level 2 will provide further information on these items.

Remuneration

A remuneration policy will be required for senior management, risk-takers, control functions and employees in equivalent remuneration brackets.

The remuneration policy must:

- Promote sound and effective risk management;
- Balance fixed and variable components;
- Allow guaranteed variable components only exceptionally;
- Require at least 50% of variable remuneration to be in units of shares of AIF;
- Require at least 40% of variable remuneration to be deferred over the lifecycle of AIF;
- Be periodically reviewed by management;
- Cover carried interest; and
- Require a remuneration committee for large AIFM/AIF with large amount of AuM.

Depositary

Every AIF must have a single depositary. The depositary should be responsible for the proper monitoring of the AIF's cash flows and, in particular, for ensuring that investor money and cash belonging to the AIF, or to the AIFM acting on behalf of the AIF, is booked correctly.

The depositary should have its registered office or a branch in the same country as the AIF.

Whoever acts as the depositary, whilst they can delegate sub custody, remains responsible on a strict liability basis for the sub-custody function.



The depositary liability standard is under discussion as they will be liable for the acts of the sub custodians.

Delegation of certain tasks can also be given to a non-EU sub-depositary in certain conditions. Investors will need to be informed of such delegation.

The AIFM cannot be the depositary.

Capital requirements

External AIFMs will need to have capital of at least €125,000 and self-managed AIFMs will need to have capital of at least €300,000.

AIFMs managing funds exceeding €250 million must have own funds of 0.02% of the amount by which the value of the portfolios of the AIFM exceeds €250 million but the required total of the initial capital and the additional amount must not exceed €10 million.

Passporting

AIFs can be passported by managers in one member state to investors in other member states within the EU. EU AIFMs will be able to market units or shares in EU AIFs to professional investors in any member state once it has notified the home regulator of where it intends to market. The home regulator will then notify the other competent authorities across the EU.

The basic EU passport to take effect in 2013 and will supersede domestic rules in EU member state for marketing and management. The EU passport will allow EU AIFMs authorised in one member state to:

- Market EU AIFs to professional investors throughout the EU; and
- Manage AIFs throughout the EU

For EU AIFMs marketing non-EU AIFs, additional conditions will apply as follows:

- There must be appropriate co-operation arrangements between member state and third countries;
- The third country must not be on the FATF blacklist;
- There must be OECD tax arrangements with each relevant member state.

Further details on the above are to be set out by the EU.



From 2015 for non-EU AIFMs managing/marketing EU AIFs, the requirements are the same as for EU AIFMs, plus:

- An EU legal representative must be appointed; and
- There must be no domestic preventions on EU authorities exercise of supervision.

Valuation

The valuation procedures used shall ensure that the assets are valued and the net asset value per unit or share is calculated at least once a year.

If the AIF is of the open-ended type, such valuations and calculations shall also be carried out at a frequency which is both appropriate to the assets held by the AIF and its issuance and redemption frequency.

All AIFMs are to implement valuation procedures resulting in the proper valuation of assets of AIFs. The process for valuation of assets and calculation of the net asset value should be functionally independent from the portfolio management and the remuneration policy of the AIFM and other measures should ensure that conflicts of interest are prevented and that undue influence on the employees is prevented. Subject to certain conditions, AIFMs should be able to appoint an external valuer to perform the valuation function.

The European Commission is expected to adopt further rules when the level two requirements are agreed, this will include further rules on valuation procedures; guarantees required from valuers and the frequency of valuations for open-ended funds.

Transparency requirements

As part of their authorisation requirements, AIFMs will be required to provide the competent authority with certain information about all the funds they manage. This will include the funds' rules/instrument of incorporation; details about the manager's leverage policy; information about the funds' strategy; marketing plans and information about the safe-keeping of the funds' investments.

Leverage

The AIFM shall demonstrate that the leverage limits set by it for each AIF it manages are reasonable and that it complies with those limits at all times. The Financial Services Commission shall assess the risks that the use of leverage by an AIFM with respect to the AIFs it manages could entail, and, where deemed necessary in order to ensure the stability and integrity of the financial system, AIFMs shall regularly conduct stress tests, under normal and exceptional liquidity conditions, which enable them to



assess the liquidity risk of the AIFs and monitor the liquidity risk of the AIFs accordingly.

The AIFM must:

- Set a maximum level of leverage for each AIF;
- Limit the reuse of any collateral or guarantee under a leveraging arrangement;
- Be able to demonstrate that leverage limits are reasonable and complied with.

The EU is expected to provide guidance on how to calculate leverage exposures.

This will affect open ended funds, not closed ended.

What we expect firms to do at the initial stages

Firms are advised to start carrying out an impact analysis, to ascertain whether their existing resources and techniques are adequate to define their own risks and those of the funds they manage. It is possible that firms may determine that additional resources are needed.

A firm should consider the various requirements set out by the Directive and how it will meet these, for example the firm will need to ensure that it conducts risk management functions for the AIFs managed.

Firms should also be looking into how internal structures and relationships with third party providers are going to function in the future. There is a major task ahead for those fund managers that have previously relied upon relationships with prime brokers and who have only used third-party custodians. These firms will need to define relationships with depositaries and redefine relationships with prime brokers.



Published by:

Financial Services Commission
Atlantic Suites
Gibraltar

www.fsc.gi

Tel : +350 200 40283

Fax : +350 200 40282

Any advice or interpretation covered in this Newsletter represents the views of the FSC as to its expectations of how the requirements of the relevant Directive in question is to be complied with and/or how it fails to be applied. This, however is not intended as a definitive interpretation of the applicable Directive which is ultimately a matter for the courts to determine. The FSC does not provide, or purport to offer, legal advice.