

AIFMD - Delegation of Functions

Directive 2011/ 61/EU on Alternative Investment Fund Managers (AIFMD) must be implemented by EU Member States by 22 July 2013. AIFMD is supplemented by a delegated level 2 regulation (AIFMD Regulation). AIFMD regulates the activities of Alternative Investment Fund Managers (AIFMs) and their Alternative Investment Funds (AIFs). AIFMD has been implemented in Ireland by the European Union (Alternative Investment Fund Managers) Regulations, 2013.

The issue of delegation developed into one of the hottest topics covered by the AIFMD, principally driven by a concern that the provisions, particularly in the AIFMD Regulation, were an attack on the well-established fund structures utilised in a number of jurisdictions in Europe, in particular in Ireland and Luxembourg.

Thankfully, sense prevailed and while an AIFM needs to be careful as to the extent of delegation of its functions, it will be possible to structure a self-managed AIF in a way that is not dramatically different to current self-managed non-UCITS structures available in Ireland.

Delegation under the Directive

Article 20 of the AIFMD provides that an AIFM can delegate tasks to third parties, which in turn can sub-delegate such tasks. This, though, is subject to a number of conditions which are further elaborated upon in the AIFMD Regulation.

In particular, the AIFM must notify the competent authority of its home Member State before any delegation arrangements become effective. This is similar to the existing requirement to have delegation of any investment management and administration functions approved by the Central Bank but it is potentially broader as it also covers risk management functions and other forms of delegation.

In addition, the following are some of the other key conditions that must be met:

- The AIFM must be able to justify its delegation structure on objective reasons (which can include the optimising of business functions and processes, cost savings, expertise of the delegates and access to global trading capabilities, as applicable);
- A delegate must have sufficient resources to enable it to carry out the tasks delegated to it and must be sufficiently experienced and of good repute (the AIFMD Regulation sets out details of the type of due diligence that will need to be undertaken in respect of the parties who effectively conduct the delegated activities – i.e. the senior management of the delegate);
- Where the delegation concerns portfolio management or risk management, the delegate must be authorised or registered for the purposes of asset management and subject to supervision or (where this condition cannot be met), their appointment is subject to prior approval by the competent authorities of the home Member State of the AIFM. Again the AIFMD Regulation sets out details of entities that will be deemed to be authorised and the requirements where delegation is to an entity in a third-country, one such requirement being that a written agreement is in place between the competent authorities of the home Member State of the AIFM and the supervisory authority of the delegate;
- The delegation must not prevent the effectiveness of the supervision of the AIFM and must not prevent the AIFM from acting or the fund being managed in the best interests of the investors. The AIFMD Regulation sets out details to be considered. In particular, the AIFMD Regulation sets out specific requirements that have to be met when considering whether portfolio or risk management functions may be considered to be functionally and hierarchically separated (which is a requirement before delegation of such activities can occur).
- Neither portfolio management nor risk management can be delegated to the depository or a delegate of the depository.
- The AIFM's liability towards the fund and its investors will not be affected by any delegation to a third party or any further sub-delegation.
- Sub-delegation is permitted, subject to the consent, on a case by case basis, of the AIFM and the AIFM must have notified the competent authorities of its home Member State before the sub-delegation arrangements become effective. All of the conditions relating to delegation apply to sub-delegation arrangements.

Prohibition of being a letter box entity

One of the most important provisions in the AIFMD Regulation is Article 82 which sets out when an AIFM will be deemed to be a letter box entity, as a consequence of the amount of delegation it has entered into in respect of an AIF. An AIFM cannot be a letter box entity.

As a consequence it will not be possible to delegate all portfolio management functions and all risk management functions and still remain as the AIFM. However, an AIFM will be able to delegate a number of portfolio management functions and a number of risk management functions, while at the same time retaining some of each and, accordingly, not fall into the trap of being considered a letter box entity. This will require a degree of analysis on a case by case basis but of importance will be matters such as:

- the AIFM retaining the necessary experience and resources to supervise any delegated tasks and manage associated risks;
- the AIFM maintaining the power to take decisions (in particular to provide overriding instructions to any investment manager, as necessary);

- the AIFM setting and retaining the power to set an AIFs investment policies and investment strategies;
- the AIFM setting and retaining the power to set an AIFs leverage limits;
- the AIFM setting and retaining the power to set an AIFs geographical and sectorial spread of investments, as applicable;
- the AIFM setting and retaining the power to set an AIFs risk profile and risk appetite;
- the AIFM retaining discretion as to the selection of key counterparties and prime brokers, etc;
- the AIFM retaining the right to determine identity of delegates and their sub-delegates and their spheres of operation;
- an enhanced level of reporting to the AIFM in respect of all delegated matters;
- the AIFM retaining responsibility, together with the delegate, for identifying and documenting risks (it is currently the case that a self-managed AIF or management company must take responsibility for the risk factors in a prospectus so this should not be a significant departure);
- the AIFM setting risk limits, following input from the relevant delegates, and assessing any risk mitigation steps that can be taken together with the applicable risk controls that should be implemented (again with input from the relevant delegates).

Detail in the programme of activities

It will be important to outline in the AIFM's Programme of Activities, its processes and procedures around delegation as well as, crucially, the aspects of portfolio management and risk management that are not to be delegated.

Review by the Commission

The AIFMD Regulation requires the Commission to undertake a review of the application of Article 82 (the Article dealing with letter box entities) and, if necessary, to take measures to further specify conditions under which the AIFM should be deemed to have delegated its functions to the extent that it has become a letter box entity. This is to occur by July 2015. ESMA may also issue guidelines to ensure consistent assessment of delegation structures across the EU.

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