

The Appointment of Delegates Under the AIFMD

Key considerations and practical implications

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The Alternative Investment Fund Managers Directive which became effective on 22 July 2013 not only represents a sea change in the regulation of managers established in Europe but also has significant effects on managers outside of Europe. Much has already been written in relation to the restrictions on the marketing of alternative investment funds (AIFs) by non-EU managers to EU-based investors but another aspect of the

Definitions

Manager: an entity that undertakes portfolio management (i.e., discretionary management of portfolios) and/or risk management (i.e., operational risk). In the US context the manager is likely to be either the general partner of the fund if it has investment discretion or a separate entity appointed to act as manager.

AIF: an alternative investment fund – a collective investment undertaking, not including UCITS funds, that raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

Delegate: any entity to whom the manager has delegated all or part of the portfolio management or risk management functions. Note, however, that to the extent that an entity is merely providing investment advice to the manager of the AIF and does not exercise any discretion over the AIF then it would not be a delegate. Delegation of portfolio management or risk management to a depositary or a delegate of a depositary is prohibited in view of the potential conflict of interest (a depositary's functions are broader than just those of a custodian and include monitoring the AIF's cash flows, ensuring that the value of shares or units in the AIF are correctly calculated and that the AIF's income is correctly distributed).

Directive: Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers.

Delegated Regulation: Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

Directive that has received less attention but which has a material impact on non-EU managers is the appointment of delegates, both where an EU manager seeks to appoint a non-EU delegate and where a non-EU manager seeks to appoint an EU delegate.

This article examines some of the key elements of the new regime under the Directive relevant to the appointment of delegates and focuses on the practical implications both for non-EU managers and non-EU delegates.

Non-EU delegates of EU managers

EU managers may, provided they have first notified the relevant competent authority of their home Member State, delegate one or more of their functions to a delegate. Three key principles apply where a manager seeks to appoint a delegate:

- The appointment of the delegate should not allow the manager to circumvent its responsibilities or liabilities;
- As a result of the delegation, the manager's obligations to the AIF that it manages should not be altered; and
- The delegation should not be to such an extent that the manager effectively becomes a "letter-box entity" (see below).

The obligations placed on EU managers when appointing delegates will have an impact on, and a number of practical implications for, non-EU delegates appointed by EU managers. These are discussed below.

(1) The manager must be able to objectively justify the delegation and the objective reasons for the delegation must be provided to the relevant competent authority in writing together with supporting evidence. It is unclear from the Directive and the Delegated Regulation whether this must be provided to the relevant competent authority prior the delegation or not. In the UK, a UK-authorized manager will not require the Financial Conduct Authority's prior approval to the extent that the delegate is "authorised or registered for the purpose of asset management; and ... subject to supervision in relation to [that] function". Other Member States may have interpreted the Directive and Delegated Regulation's requirements differently, so the advice of local counsel in the Member State of the manager should be sought before a manager delegates any of its functions. The Delegated Regulation sets out a number of criteria that should be considered, including "expertise of the delegate in ... specific markets or investments [and] ... access of the delegate to global trading capabilities."

(2) The manager must be able to demonstrate that it exercised all due care in its appointment of the delegate, that the persons at the delegate who effectively conduct the delegated activities are of sufficiently good repute and that the delegate is both qualified (including, where delegation includes portfolio management or risk management, having the necessary regulatory authorisations and permissions from the appropriate competent authority) and has sufficient expertise and resources to undertake the functions delegated to it.

(3) The manager must be in a position to effectively monitor the delegation and give further instructions to the delegate where necessary. The manager is further obliged to review on an ongoing basis the services provided by the delegate. In addition, the manager must retain the right to withdraw the delegation with immediate effect where it is in the interests of the investors to do so. In practice, the manager will need to ensure that the delegate is carrying out its functions in compliance with the manager's obligations under the Directive. Consequently, the delegate will likely find that the manager will require it to indirectly comply with certain obligations imposed by the Directive, including, depending on the scope of the functions delegated, in relation to conflicts of interest, operational and organisational structure, disclosure and transparency requirements and portfolio and risk management.

(4) The delegation to the delegate must not prevent the effective supervision of the manager by the relevant competent authority. Effective supervision will be deemed to be prevented where, for example, the manager does not have "effective access to data related to the delegated functions and to the business premises of the delegate" or the delegate does not cooperate with the manager's competent authority in relation to the delegated function. Where the delegation includes portfolio management or risk management, and the delegate is not based in the EU, "co-operation between the competent authorities of the home Member State of the [manager] and the supervisory authority of the [delegate] must be ensured." Delegates should therefore be prepared to grant the managers appointing them the right to both information and access to its premises. They should also be prepared to cooperate with the appointing manager's competent authorities and, where portfolio management or risk management is being delegated, should ensure that there is an appropriate cooperation agreement in place between the competent authorities of the manager and the delegate.

