

Implementing measures on the Alternative Investment Fund Managers Directive: CESR call for evidence

Initial submission by the Association of Investment Companies

The Association of Investment Companies (AIC) represents closed-ended investment companies whose shares are traded on public markets. They offer investors access to a diversified portfolio of assets and will be regulated under the AIFM Directive. Our members are either UK based (and include investment trust companies and Venture Capital Trusts) or based outside the EU but trade their shares on UK markets (predominantly the London Stock Exchange).

The AIFM Directive is a critical regulatory mechanism for our sector. We are very keen that it is implemented in a way which is sympathetic to the unique aspects of our structure. We were reassured that the Commission's original proposal for a Directive recognised that there would have to be some tailoring of aspects of the rules to accommodate the diversity of sectors to be regulated. The AIC **recommends** that the implementing measures to be introduced at level 2 should also be customised to accommodate different types of entities which are to be within scope. This will ensure that the Directive secures effective regulation for all types of fund and that its application is proportionate.

Facilitating an effective policy making process

The AIC recognises that there is a significant amount of work to do before CESR can provide full advice to the Commission. It also recognises that CESR is working to a very tight timetable. It welcomes the extension to the consultation period already provided. Nevertheless, the time allowed still presents a significant challenge for stakeholders seeking to inform CESR's views. For this reason this submission will highlight issues where the AIC has a strong initial view on developing the level 2 measures. We anticipate that there will be other areas where we have views which emerge once we are able to give the questions raised more consideration. With this in mind, we envisage providing further submissions on other agenda items in due course. We **recommend** that CESR should formally encourage stakeholders to provide supplementary responses and welcome such submissions. A public statement would be invaluable to encourage full participation.

Given the complexity of the issues raised by this call for evidence, we welcome CESR's commitment to providing further details in relation to public consultations to be carried out in light of responses. We **recommend** that CESR maximises the transparency of the process of developing its advice. This would involve publishing working papers and preliminary recommendations where possible – including making them available on its website. This will offer the best prospect for full stakeholder engagement and help deliver effective and proportionate regulation.

The advisory process will also be enhanced if CESR concentrates its resources on areas which are unique to the Directive and/or have not been considered before. With this in mind the AIC **recommends** that it should, where appropriate, make use of established approaches set out in existing international standards (such as technical advice provided by IOSCO) and existing Directives which regulate funds and related activities (such as MiFID). This will help ensure the creation of workable and proportionate rules. This will also facilitate equivalent implementation and, ultimately, common approaches to interpretation and enforcement across Member States. However, there are limits to this approach. Discretion should be left for

individual competent authorities to take account of the specific features of different types of fund which have unique characteristics. This could be required where aspects of existing regulation – notably the UCITs Directive – are based on open-ended structures and may not be appropriate for alternative approaches, particularly closed-ended funds. The AIC **recommends** that the unique needs of closed-ended funds are given particular consideration in developing the required Level 2 measures.

Specific questions raised by the call for evidence

Q.1 Which categories of investment manager and investment fund will fall within the scope of the AIFM Directive?

The AIC represents closed-ended investment companies which primarily offer their shares to investors in the UK. These include UK investment trust companies, Venture Capital Trusts and non-UK investment companies (usually domiciled in the Channel Islands) whose shares are traded on UK exchanges.

Investment companies are corporate collective investment undertakings, overseen by a board of directors. They offer a variety of investment strategies and are invested in assets including public and private equity, corporate bonds, gilts, commercial property and derivatives. They also invest in a wide range of geographical locations, including emerging markets.

Investment companies vary in size. The largest may have assets under management of billions of pounds. The smallest (including Venture Capital Trusts) often hold assets of a few tens of millions.

The shares of the majority of our members are traded on regulated markets and are on the UK's official list. This means that they are subject to the Consolidated Admissions and Reporting Directive (supplemented by the UK Listing Rules), the Prospectus Directive and the Transparency Directive. Where they are incorporated in the UK they are also subject to UK and European company law. They also have to apply relevant accounting standards and are bound by the Market Abuse Directive.

