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Hedge Funds and Private Equity Funds Beware: CFTC Extends Its Reach Globally

In March 2013, *The Wall Street Journal* reported that the Commodity Futures Trading Commission (CFTC) is examining the setting of prices in the gold and silver rings on the London Metal Exchange. In February 2013, the CFTC settled an enforcement proceeding against the Royal Bank of Scotland with respect to its London-based conduct in connection with the setting of Libor and Eurobor. That settlement followed on the heels of settlements with Barclays Bank and UBS in connection with their submissions for Libor and Yen Libor in London and Tokyo. These enforcement actions are the most dramatic illustrations of the CFTC's Pax Americana view of its power to police the global financial markets. These developments should be of great concern to hedge funds and private equity funds operating internationally.

CFTC Expands Its Extraterritorial Jurisdiction

From time to time in the past, the CFTC has exercised its jurisdictional reach to address conduct in markets outside of the United States, but typically when there was a nexus to actual conduct in the US as well. Since the collapse of the financial markets in 2008 and the adoption of Dodd-Frank, however, the CFTC has embraced an aggressive and expansive view of its extraterritorial jurisdiction to police the financial markets. Many hedge funds and private equity funds regularly conduct their investment activities in a way that could cause them to fall within the CFTC's jurisdiction.

Under the Commodity Exchange Act, the CFTC has jurisdiction over the trading of a commodity or futures contract that affects the price or the trading of the commodity or the related futures contract in "interstate commerce." Title VII of Dodd-Frank has strengthened the CFTC's view of its jurisdiction. As a result, the CFTC has concluded that it has jurisdiction to police any conduct regarding the pricing or trading of commodities and commodity futures contracts outside of the US that may have an impact through economic forces on prices in the US.

The Libor cases reveal the expansive reach of the CFTC's extraterritorial jurisdiction. Each of those enforcement actions resulted in fines in the hundreds of millions of dollars for the CFTC. Even though those enforcement actions were pursued in concert with regulatory authorities in the United Kingdom, the CFTC drove the investigation and the settlements. In two of the three instances, none of the conduct occurred whatsoever in the US. In the third instance, almost all of the conduct occurred outside of London—only a portion of the pre-2008 conduct occurred in the US. In all three enforcement actions, the CFTC premised its jurisdiction on its findings that Libor is the basis of the settlement of interest rate futures and options contracts on all of the world's major futures and options exchanges, including the Chicago Mercantile Exchange, and that Libor has a widespread impact on the consumers and businesses for which Libor is a benchmark interest rate.

The CFTC has taken a similarly aggressive view with respect to the regulatory authority conferred by Dodd-Frank with respect to swaps transactions. In its July 12 Proposed Interpretative Guidance entitled Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act (77 Fed. Reg. 41214 (Jul. 12, 2012)), the CFTC adopted a sweeping view of its ability to regulate swaps transactions outside of the US because it "believes that US persons' swap activities outside of the United States have a direct and significant connection with activities in, or effect on, US commerce."[1]

Consequently, the CFTC has proposed that its regulations apply to a non-US person if a swap solicited by a US branch agency, affiliate or subsidiary of the non-US person is booked by the non-US person, or if a non-US person exceeds the *de minimus* threshold for swap dollars or the requirements for Major Swap Participants. In addition, when one of the counterparties is a US person, "the Commission proposes to interpret Section 2(i) [of the Commodity Exchange Act] in a manner so that the Dodd-Frank Act requirements relating to clearing, trade-execution, real time public reporting, Large Trader Reporting, and SDR Reporting and recordkeeping apply to such swaps."[2] The CFTC proposes adopting this interpretation, even though it acknowledges that its extraterritorial application of its regulations may result in two or more jurisdictions asserting authority over the same swap transactions.

Market Participants Should Stay Alert

As these recent events demonstrate, any participant in the global markets for commodities or futures contracts, including hedge funds and private equity funds, has to be alert to the CFTC's enforcement power and the obligations imposed by the CFTC's regulations. Separate and apart from compliance with regulatory requirements for swap transactions and registration, market participants need to be most alert to the CFTC's willingness to take enforcement action against conduct that it believes has manipulated prices. As a result of amendments that Dodd-Frank made to the anti-manipulation provisions of the Commodity Exchange Act, the CFTC has expanded its definition of what constitutes unlawful conduct. Under Rule 180.1, which was adopted as a result of Dodd-Frank, the CFTC is empowered to pursue enforcement actions against a party who uses a manipulative device, scheme or artifice to defraud; makes an untrue or misleading statement of fact; or engages in a course of conduct that would operate as a fraud in connection with a swap, a contract to sell a commodity or a contract for future delivery. Importantly, under this rule, there is no specific intent requirement, and the CFTC has to establish only that the conduct was reckless (i.e., the conduct involved "an act or omission that 'departs so far from the standards of ordinary care that it is difficult to believe that the actor was not aware of what he or she was doing'").

