
Flash News

AIFMD: the finer details take shape

December 2012

With an inimitable sense of timing and giving the slight feeling of a clearing of the desks before the holidays, the European Commission (EC) finally published its delegated acts (the Level 2 Regulation) under the Alternative Investment Fund Managers Directive (AIFMD) on 19 December 2012. The EU Parliament and the Council have three months to scrutinise the Regulation, but the likelihood of rejection by them seems low.

The Level 2 Regulation has had a turbulent ride to get to this point. Initial industry responses to the first draft identified several areas where the Commission's proposed rules differed substantially from the final advice from ESMA, which, if not ideal from industry's perspective, did at least reflect the product of a consultation process. The final Level 2 Regulation, while better in some areas than the initial draft is still not what industry would like or hoped for and still deviates from ESMA's technical advice in a number of key areas, notably on delegation, "letter-box entities" and depositary requirements. However, absent some unforeseen event, it is now fairly locked in stone and those affected by AIFMD should assume they can now see the regulatory environment with which they are going to have to comply.

Level 2 regulation

The Level 2 Regulation provides the long awaited detail behind many of the elements of AIFMD, which fund managers and service providers needed before they can design and fully implement AIFMD change plans. AIFMs and depositaries now need to move forward to review where they are against AIFMD deadlines and begin to make the appropriate changes.

The timeframe for implementing AIFMD is now short and fund managers must act quickly to ensure they implement the required changes in time, including retaining key service providers where necessary.

Key provisions

- **AIFM General operating conditions:** the Regulation contains lengthy and detailed general operating conditions that AIFMs must satisfy. These requirements cover conflicts of interest, risk management and an AIF's risk profile, the due diligences AIFMs should perform and liquidity management.
- **Delegation:** The key issue for industry around delegation were EC views on how much functionality AIFMs could delegate to third parties without becoming "letter box entities" thereby making the delegate the AIFM. The Level 2 Regulation moves away from a quantitative approach, widely regarded as unworkable within current structures, towards a principles-based approach that allows national regulators more leeway to exercise their judgement on the acceptability of delegation structures. AIFMs will have scope to delegate tasks, but they still must retain either portfolio management or risk management. However, to avoid being deemed a "letter-box entity", AIFMs will still have to perform investment management activities themselves that exceed by a substantial margin activities delegated. On delegation within groups, the Regulation allows more flexibility which is positive news for firms wanting to use their existing MiFID investment firm as the AIFM. Working through these rules and mapping them to existing business structures will be an immediate priority for larger groups.

- **Third countries:** the EC has softened initially proposed requirements on cooperation agreements between European regulators (through ESMA) and non-EU regulators, which should allow non-EU AIFMs and AIFs to be marketed into the EU under national private placement regimes. Assuming ESMA signs cooperation agreements with key non-EU regulators in good time, non-EU AIFs should continue to be able to access the EU market (subject to compliance with the new disclosure regimes and provided individual member states do not close the door to private placement, which is a policy some are actively considering).
- **Transparency requirements:** the EC has confirmed the information that AIFMs will need to submit to national regulators and to investors. The requirements are granular and may well prove extremely challenging for AIFMs to meet; particularly for AIFMs with over €1bn AuM in aggregate who will need to file regulatory reports on a quarterly basis. Operationally, AIFMs should start to focus on this area fast, as the systems and data integrity issues should not be underestimated and build times for large data management projects can take time.
- **Remuneration:** firms will need to disclose more than just total remuneration data, and not just relating to AIFMD Code Staff. Another key objective is disclosure of the proportion of total variable remuneration that AIFs fund by paying performance fees or carried interest. However, details are still unclear – AIFMs still have to wait, unhelpfully, for more guidance, which given remuneration planning can take time and is always a sensitive issue, is unhelpful.
- **Depository provisions:** the Level 2 Regulation defines depositories' duties, including specifying the financial instruments they are required to hold in custody, the due diligence and monitoring they must perform and the oversight obligations they will have over AIFMs. The depository provisions are extremely burdensome and AIFMs need to focus very quickly on the new relationships that they are going to have to create with the entities that will act as depositories to their funds. AIFMs should expect prescriptive due diligence on their systems and controls and demands for line of sight through asset holding structures. In the hedge fund arena, managers, prime brokers and depository banks have particular issues to deal with to ensure, to the extent possible, existing strategies can continue to be supported. Getting into early discussions with the entities who will act as depositories needs to be an absolute priority.
- **Leverage:** many AIFMs will be disappointed to see the Regulation only allows leverage to be calculated using the commitment and gross methods. The advanced method proposed in ESMA's technical advice is not included as a valid method for calculating leverage, but that could change in future. The EC will review the success of these calculation methods by July 2015, and could suggest an optional alternative method.

ESMA consultations

ESMA has also issued two consultations on AIFMD: ESMA has proposed a Regulation defining standards for what constitutes an open-ended AIF and Guidelines for identifying AIFs. ESMA suggests some guidelines for defining some key terms and concepts including “collective investment undertaking”, “defined investment policy” and to “raise capital from a number of investors”. While these guidelines are helpful, ESMA is still asking for input on some other important issues, e.g. whether the term “joint venture” should be clarified. Both consultations close on 1 February 2013, so it is likely to be several months before we have a landing on the issues they cover.

What should you do now?

The evolution of AIFMD has now reached a tipping point. A great deal of detail is now available and the excuse of “waiting for Level 2” is no longer available. Those affected by the Directive now need to act. The steps to take are to:

- Re-engage with your advisers and your key internal stakeholders to bring them up to date on recent developments.
- Examine your relationships and group structures - determine which of your AIFs are in or out of scope of the AIFMD. Determine precisely “who does what” – will your delegation and outsourcing arrangements, for example, stand up under the new regime, or do you want to adjust them.
- Consider key strategic decisions that you will need to make: e.g. who are you marketing to? Do you need actively to access EU investors? Where do you want your AIFM or AIFs to be domiciled? Who will your depositary and other service providers be?
- Conduct a detailed gap analysis to determine where to focus your implementation efforts and whether you have the resources necessary to deal with change.
- Engage in detailed implementation planning to put into effect your strategic decisions and the operational changes required under AIFMD, including establishing an implementation timetable and project budget.
- Enjoy the holidays, but mobilise your implementation team and get started on implementation early in the New Year!

PwC continues to engage with regulators, trade associations and clients who will be affected across all sectors of the asset management community. We will be circulating more detailed analyses of the impact of the Level 2 Regulation early in the New Year, focusing on sectoral and practical issues. In the interim, if you have any questions, please contact your usual PwC contact or any of the people named below.

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