

European Commission Publishes Proposed Delegated Regulation under the AIFMD

On December 19, 2012, the European Commission published its proposed delegated regulation (the “Delegated Regulation”)¹ on exemptions, general operating conditions, depositaries, leverage, transparency and supervision under Directive 2011/61 (the “AIFMD”)² on alternative investment fund managers (“AIFMs”). The European Parliament and the European Council have three months to review the Delegated Regulation. They have the right to block the Delegated Regulation from entering into force (not to amend it), but they are highly unlikely to do so. As a result, the Delegated Regulation is likely to enter into force unchanged. A brief summary of the Delegated Regulation is set out below.

Separately, the European Securities and Markets Authority (“ESMA”) published consultations on key concepts under the AIFMD³ and is expected shortly to publish guidelines on the remuneration policies AIFMs are required to implement consistent with Annex II to the AIFMD.

Calculation of assets under management (Articles 2-5) - Article 3 AIFMD

The Delegated Regulation establishes the procedure for AIFMs to calculate assets under management (“AuM”) for purposes of applying the exemption for small AIFMs under Article 3 AIFMD (Article 2). AIFMs have to calculate total AuM by determining the value of all assets managed, without deducting liabilities and valuing financial derivative instruments at the value of an equivalent position in the underlying assets. The Delegated Regulation also contains requirements on monitoring AuM (Article 3), actions to be taken when the Article 3 AIFMD thresholds are occasionally breached (Article 4) and authorities’ right to check AIFMs’ calculations (Article 5).

¹ [Commission Delegated Regulation](#) supplementing Directive 2011/61/EU of the European Parliament and of the Council with regards to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

² [Directive 2011/61/EU](#) of the European Parliament and of the Council 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 1095/2010.

³ Please see for further details our client alert on the ESMA Consultations on Key AIFMD Concepts published on January 2, 2013.

Calculation of leverage (Articles 6-11) - Article 4 AIFMD

The AIFMD contains a number of obligations relating to the use of leverage: AIFMs have to report leverage to investors and supervisory authorities (Article 24(4)), set out their policy with regard to the use of leverage (Article 7(3)(a)) and set a maximum level of leverage for each alternative investment fund (“AIF”) they manage (Article 15(4)).

Article 4(1)(v) AIFMD defines leverage as any method by which the AIFM increases the exposure of an AIF, whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means. Articles 6 to 11 of the Delegated Regulation provide two methods for calculating leverage: the “gross” and “commitment” methods. Both methods are obligatory for all AIFMs. The Commission may adopt additional delegated acts on an optional “advanced” method for the calculation of leverage, on the basis of technical advice to be developed by ESMA.

Additional own funds/professional indemnity insurance (Articles 12-15) – Article 9 AIFMD

The AIFMD requires AIFMs to hold additional own funds or professional indemnity insurance (“PII”) to cover potential liability for professional negligence. The Delegated Regulation establishes a common definition for professional liability risks, provides an indicative list of events to be covered (Article 12), and lays down qualitative requirements for AIFMs to appropriately monitor operational risks (Article 13). An AIFM’s additional own funds are considered appropriate if they represent at least 0.01% of the value of the portfolios of the AIFs it manages (subject to adjustment to reflect the risk profile of the AIFM) (Article 14). When an AIFM uses PII to cover its professional liability risks, such PII should cover 0.9% of AuM in aggregate and 0.7% of AuM per claim per year (Article 15).

Operating conditions for AIFMs – general principles and conflicts of interest (Articles 16-37) - Articles 12 and 14 AIFMD

The Delegated Regulation clarifies the general duty of AIFMs to act in the best interests of the AIF or its investors and the integrity of the market and the scope of AIFMs’ due diligence obligations, in general and specifically where AIFs invest in assets with limited liquidity or appoint counterparties or prime brokers.

The Delegated Regulation also sets out rules on inducements and handling of orders, including reporting obligations and rules on placing, aggregating and allocating orders. The Delegated Regulation specifies the types of conflicts of interest that may arise and lays down elements of a conflicts-of-interests policy, including procedures to identify, prevent, manage, monitor and disclose conflicts of interest.

Operating conditions – risk management (Articles 38-45) - Article 15 AIFMD

The Delegated Regulation contains rules on risk management systems, including the organizational structure, policies and procedures for managing the risks relevant to each AIF's investment strategy and the processes and techniques used to measure and manage those risks. In terms of organizational structure, the Delegated Regulation requires a permanent risk management function to be established and entrusts it with specific tasks, including implementation of the risk management policy, risk monitoring, measuring the risk level and ensuring that the risk level complies with the AIF's risk profile. The Delegated Regulation also lays down conditions for functional and hierarchical separation of the risk management function from operating units and specifies safeguards against conflicts of interest to ensure that risk management activities are carried out independently.

Operating conditions – liquidity management (Articles 46-49) – Article 16 AIFMD

The AIFMD requires AIFMs to employ, for each AIF that is not an unleveraged closed-ended AIF, an appropriate liquidity management system and to adopt procedures to monitor AIFs' liquidity risk and to ensure that the liquidity profiles of the AIFs' investments comply with their underlying obligations. These liquidity management systems should allow AIFMs to cope with illiquid assets when responding to redemption requests. Such arrangements may include "special arrangements" such as "side-pockets." AIFMs should set suitable limits for the liquidity/illiquidity of each AIF consistent with its redemption policy and conduct stress tests at least annually.