> *Since the collapse of the financial markets in 2008 and the adoption of Dodd-Frank ... the CFTC has embraced an aggressive and expansive view of its extraterritorial jurisdiction to police the financial markets.*

Non-US hedge funds and private equity funds that trade outside of the US, like domestic-based funds or funds that trade in the US markets, are exposed to the risk of CFTC enforcement actions. If a fund engages in questionable trading in London or some other foreign market that may have an impact on prices in the US (which is almost invariably the case), the fund is at risk of an enforcement action. If the CFTC believes that trading conduct may have distorted prices, there is a meaningful risk that the CFTC will seek to investigate and to take action against such conduct. As illustrated by enforcement actions that the CFTC has commenced in the past, such conduct can include efforts to squeeze a market by acquiring and holding large physical positions on an exchange when there may not be a commercial need for the physical commodity,[3] efforts to "bang the close" by trading substantial volumes of contracts at the close

[1] 77 Fed. Reg. at 41234.

[2] *Id.* at 41234.

[3] See *In re Sumitomo Corp.*, No. 98-14 (CFTC May 11, 1998); *CFTC v. Parnon Energy, Inc.*, No. 11 Civ. 3543 (SDNY) (Complaint filed May 24, 2011).

in order to move the settlement price,[4] or other efforts to affect the price of a commodity or a futures contract.[5] Similarly, a fund may be at risk if it can be seen as engaging in wash trading or prearranged trading.[6]

Funds Should Adopt Compliance Programs

These risks mandate that funds and other market participants, be they located in or outside the US, strengthen their compliance activities. If a fund's trading activity is large enough to have a market impact, it is important that it establish systems to monitor such trading activity on a routine basis. Many significant CFTC enforcement actions over the past decade, be they concerning Libor or other market activities, have resulted because of the absence or breakdown of compliance systems to monitor trading activity. Indeed, as part of the Libor settlements, the banking institutions had to agree to establish substantial compliance and monitoring programs to prevent a repetition of such conduct.

These risks mandate that funds and other market participants, be they located in or outside the US, strengthen their compliance activities.

The adoption of prophylactic compliance programs is important for many reasons. Not only will such programs protect a fund against an enforcement action by the CFTC, but they will also protect the fund from the substantial class action litigation that almost always follows in the wake of enforcement actions. Large institutions generally have an ability to absorb such litigation risks. The risk of civil litigation can be devastating, however, for hedge funds and private equity funds, as illustrated by the collapse of Amaranth as a result of its manipulative trading in the mid-2000s.

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4 See *CFTC v. Optiver US, LLC*, 08 Civ. 6560 (SDNY April 19, 2012).

5 See *In re DiPlacido*, No. 01-23, 2008 WL 4831204 (CFTC Nov. 5, 2008).

6 See *In re Enskilda Futures Ltd.*, No. 12-04 (CFTC Nov. 28, 2011).

SEC Enforcement Outlook for Investment Funds: Focus on Valuation, Insider Trading and Other Fraudulent Practices


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The SEC continues its enforcement efforts relating to hedge funds and private equity funds. In recent remarks, Bruce Karpati, Chief of the SEC Enforcement Division's Asset Management Unit (AMU), indicated that the number of cases involving private equity will increase. Karpati stated that areas of focus include (1) misrepresentations concerning the value of assets, (2) insider trading and (3) other fraudulent practices. Recent SEC enforcement actions against private funds and their managers demonstrate that enforcement in these areas is robust and likely to continue throughout 2013.

Continued Enforcement Regarding Fund Valuation

As discussed in Kaye Scholer's Summer 2012 Investment Funds Newsletter, the SEC is aggressively policing asset valuation issues—a trend that has continued into 2013 and that is anticipated to continue. In his recent remarks, Karpati stated, "the temptation to overvalue assets to boost compensation has emerged repeatedly in enforcement cases. The AMU is focused on detecting fraudulent or weak valuation practices—including lax valuation committees ... and the failure to follow a fund's stated valuation procedure." Karpati further stated, "[f]unds need to show performance metrics that will make the fund attractive to new investors and keep current investors satisfied." The AMU division has demonstrated a willingness to take on cases with complex and technical issues, specifically ones involving illiquid asset valuations.

