

**MEMO# 26858**

January 10, 2013

# **European Commission Adopts Level 2 Implementing Rules for the Alternative Investment Fund Managers Directive and ESMA Issues Two Consultations on the AIFMD**

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TO: ICI GLOBAL MEMBERS  
INTERNATIONAL COMMITTEE No. 2-13  
INTERNATIONAL INVESTING SUBCOMMITTEE No. 1-13  
RE:

EUROPEAN COMMISSION ADOPTS LEVEL 2 IMPLEMENTING RULES FOR THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE AND ESMA ISSUES TWO CONSULTATIONS ON THE AIFMD

On December 19, 2012, the European Commission (“EC”) adopted Level 2 implementing rules (“implementing rules” or “delegated act”) for the Alternative Investment Funds Managers Directive (Directive 2011/61/EU), which was a precondition for the application of the Directive (the “AIFMD”) in European Union countries (the “EU”). [\[1\]](#) On the same day, the European Securities and Markets Authority (“ESMA”) published two consultation papers on the AIFMD, one on draft regulatory technical standard on types of alternative investment fund managers (“AIFMs”) and the other on guidelines on key concepts of the AIFMD. [\[2\]](#)

## **EC Adopts Level 2 Measures for the AIFMD**

The delegated act adopted by the EC supplements certain elements of the AIFMD and, in particular, addresses:

- conditions and procedure for the determination and authorization of AIFMs;
- operating conditions for AIFMs, including rules on remuneration, conflicts of interest, risk management, liquidity management, investment in securitization positions, organizational requirements, and rules on valuation;

- conditions for delegation;
- rules on depositaries, including the depositary's tasks and liability;
- reporting requirements and leverage calculation; and
- rules for cooperation arrangements.

In certain key respects, the delegated act contains noteworthy departures from the technical advice published by ESMA in November 2011 and, arguably, goes beyond what was envisioned in the AIFMD. The delegated act has been transmitted to the European Parliament and the Council and is subject to a three-month scrutiny period. The act will enter into force following that period provided that neither co-legislator objects.

## Delegation Provisions

Of particular relevance, and of potential concern, to members are the delegated act provisions regarding delegation and, specifically, the provisions on letter-box entities. Article 20 of the AIFMD directs the Commission to adopt measures specifying the conditions for fulfilling the delegation requirements and the conditions under which the manager has delegated its functions to the extent that it becomes a letter-box entity and can no longer be considered to be the manager of the alternative investment funds ("AIF").

On letter-box entities, the EC's delegated act includes two relevant recitals and one article, which read as follows:

### Recitals

(91) The assessment of a delegation structure is a complex exercise that has to be based on a series of criteria in order for the competent authorities to form their judgement. The combination is necessary to take into account the variety of fund structures and investment strategies across the Union. ESMA may develop guidelines to ensure a consistent assessment of delegation structures across the Union.

(92) The Commission shall monitor how the criteria are applied and their impact on the markets. The Commission shall review the situation after two years and, should it prove & necessary, shall take appropriate measures to further specify the conditions under which the AIFM shall be deemed to have delegated its functions to such an extent that it becomes a letter box entity and can no longer be considered to be the manager of the AIF.

### Article 82 - Letter-box entity and AIFM no longer considered to be managing an AIF

1. An AIFM shall be deemed a letter-box entity and shall no longer be considered to be the manager of the AIF at least in any of the following situations:

(a) the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;

(b) the AIFM no longer has the power to take decisions in key areas which fall under & the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the

implementation of the general investment policy and investment strategies;

(c) the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice;

(d) 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. When assessing the extent of delegation, competent authorities shall assess the entire delegation structure taking into account not only the assets managed under delegation but also the following qualitative criteria:

(i) the types of assets the AIF or the AIFM acting on behalf of the AIF is invested in, and the importance of the assets managed under delegation for the risk and return profile of the AIF;

(ii) the importance of the assets under delegation for the achievement of the & investment goals of the AIF;

(iii) the geographical and sectoral spread of the AIF's investments,

(iv) the risk profile of the AIF;

(v) the type of investment strategies pursued by the AIF or the AIFM acting on behalf of the AIF;

(vi) the types of tasks delegated in relation to those retained; and

(vii) the configuration of delegates and their sub-delegates, their geographical sphere of operation and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM.

