

AIFMD: Calculation of Assets Under Management (AUM); Breaches of Thresholds; Calculation of Leverage; Professional Liability Risk Cover.

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 regulation (AIFMD Regulation). AIFMD regulates the activities of Alternative Investment Fund Managers (AIFMs) and their Alternative Investment Funds (AIFs). This note deals with the following:

- calculation of AUM - this is relevant for identifying AIFMs qualifying for simple registration rather than full blown authorisation under the AIFMD;
- provisions relating to where there are occasional breaches of thresholds (which delineate between whether registration or full blown authorisation is required) and applications for registration;
- calculation of leverage – which is relevant for a variety of purposes and must be reported to regulators and investors;
- professional liability risks and the obligation to cover these either with additional own funds or professional indemnity insurance.

Calculation of an AIFM's AUM for the purposes of AIFMD

The AUM of relevance here are the AUM of all the AIFs for which the AIFM acts as AIFM. For each AIF, the AIFM values its assets in accordance with the valuation rules laid down in the country where the AIF is established.

All assets acquired through leverage must be included in the calculation (i.e. it is a gross asset value that must be determined).

Even where the AIFM has delegated functions, it should include the AUM of the AIFs for which it has delegated functions to others. However, if the AIFM (call it AIFM1) is managing the assets of an AIF under a delegation arrangement where it is the delegate and another entity is the AIFM (call it AIFM2) of that AIF, then the AUM of that AIF is excluded when calculating the aggregate AUM of AIFM1.

Where one AIF invests in another AIF managed by the same external AIFM, that investment can be excluded from the calculation of the AIFM's AUM (that exclusion also applies where one sub-fund invests in another sub-fund managed by the same AIFM).

If the AIFM is managing UCITS funds, the AUM of these funds are excluded.

The total AUM calculation must be carried out at least annually using the latest available values (i.e. the latest available value produced during the preceding 12 months). The calculation date should be applied in a consistent manner. Any change of the date of the calculation of the AIFM's AUM must be justified to its competent authority.

The value of individual discretionary management mandates managed by an AIFM (i.e. for the client that is an AIF) is to be excluded from the calculation.

Occasional breaches of the threshold and application for registration

AIFMs are obliged to have procedures in place to monitor on an on-going basis their total AUM. The AIFMD Regulation provides for occasional breaches of the threshold (e.g. where the AUM exceeds €100 million or €500 million for a period depending on the types of AIFM).

If an AIFM finds that its AUM has exceeded a threshold then:

- it must notify its competent authority without delay;
- it must determine if the situation is of a temporary nature or not (temporary would be if it is likely to continue for a period of no more than three months);
- if it is not a temporary situation, then the AIFM is obliged to seek full authorisation within 30 calendar days;
- if it is a temporary situation, the AIFM is obliged to re-calculate its AUM three months after the original calculation in order to show that it is below the relevant threshold or demonstrate to the competent authority that the situation which gave rise to exceeding the threshold has been resolved and an application for authorisation is not required.

An AIFM seeking registration is obliged to provide the total value of AUM to the relevant competent authority. In addition, it is obliged to provide an extract from the offering document of each AIF or a general description of its investment strategy. Such information should include the main categories of assets in which the AIF may invest, any industrial, geographic or market sectors or specific classes of assets which are the focus of the investment strategy and a description of the AIF's borrowing or leverage policy.

Information provided for registration purposes must be updated on an annual basis. Competent authorities can request a more frequent provision of information.

Calculation of leverage

The AIFMD Regulation provides that leverage of an AIF must be expressed as a ratio between the exposure of an AIF and its NAV.

Exposure must be calculated on a gross asset value basis and also on a commitment method basis. The EU Commission may add other methods of calculating leverage but have not done so yet (for example there is no facility to use VaR for AIFMD purposes).

AIFMs can exclude borrowing arrangements entered into if these are temporary and are fully covered by contractual capital commitments from investors.

