Delegation of Investment Management under the AIFMD

The delegation model of fund management, whereby self-managed investment vehicles or their management companies appoint third party investment managers and advisers, has been a key basis upon which the success of the funds industry in Ireland has been built. There are currently in excess of 5,000 Irish domiciled funds and sub-funds, with assets in excess of 1 Trillion Euro, which have been established by over 400 fund promoters based in over 50 countries. An incredible 98% of these promoters are based outside Ireland and in most cases investment management services will be provided from the promoter’s home jurisdiction, clearly showing the attraction of Irish domiciled vehicles and the delegation model for international fund managers.

The finalised text of the level 2 measures (“Level 2”) to the Alternative Investment Fund Managers Directive, (Directive 2011/61/EU) (the “AIFMD”), approved and published by the European Commission (the “Commission”) on 19 December, 2012, details the specific conditions to be applicable where investment management functions are to be delegated or sub-delegated under this legislation. This article explores the specific requirements contained in this finalised text relating to delegation and highlights the legal documentation which will be required to ensure compliance.

Background to the AIFMD and the Level 2 Regulation

The European Commission (the “Commission”) first published a proposal for a directive regulating alternative investment fund managers (“AIFMs”) at a European level in April 2009 in the wake of the global financial crisis. Fundamental aims of this proposed directive were stated to be to assist
in securing investor protection and to limit the potential for alternative products to pose a systematic risk to financial systems. Following numerous counter-proposals and amendments, a draft directive was ultimately agreed in October 2010. This directive, which regulates alternative managers, proposed a potential new European “passport” for compliant alternative funds similar to the highly successful one currently afforded to UCITS. Accordingly it is expected to lead to a significant boost for the alternative funds industry within Europe once this becomes operational from mid-2013.

The AIFMD does note in its preamble that, depending on their legal form, it should be possible for alternative investment funds falling under the directive (“AIFs”) to be either externally or internally managed and that AIFs that do not appoint an external AIFM will themselves constitute the AIFM. AIFs structured as self-managed investment companies, for example, will typically fall into this category. The AIFMD does specifically address the right of AIFMs to delegate their functions, subject to applicable conditions. However, the AIFMD was prepared as a principle-based framework document under the “Lamfalussy Process” and accordingly, following its implementation, much of the fine detail remained to be determined as “Level 2” measures.

As a result, the European Securities and Markets Authority (“ESMA”), which replaced the Committee of European Securities Regulators (“CESR”), prepared advice in 2011 to assist in finalising the relevant details for the ultimate implementation of relevant aspects of this directive. The Commission then produced draft finalised text in light of this for Level 2 in 2012.

The initial draft wording for the Level 2 measures circulated by the Commission in 2012, disregarded the advice of ESMA in key respects, including in relation to delegation, and raised concerns that this legislation might jeopardise Ireland’s position as the leading European domicile for AIFs due to the constraints imposed in this regard. However, the finalised text contained in a regulation approved by the Commission on December 2012 (the “Regulation”) clarifies that delegation will continue to be acceptable under this legislation in practice and sets out the relevant applicable requirements in greater detail.

Overview of Delegation under the AIFMD

Delegation of investment management was provided for in the AIFMD itself and this general concept is addressed and expanded upon in Section 8 of the Regulation. This section addresses the topic under a number of headings, including general principles, reasons for the delegation, the nature of the delegate, potential conflicts of interest and the effective supervision of the delegate.

The relevant “General principles” include ensuring that the delegation structure does not allow for the circumvention of the AIFM’s responsibilities, obligations or liability (including in relation to its authorisation). Delegation arrangements must be documented in written agreements between the AIFM and the delegate and there are significant requirements relating to the specific contents of such agreements, including obligations to set out in the agreement:

1) the respective rights and obligations of the parties, including rights of information, inspection, admittance and access for the AIFM and its instruction and monitoring rights with regard to the delegate in order to ensure effective supervision;
2) terms requiring the delegate to properly supervise the performance of the delegated functions and adequately manage associated risks internally;
3) instruction and termination rights, including a requirement that sub-delegation can take place only with the consent of the AIFM;
4) a requirement on the delegate to disclose to the AIFM any development

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1 Point 20, Preamble to Directive 2011/61/EU
2 Section 3, Article 20, of Directive 2011/61/EU
3 Section 3, Article 20, Directive 2011/61/EU
4 Articles 75-82 of the Regulation
5 Article 75 of the Regulation
that may have a material impact on the delegate’s ability to carry out the
delegated functions effectively and in compliance with applicable laws and
regulatory requirements;

5) an obligation to protect any
confidential information relating to the
AIFM, the relevant AIF itself and the
investors in that AIF; and

6) a requirement to ensure that the
delegate establishes, implements and
maintains an appropriate contingency
plan for disaster recovery and periodic
testing of backup facilities.