A wide range of entities adopting a variety of organisational and legal structures may fall within the broad definition of closed-ended investment companies. Where these companies fulfil the role of the AIFM, and can demonstrate to the competent authority that they have the capacity to ensure compliance with the Directive, they may be self-managed AIFMs for the purposes of the Directive. However, there may be other closed-ended corporate funds which do not meet these conditions and these would be an AIF which will need to employ an authorised, external AIFM to be marketed to EU investors or to be managed within a Member State. Whether or not an investment company would be both the AIF and the AIFM, or will have to employ an external AIFM, will depend on its particular circumstances.

Q.2 Which measures should be most appropriately adopted in the form of regulations or directives?

The AIC **recommends** that level 2 measures be adopted in the form of directives wherever possible. We anticipate that this approach will make it easier for respective competent authorities to implement the AIFM Directive's regulatory provisions in an integrated and coherent manner. It will allow for an orderly transition to the new regime.

Q.3 Do you have sources of data which CESR could benefit from in preparing its advice?

The AIC publishes a range of statistics about investment companies on its website. These can be accessed through the following link: <http://www.theaic.co.uk/Statistics-publications/> Please contact the AIC (details at the end of this submission) for any further information.

Comments on selected level 2 issues

These comments represent the AIC's initial views. We anticipate providing supplementary material once we have had time to consider further the issues raised.

We note that the AIFM Directive is already a detailed text. It includes a significant number of very specific obligations which are comparable to the measures adopted at level 2 for other regulatory initiatives (including MiFID and UCITs). These mechanisms successfully deliver effective and consistent regulation. With this in mind, we **recommend** that the adoption of further, detailed measures at level 2 should be carefully considered and only taken forward where this is required. There is a risk that the introduction of further legislation will result in disproportionate obligations or unnecessarily restrict the ability of competent authorities to discharge their duties effectively.

II.2. Issue 2 – Article 9 Initial capital and own funds

- Q1. What risks should be covered by additional own funds or professional indemnity insurance (PII)?
- Q2. What methods for calculating the level of additional own funds or PII should be used?

An internally managed AIF which is also the AIFM must satisfy any on-going capital requirement through professional indemnity insurance (PII) rather than their own resources. It is not appropriate for such an AIFM to hold capital on its own account as this capital cannot be segregated from investors' funds. Even if such segregation could be achieved it would not be desirable as it would simply reduce the amount of their capital which would be invested in accordance with the AIF's investment policy, while not providing any additional protection or security for investors. On the other hand, a limited amount of PII could potentially provide benefits as long as it can be secured at a reasonable price.

Where PII is held it must not seek to cover any losses incurred through the normal activity of the fund. After all, exposure to risk and possible losses is inherent in the investment process. PII cover should be limited to potential losses arising from negligence. Risks covered might include losses:

- incurred by a failure to follow investment or gearing mandates;
- arising from the incorrect valuation of assets;
- attributable to the incorrect administration of a distribution.

However, the extent of the coverage should be properly limited. Any insurance that sought to cover all potential losses pound for pound would be prohibitively expensive. It is not a credible or proportionate regulatory position to expect such cover. Instead

the AIFM Directive creates rules for AIFM to follow, and be held accountable to. This obligation will create processes which reduce the risk that the problems identified above materialise.

CESR should take as a guide the level of capital currently required in the UCITs rules and CRD. This creates a maximum of Euro 10 million (or a quarter of the preceding year's fixed overheads if that amount is smaller). The AIC **recommends** that the additional funding requirement for AIFM should be limited to these amounts and that they can be covered by PII insurance for self-managed AIFM.

II.3. Issue 3 – Article 12 General principles

Q.1 What criteria should be used to assess whether AIFM comply with their obligations under Article 12?

In considering whether or not an AIFM has met its general duties as set out in Article 12, the AIC **recommends** that competent authorities should take account of the specific circumstances of each AIFM. The AIC also **recommends** that competent authorities should have regard to what it would be reasonable for the AIFM to do.

Where an AIFM faces potentially conflicting obligations, its duties to its investors should take precedence. This conforms to other legal obligations (such as UK company law) where the interests of shareholders will take precedence in assessing the duties of directors. In any event, all AIFM will be required to comply with specific obligations under the Directive and other existing regulatory standards such as those set out in the Market Abuse Directive, Transparency Directive etc.