Allegations regarding whether the valuation is "accurate" or even "fair" are difficult to prove. As a result, the SEC has favored allegations about adherence to internal policies or other representations regarding valuation practices. For example, on March 11, 2013, the SEC announced a $2.8 million settlement with a fund it alleged disseminated misleading information about its valuation methods. In *SEC v. Oppenheimer Asset Mgmt., Inc.*, the SEC alleged that, while the fund's marketing materials represented that the funds were valued "based on the underlying managers' estimated values," in reality, the portfolio manager actually valued the fund's largest investment at a significant markup to the underlying managers' estimated value.

Since the beginning of 2010, the SEC has filed more than 100 cases alleging misconduct at hedge funds ranging from misusing investor assets to misrepresenting investment strategy or performance, charging excessive fees, or hiding conflicts of interest.

This change made the fund's performance appear significantly better as measured by its internal rate of return. Regarding this settlement, Acting Enforcement Director George Canellos stated, "Honest disclosure about how investments are valued and how performance is measured is vital to private equity investors." While the SEC noted that the assets were valued incorrectly, the crux of the allegation was that the fund did not adhere to its stated policies, and therefore misled investors about its valuation practices.

On March 22, 2013, the SEC announced charges against two hedge fund managers and the investment adviser and broker-dealer they ran, alleging, among several other things, that the fund inflated the valuations of its fund's assets. In *In the Matter of John Thomas Capital Mgmt. Group LLC*, the fund manager allegedly recorded arbitrary valuations that lacked any reasonable basis for certain of the fund's largest holdings. This, the SEC alleged, ran contrary to numerous representations made to investors, including representations in the investment adviser's financial statements claiming that investments were recorded at "fair value" and that the respondents had adopted Financial Accounting Standard 157.

The SEC also brought an aggressive case alleging lax oversight by outside directors. In December 2012, the SEC announced charges against eight former members of the boards of directors of five funds for violating their asset pricing oversight responsibilities under the federal securities laws. In its order instituting cease-and-desist proceedings in *In the Matter of Alderman*, the SEC alleged the funds fraudulently overstated the value of their securities at the onset of the financial crisis in 2007. The SEC further alleged that the eight charged directors (1) improperly delegated their fair valuation responsibility to a valuation committee without providing meaningful guidance on how fair valuation determinations should be made; (2) made no meaningful effort to learn how fair values were being determined; (3) received limited information about the factors involved with the funds' fair value determinations; and (4) obtained almost no information explaining why particular fair values were assigned to portfolio securities. Robert Khuzami, then Director of the SEC's Enforcement Division, stated, "had the board not abdicated its responsibilities, investors may have stood a better chance of preserving their hard-earned assets." This matter is presently being litigated.

Additionally, in *SEC v. Yorkville Advisers LLC*, the SEC charged an investment adviser, its president and CFO with overvaluing assets under management and exaggerating the reported returns of the funds in order to hide losses and justify fees. The SEC alleged that respondents valued certain investments at face value while representing to investors that those investments were valued at fair value.

Continued Enforcement Regarding Insider Trading

Since October 2009, the SEC has filed more than 170 insider trading actions charging more than 410 individuals and entities, a number of which were hedge funds or their employees. This is the largest number of actions in the agency's history for any three-year period. In remarks made in November 2012, former Enforcement Director Khuzami warned, "my message to tomorrow's insider traders is that it's a dangerous world for those who trade on insider information. And it's getting more dangerous." Karpati similarly pointed out that in the context of investment funds, "[d]ue in part to investment strategy, hedge funds may be desperate to get an information edge on the market."

On March 21, 2013, the SEC charged Rengan Rajaratnam with insider trading related to his involvement in the Galleon Management insider trading scheme run by his brother, Raj. Rengan Rajaratam allegedly made several profitable trades on the basis of inside information that he received from his brother. The allegations are similar to those made against Raj Rajaratnam, with the exception that Rengan allegedly received his tips from Raj. Rengan was also charged criminally.

In *SEC v. CR Intrinsic Investors, LLC*, the SEC alleged that a hedge fund, its former portfolio manager and a medical consultant were involved in a $276 million insider trading scheme related to a clinical trial for an Alzheimer's drug. Criminal charges were also brought against the portfolio manager. CR Intrinsic Investors recently settled with the SEC for over $600 million (approximately $275 million in disgorgement, $50 million in pre-judgment interest and $275 in penalties). This is the largest insider trading settlement ever. Regarding this settlement, Acting Enforcement Director George Canellos said, "The historic monetary sanctions against CR Intrinsic and its affiliates are a sharp warning that the SEC will hold hedge fund advisory firms and their funds accountable when employees break the law to benefit the firm."