Existing contractual arrangements relating to
deblegation, i.e investment management
agreements, will need to be reviewed and
may need to be revised to ensure all of these
requirements are addressed where the
relevant fund structure falls under the terms
of the AIFMD. In addition to specific
requirements, such as those above, required
to be included in the actual delegation
contact itself, a series of on-going
obligations are also imposed on the AIFM by
the applicable general principles. It is likely
that these will be addressed and documented
separately in a procedures manual or
business plan of the AIFM. Examples of
these obligations include:

1) establishing methods and procedures
for reviewing on an on-going basis the
services provided by delegates to
ensure that they carry out the
delegated functions effectively and in
compliance with applicable law and
regulatory requirements to an
appropriate quality standard;

2) setting out the appropriate action to
be taken if it appears that the
delegate cannot carry out the
functions effectively or in compliance
with applicable laws and regulatory
requirements;

3) ensuring that the AIFM has the
necessary expertise and resources to
supervise the delegated functions and
in fact effectively supervises the
delegated functions and manages the
risks associated with the delegation; and

4) instructing the delegate regarding
implementation of the investment
policy of the AIF and monitoring
compliance on an on-going basis.

Many investment managers will already have
some form of internal procedures and policy
manuals which can be adapted to specifically
address these requirements. Otherwise, and
for self-managed corporate structures in
particular, the form of “business plan”
currently required for UCITS may constitute a
useful basis upon which to base such a
document.

Delegation of portfolio or risk
management

At present, the decision to delegate
investment functions is entirely one at the
discretion of management. However, there
will be a new requirement under the AIFMD
to justify this decision upon “objective
reasons”\(^7\). Examples of reasons which would
be acceptable for this purpose are included in
the Regulation\(^8\) and these include: (a) cost
savings; (b) expertise of the delegate in
specific markets or investments; or (c) access
of the delegate to global trading capabilities.
It will be necessary for the AIFM to provide
the competent authorities with a detailed
description of the delegate and explanation of
the objective reasons for any delegation with
supporting evidence.

Delegates are required to have sufficient
resources and to employ sufficient personnel
with the skills, knowledge and expertise
necessary (including appropriate training and
previous experience) for the proper discharge
of the tasks delegated. Personnel of the
delegate are also required to be of sufficiently
good repute and examples of the research to
be undertaken to confirm such matters are
detailed, for example specific attention is
required to be paid to any previous
convictions for dishonesty or fraud\(^9\). The
requirements in this regard are broadly
similar to those currently applicable under the
“fitness and probity” regime of the Central

\(^6\) Article 75 (f) of the Regulation
\(^7\) Article 20 (1) (a), Directive 2011/61/EU
\(^8\) Article 76 (1) of the Regulation
\(^9\) Article 77 (2) and (3) of the Regulation
Bank of Ireland (the “Central Bank”) and therefore this can essentially be regarded as applying concepts similar to those that apply to, for example, directors of Irish regulated funds, to delegates.

Where delegation of portfolio management or risk management is proposed the Regulation sets out the types of EU regulated entities to be deemed to be appropriately authorised for such purposes. It also notes that non-EU entities authorised under the AIFMD or those authorised or registered for the purpose of asset management and effectively supervised by a competent authority in their home country would also qualify, subject to certain conditions. Specifically, there must be a written agreement between the competent authorities of the home Member State of the AIFM (the “Competent Authority”) and the supervisory authorities of the delegate which allows the Competent Authority to:

1) obtain on request information and documents necessary to carry out their supervisory tasks as provided for under the AIFMD;

2) receive information from the supervisory authority in the third country for the purpose of investigating apparent breaches of the AIFMD and Regulation as soon as possible;

3) obtain cooperation with regard to enforcement matters in accordance with applicable local law in cases of any such breaches; and

4) carry out on-site inspections on the premises of the delegate.