The AIC also **recommends** that, where an AIFM is managing more than one AIF, it must also seek to balance the interests of each group of investors. An AIFM which is managing more than one AIF must not prioritise one particular AIF (or its investors) according to its own commercial interests (for example, favouring those in AIF which pay higher management fees). Considerations of this nature would be particularly relevant, for example, where an AIFM was required by a competent authority to reduce the overall level of gearing of the AIFs it manages, which might be distributed across a number of different AIFs.

The AIC also **recommends** that a key consideration of a competent authority should be the extent to which an AIFM's actions generally support the effective delivery of each AIF's investment policy.

An AIFM has an obligation to exercise due care, skill and diligence. The AIC **recommends** that judging whether or not this has been achieved should be based upon normal market practice and expectations. Assessment of these obligations should also consider whether or not the AIFM has acted in good faith. Where these criteria have been satisfied this should be sufficient to discharge this general duty.

The AIC also **recommends** that competent authorities should consider whether or not an AIFM's decisions in relation to an AIF have been made independently of any commercial relationships it may have with other parties, be that other AIF it manages or any other entity or individual.

Although these are the type of criteria which should be used to judge the provisions set out in Article 12, it would not be appropriate to create detailed legislation on these issues. The AIC **recommends** that it would be preferable to minimise legislation in this area and instead set out an advisory framework for competent authorities. This

will allow practice to develop over time in a way which will maintain high standards and secure the optimum regulatory outcome.

II.4. Issue 4 – Article 14 Conflicts of interest

Q1. What types of conflict may arise?

Conflicts of interest arise where securing the interests of the AIFM, or key decision makers within the AIFM, are contrary to delivering the best outcome for an AIF or its investors. This risk arises most clearly where the AIFM has a material financial interest in a certain activity or approach. These might particularly arise where the AIFM (or relevant individuals) are remunerated by more than one AIF or other client.

Conflicts of interest might also materialise where the AIFM has a specific duty to act on behalf of one or more entities. This might include, for example, other companies in the same commercial group as the AIFM or different AIFs.

Q2. What reasonable steps should an AIFM take to identify, manage, disclose and monitor conflicts of interest?

Systems to manage conflicts of interest should identify and record potential conflicts. This will involve identifying the material relationships an AIFM, or key individuals, has with other parties. AIFM should make an assessment of whether or not these matters are sufficient to risk influencing their decision making processes.

The ultimate oversight of potential conflicts of interest should be provided by a senior decision making forum. This body should consider any issues identified and minute discussions on how such conflicts should be resolved. Decisions taken should also be recorded. Individuals with particular interests might be excluded from carrying out certain functions or making certain decisions. Some decisions might be reserved for the AIFM's governing board to ensure that key issues are considered by individuals with suitable seniority.

Effective management of conflicts of interest is already required of investment companies. Company law requires directors to report and monitor potential conflicts. They can be required to absent themselves from discussions related to those conflicts. Key decisions are subject to full board scrutiny and some matters must be referred to shareholders for agreement. Where an investment company is an internally managed AIF, the AIC **recommends** that such procedures will be suitable for discharging their duties to manage conflicts of interests under the Directive.

II. Issue 5 – Article 15 Risk management

Q2. How frequently should risk management systems be reviewed?

The AIC **recommends** that requirement should be for the risk management system to be reviewed at least once a year. In the normal course of business it is doubtful that more frequent reviews would be necessary, regardless of the nature of the AIF's investment strategy or structure.

Q3. How should a competent authority assess whether or not the risk management function of an AIFM is “functionally and hierarchically” separated from the operational units?

The key risk management obligation on the AIFM is to hierarchically and functionally separate risk management from ‘operating units’.

With this in mind, the competent authority’s main concern should be whether the ultimate decisions about the nature and management of the key risks facing AIFM is separated from the individuals who carry out the day-to-day tasks of implementing risk management procedures.

Where an internally managed investment company is concerned, this will customarily be achieved by reserving to the board the responsibility for key issues related to risk. That is, asset allocation, maximum exposures, method and level of gearing etc. Some of these decisions will also be subject to shareholder ratification. Nevertheless, the responsibility for taking the key decisions, and allocating operational responsibility, lies with the investment company board. The operational (functional) separation is achieved as employees or other suppliers to the company are engaged to undertake discrete tasks within boundaries established by the board.

