

THE SMAIF PASSAGE

IN THE SURGE OF POST-FINANCIAL CRISIS REGULATION, THE THE AIFMD HAS STOOD OUT AS LEGISLATION THAT WILL AFFECT THE EUROPEAN FUND INDUSTRY THE MOST CONSIDERABLY. **AARON MULCAHY** AND **DECLAN O'SULLIVAN**, OF **DECHERT**, DISCUSS THE POSSIBLE IMPACTS THE DIRECTIVE WILL HAVE ON SELF-MANAGED ALTERNATIVE INVESTMENT FUNDS (SMAIFS) IN LIGHT OF THIS



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In last year's *HFMWeek* Ireland Report, I wrote about how it might be possible to comply with the provisions of the Alternative Investment Fund Managers Directive (the AIFMD) by structuring alternative investment funds (AIF) as self-managed investment companies in the same way that Ucits self-managed investment companies (SMICs) are managed.

In discussing the topic, I sounded a note of caution as there was not much direction given on how a self-managed alternative investment fund (which we will inelgantly call a 'Smaif') might look in terms of the AIFMD implementing measures. There were also concerns that, notwithstanding the very important Ucits precedent, the delegation that would be inherent in a Smaif might be such that it would become a letter box entity.

The publication in November last year of Esma's Level II Technical Advice to the European Commission on possible implementing measures of the AIFMD (Level II) provides helpful guidance on how a Smaif might look and goes into detail in respect of the general operating conditions for Alternative Investment Fund Managers (AIFM) including Smaifs. I think it could be said that the concept of a self-managed AIF got Smaif passage through the Level II process.

WHY ARE SMAIFS IMPORTANT?

Quite simply, structuring an AIF as a Smaif means that the fund is both an EU AIF and an EU AIFM, which, subject to compliance with the provisions of the AIFMD will be able to avail of the passporting provisions of the AIFMD in the same way that a Ucits can, from July 2013.

Earlier drafts of the AIFMD provided that AIFMs could only delegate to other AIFMs. This position was changed in subsequent drafts so that, as a general rule, delegation of portfolio management or risk management is permitted where the delegate is authorised or registered for the purpose of asset management and subject to supervision and where cooperation between the competent authority of the home member state (EU Competent Authority) of the AIFM/Smaif and the supervisory authority of the undertaking is ensured.

Accordingly, Smaifs should be able to delegate to US and other non-EU investment managers without that investment manager

having to be an AIFM and having to comply with either the private placement or third country provisions of the AIFMD.

Esma, in its Level II advice, removed an earlier requirement that equivalence should apply to the consideration of any delegated entity. However, in discussing how cooperation can be assured between the EU Competent Authority and the supervisory authority of the delegate, it has set out a requirement that the cooperation should be based on written arrangements. It will be necessary to ensure that these arrangements are put in place as soon as possible.

THE PROBLEM WITH PRIVATE PLACEMENT

For US and other non-EU investment managers, the opportunity to sell funds in Europe using the the AIFMD passport will not be available for at least two years after the implementation of the AIFMD and, accordingly, in the absence of the option of a Smaif, such managers will be required to rely on the continuance of private placement.

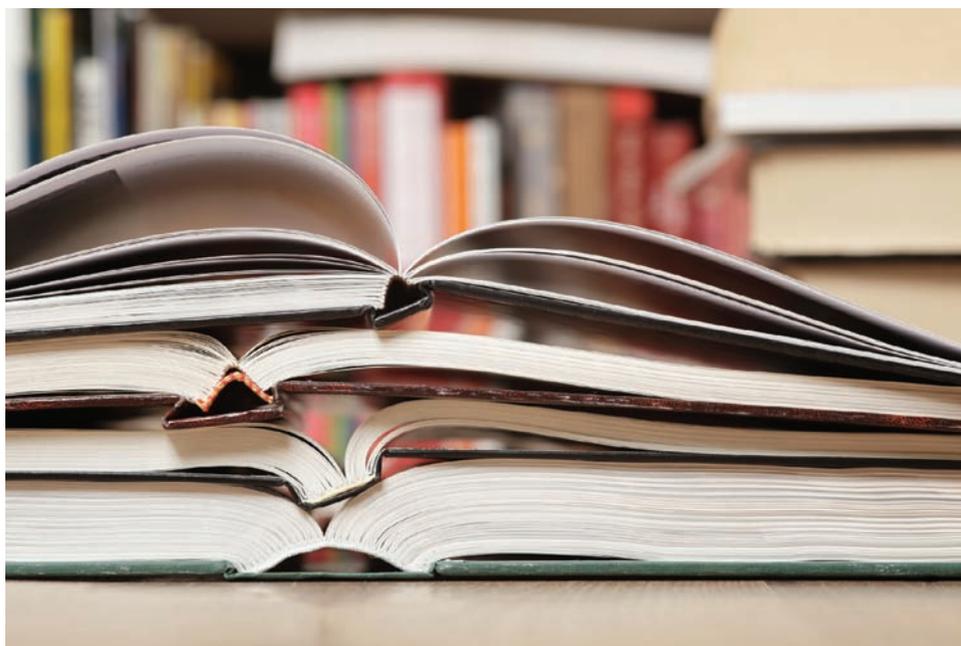
The continuance of private placement under the AIFMD is subject to a number of fundamental uncertainties.

