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The Limits of Delegation Under the Alternative Investment Fund Managers Directive

By [Tim Aron](#), [Nathaniel W. Lalone](#) and [Carolyn H. Jackson](#)

The EU Alternative Investment Fund Managers Directive (2011/61/EU) (the “Directive” or “AIFMD”) limits delegation by a manager regulated under the Directive (an “Alternative Investment Fund Manager” or “AIFM”). Delegation by an AIFM is subject to the criteria set out in Article 20 of the Directive and elaborated in Articles 75 to 82 of the European Commission’s December 19, 2012, Delegated Regulation (the “Level 2 Regulation”).

An AIFM intending to delegate any functions to a third party must notify its regulator before the delegation arrangements become effective and must comply with numerous conditions set out in the Directive and elaborated in the Level 2 Regulation. In particular, Article 20(3) of the Directive prohibits an AIFM from delegating its functions to such an extent that it can no longer be considered to be acting as manager of the relevant fund and becomes a “letter-box entity.” Article 82 of the Delegated Regulation sets out situations in which an AIFM has delegated the performance of its functions to such an extent that it will be deemed to be a letter-box entity.

General Provisions

Before the letter-box entity question can be examined in detail, it is necessary to consider the delegation provisions of the Directive and the Level 2 Regulation. Delegation is permitted only when it can be objectively justified by the AIFMⁱ and where the delegate has sufficient resources and qualified personnel to perform the delegated functions. Delegation must not prevent effective supervision of the AIFM by relevant regulators.ⁱⁱ These provisions apply to delegation of the core AIFM management functions listed in Annex 1 of the Directive; they do not apply to technical or logistical support tasks.ⁱⁱⁱ The core functions set out in Annex 1 include:

- portfolio management;
- risk management;
- marketing;
- activities relating to the assets of funds, including services necessary to meet fiduciary duties and services connected to the management of the fund; and
- administration, including legal and fund management accounting services, issue and redemption of fund shares and regulatory compliance monitoring.

Objective Justification

Objective justification criteria for delegation are set out in the Level 2 Regulation^{iv} and comprise:

- optimizing business functions and processes;
- cost saving;
- expertise of the delegate in administration or in specific markets or investments; and
- access of the delegate to global trading capabilities.

Delegate’s Resources

The Level 2 Regulation requires that the delegate must have sufficient resources and must employ sufficient personnel with the skills, knowledge and expertise necessary for the proper discharge of the tasks delegated to it. It must also have an organizational structure which is appropriate to support the performance of the delegated tasks.^v

Written Agreement

Delegation must be under a written agreement between the AIFM and the delegate.^{vi} The Level 2 Regulation mandates key points that must be covered in the agreement, including:^{vii}

- the AIFM's instruction, monitoring and termination rights;
- the information that will be provided to the AIFM; and
- the AIFM's inspection rights and access to books and premises.

In addition, the agreement must provide that sub-delegation requires the AIFM's written consent.^{viii} A general advance consent to sub-delegation is not sufficient.^{ix} Each sub-delegation must also be the subject of a prior notification to the AIFM's regulator before the sub-delegation arrangements become effective.^x

The delegating AIFM is also required to ensure that the delegate meets other requirements and these too will generally be covered in the agreement between the AIFM and the delegate. These matters include:

- Effective performance of functions;^{xi}
- Compliance with applicable legal and regulatory requirements;^{xii}
- Disclosure to the AIFM of any development which may materially impact the delegate's ability to perform its functions;^{xiii}
- Treatment of confidential information;^{xiv} and
- Disaster recover planning.^{xv}

Letter-Box Entities

The Explanatory Memorandum issued alongside the Level 2 Regulation summarizes when an AIFM will be considered to be a letter-box concept as follows:

The AIFM has at least to keep the decision making functions which are in fact its primary business role. It therefore has to perform at least functions relating to either risk or portfolio management.^{xvi}

If it is deemed to be a letter-box entity, the delegating AIFM will no longer be considered the AIFM of the relevant fund. Therefore, if a non-EU AIFM delegates functions to an EU sub-manager to the extent that the non-EU AIFM becomes a letter-box entity, the EU sub-manager will become the fund's AIFM. Conversely, if an EU AIFM delegates its risk and portfolio management functions to an offshore entity to the extent that the EU-based manager becomes a letter-box entity, then it will no longer be functioning as an EU-regulated AIFM under the Directive.

Article 82 of the Level 2 Regulation then sets out four situations where an AIFM which delegates functions will be deemed to become a letter-box entity and will no longer be considered to be the manager of the relevant fund. The first three^{xvii} are fairly straightforward to apply:

- where the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- where the AIFM no longer has the power to take key senior management decisions nor to perform senior management functions, in particular in relation to the implementation of the general investment policy and investment strategies; and
- where the AIFM loses its contractual rights to inquire, inspect, have access to or give instructions to its delegates or where as a practical matter the exercise of such rights becomes impossible.

The fourth of the Article 82 criteria is more complex and judgement-based, addressing where the AIFM delegates the performance of investment management functions to an extent that exceeds "by a substantial margin" the investment management functions retained and performed by the AIFM itself.^{xviii} The Level 2 Regulation states in Article 82(1)(d) that in assessing the extent of delegation for the purpose of applying this test, regulators are required to consider the entire delegation structure, taking into account not only the amount of assets managed under delegation but also qualitative criteria including:

- the types of assets the fund invests in and the importance of the assets managed under delegation to the risk and return profile of the fund;
 - the importance of the assets managed under delegation to the achievement of the fund's investment goals;
 - the geographical and sectoral spread of the fund's investments;
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- the fund's risk profile;
- the fund's investment strategies; and
- the types of tasks delegated compared to those retained.

Taken together, the AIFMD delegation provisions mean that previously common delegation structures will require careful examination going forward.

For more information, please contact any of the following members of Katten's **London Financial Services Practice**.

Tim Aron
+44.0.20.7776.7627
tim.aron@kattenlaw.co.uk

Carolyn H. Jackson
+44.0.20.7776.7625
carolyn.jackson@kattenlaw.co.uk

Nathaniel W. Lalone
+44.0.20.7776.7629
nathaniel.lalone@kattenlaw.co.uk

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- ⁱ Directive, Article 20(1)(a).
 - ⁱⁱ Directive, Article 20(1)(e); Level 2 Regulation, Article 79.
 - ⁱⁱⁱ Directive, Recital 31; Level 2 Regulation, Recital 82.
 - ^{iv} Level 2 Regulation, Article 76(1).
 - ^v Level 2 Regulation, Article 77(1).
 - ^{vi} Level 2 Regulation, Article 75(d).
 - ^{vii} Level 2 Regulation, Article 75(h).
 - ^{viii} Level 2 Regulation, Article 75(h).
 - ^{ix} Directive, Article 20(1)(a); Level 2 Regulation, Article 81(1).
 - ^x Directive, Article 20(4)(b).
 - ^{xi} Level 2 Regulation, Article 75(e).
 - ^{xii} Level 2 Regulation, Article 75(e).
 - ^{xiii} Level 2 Regulation, Article 75(j).
 - ^{xiv} Level 2 Regulation, Article 75(k).
 - ^{xv} Level 2 Regulation, Article 75(l).
 - ^{xvi} Level 2 Regulation, Explanatory Memorandum, Section 3.2.10.
 - ^{xvii} Level 2 Regulation, Article 82(1)(a) to (c).
 - ^{xviii} Level 2 Regulation, Article 82(d).

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Katten Muchin Rosenman UK LLP

www.kattenlaw.co.uk

125 Old Broad Street • London EC2N 1AR
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

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