

Gibraltar and the AIFMD – Implications, Challenges and Opportunities

By Jon Tricker, Audit Partner, Deloitte Gibraltar

The Alternative Investment Fund Managers Directive (AIFMD) has been years in the making and similar to almost all EU affairs it has been the subject of intense negotiation and concessions. Anxious years of waiting are now almost over – individual member states had until 22 July 2013 to transpose the directive into their respective national laws; there is little flexibility in the directive but as the final Level 2 regulations were only published seven months prior to that date, time was of the essence and a few points of interest are to some extent still being debated and understood.

Once the directive is transposed, Gibraltar entities wishing to be authorised, have until 22 July 2014 to apply to the Financial Services Commission, but in the intervening period may not market their funds throughout the EEA until they are fully authorised.

The directive poses several challenges to the hedge fund / investment management industry in Gibraltar. If those challenges can be overcome, the foundations of the strong investment management and funds industry, already in place in the jurisdiction, together with external factors, are likely to make Gibraltar even more attractive meaning that Gibraltar is well placed to attract more business – for both AIFMD compliant managers and funds.

Implications of AIFMD

The implications of AIFMD are wide-ranging and it is impractical to discuss them all here. Below is a brief summary on determining which entities will be affected by the directive and the implications of being in-scope.

The Scope of the Directive

In basic terms, under the AIFMD all EU funds will either be UCITS or alternative investment funds ('AIFs'). The scope of the AIFMD is therefore very large and in Gibraltar it will cover experienced investor funds ('EIFs'), authorised funds, private funds, some recognised funds, and even potentially holding companies which meet the definition below.

The AIFMD, however, does not directly regulate the operations of AIFs but instead regulates the managers of the AIFs; ie, the alternative investment fund managers ('AIFMs'). The AIFMD defines AIFMs as: *“legal persons whose regular business is managing one or more AIFs”* (meaning that the definition of AIFMs is heavily dependent on the definition of an AIF). The AIFMD defines AIFs as:

“collective investment undertakings, including investment compartments thereof, which:

a. raise 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

b. do not require authorisation pursuant to Article 5 of Directive 2009/65/EC (on UCITS).”

Each AIF must have a single AIFM responsible for ensuring compliance with the AIFMD. The AIFMD provides for two possible types of AIFM - the external manager that manages AIFs and the AIF itself, when it is self-managed.

In the case of self-managed AIFs, it will be the AIF itself which is subject to the requirements of the directive.

Amongst certain entities exempt from the directive are small AIFMs, which are required to register as small AIFMs with the local financial regulator (the FSC), and which must keep regular records to ensure that they remain small AIFMs and do not become in-scope.

A small AIFM is defined as follows:

“Small AIFMs are AIFMs which either directly or indirectly, through a company with which the AIFM is linked by common management or control, or by substantive direct or indirect holding, manage portfolios of AIFs whose assets under management:

(a) including any assets acquired through use of leverage, in total do not exceed a threshold of EUR 100 million; or

(b) in total do not exceed a threshold of EUR 500 million when the portfolios of AIFs consist of AIFs that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF.”

On the face of it, for the more niche funds/managers in Gibraltar, remaining out of scope of the directive by being a small AIFM appears attractive and would reduce compliance costs. But there are complications.

Exemptions may not always be available – the definition of assets under management under the AIFMD is broad and in the main takes into account gross assets rather than net assets; it appears for example that funds trading in futures, even with relatively small net assets, will in many cases be in-scope due to the manner in which the gross value of futures is calculated.

Furthermore, being authorised under the AIFMD has advantages in that it allows for passporting to other EU member states. There is talk of some EU nations enacting legislation effectively meaning that their residents can only invest into funds which are either UCITS or AIFMD recognised. By not being in-scope of the directive, funds may be limiting their potential investor pool and this may mean that small AIFMs may wish to opt in (and if they do so, they must opt in to the AIFMD in its entirety).

Requirements of the AIFMD

There are numerous conditions and requirements under the AIFMD, which compliant AIFMs need to meet. In terms of capital, a self-managed AIFM will need minimum capital of €300,000; an AIFM will need minimum capital of €125,000, with that amount increasing by 0.02 per cent of the amount by which funds under management exceeds €250m, up to an amount of €10m.

The main other requirements of the directive relate to the following:

- -Delegation
- -Depositary
- -Marketing
- -Organisational requirements (including valuation)
- -Operating conditions
 - Remuneration
 - Conflicts of interest
 - Risk management
 - Liquidity management
 - Investment in securitisation positions
 - Transparency requirements
 - Annual return
 - Disclosure to investors

 - Reporting obligations

Challenges and Opportunities for Gibraltar

Depositaries

One of the key AIFMD requirements is that AIFs managed by the AIFM have a named 'depository' and for that single depository to be established in Gibraltar (although the FSC can allow depositaries licensed in other EU member states to act for Gibraltar AIFMs until 22 July 2017). The depository is the key independent party in AIFMD and is charged with protecting the investors in each AIF.

The depository has three major roles: (a) to safe keep assets, (b) monitor cash, and (c) oversee NAV calculation and fund administration.

