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THE EU ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: IMPACT ON NON-EU FUND MANAGERS

WHAT IS THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE?

The Alternative Investment Fund Managers Directive (the "**Directive**") aims to create a harmonised European regulatory framework for managers of alternative investment funds ("**AIF**"). In broad terms, the Directive regulates the management and marketing of AIF where the activity takes place in the European Union or the AIF concerned are established in the European Union (the "**EU**").

AIF Definition

An AIF is broadly defined as a collective investment undertaking (irrespective of its legal structure):

- that 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
- is not required to obtain authorisation under the Undertakings for Collective Investment in Transferable Securities ("**UCITS**") Directive (the EU directive which establishes a single market for open-ended retail investment funds to ensure a high level of protection for retail investors across the EEA).

Although the Directive aims to regulate managers of alternative investment funds, the broad definitions given to "alternative investment fund manager" ("**AIFM**") and "AIF" have the effect of bringing within the Directive's scope not only managers of hedge funds and private equity funds but also managers of all types of investment fund that are not UCITS, including real estate funds, commodity funds and infrastructure funds and funds of funds.

The Directive entered into force on 21 July 2011 and must be implemented by EU member states by 22 July 2013.

The Directive is expected to be implemented in the EEA states which are not also EU member states - i.e. Norway, Lichtenstein and Iceland. Accordingly, references in this note to the EU should be read as references to the EEA.

THE REQUIREMENT FOR AUTHORISATION

The Directive requires that AIFMs falling within its scope be authorised and subject to supervision by the regulator in their home jurisdiction. The Directive also introduces a European "passport" under which authorised AIFMs are entitled, subject to compliance with certain requirements, to manage AIF in other EU member states and market AIFs to professional investors throughout the EU.

Exemptions

The Directive provides for exemptions for certain types of entity which might otherwise fall to be treated as an AIFM. These include: certain holding companies, institutions for occupational retirement provision and their managers and investment managers (provided that they do not manage AIF), employee participation and savings schemes, securitisation special purpose entities and joint ventures. In addition, AIFMs that manage AIF whose only investors are companies in the same group as the AIFM are also exempt.

Further, there is a size threshold exemption for AIFMs based on the level of assets under management. The Directive applies only very limited requirements to AIFM which manage AIF whose assets under management (across all managed AIF) do not exceed €100 million in aggregate or, if the AIF under management are unleveraged and do not offer redemption rights exercisable during the initial 5 years of the fund's life, €500 million in aggregate.

The limited requirements for AIFMs under the threshold are a requirement to register with a regulator in the home member state of the AIFM and a requirement to provide to the regulator information on the investment strategies of the AIF under management and periodic information on the main instruments traded, principal exposures and concentrations. These are however minimum requirements. It is open to member states to impose additional or stricter requirements. The UK is currently proposing not to impose additional or stricter requirements except in the case of AIFM managing certain categories of UK authorised funds.

APPLICATION TO NON-EU FUND MANAGERS

In addition to applying to AIFMs established in the EU, the Directive applies to AIFMs which are established in countries outside the EU ("**non-EU AIFMs**") and which either:

- manage AIFs established in the EU ("**EU AIF**"); or
- market any AIFs (whether or not established in the EU) to investors in the EU.

The European Commission has acknowledged its lack of experience in regulating firms established in jurisdictions outside the EU and the potential uncertainties in applying the authorisation and EU-wide passport provisions of the Directive to non-EU AIFMs. Therefore, the Directive provides that its application to non-EU managers carrying on the management and/or marketing activities described above will be subject to a review to be undertaken not later than July 2015. Pending the outcome of that review, non-EU managers marketing AIFs to investors in the EU will be subject to certain minimum mandatory requirements which will need to be met both in relation to the marketing and on a continuing basis.

The outcome of the review will determine whether non-EU managers carrying on the management and/or marketing activities described above will be brought within the full scope of the Directive. It is anticipated that this is likely to be the case from some point in late 2015.

