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AIFMD
Are you ready?

The release of the second FSA* consultation paper on the Alternative Investment Fund Managers Directive (AIFMD or the Directive) brings us all a step closer to the full implementation of the Directive in July 2013.

While certain transitional provisions will be put in place, the deadline for making informed decisions regarding compliance with the Directive is fast approaching.

*The Financial Services Authority was replaced by the Financial Conduct Authority (FCA) on 1 April 2013.

Operational and compliance overheads remain central to AIFMD but the starting point will be to get the organisational structure and design right and, while we cover the key features of the regulation and its impacts, we also invite you to assess how Capita's independent Alternative Investment Fund Manager (AIFM) proposition could help make your preparation and implementation as seamless as possible.

Fundamental considerations to be addressed at a strategic level:

- Assess organisational structure in light of delegation, funds in scope and capital adequacy - who should be the AIFM?
- Review compliance, risk and senior management overheads in light of emerging rules
- Assess data, transparency and reporting requirements
- Appoint a suitable depositary
- Define your distribution strategy in the short and long term.

It is now time to start considering whether you or an independent provider will be the AIFM for your funds.

What is the impact?

The Directive seeks to regulate the AIFM as opposed to the Alternative Investment Fund (AIF) by formalising the day-to-day oversight control requirements regarding risk management, portfolio management and valuation integrity. It also introduces the appointment of an independent depositary which carries depositary liability for the AIF's assets.

Under the directive the AIFM has full regulatory responsibility for the AIF, except for those responsibilities that are specific to the depositary.

This, when interpreted in practical terms, will lead to a significant increase in oversight responsibilities and granularity of reporting detail both internally and to the regulators.

The key areas of the Directive that will impact affected funds include:

- Authorisation
- Organisational structure
- Regulatory capital
- Valuation
- Regulatory reporting
- Remuneration disclosures
- Delegation arrangements and ongoing monitoring
- Transparency
- Conflicts of interest
- Risk management
- Liquidity management
- Leverage.

To better understand the impact of the Directive a checklist is attached as an appendix.

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What next?

Is AIFMD the new label for alternative non-UCITS funds in the next wave of regulation and investor protection?

While the answer to the above will emerge over time, the underlying demand for transparency and oversight will drive business models at a detailed level.

We consider that the AIFMD will, in the future, become as important as the "UCITS brand" is today. As with UCITS there is a choice in achieving AIFMD compliance:

– become a self managed AIF
– use a single AIFM for all your entities
– use multiple AIFMs depending on your entity types and asset mix
– appoint an independent external AIFM.

Key points to consider:

– Size of AUM
– Asset mix and complexity
– Distribution and marketing aspirations
– In-house capabilities for compliance and independent risk function
– Corporate and delegation structure (an AIFM can delegate either portfolio or risk management, but not both)
– Other infrastructure requirements related to valuation, administration and conflict of interest management
– Tax considerations based on location and fund structure
– Remuneration policies
– Capital adequacy requirements.

Advantages of an independent AIFM

The appointment of an external third party to act as the AIFM will help to preserve functional independence, separating the risk management oversight and responsibility from portfolio management. This will enable an effective independent governance and oversight framework between the AIFM, portfolio manager, depositary and the fund board.

This has been common practice for UCITS and other regulated funds for a number of years and using an external entity that has developed sophisticated risk management systems and processes will ensure that the fund is able to benefit from the experience and necessary skills to comply fully with the Directive.

Independent AIFM providers will also have existing relationships with other stakeholders such as depositaries and administrators providing economies of scale which can help to reduce costs. In addition, an independent AIFM will maintain the level of capital adequacy as required by the Directive. As a consequence investment managers will not be tying up their own funds to meet this requirement.

What is the AIFMD?

The AIFMD is a European Directive, which is due to be transposed into European law by 22 July 2013, subject to some limited transitional provisions. It aims to regulate the non-UCITS fund sector by harmonising the EU framework for monitoring and supervising the risks AIFMs pose to their investors.

In recent years, and particularly since the financial crisis, fund managers and collective investment vehicles have come under increasing scrutiny by regulators. This is evident by the often reported trend of convergence between long only and hedge fund structures or more topically between UCITS and non-UCITS, following the popularity of the UCITS label in the EU and beyond.

As a consequence the main objective of AIFMD is to identify and mitigate systemic risk, in order to enhance investor protection, as highlighted by the recent financial crisis and the losses suffered in its wake.

What is an AIFM?

"An AIFM is a legal person whose regular business is managing one or more AIFs[1]" .

What is an AIF?

An AIF is "a collective investment undertaking 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, and that does not require authorisation under the UCITS Directive[2]".

AIFMD: Which funds are affected?

The directive applies to the majority of non-UCITS funds[3] , including:

- Hedge Funds
- Private Equity and Venture Capital Funds
- Property Funds
- Investment Trusts
- Commodity Funds
- Infrastructure Funds
- Charity Funds
- and some types of REITS.