A competent authority assessing such arrangements should consider the extent to which the investment company board (or other AIFM governing body) has reserved decision making about key risks.

It might also consider the mechanisms established to receive relevant information from those performing operational tasks and whether or not these activities have been carried out within the limits set.

The competent authority’s consideration of hierarchical separation will also involve assessing where key decisions are taken. For example, in the case of a self-managed investment company, this would include receiving evidence that the board has the capacity to require changes to operational systems so as to maintain adequate standards of risk management. It should also have the capacity to alter the level of resources devoted to relevant activities. It should also be able to obtain the information it requires to review the approach taken.

The AIC **recommends** that where the overall decision making function for key aspects of risk (e.g. asset allocation and gearing levels) lies within a distinct forum, this will be sufficient to demonstrate functional separation of risk management.

II.9. Issue 9 – Article 19 Valuation

Q1 What criteria should be used to assess the procedures for the proper valuation of assets?

Views on best practice and methodology for valuations change over time and differ in relation to different asset classes. They reflect changing industry views and the development of accounting practice as determined by international accounting standards. The Commission should not set detailed criteria for the proper procedures for the valuation of assets at Level 2.

Instead the AIC **recommends** that any rules adopted should focus on the general approach expected. That is, that the valuation should present a fair assessment of the value of the assets which provides investors with the most realistic view of the

value of the portfolio. This should reflect current market practice or international standards (such as those established by IOSCO or set out in international accounting standards). Where there is a deviation from such practice, the reasons for that deviation should be clearly explained.

II.10. Issue 10 – Article 20 Delegation of AIFM functions

Q2 a) What criteria should competent authorities use to assess whether the delegation structure of an AIFM is objective?

Objective reasons for delegation will include, for example, securing a firm's skills and experience in:

- managing specific asset classes.
- operating in specific geographical markets.
- managing back-office, legal, tax or other compliance tasks.

It would not be acceptable for the reason for delegation to be to avoid complying with relevant obligations under the Directive.

Q2 b) & c) What criteria should a firm meet to be deemed to have sufficient resources and be of sufficiently good repute? What types of institutions should be considered as authorised or registered at a sufficient standard to be able to carry out delegated asset management?

The AIC **recommends** that it should be automatic that any firm authorised to conduct business under MiFID meets the standards required of a firm carrying out delegated functions.

Where a firm does not have MiFID authorisation, the criteria used for MiFID approval should provide the basis for the standards set out in Level 2.

It may be that certain non-EU jurisdictions (such as the USA) will also be considered to have sufficiently high regulatory standards to provide automatic approval in relation to the delegation provisions. Whether or not such a conclusion would be possible will only be clear once the Commission has established the detailed Level 2 requirements. Once these are clear, details of which jurisdictions meet the required standards should be published.

Q5 Under what conditions would an AIFM be considered to have delegated its functions to the extent which it has become a letter box entity?

In the context of the Directive an AIFM will become a 'letter box entity' if it has eroded its own freedom of action and oversight to the extent that it is unable to ensure that its broad regulatory obligations are maintained. This would occur where an AIFM used delegation arrangements which relinquished control over key decisions in the areas of:

- the determination of overall asset allocation within an AIF's portfolio, including the power to limit the investment mandate of a delegated manager.
- The level of diversification in an AIF's portfolio.

- the level of gearing adopted by an AIF.
- the continued appointment of any firm carrying out delegated functions.
- approval of the AIF's report and accounts or other investor communications.

Where an AIFM maintains responsibility for decision making in these areas it will not be a 'letter box entity'. An AIFM's justification for its delegation structure should confirm that it retains its responsibility for these critical issues.

An AIFM could practically demonstrate that these decisions are retained by the AIFM by providing evidence:

- of constitutional or other legal arrangements which reserve decision making on these issues to the AIFM.
- of service contracts which set out the extent of, and limit, the supplier/s role.
- that the AIFM is able to terminate delegation arrangements (subject to reasonable contractual considerations).
- that firms undertaking delegated functions provide adequate reports to the AIFM which allow the monitoring of the supplier's activity.
- (such as meeting minutes) that demonstrate the AIFM regularly reviews the work undertaken by firms carrying out delegated functions.
- (such as meeting minutes) which demonstrate that the AIFM regularly considers the issues over which it retains decision making responsibility (asset allocation, leverage levels, the continued appointment of suppliers etc.).
- that the AIFM signs-off the content and publication of the annual report and accounts, other financial and regulatory statements and investor communications.