The following set of timelines summarise how the Directive will apply to non-EU AIFMs over the next few years:	
Prior to 22 July 2013	Non-EU AIFMs may continue to manage EU AIFs and market both EU and non-EU AIFs managed by them in EU member states in compliance with currently applicable local laws in those member states.
22 July 2013 to 2015	Non-EU AIFMs may continue to manage EU AIFs and market both EU and non-EU AIFs managed by them in EU member states in compliance with applicable local laws in those member states. However, in relation to any marketing activity, member states will be required to impose certain additional requirements *(see "Mandatory Requirements for non-EU AIFM marketing AIF to EU Investors" below)*.
2015 to 2018	Assuming the review to be undertaken by July 2015 results in the Directive's authorisation regime being applied to non-EU AIFMs: (i) non-EU AIFMs managing EU AIFs will, subject to any exemption being available, be required to be authorised under the Directive which will mean submission to the full Directive regime (which will carry an entitlement to market EU and non-EU AIFs managed by the non-EU AIFM to EU investors, subject to applicable conditions being met); (ii) non-EU AIFMs marketing non-EU AIFs managed by them to EU investors (but not managing any EU AIF) may either: • become authorised under the Directive on a voluntary basis in order to take advantage of the EU marketing passport; or • remain unauthorised and market those non-EU AIFs in compliance with applicable local laws in the relevant member states, which will reflect the additional mandatory requirements in relation to marketing activity referred to above *(see "Mandatory Requirements for non-EU AIFM marketing AIF to EU Investors" below)*.
2018 onwards	Subject to a review on the functioning of the passport under the Directive (to be undertaken 3 years after the Directive's authorisation regime is applied to non-EU AIFMs), the ability for non-EU AIFMs to market their AIFs to EU investors in compliance with individual member state national laws without being authorised under the Directive is expected to be phased out. Non-EU AIFMs marketing non-EU AIFs managed by them to EU investors will be required to be authorised under the Directive which will mean submission to the full Directive regime (and which will carry an entitlement to market the AIFs to EU investors, subject to applicable conditions being met).

MANDATORY REQUIREMENTS FOR NON-EU AIFMS MARKETING AIF TO EU INVESTORS

From 22 July 2013, EU member states will be required to impose the following requirements in relation to any marketing to professional (i.e. non-retail) investors in their jurisdictions by non-EU AIFMs of AIFs (whether EU or non-EU) managed by them. These requirements will apply in addition to any local law requirements in member states. It should be noted that, as is the case currently, there is no requirement for member states to permit marketing activity by non-EU AIFMs; this is at the discretion of individual member states. In contrast, non-EU AIFM which become authorised under the Directive in due course (if this becomes possible, it will not be until 2015 at the earliest) will have an entitlement to market AIF managed by them on a pan-EU basis, subject to meeting certain specified conditions. The requirements noted below (or substantially similar requirements) will also apply to an authorised non-EU AIFM in connection with any marketing activity.

The requirements applying from 22 July 2013 are as follows:

(a) Existence of Cooperation arrangements/no connection with NCCTs

A cooperation arrangement for the purpose of systemic risk oversight in line with international standards must be in place (i) where the AIF being marketed is a non-EU AIF, between the regulator in the member state in which the AIF will be marketed and the supervisory authorities in both the non-EU AIFM's jurisdiction of establishment and the supervisory authority in the jurisdiction in which the AIF is established, or (ii) where the AIF being marketed is an EU AIF, between the regulators in both the member state in which the AIF will be marketed and the member state in which the AIF is established and the supervisory authority in the non-EU AIFM's jurisdiction of establishment. Marketing in the EU will be prohibited in circumstances where the country in which either the non-EU AIFM is established or the jurisdiction in which the AIF to be marketed is established (if it is a non-EU AIF) is on the list of Non-Cooperative Country and Territories published by the Financial Action Task Force.

The establishment of co-operation arrangements between EU member states and non-EU jurisdictions is being handled on a co-ordinated basis by the European Securities and Markets Authority (ESMA) on behalf of EU member states. To date, an agreement has been entered into between the Swiss Financial Market Supervisory Authority (FINMA) and the EU securities regulators. No agreements with other non-EU supervisory authorities have yet been put in place and the timeframe for concluding agreements with authorities in other jurisdictions is uncertain.

(b) Compliance with Transparency requirements

- Disclosures to investors: for each AIF marketed in the EU, non-EU AIFMs will be required to make available to the EU investors concerned before they invest prescribed information relating, amongst other things, to: the AIF's objectives and investment strategy and restrictions, the types of assets to be invested in, the investment techniques to be employed and associated risks, historical performance (where available), the use of leverage and associated risks, collateral and asset re-use arrangements, information relating to the AIFM, depositary, prime broker and other service providers (and any delegation arrangements), the valuation procedure and methodology, liquidity risk management and any preferential treatment given to any investors.