[1] Article 4(1)(b) AIFMD.
[2] Article 4(1)(b) AIFMD.
[3] Funds not covered by the Directive where de minimis rule apply (AUM under €100m including leverage or unleveraged AUM under €500m and no redemption rights within 5 years of initial investment).

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How can Capita help you as an independent AIFM?

- Capita, through its authorised company Capita Financial Managers Limited, is an experienced and market leading independent Authorised Corporate Director (ACD) and is a subsidary of Capita plc, a FTSE 100 company
- Capita has vast experience in delegating portfolio management to investment managers and maintaining the risk management to the funds for which it acts as the ACD, representing circa 10% of the authorised UK funds market
- Capita already demonstrates the necessary experience that the AIFMD imposes on the AIFMs and will become an AIFM
- Capita has broad and extensive experience in maintaining regulatory responsibility and oversight for its UK authorised funds (e.g. UCITS, NURS, QIS)
- Capita acts as an independent Manco in Dublin
- Capita has developed professional relationships with the depositary service providers
- Capita provides valuation and investor administration services to a large number of funds.

In summary Capita can offer you the valuable benefits of an independent external AIFM:

- an independent entity specialising in oversight and risk management and employing the requisite skill set and resources
- reducing risk and cost
- removing the need for complex organisational models
- providing a single point of contact for supervisory and regulatory relationships
- access to established working relationships with a range of services providers and other third parties including depositaries.

Using the independent AIFM model, Capita can provide you with a robust regulatory framework leaving you free to concentrate on portfolio management and distribution.

If you have any questions on the information provided above, or wish to discuss how Capita can help you meet the challenges set out by the AIFMD in more detail please get in touch.

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AIFMD requirements checklist

Aspect of AIFMD	AIFMD Requirement	Capita's AIFMD Offering
Regulatory Capital	Self managed AIFM's require: €300,000 plus 0.02% of Assets Under Management (AUM) over €250 million. External AIFM's require the greater of: • €125,000 plus 0.02% of Assets Under Management (AUM) over €250 million, or; • One quarters fixed overhead expenditure. An AIFM must either have professional indemnity insurance or have additional own funds appropriate to cover risks arising from professional negligence. Where this is covered by additional own funds 0.01% of the value of the portfolios of AIFs managed must be maintained. Where PII is taken, coverage of 0.9% of AUM for claims in aggregate in any one year and 0.7% of AUM per individual claim is required. Where an AIFM is required to hold capital, it must be held in liquid assets or in non-speculative assets than can be readily converted into cash within one month.	As part of our independent AIFM service Capita will maintain the required regulatory capital in relation to your fund. Where Capita is the AIFM we will ensure that the required level of cover for risk arising from professional negligence is in place. Capita will hold regulatory capital in the form of assets that comply with the directive.
Authorisation	An AIFM is required to be authorised by the local competent authority. Authorisation will only be granted where the AIFM can fully comply with the Directive.	Capita is currently authorised as an ACD, we are currently implementing enhancements to our systems and processes to ensure full compliance with the Directive. Capita will be applying for authorisation as an AIFM.
Valuation	An AIFM is required to establish appropriate and consistent procedures so that a proper and Independent valuation of the assets of the AIF can be performed.	The AIFM function sits separate to the pricing function and provides independent challenge and oversight of the valuation process. Capita already has a Fair Value Pricing Committee that meets regularly to review the pricing of difficult to value assets and to ensure that the procedures followed by the pricing teams remain current and fit for purpose.

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Regulatory Reporting	An AIFM is required to provide regular comprehensive reporting at fund level to the competent authorities. The reporting covers a wide range of aspects of the fund requiring the consideration of circa 500 data points. It includes: • Investment Strategies • Portfolio deconstruction at asset, instrument, strategy, geography and sector levels • Markets traded • Analysis of funding, borrowing and counterparty arrangements • Derivative positions • Types of investor • Leverage • Liquidity • Stress testing • Performance	Capita will have the system capability to provide these regulatory reporting requirements. The Capita Risk Team will be responsible for ensuring that accurate reporting is provided in a timely manner to the relevant competent authorities.
Remuneration Policy	An AIFM must have remuneration policies and procedures in place in relation to those staff whose professional activities have a material impact on the risk profiles of the AIF/s they manage. These policies and procedures must be consistent with, and promote, sound and effective risk management and must not encourage risk-taking. Dependant on size the AIFM may be required to have a Remuneration Committee. Affected staff include: • Senior management (including non – executives) • Risk-takers • Control Function Holders • Employees receiving total remuneration that takes them into the same remuneration bracket as senior management. The AIFM is responsible for ensuring that remuneration policies as required by Level One of the Directive (subject to proportionality) are followed. Where portfolio or risk management is delegated, the AIFM must ensure that its delegate is either is subject to the equivalent remuneration requirements to AIFMD, or that contractual requirements are in place between the AIFM and its delegates to ensure that there is no circumvention of the AIFMD remuneration rules.	Capita is developing an AIFMD compliant Remuneration Policy. This will be overseen by a Remuneration Committee. The policies will ensure that appropriate remuneration arrangements are in place to reflect any delegated portfolio management. Capita will ensure that the required compliant disclosure surrounding remuneration is included within the appropriate investor documentation.