The notion of entering into agreements which will have the effect, in accordance with the final point above, of permitting European supervisory authorities to carry out inspections on their premises outside Europe may pose concerns for some asset managers. However, the explanatory memorandum to the Regulation clearly specifies that the right to carry out on-site inspections should include the ability to request the local third-country supervisory authority to carry out on-site inspections and also, where permission is obtained from the third-country supervisory authority, the ability of the Competent Authority to carry out the inspection themselves, or to accompany staff of the local supervisory authority to assist with an on-site inspection.

One of the stated aims of the AIFMD is to ensure more effective oversight of the alternative sector and the directive makes it clear that delegation should not be permitted where it prevents effective supervision. The Regulation clarifies that a delegation shall be deemed to prevent the effective supervision of the AIFM where:

1) any of the AIFM, its auditors or the Competent Authority do not have effective access to data related to the delegated functions and to the business premises of the delegate, or the Competent Authority is not able to exercise those rights of access; or

2) the delegate does not cooperate with the Competent Authority in connection with the delegated functions.

Conflicts of interest

The AIFMD precludes delegation in circumstances where it conflicts with the interests of the AIFM or investors in the relevant AIF. The Regulation clarifies that determining this shall include consideration (at least) of:

a) the extent to which the delegate controls the AIFM or has the ability to influence its actions, where there is any other contractual relationship between them;

b) the extent to which the delegate itself is controlled by an investor in the relevant AIF where there is any other contractual relationship between them;

c) the likelihood that the delegate makes a financial gain, or avoids a financial

10 Article 78 (2) of the Regulation
11 Article 78 (3) (b) of the Regulation
12 Article 79 (a)-(c) of the Regulation
13 Article 20 (2) (b), Directive 2011/61/EU
14 Article 80 of the Regulation
loss, at the expense of the AIF or the investors in the AIF;

d) the likelihood that the delegate has an interest in the outcome of a service or an activity provided to the AIFM or the AIF;

e) the likelihood that the delegate has a financial or other incentive to favour the interest of another client over the interests of the AIF or the investors in the AIF;

f) the likelihood that the delegate receives or will receive from a person other than the AIFM an inducement in relation to the collective portfolio management activities provided to the AIFM and the AIFs it manages in the form of monies, goods or services other than the standard commission or fee for that service.

The appointment of a strong independent board to the AIFM would ensure that the “control” test in (a) above would be satisfied. It can be noted that the Corporate Governance Code for Collective Investment Schemes and Management Companies adopted by the Irish Funds Industry Association in consultation with the Central Bank, and which is now applicable to Irish funds, does require the appointment of at least one entirely independent board member.

In relation to concerns regarding potential gains or losses, options to minimise the likelihood of any issues arising on these grounds would include addressing these concerns in the conflicts section of the delegation agreement itself, as well as including disclosures and representations in the offering document of the relevant AIF. The exemptions discussed below are also relevant.

There are exemptions to the general prohibition on delegation where this may lead to a potential conflict of interest included in the AIFMD itself where (a) the portfolio or risk management function may be considered to be functionally and hierarchically separated from other potentially conflicting tasks and (b) where potential conflicts of interest are deemed properly identified, managed, monitored and disclosed to the investors of the AIF. The Regulation addresses these considerations further. It provides that the former issue may be deemed satisfied where:

a) persons engaged in portfolio management tasks are not engaged in the performance of potentially conflicting tasks such as controlling tasks;

b) persons engaged in risk management tasks are not engaged in the performance of potentially conflicting tasks such as operating tasks;

c) persons engaged in risk management functions are not supervised by those responsible for the performance of operating tasks;

d) the separation is ensured throughout the whole hierarchical structure of the delegate up to its governing body and is reviewed by the governing body and, where it exists, the supervisory function of the delegate.

In relation to point (b) above, the identification, management, monitoring and disclosure requirements will be deemed satisfied only where:

a) the AIFM ensures that the delegate takes all reasonable steps to identify, manage and monitor potential conflicts of interest that may arise between itself and the AIFM, the AIF or the investors in the AIF and that it has appropriate procedures in place for such purposes;

b) the AIFM ensures that the delegate discloses potential conflicts of interest as well as the procedures and measures to be adopted by it in order to manage such conflicts of interest to the AIFM which in turn discloses to the AIF and its investors as appropriate.