  Any subsequent material change to that information would also need to be disclosed. Further, a continuing obligation to disclose certain information on a periodic basis (including information relating to illiquid assets, liquidity management, leverage employed, risk profile and risk management) would apply. Detailed rules made by the EU Commission will apply to the initial and periodic disclosures to be made.

- Preparation of Annual Reports: for each AIF marketed in the EU, non-EU AIFMs will be required to prepare an annual report for each financial year of the AIF and make it available not later than 6 months after the end of the financial year to the regulator in each member state in which the AIF was marketed. In addition the annual report would need to be made available on request to EU investors in the AIF. The mandatory content requirements for such annual reports include, amongst other information, the total amount of remuneration for the financial year (split into fixed and variable remuneration) paid by the AIFM to its staff, the number of beneficiaries, and, where relevant, the carried interest paid by the AIF as well as the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF. The preparation of annual reports will be subject to detailed rules made by the EU Commission.

  The accounting information in the report will need to be prepared in accordance with accounting standards of the jurisdiction in which the AIF is established and the accounting rules laid down in the AIF rules or constitution. The report will need to be audited in accordance with applicable EU auditing standards if the AIF is established in the EU or, if it is not and if permitted by the member states into which the AIF is marketed (which is optional), in accordance with international auditing standards in force in the jurisdiction in which the AIF is established.

- Periodic filings with regulators: for each AIF marketed in the EU, non-EU AIFMs will be required periodically to provide to the regulator in each EU jurisdiction in which the AIF is marketed certain information relating to the principal markets and instruments in which the non-EU AIFM trades on behalf of the AIF, assets which are illiquid, the risk profile of the AIF and the risk management systems employed, the results of liquidity stress tests and investment risk stress tests and information in relation to leverage (where substantial leverage is employed). The information to be provided will be subject to detailed rules made by the EU Commission.

(c) Compliance with Restrictions on "asset stripping"

Non-EU AIFMs marketing AIF to EU investors will be required to comply with the Directive's restrictions in relation to the prevention of "asset stripping". Where the marketed AIF acquires (either itself or acting together with other AIFs managed by its AIFM or with AIFs managed by third party AIFMs):

- control (i.e. 50% or more of the voting rights) of an EU company which is not admitted to trading on an EU regulated market (and which is not a small or medium sized enterprise[1] or a real estate SPV); or
- control[2] of an EU company which is admitted to trading on an EU regulated market;

The AIFM must not, for a period of 24 months following the acquisition of control, facilitate, support (including by voting in favour of) or instruct, and must use its best efforts to prevent, any distribution, capital reduction, share redemption and/or acquisition of own shares by the company funded, broadly speaking, otherwise than out of the company's distributable profits and reserves.

[1] Micro, small and medium-sized enterprises are enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million.

[2] Control in relation to a traded company is the percentage of voting rights determined by the member state in which the company has its registered office for the purposes of the EU Takeover Directive. In the UK it is 30%.

(d) Compliance with Notification of Holdings requirements

Investment in EU unlisted companies

Non-EU AIFMs marketing AIF to EU investors will be required to comply with the Directive's restrictions on the notification of holdings in EU companies which are not admitted to trading on an EU regulated market (and which are not small or medium sized enterprises or real estate SPVs). These are of particular relevance to private equity funds investing into the EU. The AIFM will be required:

- to notify the regulator in each member state in which the AIF is marketed of holdings of the marketed AIF of voting shares in such companies that reach, exceed or fall below certain specified thresholds (10%, 20%, 30%, 50% and 75%);
- where the marketed AIF acquires (either itself or acting together with other AIFs managed by its AIFM or with AIFs managed by third party AIFMs) 50% or more of the voting rights of any such company, to notify the company (and, via the company, its employees), its shareholders (to the extent that these can be identified by the AIFM) and the regulator in each member state in which the AIF is marketed of:

  1. the acquisition of control, including the level of voting rights acquired and the conditions under which control was acquired (including the identity of the shareholders involved, persons entitled to exercise votes on their behalf and, if applicable, the chain of ownership through which voting rights are held) and the date on which control was acquired;

  2. the identity of the AIFM and the policy for preventing and managing conflicts of interest, in particular between the AIFM, the AIF and the company (including information about the specific safeguards established to ensure that any agreement between the AIFM and/or the AIF and the company is concluded at arm's length) and the policy for external and internal communication relating to the company in particular as regards employees; and

  3. its intentions with regard to the company's future business and any likely repercussions on employment (including any material change in employment conditions) (note this information need not be notified to the regulators in member states where the AIF was marketed).