Additionally, in *SEC v. Massoud*, the SEC settled charges that an executive at an investment advisory firm engaged in insider trading using nonpublic information contained in an online data room to which he obtained access pursuant to a confidentiality agreement. In violation of the confidentiality agreement's prohibition on trading, the executive allegedly purchased the stock of the company being sold on multiple occasions. Massoud agreed to a fine, an injunction against future violations, and to be effectively barred from the securities industry.

Increased Enforcement Regarding Other Fraudulent Practices

Since the beginning of 2010, the SEC has filed more than 100 cases alleging misconduct at hedge funds ranging from misusing investor assets to misrepresenting investment strategy or performance, charging excessive fees, or hiding conflicts of interest. In his recent remarks, Karpati indicated that the AMU examines fraud through the lens of fiduciary duties funds and their managers owe fund clients.

In November 2012, the SEC charged a hedge fund and its manager with defrauding investors by hiding millions in losses. In *SEC v. Commonwealth Advisers, Inc.*, the SEC alleged that the investment adviser and its manager directed employees to conduct over 150 cross trades between hedge funds they advised and a collateralized debt obligation (CDO) whose collateral they managed, the purpose of which was to conceal losses. The basis of this charge was that an investment adviser owed a duty to each of the funds and CDOs managed, and that one fund's interests may not be subordinated to another's. Thus, as a practical matter, when a fund manager sells a non-performing asset from a troubled fund to a healthier fund, the burden will be on the fund manager to demonstrate that the sale was in the purchasing fund's best interests.

Trade allocation issues have also drawn SEC scrutiny. In *SEC v. Aletheia Research & Mgmt., Inc.*, the SEC charged a hedge fund manager and his investment advisory firm with engaging in a "cherry-picking" scheme in violation of their fiduciary duties. Specifically, the SEC alleged that the fund disproportionately allocated winning trades to its proprietary trading accounts and those of select clients, which resulted in monetary loss for most fund investors. The SEC further alleged that the fund failed to implement policies or a code of ethics aimed at preventing this type of misconduct.

> *...in light of the SEC's focus on valuation, funds should focus on contemporaneous documentation of their valuations and the use of consistent valuation methodologies.*

In *SEC v. Alleca*, the SEC charged a fund manager and investment adviser with defrauding investors by misrepresenting the nature of the funds and their strategy, and by concealing trading losses. According to the SEC, the defendants falsely told investors they operated a "fund of funds" when, in fact, they engaged in active securities trading. When that trading incurred substantial losses, the SEC further alleged, the fund managers attempted to make the original fund whole by starting two new funds, all while concealing the losses with false account statements.

Additionally, the SEC recently announced a settlement with an investment adviser for allegedly fraudulent marketing practices. In *In the Matter of Aladdin Capital Mgmt.*, the fund marketed itself as being "better" because it "co-invests alongside ... investors in every program. Putting meaningful 'skin in the game' as we do means our financial interests are aligned with those of our ... investors." Despite the assertions in the marketing materials, the SEC alleged that the fund did not co-invest.

Best Practices

Enforcement trends relating to valuation issues, insider trading and other fraudulent practices are likely to continue this year, especially in light of the recent statements made by SEC leadership.

In this environment of heightened enforcement, strong training and compliance policies are the first line of defense. In several actions, the SEC has noted the absence of meaningful policies or, where such policies exist, the respondents' deliberate disregard of those policies. Particularly in light of the SEC's focus on valuation, funds should focus on contemporaneous documentation of their valuations and the use of consistent valuation methodologies. Karpati suggested that firms should "test and verify [their] valuation procedures." Specifically regarding the compliance structure in private equity funds, Karpati pointed out, "Private equity COOs and CFOs are absolutely critical in making sure that clients' interests are placed ahead of the interests of the management company and its principals ... Private equity firms should integrate compliance risk into their overall risk management process and should ensure that COOs, CFOs, CCOs and other risk managers are able to proactively spot and correct situations where [issues] may arise."

Although there is no magic formula that can guarantee freedom from SEC inquiries, regulators generally view strong policies favorably in conducting their investigations. Should an SEC examination occur, Karpati advised, "It is important to be cooperative with exam staff while an examination takes place. It is also important to implement any necessary corrective steps if the SEC staff identifies deficiencies or possible violations. Taking these steps will help the examination process to proceed more efficiently and reduce the likelihood of more formal inquiries by the Enforcement Division or AMU staff."