Operating conditions - investment in securitization positions (Articles 50-56) - Article 17 AIFMD

With a view to achieving cross-sectoral consistency, Article 51 requires an AIFM assuming exposure to a securitization to retain material net economic interest. The Delegated Regulation also contains requirements relating to the securitization's sponsor and originator (Article 52) and qualitative requirements applicable to the AIFM itself (Article 53). Article 54 provides for corrective action if the retained net economic interest is below the required level.

Organisational requirements – general principles (Articles 57 – 66) - Article 18 AIFMD

AIFMs are required to use, at all times, adequate and appropriate human and technical resources necessary for the proper management of AIFs, including administrative and accounting procedures and adequate internal control mechanisms. The Delegated Regulation requires AIFMs to establish a well-documented organizational structure that assigns responsibilities, defines control mechanisms and ensures a good flow of information.

When allocating functions internally, the AIFM should ensure that the governing body, senior management and, where relevant, the "supervisory function" are responsible

for the AIFM's complying with its obligations under the AIFMD. AIFMs should also apply policies and procedures designed to detect any risk of compliance failure. The permanent compliance function and the permanent internal audit function should be separate and independent from other functions. AIFMs should also establish systems to safeguard information and ensure business continuity.

Valuation (Articles 67-74) - Article 19 AIFMD

The AIFM has to ensure that, for each AIF it manages, appropriate and consistent procedures are established so that a proper and independent valuation of the AIF's assets can be performed in accordance with Article 19 of the AIFMD and other applicable rules.

Article 67 requires the AIFM to establish, maintain and implement policies and procedures for the valuation of assets and lays down the main features they must contain. Specific rules apply when models are used to value assets (Article 68). Article 69 spells out the principle of consistent application of valuation policies and procedures.

The Delegated Regulation also contains rules on the review of valuation policies and procedures (Article 70), individual asset values (Article 71), net asset value per unit or share (Article 72), professional guarantees to be provided by external valuers (Article 73) and the frequency of valuation by open-ended AIFs (Article 74).

Delegation of AIFM functions (Article 75-82) - Article 20 AIFMD

Articles 75 to 81 spell out the conditions under which the AIFM is allowed to delegate certain functions. In particular, the AIFM has to keep functions relating at least to either risk or portfolio management (Article 82).

Depositaries (Articles 83-102) - Article 21 AIFMD

The Delegated Regulation contains detailed provisions on depositaries' obligations and rights, including monitoring cash flows, the scope of financial instruments to be held in custody, general oversight duties, delegation of custody and liability for the loss of a financial instrument held in custody.

Articles 85 and 86 contain access and information requirements on AIF's cash flows as provided for by Article 21(7) AIFMD.

Article 88 provides that all financial instruments that can be registered in a financial instruments account (essentially, transferable securities, money market instruments and units in collective investment undertakings) and belong to an AIF must be held in custody. AIFs' assets may not be excluded from custody because they are subject to collateral or other business arrangements. Where AIF assets are provided as collateral, custody can be arranged in several ways: (1) the collateral taker is the depositary of the AIF or is appointed

by the AIF's depositary as sub-custodian over the AIF's collateralized assets; (2) the AIF's depositary appoints a sub-custodian that acts for the collateral taker; or (3) the collateralized assets remain with the AIF's depositary and are "earmarked" in favor of the collateral taker (recital 98).

Article 92 contains requirements on depositaries' oversight and control functions.

Articles 100-102 address depositaries' liability under Articles 21(12) and 21(13) AIFMD.

Transparency and information exchange (Articles 103-112) - Articles 22-24 AIFMD

Articles 103 to 111 spell out the requirements of Articles 22 to 24 AIFMD. Articles 103 to 107 outline minimum requirements for the contents of annual reports. Articles 108 and 109 stipulate the content and format of information disclosed to investors, and Article 110 establishes the content, format and frequency of information to be provided to authorities. Under Article 111, an AIF would be considered to be employing leverage on a substantial basis – triggering special reporting obligations -- when its exposure exceeds three times its net asset value using the "commitment method."

Third-country-related rules (Articles 113-115) - Articles 34-37, 40 and 42 AIFMD

A number of provisions in the AIFMD require cooperation arrangements to be established between European competent authorities and supervisory authorities from the country of origin of non-EU AIFMs and AIFs. The Delegated Regulation specifies some aspects of those cooperation arrangements. Article 113 lays down the scope, form and objectives of the cooperation arrangements. Article 114 requires cooperation arrangements to provide for mechanisms, instruments and procedures necessary for EU authorities to perform their duties under the AIFMD. Article 115 requires cooperation arrangements to include a data protection safeguard in line with Article 52 AIFMD.

Information relating to potential systemic consequences (Article 116) – Article 53 AIFMD

Article 116 specifies the exchange of information between the competent authorities of the Member States, ESMA and the European Systemic Risk Board which is required under Article 53 AIFMD for the purpose of identifying potential systemic consequences of AIFM activity.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed on our website at <http://www.clearygottlieb.com>.

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