

Key concepts of The Alternative Investment Fund Managers Directive and types of AIFM

Submission from The Association of Investment Companies (AIC)

The AIC represents investment companies. These are closed-ended corporate investment vehicles which are governed by company law and governed by a board of directors with legal and fiduciary duties to shareholders. Investment company's shares are admitted to trading on public markets. The sector is primarily UK-focussed: other Member States do not tend to host investment vehicles of this type.

The discussion paper in context

We anticipate that our members will be regulated under the AIFM Directive ('the Directive'). They may also have unique issues because of their specific structure and approach. In due course it will be useful for ESMA to clarify various issues raised by the Directive to assist with the consistent application of the rules by Member State regulators and to enable ESMA to carry out its own on-going obligations. However, the AIC is unconvinced that it is possible to complete such an exercise now. The level two measures have not yet been agreed (or published). This makes it very difficult, if not impossible, for those likely to be affected by this legislation to provide a clear insight into how the rules might affect or apply to them.

With this in mind the AIC **recommends** that ESMA should not publish any conclusions on the issues raised by this paper in advance of publication of the Level two obligations. ESMA should undertake further engagement with industry after details of the level two rules have been agreed. That said, it is useful for this process to have begun and the AIC welcomes the opportunity to provide its early thoughts.

Our comments on the issues raised in the Discussion Paper are limited to areas most likely to be directly relevant to the investment company sector.

Definition of open and closed-ended funds (Q. 11)

ESMA suggests that open-ended funds are those funds:

"the units/shares of which may be, at the holder's request, repurchased or redeemed without any limitation, directly or indirectly, out of the assets of those undertakings at least annually".

Furthermore, it also asks if it is correct to consider a closed-ended fund as those which:

"offer the ability to repurchase or redeem their units at less than an annual frequency".

The AIC does not wholly agree with these definitions. The critical distinction between open-ended and closed-ended funds is that a closed-ended fund does not, as a matter of fact, give investors any automatic rights to redemption at Net Asset Value. This would be the case, for example, for an investment company. Their shares are customarily traded between investors via stock markets. The company offers no automatic right to repurchase shares. That said, there may be occasions when the company does decide, at its own instigation, to make an offer to repurchase its shares through the market (customarily at a discount to Net Asset Value). Such actions are at the discretion of the company and cannot be demanded by an individual investor. In contrast, open-ended funds provide explicit rights for investors to sell their shares back to the operator of an open-ended fund, although the frequency of these opportunities may vary.

One of the difficulties in drawing distinctions between open-ended and closed-ended funds is that they could potentially change their status. For example, an open-ended fund could cease redemptions and become closed-ended. The UK regime seeks to deal with this by taking an overall view of what a hypothetical 'reasonable' investor can expect from a fund. The conclusion on whether a fund can be considered open or closed is based on issues such as the declared policy of the fund and the asset-class it is exposed to. For example, a fund with liquid assets which did not provide redemptions for a period of six-months might (generally) be considered closed-ended. If the fund were invested in illiquid assets, such as property, but offered redemptions on a six-month basis, it might reasonably be considered to be open-ended.

The AIC **recommends** that the determination of whether or not a fund is open or closed should be based on taking a reasonable view of its circumstances. Factors taken into account would include an individual investor's right to demand redemption, the policy of the fund towards suspending redemptions and the asset class it is exposed to. This would be a more appropriate approach than establishing set (annual) time period for redemptions. The AIC **recommends** that the status of an AIF (as to whether it is closed or open) would be assessed by the AIFM and that this view would be subject to review by the AIFM's home regulatory authority on a case-by-case basis. The AIC **recommends** that ESMA could publish guidance on criteria likely to be relevant for making this assessment.

Concept of 'substantial leverage' (Q. 12)

There would be merit in ESMA clarifying the concept of 'substantial leverage'. The AIC **recommends** that ESMA indicate a minimum level where leverage can never be deemed to be substantial. The AIC **recommends** that the minimum level where leverage could be considered substantial is where it represents an amount which is twice as much as the Net Asset Value of an AIF

The AIC **recommends** that ESMA should confirm that leverage might, in some circumstances, exceed this limit and still not be substantial. This would depend upon the investment policy of the AIF, the nature of the assets held and the terms

on which the leverage has been taken out. The rules should allow AIFM to make representations to their home competent authority to explain the nature of their exposure and why their circumstances mean that their level of leverage is not substantial (for example, because the total assets of the fund are very small). Home state regulators would then be able to take a view and require compliance with the rules as appropriate.

Appointment of AIFM (Q. 13)

The discussion paper explores when an AIF is an AIFM and its capacity to delegate. The AIC agrees that each AIF should only have one AIFM and that an AIF can be the AIFM where its legal form permits internal management.

The AIC also agrees with the analysis set out in paragraph 47 that a company which

“performs portfolio management or risk management functions for an AIF can be the appointed AIFM or it can perform one or both of these functions under a delegation arrangement”

This is a helpful clarification of how the Directive will operate. The AIC **recommends** that this interpretation be included in any future guidance on this issue.

However, the discussion of associated issues set out in paragraphs 4 – 10 is less helpful and is rather confusing. Our view is that the analysis set out in these paragraphs agrees in substance with the conclusion of paragraph 47. That is, an AIFM can delegate aspects of both portfolio management and risk management to another entity if it chooses to do so.

Paragraphs 4 - 10 also explore the extent to which an AIFM can delegate. It is this aspect of the discussion which is less helpful and unclear. The Directive allows an AIFM to delegate both portfolio and risk management (as well as other functions) but only insofar as this does not make the AIFM a ‘letter-box’ entity. In particular, the AIFM has to retain responsibility for activities it has delegated. The AIC anticipates that paragraphs 4 – 10 intend to explain this situation. If so, the AIC agrees with this conclusion. However, the explanation included is not clear.

The AIC **recommends** that ESMA clarifies that an AIFM can delegate one or both of the functions of portfolio and risk management but only insofar as this does not make it a ‘letter-box’ entity. The AIFM must retain the expertise and resources required to supervise the delegated tasks and manage the risks associated with the delegation. It must also be able to exercise power over senior management functions related to the investment policy and strategies.

Treatment of MiFID institutions (Q. 14)

The AIC agrees that MiFID firms should be able to provide services to AIFMs under delegation arrangements (subject to the requirements of Article 20 and any relevant Level 2 measures). The AIC **recommends** that this view be set out in any forthcoming guidance.

The AIC does not believe that a MiFID authorised firm should be prevented from being an AIFM or that there is a policy justification for such an approach.

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