Firstly, it is not compulsory for member states to allow private placement or "marketing without a passport", which means that certain member states may not implement it at all. In addition, those member states that do introduce it may provide for stricter rules with regard to the marketing of such AIFs. However, the concept of reverse solicitation has been retained and will be an option and the UK Treasury has provisionally indicated its intention to continue to permit the marketing of non-EU AIF managed by EU AIFMs, and EU and non-EU AIF managed

by non-EU AIFMs, to UK professional investors, subject to compliance with the minimum requirements specified in the AIFMD. It will be interesting to see what actions other member states take in this regard.

Secondly, member states may only allow private placement where there is a cooperation agreement in place between the member state of the AIFM/where the AIF is marketed and the supervisory authority of the non-EU AIF/AIFM. There has been little progress in putting cooperation agreement in place so far and Esma has also cautioned that in putting these arrangements in place, there

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will be a need to “ensure a regular flow of information for supervisory purposes, including for systemic risk oversight [and]...that enforcement can be performed if necessary.” It is worth noting Esma’s comment that “in this context, it is crucial to avoid creating an unlevel playing field, which unduly favours entities established in third countries.”

Given the added burden that the AIFMD will undoubtedly place on EU AIFMs, we are likely to see lively debate as to what constitutes a level playing field. It is likely that the form of agreement will be a multilateral memorandum of understanding (MMoU) centrally negotiated by Esma but Esma will be challenged in meeting their goal which is “to finalise such a MMoU in good time ahead of the deadline of July 2013 and in a manner that ensures fair treatment of all third country authorities”.

Thirdly, the AIFMD also requires the competent authority in the third country to meet the standards of data protection requested by the Data Protection Directive and this too will be a difficult hurdle.

WHAT CAN WE LEARN FROM UCITS?

The template for Smaifs comes from the Ucits world where the Ucits Management Company Directive made provision for the concept of self-managed investment companies.

The Ucits Directive and Central Bank of Ireland’s (CBI) Guidance Note 4/07 on the organisation of Management Companies set out a series of operating conditions for SMICs, which are designed to ensure that the investment company has and maintains sufficient substance and does not delegate the totality of its functions to one or more third party, so as to become a letter-box entity. These requirements will form the template for putting in place a Smaif regime in Ireland.

Level II considers that an AIFM would become a letter-box entity (i) where the AIFM is no longer able to effectively supervise the delegated tasks and to manage the

risks associated with the delegation and (ii) where the AIFM no longer has the power (a) to take decisions in key areas that fall under the responsibility of the senior management or (b) to perform senior management functions.

The substance requirement is achieved by putting in place management structures meeting common EU standards. In Ireland for Ucits, the CBI has set out the key management functions that it considers to be the responsibility of the board of directors of the SMIC. The CBI regards the management functions as significant roles and requires a business plan to be prepared setting out, inter alia, the identities of the persons appointed to perform those functions and how they will be performed in practice (e.g. reports to be provided by delegates and escalation procedures etc). With the exception of requirements in relation to liquidity management, the management functions that are imposed on SMICs are broadly similar (and in some instances virtually identical) to the operating conditions under the AIFMD.

Alignment of Level II with the approach adopted in respect of Ucits highlights the likelihood that AIFMs and Smaifs will be required to put in place a business plan or procedures manual to document its operating, administrative and accounting policies and procedures. While Ucits will provide a template, it will be important to ensure that the approval process for Smaifs can be aligned as closely as possible to that existing fast track approval process for qualifying investor.

CAPITAL REQUIREMENTS

The initial capital requirements for Smaifs are equivalent to those of SMICs – €300,000 (\$395,000). In addition to the initial capital requirement, AIFMs are also subject to an own funds requirement of 0.02% of the amount by which the value of the Smaif’s portfolio exceeds €250,000,000 (Own Funds Requirement). The Own Funds Requirement has been criticised as inappropriate in the context of Smaifs and it was hoped that Level II would clarify that the Own Funds Requirement did not apply. Unfortunately, the Level II did not provide this clarity and focused on the Own Funds Requirements in the context of cover for potential liability risks. Notwithstanding the absence of clarity, the FSA in its discussion paper on the implementation of the AIFMD suggests that the Own Funds Requirement applies only to externally managed AIFM. If Smaifs are subject to the Own Funds Requirement, this would mark a significant divergence from the Ucits Directive.

NEXT STEPS

The Commission is now in the process of preparing implementing measures in light of the Level II advice. The alternative investment funds industry will be watching closely the implementing measures adopted by the Commission and further developments by Esma relating to the form of cooperation agreements. ■

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