(5) Managers will need to ensure that their agreements with delegates cover a number of key issues including (i) the right to information and to undertake inspections (including access to the delegate's offices); (ii) the right to terminate the agreement immediately; (iii) obligations on the delegate necessary to allow the manager to comply with its obligations under the Directive (as set out in (3) above); and (iv) restrictions on sub-delegation by the delegate (as set out in greater detail below). In practice, this means that existing agreements will need to be reviewed and likely updated to ensure that they meet these additional requirements.

(6) A delegate may sub-delegate functions delegated to it by the manager provided that the manager has given its prior consent and has notified the relevant competent authority of the sub-delegation arrangements prior to them becoming effective. The obligations set out in points (1) to (5) above will also apply to any sub-delegation arrangement. As a result, in practice the compliance arrangements that apply between a manager and a delegate would need to be reflected in any further sub-delegation arrangements.

EU delegates of non-EU managers

Where a non-EU manager appoints an EU delegate, consideration will have to be given to which of the entities is deemed to be the manager. Where the functions delegated to the EU delegate include both portfolio management and risk management, the EU delegate could potentially be characterized as the manager under the Directive. The main consequences of the EU delegate being characterized as the manager are that first, the EU delegate will need to be authorised by the relevant competent authority and have the necessary permissions to undertake the portfolio management and risk management functions, second, that the restrictions on remuneration will apply to the EU delegate and third, that a depository will have to be appointed on behalf of each AIF (whether EU-based or not) that the EU delegate is deemed to be managing. These are more onerous requirements than the disclosure, transparency and reporting requirements that apply to non-EU managers.

Anti-letter-box provisions

Where a manager delegates both the portfolio management and risk management functions to the extent that it effectively becomes a mere "letter-box entity", the delegate to whom such functions have been delegated will likely be characterized as the manager. The delegation of only one of the portfolio management or risk management functions will not give rise to this risk. Although the anti-letter-box provisions apply to EU managers and not to non-EU managers delegating to EU delegates, non-EU

managers should be prepared to be able to make the case to a competent authority that it has not delegated to an EU delegate to such an extent that the non-EU manager would be deemed to be a letter-box entity. The Delegated Regulation sets out four situations in which a manager would be viewed as a letter-box entity. These are where the manager:

- Fails to retain the expertise and resources necessary to effectively supervise the delegated tasks and manage the risks associated with the delegation;
- No longer has the power to make decisions in key senior management areas or to perform senior management functions, particularly relating to the implementation of the general investment policy and investment strategies;
- Loses its contractual rights to have access to or request information from the delegate or to give it instructions (including where the exercise of such rights becomes impossible in practice); and
- Delegates the performance of portfolio management functions to such an extent that the portfolio management functions undertaken by the delegate exceed those undertaken by the manager by a "substantial margin".

How competent authorities in the different Member States intend to apply these criteria remains to be seen. In the UK, for example, the Financial Conduct Authority has noted that, notwithstanding the criteria set out in the Delegated Regulation, in its view "[t]he importance of tasks carried out by the manager is a key consideration, taking particular account of the right and ability of the manager to exercise oversight and control and the degree to which those rights are exercised." Parties should therefore consider taking local counsel's advice in relation to any structure that could potentially be viewed as falling afoul of the anti-letter-box provisions.

The European Commission has been tasked with monitoring the application of the anti-letter-box provisions and their impact on the market. The Commission is obliged to review the situation in 2015 and where necessary take appropriate measures to further specify the conditions under which an entity will be deemed to have become a letter-box entity.

Remuneration and non-EU delegates

In its February 2013 Guidelines on sound remuneration policies under the Directive, the European Securities Markets Authority suggested that delegates to whom portfolio management or risk management activities have been delegated be "subject to regulatory requirements on remuneration that are equally as effective as those applicable under [the] guidelines." The Guidelines alternatively provide that appropriate contractual arrangements be put in place with such delegates to ensure that there is no circumvention of the remuneration requirements,

with such arrangements covering any payments made to a delegate's identified staff in respect of portfolio management or risk management carried out on behalf of the manager. This requirement can be interpreted in one of two ways:

- (1) The manager is obliged to impose on the delegate the same requirements in relation to remuneration that the manager is subject to; or
- (2) The manager cannot enter into an arrangement that will allow it to circumvent the remuneration requirements.

If the first view is taken, the consequences to the delegate are considerable as the Directive imposes considerable restrictions on compensation. It could be argued that the concept of extending the remuneration requirements to non-EU delegates extends the scope of the Directive beyond the original legislative intent and as such could be subject to legal challenge.

If the second view is taken, a legitimate delegation of the portfolio management or risk management function to a non-EU delegate would not result in restrictions on the delegate's compensation.

It is unclear at the time of writing which approach the various Member State competent authorities will take with respect to the Guidelines. Managers and delegates should, in the absence of clear guidance from the relevant Member State competent authority, engage with local counsel in the relevant Member State to determine an approach to this issue.

Timing

The Directive, including the provisions relating to delegation, became effective on 22 July 2013. A number of jurisdictions, including the UK, have adopted transitional measures which mean that, in certain circumstances, these provisions will not fully apply until 22 July 2014. **THFJ**

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