Gross method for calculating exposure

In calculating exposure in accordance with the gross method, an AIFM must comply with Article 7 of the AIFMD Regulation and in particular:

- exclude the value of cash and cash equivalents (subject to certain qualifications);
- convert financial derivative instruments into the equivalent position in the underlying asset using conversion methodologies set out in the AIFMD Regulation;
- exclude cash borrowings that remain in cash or cash equivalents as referred to above;
- include exposure resulting from the reinvestment of cash borrowings expressed as the higher of the market value of the investment realised or the total amount of the cash borrowed;
- include positions within repo or reverse repo agreements and securities lending or borrowing or other arrangements in accordance with Annex I to the AIFMD Regulation.

No netting or hedging arrangements are to be applied when calculating exposure using the gross method.

Commitment method for calculating exposure

This is very similar to the UCITS requirements and specific commercial methodologies are set out in the AIFMD Regulation. Netting and hedging arrangements can be applied provided they meet requirements set out in the AIFMD Regulation.

There are provisions, as with UCITS, for excluding certain portfolio swaps, subject to certain qualifications and also excluding certain derivative instruments, where holding such instrument and cash (which is held by the AIF) is equivalent to holding a long position in the given financial asset, assuming the financial derivative instrument does not generate any incremental exposure, leverage or risk.

AIFMs managing AIFs that primarily invest in interest rate derivatives should use duration netting rules which are set out in the AIFMD Regulation.

Capital requirements and professional liability risks

The AIFMD provides minimum capital requirements that apply to any authorised AIFM.

The AIFMD provides that an internally managed AIF must have initial capital of at least €300,000.

For an external AIFM, it must have initial capital of at least €125,000.

The AIFMD goes on to provide for additional capital requirements where the value of portfolios of AIFs managed by the AIFM exceed €250 million. The additional amount is 0.02% of the amount by which the total value of the portfolios of the AIFM exceed €250 million provided that the total amount of initial capital and additional capital is not to exceed €10 million.

50% of the additional amount need not be provided where the AIFM benefits from a guarantee of the same amount given by a credit institution or an insurance undertaking which has its registered office in a member state or in a third country where it is subject to prudential rules considered by EU competent authorities as equivalent to those laid down in EU law.

The Central Bank in its draft handbook issued in January 2013 did not apply the additional capital requirement to internally managed AIFs. However the EU Commission's Q&A that issued in March 2013 suggests that the additional capital requirement should apply. This is inconsistent with both the language and the position for self-managed UCITS. We await the publication of the Central Bank's final rulebook to see if their view has changed as a result of the Q&A.

Additionally, as regards shareholder approval, the Central Bank's draft handbook of January 2013 did not require holders of 10% or more of a self-managed AIF to be approved in advance. Unfortunately the EU Commission's Q&A suggests that they should be, though their language may provide some scope for a more relaxed approach.

Professional Indemnity Insurance

The AIFMD and the AIFMD Regulation provides that an internally managed AIF or an external AIFM is obliged to cover professional indemnity risks either by taking out appropriate insurance cover or covering it with own funds.

It seems likely that that most AIFMs would choose the professional indemnity insurance route. The requirements are:

- a per claim cover of at least 0.70% of the value of the portfolios of the AIFs managed by the AIFM (calculated on the basis of the absolute value of all assets of the AIFs managed by the AIFM, including assets acquired through the use of leverage whereby financial derivative instruments must be valued at their market value);
- the aggregate per year amount of cover must be at least 0.90% of the total value of portfolios of the AIFs managed by the AIFM.

For AIFMs wishing to cover using additional own funds, the amount is 0.01% of the value of the portfolios of the AIFs managed. It must be calculated annually and adjusted accordingly and member states can, in certain circumstances, authorise individual AIFMs to provide a lower amount, but no lower than 0.008% of the value of the portfolios of the AIFs managed by the AIFM.

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