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Supreme Court: Discovery Rule Does Not Apply to SEC Enforcement Actions for Civil Penalties Under Investment Advisers Act

On February 27, 2013, the United States Supreme Court clarified in *Gabelli v. Securities & Exchange Commission* the time period in which the SEC must bring an enforcement action that seeks civil penalties. The Court held that the five-year statute of limitations begins to tick when the fraud occurs, not when it is discovered, reversing the Second Circuit's finding that the "discovery rule" delays the running of the statute of limitations until the SEC has discovered or reasonably could have discovered the fraud. While *Gabelli* specifically addressed violations under the Investment Advisers Act, the opinion suggests that it could have wide-reaching application to other SEC enforcement actions. Most notably, causes of action related to the financial crisis that accrued in 2007 are time-barred absent a tolling agreement or other exception, and the clock is ticking on actions that accrued in 2008.

Civil penalties for causes of action related to the financial crisis that accrued in 2007 are time-barred absent a tolling agreement or other exception, and the clock is ticking on actions that accrued in 2008.

Background

The Investment Advisers Act makes it illegal for investment advisers to defraud their clients and authorizes the SEC to bring enforcement actions seeking civil penalties from advisers who do so.

Under the federal "catch-all" statute of limitations for civil penalty actions, which applies because there is no specific statute of limitations for SEC enforcement actions, the SEC has five years to bring such an action "from the date when the claim first accrued."

In *Gabelli*, the SEC brought an enforcement action against a mutual fund's portfolio manager and the chief operating officer of its investment adviser in 2008 based on alleged conduct that took place from 1999 to 2002. According to the SEC, the defendants allowed one of the fund's investors to engage in "market timing" of the fund, a strategy whereby an investor can take advantage of timing differences in a fund's reported value and the real value of the assets it holds. While market timing, standing alone, is not illegal, it can harm long-term investors in a fund. Here, the alleged violation was an undisclosed *quid pro quo* arrangement whereby the defendants permitted certain investors in the fund to engage in market timing in exchange for their investments in a hedge fund run by one of the defendants, while representing to other investors that such conduct was strictly prohibited.

The District Court dismissed the SEC's civil penalty claim as time-barred, invoking the five-year statute of limitations period. The Second Circuit reversed, finding that the "discovery rule" applied since the claim sounded in fraud, and therefore the statute of limitations did not begin to run until the claim was discovered, or with reasonable diligence could have been discovered, by the SEC.

The Supreme Court's Decision in *Gabelli*

In a unanimous decision written by Chief Justice Roberts, the Supreme Court reversed. The Court held that the most natural reading of the statute of limitations provision is that the five-year clock on the SEC's claim begins to run when a defendant's allegedly fraudulent conduct occurs. The Court emphasized that this reading sets a fixed date when exposure to government enforcement efforts ends, advancing the policies of repose and certainty behind all limitations provisions.

> *The Court held that, for purposes of seeking civil penalties, the five-year statute of limitations begins to run when the fraud occurs, not when it is discovered.*

The Court then specifically rejected the argument that the "discovery rule" should apply. The Court noted that while the "discovery rule" generally applies to fraud claims, it has not previously been held to apply where the plaintiff is not the defrauded victim but rather is the government bringing an action for civil penalties. The Court drew a distinction between private parties, who "do not live in a state of constant investigation," and therefore may be unaware of a claim, and the SEC, whose very purpose is to investigate and root out fraud and which has many legal tools available to aid in that pursuit. The Court also emphasized that this action involved the imposition of penalties rather than compensation to victims.

Implications and Limitations of *Gabelli*

While *Gabelli* only specifically addressed the statute of limitations in SEC enforcement actions for civil penalties under the Investment Advisers Act, it is likely to have a much broader application. As the Court noted, the statute of limitations provision at issue is "not specific to the Investment Advisers Act, or even to securities law; it governs many penalty provisions throughout the U.S. Code." Thus, courts will likely find that the strict five-year statute of limitations applies, without the benefits of the "discovery rule," to other enforcement actions for civil penalties by the SEC and other federal agencies.

However, the reach of *Gabelli* may also be limited, as indicated by two footnotes in the opinion:

- First, the Court noted that the only issue before it was the statute of limitations applicable to actions for civil penalties, and not to actions for injunctive relief and disgorgement.

- Second, the Court limited its holding to the "discovery rule," indicating that other tolling doctrines may be available, including if the defendant takes additional steps to conceal its fraudulent conduct.

While the Court did not take a position on either of these issues, there may be room for the SEC to argue that a strict five-year statute of limitations is inapplicable under certain circumstances.

The SEC is now more likely than ever to aggressively seek tolling agreements. While *Gabelli* suggests a measure of repose for those facing scrutiny for older conduct, individuals who are targets of SEC investigations may still be hesitant to refuse an SEC request for a tolling agreement, particularly where the alternative may be to face an accelerated enforcement action by the SEC, which is now under pressure to bring such actions in a more timely manner.