Depositaries assume near strict liability for losses suffered – for example, on loss of financial instruments held by it in custody, the depository is obliged to return identical financial instruments or the corresponding amount to the AIF (or the AIFM acting on behalf of the AIF) without undue delay, even if the instruments were held in custody by a sub-custodian.

Even though there is potential for non-Gibraltar depositaries to act on Gibraltar AIFMDs, at least until July 2017, it makes sense for Gibraltar AIFMDs and their service providers to be supported by locally licensed depositaries. The vital role of the depository presents local depositaries, and the Gibraltar funds industry, with certain key challenges.

In the past some EIFs in Gibraltar employed the services of a bank only to manage their account, and the question arises as to how local depositaries will be able to discharge their specific functions under AIFMD, and indeed whether they are willing to take on the additional risks. Also, in the case of funds investing in assets which do not lend themselves naturally to safekeeping within the AIFMD context, for example private equity investments or property, the question arises as to how local depositaries would be able to ensure safe custody.

In terms of assets such as private equity or real estate, should the local banks not be willing to take on the strict liability of the depository role, it should be noted that it is possible for a depository to be an investment firm – it might be that a licensed collective scheme administrator, or even investment manager, is better placed and more willing to act as depository and ensuring the safe keeping of such assets.

Overall the market for local depositaries is potentially very significant, so it is difficult to see how they would not wish to be involved.

Gibraltar as an Established EU Centre for Investment Managers

Gibraltar is for many reasons already an established and attractive domicile for investment managers, for example:

- its status within the EU enables passporting to EU member states;

- as with all other Gibraltar companies, licensed investment managers enjoy a low tax rate of 10 per cent of profits which combines very well with the fact that individuals can apply to the Finance Centre for a Category status which sets their personal tax at a flat rate of approximately £30,000 per annum, regardless of their taxable income;

- there is an efficient and speedy regulatory process – Gibraltar's regulator, the FSC, is responsive and personable, licence applications are dealt with efficiently in line with published service standards; and

- the lifestyle benefits of the excellent climate and the direct access to Spain and its tapas bars, beaches, golf courses and skiing, as well as the excellent transport links both from Gibraltar airport and from the three well-connected Spanish airports within a relatively short drive.

Gibraltar's foundations in the investment management industry are strong and its attractions very real. There can be no question that these foundations put Gibraltar in a strong position to attract new compliant businesses to the jurisdiction.

Gibraltar's Position outside the Eurozone and its Foundations in UK Common Law

Recent events in Cyprus and the levy placed on deposits in Cypriot banks have sparked fears of similar reactions in other Eurozone countries requiring a bailout. Gibraltar's position outside the Eurozone is therefore now a unique selling point for the jurisdiction, particularly in terms of the hedge funds industry, in which Gibraltar's key competitors are all in the Eurozone – Dublin, Malta and Luxembourg. This, coupled with the fact that Gibraltar's legal system is based on UK common law, with UK case law applying equally in Gibraltar (in uncertain times a familiar legal system can only be attractive to investors in hedge funds) and the many other compelling reasons why Gibraltar is an established domicile for investment managers and funds, make Gibraltar a unique proposition within the EU.

Whilst until recently the other EU jurisdictions named above have attracted significantly more hedge funds, this can to a large extent be attributed to the herd mentality that exists (the same herd mentality that meant that the large majority of funds have traditionally been set up in the Cayman Islands, another UK common law jurisdiction). AIFMD gives Gibraltar an excellent opportunity to take advantage of that same herd mentality: as has been seen in other industries such as gaming and insurance, Gibraltar is well placed to attract compliant EU business.

Local Momentum within the Funds Industry

AIFMD arrives at a time in which Gibraltar's offering to the funds industry is becoming more compelling, and there is already significant traction. The finance centre has already made senior hires in the private clients and insurance spaces, to increase information flows and marketing about the jurisdiction, and it is expected that a similar hire will soon be finalised in the hedge fund space. In addition, there are rumours that a local stock exchange, with initial focus on alternative investment funds, is in the process of applying for a licence.

Final Thoughts

AIFMD presents great challenges for the industry, not least in ensuring its correct application across all affected parties. Gibraltar finds itself in a favourable position – particularly given its UK common law status within the EU and yet outside the Eurozone, its low tax and compliant business environment and its foundations in the industry. There can be no doubt that Gibraltar has rock solid foundations on which to build.

About the Author:

Jon leads Deloitte Gibraltar's audit services to hedge funds and was recently elected to be an executive member of the Gibraltar Funds and Investments Association. In 2012 Jon was voted to sit on the Gibraltar funds' panel, which discusses matters of mutual interest between the Financial Services Commission and industry, and also sits on the equivalent panel for auditors.

Jon graduated from Cambridge University in 2001 before qualifying as a chartered accountant whilst working in audit at the Cambridge office of Deloitte. Having joined the Gibraltar office in 2005, Jon now serves as lead contact on a variety of audit clients, including financial services clients (including licensed banks, insurance entities and hedge funds) and UK listed groups.