These are further examples of matters which could be documented in a business plan or

15 Article 20 (2) (b), Directive 2011/61/EU

16 Article 80 (2) and (3) of the Regulation
policy and procedures manual (although in this case the documentation by the delegate, rather than only the AIFM, will also be relevant) and referenced or otherwise addressed in the delegation agreement to ensure compliance.

**Sub-delegation**

As mentioned in the section addressing general principles, it will be a requirement for any sub-delegation to be subject to the prior approval of the AIFM\(^\text{17}\). It can be noted that the Regulation clarifies that a general consent will not be acceptable and instead a specific approval will be needed from the relevant AIFM for any given sub-delegation by its delegate\(^\text{18}\). The AIFM in turn will be subject to a requirement to notify its Competent Authority and provide it with details of the delegate, the name of the competent authority where the sub-delegate is authorised or registered, the delegated functions, the AIFs affected by the sub-delegation, a copy of the written consent by the AIFM and the intended effective date of the sub-delegation\(^\text{19}\). The provision in the delegation agreement providing for sub-delegation should accordingly reflect this or provide that sub-delegation will only be permitted in accordance with applicable law.

**Letter-box entities**

One of the specific concerns of the AIFMD is to prevent the use of “letterbox” entities\(^\text{20}\). Such concerns have previously been addressed in relation to UCITS, where the “four eyes” principle now applies. It can be noted that the AIFMD itself specifies that measures would be adopted detailing when an entity would be deemed to constitute a letter-box entity for the purposes of the AIFMD and no longer be considered to be the manager of the relevant AIF. Accordingly the Regulation\(^\text{21}\) sets out a series of such relevant circumstances and key considerations in this regard include where:

1. the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;

2. the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice; and

3. the AIFM delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself. A series of criteria are included in the Regulation to be used as a guide in this regard.

It can be noted that “investment management functions” are defined in the AIFMD to include both portfolio and risk management, so it is expected that the AIFM would retain one of these functions to ensure it meets this requirement and in fact the explanatory memorandum to the Regulation 2 specifically provides that when appointing a delegate the AIFM:

“has to perform at least functions relating to either risk or portfolio management”

In practice it would be anticipated that most AIFMs operating the delegation model would retain the risk management function to meet this requirement, especially in funds with a high level of trading. The manner in which this obligation was met on an on-going basis will be detailed in the procedures manual or business plan of the relevant AIF applicable to a given AIF. In cases where relatively few investment decisions are made, such as private equity, property or venture capital schemes it may be determined not to appoint a third party investment manager as a delegate and instead to appoint it in an ancillary capacity, with the AIFM itself retaining responsibility for discretionary investment management decisions, provided the necessary requirements can be met.

At the same time, the Regulation provides that determinations regarding whether an entity is a mere “letter box” will be based on the structure as a whole, bearing in mind a

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\(^{17}\) Article 20 (4), Directive 2011/61/EU

\(^{18}\) Article 81 (1) of the Regulation

\(^{19}\) Article 81 (2) of the Regulation

\(^{20}\) Article 20 (3), Directive 2011/61/EU

\(^{21}\) Article 82 (1) of the Regulation
range of factors including the types of assets held by the relevant AIF.\(^{22}\)

It can be noted that the Commission intends to monitor the application of this Article in the light of market developments and shall review the situation after two years to see if it is necessary to further specify conditions under which an AIFM shall be deemed to have delegated its functions to the extent that it becomes a letter box entity.\(^{23}\) ESMA may also issue guidelines to ensure a consistent assessment of delegation structures across the European Union.\(^{24}\)

Compliance with these requirements will entail (a) ensuring that the delegation agreement affords sufficient oversight powers to the AIFM and that the delegation only pertains to portfolio or risk management and not both; and (b) ensuring that the AIFM has the necessary expertise and resources, details of which are documented appropriately.