- where the marketed AIF acquires (either itself or acting together with other AIFs managed by its AIFM or with AIFs managed by third party AIFMs) 50% or more of the voting rights of any such company, to either include certain specified information in the annual report of such AIF or to use best efforts to ensure that such information is included in the company's annual report and is made available to the company's employees. The specified information includes a fair review of the development of the company's business over the period covered by the report and an indication of the company's likely future development.

Investment in EU traded companies

Where an AIF marketed by a non-EU AIFM to EU investors acquires control[3] of an EU company which is admitted to trading on an EU regulated market, the AIFM is required to notify the information described in (d)(ii)2. above to the company (and, via the company, its employees), its shareholders (to the extent that these can be identified by the AIFM) and the regulator in each member state in which the AIF is marketed.

[3] Control in relation to a traded company is the percentage of voting rights determined by the member state in which the company has its registered office for the purposes of the EU Takeover Directive. In the UK it is 30%.

It should be noted that the Directive permits individual member states to impose stricter rules on non-EU AIFMs in respect of the marketing of AIFs to investors in their territories.

WHAT DOES MARKETING COVER?

For the purposes of the Directive marketing extends to the direct or indirect offering or placing of units or shares in an AIF at the initiative of, or on behalf of, its AIFM. Preliminary marketing which falls short of an offer or marketing is not within the ambit of the Directive and, thus, is not regulated by it. Accordingly, engaging in preliminary marketing should not invoke the need to comply with the mandatory requirements described above. These would need to be complied with only prior to an offer or placing commencing. Preliminary marketing may of course be regulated at a national level in individual member states (as is the case in the UK).

Non-EU AIFMs marketing AIF to EU investors will, from 22 July 2013, be subject to the mandatory requirements described above whether the marketing is undertaken directly by the AIFM or indirectly through an intermediary on behalf of the AIFM. The Directive imposes an obligation on intermediaries acting on behalf of AIFMs not to offer or place units or shares in AIFs to or with EU investors unless the marketing requirements of the Directive have been met.

The Directive does not regulate or restrict investors from investing in AIFs on their own initiative. Accordingly, the mandatory requirements described above should not apply to non-EU AIFMs which admit investors to their managed funds in circumstances where those investors have approached the AIFM of their own accord without being solicited by the AIFM. It is not clear though whether demonstrating that an investment has been achieved by way of a 'reverse solicitation' will be straightforward. It remains to be seen what approach to this issue will be taken by member state regulators.

MARKETING: PRACTICAL ISSUES

A number of practical issues should be noted by non-EU managers:

- as indicated above, EU member states will not be obliged, after 22 July 2013, to allow marketing in their jurisdictions by non-EU AIFM. This will remain optional, as it is now. Moreover, member states may seek to impose stricter marketing requirements and conditions than those mandated by the Directive. There is a concern that a number of member states may use the Directive as an opportunity to tighten up, or even remove, their private placement exemptions. Some member states (for instance Germany) appear to be heading in this direction;
- this will mean that, notwithstanding the marketing requirements laid down in the Directive, it will be necessary to take local advice in relevant EU member states before proceeding with (or continuing) an EU offering or placement after 22 July 2013. Member States may not finalise or adopt their local requirements until shortly before that date and local registration or filing with a regulator may well be required before commencing marketing. It is possible that this may lead to delays in being able to commence (or continue) offering and marketing activity after 22 July 2013;
- there is uncertainty as to when the co-operation arrangements required in connection with marketing into the EU by non-EU AIFM will be put in place. It may be that arrangements will not be in place as at 22 July 2013 in relation to key non-EU jurisdictions. This would prevent any offering or placing after that date by AIFM based in jurisdictions with which arrangements are not in place or by AIFM undertaking an offering or placing in the EU of a non-EU AIF established in a jurisdiction with which no arrangements are in place (even if arrangements are in place with the jurisdiction in which the AIFM is based). This would have particular relevance in the context of an offering or placing in the EU which has commenced before 22 July 2013 but which has not finally closed by that date;