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As the July 22 deadline for the implementation of the Alternative Investment Fund Managers Directive looms, events move apace with national and EU regulators are attempting to fill in the many gaps that remain in the regulatory infrastructure.

Less Than Four Months to Transition to the AIFMD

As the July 22 deadline for the implementation of the Alternative Investment Fund Managers Directive (the AIFMD, or the Directive) looms, events move apace with national and EU regulators are attempting to fill in the many gaps that remain in the regulatory infrastructure. This article summarizes the latest developments and highlights some of the key implementation issues.

Developments in the UK

As the UK is home to a significant majority of the EU's hedge fund and private equity managers, who are considered "alternative investment managers" (AIFMs) for the purposes of the Directive, we are keenly watching the approach that the UK regulator takes in implementing the AIFMD. Yet, given that the Directive is a maximum-harmonization directive, there is limited scope for national regulators to embellish it or to modify its impact.

In this context, the date that the Directive comes into force coincides with the change of national regulator for UK AIFMs from the Financial Services Authority (FSA) to the Financial Conduct Authority (FCA) as of April 1. The handover is intended to be more administrative and procedural, and the edicts and rules of the FSA will (we hope) be transposed seamlessly to the FCA without any material change to the regulator's approach and philosophy, or to the laws and regulations that govern fund managers, promoters and advisers.

On March 19 the FSA published its second Consultation Paper (CP) on the implementation of the Directive. Among other things, the Directive:

- Sets out guidance about the scope of the AIFMD and explains the FSA's thinking about delegation by alternative investment fund managers (AIFMs), as discussed further below
- Proposes modifications to some existing organizational and conduct-of-business rules that will affect full-scope UK AIFMs
- Explains how the FSA intends to amend its rules and guidance to implement the UK Treasury's proposals for specialized regimes for smaller AIFMs
- Expands on prudential rules and guidance set out in the FSA's previous CP and includes the proposed prudential regime for small authorized UK AIFMs
- Explains how the FSA's existing rules and guidance for the protection of client assets will apply to some types of depositary
- Explains the FSA's approach to marketing under the Directive and how AIFMs may exercise single-market passporting rights
- Describes the FSA's approach to registering funds being marketed through national private placement, and to approving non-UK alternative investment funds (AIFs) as recognized schemes that can be marketed to the general public.

Delegation

The extent to which an AIFM may delegate to a sub-manager has been one of the most hotly debated aspects of the Directive. The context of the debate is that an AIF must have an AIFM, which effectively includes the AIF itself if it is self-managed. An AIF cannot have two AIFMs. Consequently, in order to apply the appropriate regulatory control and oversight of the AIF, the AIFM must have sufficient substance to be able to contract with the AIF to be its investment manager and risk manager, although these activities may be delegated, but not to such an extent that the AIFM becomes a letterbox entity.

The AIFMD implementing regulations (the Regulations), which will come into force at the same time as the Directive, set out a list of features regarding delegation designed to delineate the extent of permitted delegation by an AIFM. The key requirement (Regulation 82) is that the AIFM may not delegate investment management functions to an extent that exceeds by a substantial margin the investment management functions retained by the AIFM. Regulation 82 then specifies that local regulators (such as the FSA/FCA for the UK), when assessing the extent of delegation, need to take into account not only of the assets managed under delegation, but also certain qualitative criteria, including:

- The types of assets of the AIF and the importance of the assets managed under delegation for the risk and return profile of the AIF
- The importance of the assets under delegation for the achievement of the investment goals of the AIF
- The geographical and sectoral spread of the AIF's investments
- The type of investment strategies pursued by the AIFM on behalf of the AIF
- The type of tasks delegated and those retained
- The configuration of delegates, their geographical sphere of operation, their corporate structure and whether the delegation is intra-group.

This is therefore one area where the local regulator's policy does matter because under the Directive, a UK AIFM must notify the FSA/FCA of a proposed delegation so that it can evaluate the delegation against the above requirements.

It is of interest to note that in the CP the FSA says that it will not issue any guidance on how it will assess compliance with the AIFMD's delegation requirements. Instead, the FCA will review delegation structures on a case-by-case basis, examining an AIFM's compliance with the Directive's risk management requirements, and the efficacy of its governance by the firm's governing body and control by the firm's senior management.

The FSA goes on to say that they will not automatically presume that a UK-authorized AIFM is a letterbox entity merely because a percentage threshold has been reached on the investment management tasks proposed to be delegated, versus those that are retained by the AIFM.