**Summary of compliance steps for delegation under AIFMD**

The following is a brief overview of the key points to be addressed to ensure compliance with the requirements relating to delegation under the AIFMD:

<table>
<thead>
<tr>
<th>1-</th>
<th>ensure the draft written delegation contract (typically an investment management agreement) reflects the specific relevant requirements under the AIFMD;</th>
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<td>2-</td>
<td>ensure on-going obligations of the delegate under the AIFMD are addressed and documented in its procedures manual or business plan, where necessary;</td>
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<td>3-</td>
<td>ensure the delegation is objectively justified based on the criteria in the Regulation and document the rationale for this;</td>
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<td>4-</td>
<td>ensure the proposed delegate meets the relevant requirements under the AIFMD;</td>
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<tr>
<td>5-</td>
<td>ensure on-going obligations of the delegate under the AIFMD are addressed and documented in its procedures manual or business plan, where necessary;</td>
</tr>
<tr>
<td>6-</td>
<td>prepare an appropriate conflicts of interest policy and reflect this in all documentation</td>
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**Next steps in the legislative process**

The text of the Regulation has now been sent to the European Parliament and Council and is currently subject to a scrutiny period of three months during which these two institutions will have the ability to oppose it.

For the text to be opposed either the Council has to act by qualified majority or the Parliament by a simple majority. It is unlikely that the Regulation will be opposed at this stage as it has received support from the Parliament’s spokesperson on the issue. As neither institution has the right to amend the text of the Regulation, but only to oppose it in its entirety, it is unlikely that the current text will be amended further.

The Regulation will not require any transposition into Member State law once approved as it will be directly applicable. The Regulation is therefore expected to be in force sometime in March or April 2013.

It is anticipated that the Central Bank (and the regulatory authorities in other Member States) will then seek to enter into written arrangements with the competent regulatory authorities of the primary jurisdictions with significant asset management industries and in particular those non-EU countries whose managers currently provide investment management services to Irish domiciled funds.

It can be noted that the Central Bank has already entered into a series of international memoranda of understanding (“MOUs”) - including bilateral agreements with 28 countries as well as a further 9 multilateral...
ones. This is in addition to the 68 comprehensive double taxation agreements and 20 Tax Information Exchange Agreements Ireland has entered into with third countries.

**What this means for you?**

The approval of the Regulation has provided clarity regarding a range of issues under the AIFMD which had been deferred to be dealt with in detail at the Level 2 stage.

Fund Managers with existing alternative products domiciled in Ireland or other European jurisdictions may now wish to proceed to review their existing contractual arrangements and internal policies and procedures to consider any necessary revisions of existing documentation to ensure compliance with the AIFMD.

Fund Managers who had been postponing the launch or addition of a European, AIFMD compliant, structure pending the finalisation of Level 2 and clarity on the relevant issues, may wish to now proceed to explore European options with greater confidence.

Given the increased preference evident from institutional investors for regulated on-shore products ever since the financial crisis of 2008, and the potential pan-European passport under the AIFMD, Irish domiciled AIFMD compliant funds will afford considerable benefits. It can be noted that in addition to permitting the establishment of new funds for managers based overseas in accordance with the terms of the AIFMD, Ireland has specific legislation permitting the re-domicile of existing funds to Ireland from the key offshore centres which avoids the costs and inconvenience associated with a new launch.

It is anticipated that Ireland, which is already the leading European domicile for alternative funds, will see significantly increased growth in this sector in the coming years as international investment managers seek to take advantage of the new pan-European passport which will become available for alternative funds under the AIFMD.


How Mason Hayes & Curran can help

Mason Hayes & Curran is a full service, business law firm with 64 partners and over 300 employees specialising in Irish law. With offices in Dublin, London and New York the firm delivers sophisticated legal services to an extensive Irish and international client base. Our investment funds lawyers have a wealth of experience in the investment funds industry and have been involved in the development of policy and regulation in Ireland. We advise on the establishment and on-going operation of Irish domiciled investment funds, including those in the alternative market sectors, and regularly issue client updates on relevant issues. Our dedicated team of investment funds lawyers can also draw upon the expertise of specialist lawyers from our tax, corporate, banking, litigation, intellectual property, data protection, regulatory and compliance practices whenever required to ensure a comprehensive service.

About the Author

Mark Browne is a partner practising in the Financial Services Department. A member of the Investment Funds Unit, he has over 10 year’s experience in the funds industry and advises on all aspects of the structuring, establishment and on-going operation of investment funds in Ireland. Mark practised as an Attorney-at-Law specialising in hedge funds in the funds practice of a leading firm in the Cayman Islands for four years and advises on the redomiciliation of offshore funds to Ireland.

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