The AIC **recommends** that, where an AIFM is carrying out these roles, and can provide evidence as set out above, it will not be identified as a 'letter box entity'.

III.3. Issue 13.3 – Depositary functions pursuant to paragraph 8

The requirement to appoint a depositary is arguably the most significant regulatory obligation established by the AIFM Directive. It is critical that the overall framework is workable and proportionate. The rules must facilitate the development of a competitive market which delivers services at a realistic price. Getting the details of depositary liability right will be critical in delivering this outcome. It is also essential that the rules recognise that different structures are likely to raise specific considerations.

Q1 What conditions must a depositary comply with to be able to fulfil its duties in relation to oversight of the AIF (as set out in Article 21 (8))?

It will be essential that any Level 2 depositary rules provide sufficient flexibility for depositaries to establish a variety of arrangements which allow them to undertake these functions. A huge variety of different funds will be included within scope, many

of them will have unique legal, constitutional or other arrangements and be subject to a substantial variety of pre-existing regulatory obligations.

This can be illustrated by the example of a UK domiciled investment company admitted to the UK's official list and seeking to issue new shares. It may have to produce a prospectus, a significant and substantial document. The company already has obligations to ensure that this document is correctly prepared and distributed – it will also be reviewed by the UK Listing Authority. The company will also have to abide by a variety of relevant Listing Rules, including, for example, observing the pre-emption rights of existing shareholders. It will also have underlying company law obligations, including those arising from EU Directives and UK company law (such as complying with Directors' duties). Aside from these general obligations, it will also have to ensure that the terms of its own Memorandum and Articles of Association are observed. Ensuring compliance with these requirements is a specialised task. Investment companies customarily seek advice from lawyers, accountants and brokers to ensure that they have satisfied their compliance obligations.

Depositories are unlikely to be able to call upon internal resources to deal with the vast range of legal and regulatory provisions relevant to the oversight they are required to undertake by the AIFM Directive. This task covers a variety of activities (share sales, issue, repurchase, cancellation, calculation of unit value etc). It will have to accommodate a huge variety of jurisdictions and AIF structures.

Ensuring that depositories can work with other professional advisors, and rely upon their advice, to discharge their duties under Article 21 (8) will be essential to securing an effective regulatory outcome. This will result in the highest possible level of consumer protection as it means that the relevant tasks will be delivered with the help of specialist advisors. It reduces the risk that depositories will have to rely on a one-size-fits-all model which is inherently less able to provide effective scrutiny of the specific compliance practice of different types of funds.

Preventing depositories from providing their services in conjunction with external specialist advisors creates the risk that depositories will only be prepared or able to service a very narrow range of product types. This would compromise the Commission's intention that the Directive should not restrict competition or product diversity. Alternatively depositories will have to build internal resources to cope with the range of tasks they have to deal with. This would create substantial costs for depositories which would be passed onto AIFs. The likelihood will be that consumers will pay a very high price for the protection they receive. This would be unfortunate as existing regulatory obligations, such as the prospectus rules, already incorporate mechanisms designed to secure disclosures of the quality which investors require to make an investment decision. There is no doubt that these are effective – a conclusion endorsed by the Commission's own recent review of the Prospectus Directive. If there were concerns then these raise far more significant policy issues than the AIFM Directive seeks to address.

It is essential that the depository obligations in respect of legal oversight are proportionate. To secure this the AIC **recommends** that depositories are allowed flexibility in the arrangements they put in place to deliver their obligations under Article 21 (8).

IV.4. Issue 22 – Article 24 Reporting obligations to competent authorities

Q1. *What criteria should be used to determine whether leverage is being 'employed on a substantial basis'?*

The original proposal for a Directive set significant gearing at least 100% of share capital (where leverage exceeded the equity capital of the AIF in at least 2 of the past four quarters). The AIC **recommends** that substantial leverage should be defined at at least 100% in any Level 2 measures.

14 January 2011

For further information on the issues raised in this paper please contact:

Guy Rainbird, Public Affairs Director, Association of Investment Companies

guy.rainbird@theaic.co.uk