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EU investment manager of an offshore fund: what are the options under the EU Directive on Alternative Investment Fund Managers?

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This article provides an answer to the questions which are most frequently asked by EU investment managers of offshore alternative investment funds (e.g. hedge funds incorporated in the Cayman Islands or private equity funds incorporated in the Channel Islands) regarding the EU Directive on Alternative Investment Fund Managers (2011/61/EU) (the Directive).

1. What is the Directive and why is it relevant to the EU investment manager of an offshore fund?

The Directive is a directive of the European Parliament issued on 8 June 2011 which lays down the rules for the authorisation, ongoing operation and transparency of the managers of alternative investment funds (AIFMs) which manage and/or market alternative investment funds (AIFs) in the EU.

The Directive, which must be implemented by Member states before 22 July 2013, is relevant to EU investment managers of offshore funds because it imposes a number of new requirements relating to the management and marketing of such funds in the EU.

2. To which offshore funds will the Directive apply?

Generally speaking, the Directive will apply to all AIFs whether incorporated within or outside the EU if they are managed and/or marketed in the EU.

An AIF is defined for these purposes as a collective investment undertaking which 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 which is not authorised under the UCITS Directive.

Alternative investment companies incorporated in the Cayman Islands, the BVI, Bermuda or the Channel Islands will generally be subject to the Directive if they are managed and/or marketed in the EU.

3. What does “managed” in the EU mean?

The Directive provides that every AIF must have a single AIFM which will be responsible for ensuring that the fund it manages complies with the Directive.

For the purposes of the Directive, a person will be “managing” an AIF if it performs the portfolio management function and/or the risk management function in relation to such fund.

An EU investment manager which performs the portfolio management function in relation to an offshore fund will therefore generally be deemed to be “managing” such fund for the purposes of the Directive.

4. Does this mean that the EU investment manager of an offshore fund will become the AIFM of such fund?

Not necessarily.

An EU investment manager which performs both the portfolio management function and the risk management function in relation to an offshore fund will generally become the AIFM of such fund because no other entity could be said to be “managing” such fund for the purposes of the Directive.

However, if in relation to an offshore fund the portfolio management function is performed by an EU investment manager and the risk management function is performed by another entity, it is expected that the fund will have a choice as to which of the EU investment manager or the entity performing the risk management function should be appointed as the AIFM of the fund.

In such a scenario, therefore, the fund could choose to appoint the entity performing the risk management function (rather than the EU investment manager) as its AIFM on the understanding that such entity would delegate the portfolio management function to the EU investment manager to the maximum extent permitted by the Directive.

5. Which entity (other than an EU investment manager) could therefore be appointed as the AIFM of an offshore fund?

There are two options available.

i) The board of directors of the fund

For funds which have a corporate structure, and are therefore incorporated as a company having a board of directors, it is expected that the board of directors of the relevant company could be appointed as the AIFM of the fund.

The board could, for example, perform the risk management function (on its own or with the support of a professional service provider) in relation to the fund and delegate the portfolio management function to an EU investment manager to the maximum extent permitted by the Directive.

It is expected that this type of structure will comply with the requirements of the Directive provided that the board of directors of the relevant company has the necessary expertise and resources to carry out its role as AIFM of the fund effectively.

In practice, however, the directors of offshore funds generally act only in the capacity of non-executive directors of the relevant funds.

On that basis, they may be unwilling to assume the additional responsibilities that being appointed as the AIFM of their fund would bring and/or may lack the expertise and resources that are necessary to carry out such role effectively.

For a majority of offshore funds, therefore, appointing their board of directors to act as their AIFM may not be a viable option.

ii) A professional service provider

A more viable option for an offshore fund could be to appoint a professional service provider (such as the fund administrator or a newly appointed service provider) to act as its AIFM.

Such service provider could, for example, perform the risk management function (on a standalone basis or in addition to other functions) in relation to the fund and delegate the portfolio management function to an EU investment manager to the maximum extent permitted by the Directive.

It is also expected that this type of structure will comply with the requirements of the Directive assuming, as always, that the service provider appointed to be the AIFM of the fund has the necessary expertise and resources to carry out its role effectively.

Indeed, it is anticipated that a number of professional service providers, both based in the EU and offshore, will begin to offer the service of acting as the AIFM of offshore funds as an additional or standalone service to their clients.

6. If an offshore fund appoints any of the above entities to act as its AIFM, to what extent will such entity be able to delegate the portfolio management function to an EU investment manager?

Unfortunately, it is still not known to what extent the AIFM of an offshore fund will be able to delegate the portfolio management function to an EU investment manager under the provisions of the Directive.

Among other things, the Directive provides that an AIFM that delegates the portfolio management function to another person must:

- (i) retain the necessary expertise and resources to supervise the delegated task effectively and manage the risks associated with such delegation;
- (ii) have the power to take decisions in key areas which fall under the responsibility of the senior management;
- (iii) have the power to perform senior management functions in relation to the implementation of the general investment policy and investment strategies of the fund;
- (iv) have a contractual right to inquire, inspect, have access or give instructions to its delegate; and
- (v) not delegate the performance of the portfolio management and risk management functions (taken as a whole) to an extent that exceeds “by a substantial margin” the portfolio management and risk management functions performed by the AIFM itself.

It is still not known what the above provisions will mean in practice and in particular whether it will be possible for an offshore AIFM to delegate the whole (or substantially the whole) of the portfolio management function to an EU investment manager without causing such investment manager to become the AIFM of the fund for the purposes of the Directive.

7. Is there any additional factor that should be taken into account for the purpose of determining which entity should act as the AIFM of an offshore fund?

There are a number of additional factors which the EU investment manager of an offshore fund should take into account for the purpose of determining which entity should act as the AIFM of such fund.

Among these:

- (i) choosing between an EU AIFM and a non-EU AIFM: it is expected that at least until 2018 it will be possible to market in the EU an offshore fund which has appointed a non-EU AIFM without having to comply with most of the requirements of the Directive;
- (ii) size: it is expected that an AIFM which manages AIFs having no more than EUR 100 million in gross assets or EUR 500 million in assets when the

relevant AIFs are unleveraged and closed-ended will be exempt from most of the requirements of the Directive;

- (iii) simplicity: for certain EU investment managers, becoming the AIFM of their offshore funds will be the simplest and most cost effective option and will enable them to retain full control over their funds;
- (iv) taxation: there is a concern that an offshore fund that appoints an EU AIFM could cease to be resident offshore for taxation purposes.

8. Is there any deadline for making a decision?

The Directive provides that AIFMs performing activities under the Directive immediately before 22 July 2013 are required to take all necessary measures to comply with national law stemming from the Directive and submit an application for authorisation within one year of that date.

EU investment managers of offshore funds who do not envisage becoming the AIFM of their funds may wish to ensure that by 22 July 2013 they have organised their affairs in such a way as they cannot be deemed to be carrying out the function of an AIFM immediately before that date.

9. Any final word of advice?

The provisions of the Directive that are applicable to offshore funds and their AIFMs are very detailed and contain a number of exclusions and exceptions.

For that reason, investment managers are strongly encouraged to seek professional advice before taking (or refraining from taking) any action in connection with the Directive.