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Delegation	The AIFM may delegate certain functions however it must be able to justify its entire delegation structure to the regulator; the AIFM will remain liable for all delegated functions; and it must not become a "letter box" entity. The AIFM may outsource portfolio management or risk management but not both. It must have adequate expertise and resources to supervise all delegated activities.	Capita has many years of experience as an independent ACD. Currently we delegate portfolio management to over 50 investment managers. As a result of this we have a comprehensive governance and risk framework. This includes a robust monitoring and oversight programme to ensure that delegates fulfil their obligations under the appropriate regulation. The Capita risk team consists of 15 individuals, most of whom have many years experience in the asset management industry.
Transparency	There are a number of requirements within AIFMD to ensure that investors receive timely and accurate information regarding the AIFs in which they are about to or have invested in. This includes the following obligations: • Audited annual reports. These must be made available by an AIFM for each EU AIF it manages, within six months following the end of the financial year. The annual report must be provided to investors on request and made available to the AIFM's Member State regulator. • Annual reports must be prepared in accordance with the accounting standards of the home Member State of the AIF or the third country where the AIF has its registered office. • An AIFM must make available to investors certain information before they invest in the AIF, together with any updates.	The disclosure requirements under AIFMD are similar to those that Capita currently provide as an independent ACD. There is a controlled and robust process in place to ensure that timely and accurate disclosure is made to investors. This includes a continuous review process of fund and investor documentation. Capita will ensure that all required investor documentation is completed and made available in accordance with the Directive.

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High level conduct of business principles	Member states shall ensure that, at all times, AIFMs: • act honestly, with due skill, care and diligence and fairly when conducting their activities; • act in the best interest of the AIFs or the investors; • have and employ effectively the resources and procedures that are necessary for the proper performance of their business activities; • take all reasonable steps to avoid conflicts of interest, and when they cannot be avoid, to identify, manage and monitor and, where applicable, disclose those conflicts of interest; • comply with all regulatory requirements applicable to the conduct of their business; • treat all AIF investors fairly.	The Capita group includes authorised firms that already comply with the FCA and Central Bank of Ireland principles.
Conflicts of Interest	An AIFM shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors. An AIFM must take all reasonable steps to identify conflict between: • itself and AIFs it manages (or the investors in the AIF); • two AIFs it manages (or investors in the AIFs) • an AIF it manages (or investors in the AIF) and another client of the AIFM; • an AIF (or investors in the AIF) and a UCITS managed by the AIFM (or investors in the UCITS); and • two of the AIFM's clients.	Capita has a Conflicts of Interest Committee which meets on a quarterly basis. It is responsible for ensuring that robust conflict of interest policies and procedures are in place and are actively managed.
Risk Management	The directive requires the risk management function of the AIFM to be functionally and hierarchically separate from the operating units and portfolio management functions. The AIFM must have adequate risk management systems in place which must be reviewed at least annually. A permanent risk management function which must implement effective risk management policies and procedures in order to identify, manage and monitor on an ongoing basis all risks relevant to each AIF's investment strategy to which each AIF is or may be exposed.	Capita has in place a permanent risk management function which is independent of the portfolio management activity. Capita has well documented risk management policies and procedures. These set out all the required activity to oversee the risk of Capita's funds. The risk function reports to the Risk Committee on a monthly basis on its activity.

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Liquidity Management	An AIFM must employ (for each AIF it manages) an appropriate liquidity management system and adopt procedures which enable it to monitor the liquidity risk of the AIF and to ensure the liquidity profile of the AIF's investments complies with its underlying obligations. Regular stress tests to assess the AIF's liquidity risk are required. AIFM must also document its liquidity management policies and procedures.	Capita monitors liquidity on all its funds on an ongoing basis. Capita stress tests portfolios against adverse market scenarios to ensure that potential liquidity constraints are identified and understood at an early stage.
Leverage	The directive defines leverage as "any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash securities, or leverage embedded in derivative positions or by any other means". An AIFM should set leverage limits in respect of each AIF it manages. The AIFM must also demonstrate that the leverage limits are reasonable and the AIF complies at all times with the leverage limits. The AIFM must also employ two thods for calculating the amount of leverage employed: the Gross and Commitment Methods. Leverage should be expressed as a ratio between the exposure of the AIF and its net asset value.	Capita monitors leverage within its funds on an ongoing basis. Leverage is monitored whether it is achieved through direct borrowing or the exposure created by investments. Capita has the capabilities required to calculate leverage on both a commitment and gross basis, as required by the Directive. Capita will work with the Board and/ or investment manager to ensure that the appropriate leverage limits are set.