Senior management and the AIFM's governing body will have to exercise effective oversight and control over risk and portfolio management. This is the case whether the investment management activities are retained in-house, delegated to another firm in the same corporate group, or delegated to an independent third-party service provider, irrespective of the service provider's geographic location.

The FCA's assessment of delegate risk will form part of a wider assessment to ensure that those responsible for the activities of an AIFM monitor and manage overall risk appropriately. This involves the AIFM carrying out suitable due diligence for a prospective delegate, and continually supervising them in an active rather than passive way. The FCA will look for evidence that there is no improper delegation resulting from an abdication of responsibility by senior management and the governing body.

Recognizing that the delegation requirements affect a broad range of AIFMs, the FCA will take into account the objective reasons and commercial imperatives for delegation, with reference also to specific, real-world operating models.

It should also be noted that the European Commission will monitor how European Economic Area (EEA)-competent authorities supervise AIFM delegation requirements and how the letterbox entity test is being applied in the AIFM sector. In 2015, the European Commission will consider whether to adopt any additional measures that specify the conditions under which a letterbox entity should be assessed.

Handling the Transition to AIFMD

Although there are differing views on the availability of the transitional period for compliance by AIFMs with the Directive, the UK Treasury has affirmed that all UK AIFMs will have one year, until July 21, 2014, to comply with the Directive.

However, in order to use the AIFMD passport to permit marketing to professional investors in other EEA member states, a UK AIFM will need to have been approved as such by the FCA by July 22, 2013. To do that, a UK AIFM must have applied to the FCA for a variation of permission (VoP) from a Markets in Financial Instruments Directive (MiFID) firm to an AIFM under the AIFMD. The catch-22 is that the FCA had said it would not accept AIFMD VoP applications before July 22.

Recognizing the quandary and mindful of its self-perception as a flexible regulator, the FSA has indicated that firms who have completed its AIFM survey by March 28 may be able to use the passport from July 22 without any interruption in their current marketing activities. Since several hundred firms responded to the survey, the regulator is left with the unenviable task of establishing an order of priority among the respondents. Those who are fast-tracked will, it is assumed, have their VoP applications processed by July 22, and the FCA has now said that application forms for AIFM status will be available on its website in May.

Under the Directive, the FCA must determine a VoP application within three months. Given the number of VoP applications the FCA will receive from AIFMs, it is likely that the FCA will not be able to process the initial volume within that time and inevitably many AIFMs will be in limbo from a passporting perspective from July 22 until their VoP applications are approved. Those who do not immediately require the passport may take a more leisurely approach to the AIFMD transition may be taken.

Use of National Private-Placement Rules

AIFMs based outside the EU, AIFMs within it who manage and market non-EU AIFs, and sub-threshold AIFMs, that is, hedge fund managers managing up to €100 million (including on a leveraged basis) and private equity managers managing up to €500 million, will only be able to market their AIFs under national private-placement rules (NPPRs) until 2015. Yet sub-threshold AIFMs may opt in to the Directive in order to use the passport.

There are two potential problems with the availability and use of the NPPRs. First, some countries may disapply them or restrict them to such an extent that they are effectively unusable. Second, in order to use the NPPRs, cooperation agreements must be in place between the regulatory authorities in the member states where the fund is marketed, the regulator of the home country of the AIF and the regulator of the AIFM. For example, in order for Cayman Islands hedge funds to be marketed in the EU, a cooperation agreement needs to be in place with the Cayman and each appropriate EU member state regulator.

With less than four months to go until the Directive is live, it is imperative that affected AIFMs understand its impact on their business and take the appropriate steps to ensure compliance.

On the first point, the UK Treasury has affirmed that the UK NPPRs will remain intact and usable. Other countries, notably Germany, intend to remove their private placement regimes. On the second point, regarding cooperation agreements, there is a rush to negotiate these in time for the July 22 deadline.

The body responsible for negotiating the cooperation agreements is ESMA, the European Securities Markets Authority, which intends to have all of these in place by July, although some question whether that is an optimistic position. These agreements are also required for the delegation of investment management activities to non-EU investment managers. Thus, the need for them to be in place in time is, in many cases, critical to permitting not only private placement, but to the continuance of existing delegation arrangements.

Finally, third parties such as MiFID firms who market AIFs may continue to do so only to the extent that the AIFM itself can, and that includes, for example, the requirement that a non-EU AIFM marketing in the UK has to register details of the AIF with the FCA. It should be noted, however, that AIFMs may accept investors into an AIF as a result of reverse solicitations, which do not constitute "marketing" for the purposes of the Directive.