2. The Commission shall monitor, in the light of market developments, the application of this Article. The Commission shall review the situation after two years and shall, if necessary, take appropriate measures to further specify the conditions under which the AIFM shall be deemed to have delegated its functions to the extent that it becomes a letter box entity and can no longer be considered to be manager of the AIF.

3. ESMA may issue guidelines to ensure a consistent assessment of delegation structures across the Union.

The situations outlined by the EC above raise significant concerns for global asset managers with respect to delegation arrangements within the EU and also for the delegation of functions into or outside of the EU. How these provisions are ultimately implemented and/or interpreted is critical because an overly-prescriptive or narrow interpretation could threaten the existing arrangements for outsourcing of portfolio management activities and could have a number of consequences for funds, including limiting a manager's access to outside expertise and resources.

In the case of U.S. registered investment companies that retain investment advisers based in the EU and do not market in the EU, if under the implementing rules the EU based investment adviser is considered the AIFM, [\[3\]](#) the EU AIFM will need to comply with the requirements of the AIFMD for the non-EU AIF it manages, except the provisions on depositaries and the annual report. [\[4\]](#) Conversely, if an EU AIFM delegates functions to a non-EU investment adviser such that it is viewed as a letter-box entity, the EU-AIF may be found to have a non-EU AIFM rather than an EU-AIFM. The non-EU AIFM would then need to comply with all provisions of the AIFMD applicable to non-EU AIFM managing EU AIF (e.g., all of the provisions of the AIFMD except those outlining the rights of EU AIFM to market and manage EU AIF in the EU).

We intend to work closely with members and other interested parties on this issue and plan to meet with policymakers and other stakeholders over the coming weeks.

## **ESMA Consultation on Draft Regulatory Technical Standards on Types of AIFMs**

This consultation sets out formal proposals for the draft regulatory technical standards (“RTS”) to determine types of AIFM covered by the AIFMD on which ESMA is seeking input by February 2, 2013. The consultation follows the February 23, 2012, ESMA discussion paper on key concepts of the AIFMD and types of AIFM, which covered a number of topics, including identification by ESMA of a number of ways in which AIFMs could be differentiated for the purposes of drafting the RTS. Of the topics covered in the discussion paper, which included the distinguishing between open-ended and closed-ended funds, externally versus internally managed funds, and those employing leverage or substantial leverage, ESMA determined only to cover the notion of open-ended and closed-ended funds in this consultation. This distinction will be made in order to ensure that the rules on liquidity management, the valuation procedures and the transitional provisions of the AIFMD are applied to AIFM in a uniform manner. ESMA has requested feedback regarding its approach on which topics to include, as well as the proposed definition of open-ended and closed-ended funds.

## **ESMA Consultation on Guidelines on Key Concepts of the AIFMD**

Like the consultation on the draft regulatory technical standards, this consultation also stems from the February 2012 ESMA discussion paper. ESMA has requested comments by February 1, 2013. The consultation sets out ESMA’s proposed clarifications on the following concepts extracted from the definition of AIF: “raising capital,” “collective investment undertaking,” “number of investors,” and “defined investment policy.” ESMA has requested feedback regarding its approach on which topics to include, as well as on its proposed definitions.

**endnotes**

[1] The delegated act is available at [http://ec.europa.eu/internal\\_market/investment/docs/20121219-directive/delegated-act\\_en.pdf](http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf).

[2] The consultations follow the February 23, 2012, ESMA discussion paper on key concepts of the AIFMD and types of AIFM, which covered a number of topics, including the development of draft regulatory standards under Article 4(4) of the AIFMD.

[3] It is uncertain how the provisions regarding a letter-box entity affect the structure and operation of internally managed funds.

[4] Examples of AIFMD provisions that would impact non-EU AIF include provisions on liquidity management, disclosure to investors, remuneration, valuation, and risk management.