Actions to Take

AIFMs who wish to use the passport as soon as practicable must also be AIFMD-compliant in all other respects, and that includes ensuring that any delegation arrangements do not leave the AIFM as a letterbox.

Non-EU AIFMs who manage AIFs with EEA investors and who wish to market the AIF in the EEA will need to be aware of all pre-conditions to be met to do so, including checking that appropriate cooperation arrangements are in place in relation to the jurisdiction of the fund, and understanding the reporting and transparency requirements relating to the fund and the AIFM.

Funds offering documents should all be AIFMD-compliant, and country legends and selling restrictions checked and updated.

With less than four months to go until the Directive is live, it is imperative that affected AIFMs understand its impact on their business and take the appropriate steps to ensure compliance.

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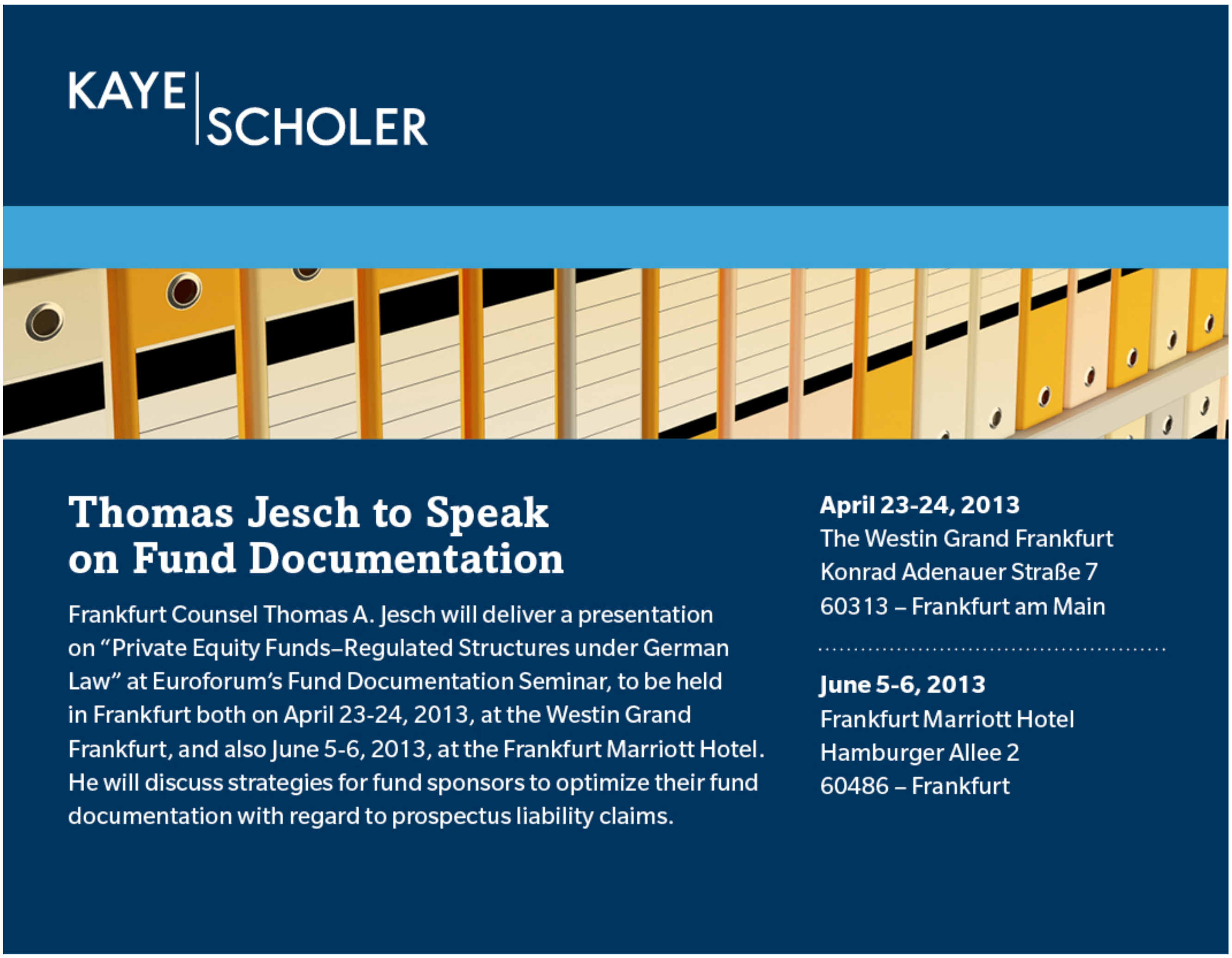

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