- if the necessary co-operation agreements for a marketing to EU investors are in place, in order to proceed with (or continue) an offering or placement after 22 July 2013, a non-EU AIFM will need to have a disclosure document prepared to give to EU investors and have developed the appropriate systems and controls to ensure that it can comply with the required periodic disclosure and annual report requirements, filing requirements and, if marketing an AIF which invests into the EU and may acquire controlling interests or interests above the notification threshold, with the notification requirements and anti-asset stripping restrictions;
- it may be prudent for non-EU managers contemplating marketing into the EU to consider whether the mandated disclosure requirements would give rise to any asymmetry in relation to information given to EU investors and that given to non-EU investors in the marketed AIF and whether this may drive any need to make additional/broader disclosures to non-EU investors;
- it will be prudent for non-EU AIFM to bear in mind, in developing any new fund structure, that if the AIF is established in an EU member state, it is likely that, with effect from 2015, the non-EU AIFM will be required to become authorised by an EU regulator and will be subjected to the full regulatory regime imposed by the Directive.

AUTHORISATION FOR NON-EU AIFMS

As indicated above, the authorisation and passport regime under the Directive is expected to be applied to non-EU AIFMs from 2015 at the earliest. Once this occurs any non-EU AIFM managing an EU AIF would need to be authorised by the competent authority in the non-EU AIFM's "member state of reference". The Directive sets out various factors to determine a non-EU AIFM's member state of reference including: the jurisdiction of EU AIFs managed or marketed by the AIFM, the jurisdiction of the EU AIF with the largest amount of assets and (in the case of a non-EU AIF) the EU jurisdictions in which the EU AIF intends to market AIF interests. A non-EU AIFM marketing AIF to EU investors but not acting as the manager of any EU AIF could opt to be authorised once the Directive is extended in full to non-EU AIFMs in order to take advantage of the marketing passport regime but would not be required to do so for so long as individual member states permit marketing under their individual private placement regimes (which would reflect the mandatory requirements described above). As indicated above, it is expected that the ability of member states to permit marketing of funds by non-EU AIFMs under individual private placement regimes will be phased out in 2018, following which it would be necessary for non-EU AIFMs to become authorised in order to market any AIF (whether established in or outside the EU) to EU investors.

In order for a non-EU AIFM to be authorised, appropriate cooperation arrangements must be in place between the supervisory authority in its jurisdiction of establishment and (i) the regulator in the non-EU AIFM's member state of reference and (ii) the regulators in each member state in which any EU AIF managed by the non-EU is established. In addition, the country in which the non-EU AIFM is established must not be on the Financial Action Task Force list of Non-Cooperative Country and Territories and must have entered into a tax information exchange agreement, complying with the OECD Model Tax Convention, with the non-EU AIFM's member state of reference.

Further, the non-EU AIFM would be required to appoint a "legal representative" in its member state of reference to act as a point of contact for the investors of the relevant AIF, for the European Securities and Markets Authority and for relevant EU regulators. The legal representative would be required to perform the compliance function relating to the non-EU AIFM's management and marketing activities and would need to be sufficiently equipped for this purpose.

Authorisation would subject the non-EU AIFM to the full requirements of the Directive, for instance in relation to the maintenance of a required level of capital and compliance with operating conditions and organisational requirements relating to the conduct of business, remuneration of staff, conflicts of interest, risk management, liquidity management, valuations, delegation and the appointment of depositaries in relation to managed AIF. In addition, an authorised non-EU AIFM would be subject to the disclosure, reporting and filing obligations described above.

SUGGESTED PREPARATORY STEPS FOR NON-EU MANAGERS

Non-EU fund managers who are contemplating marketing funds (either directly or indirectly through affiliates or third parties) to investors in the EU after 22 July 2013 should consider taking the following preparatory steps:

- identifying in which member states the marketing is likely to take place;
- assessing the development of the private placement regimes which will be in effect in those member states as from 22 July 2013 and confirming the requirements which will need to be complied with under local law in each member state (and, in particular, whether there will be any requirements additional to the requirements mandated by the Directive);
- monitoring the progress of cooperation agreements between the EU and the jurisdictions in which the manager and the funds to be marketed by it are established;
- assessing the documentation relating to the funds to be marketed to EU investors for compliance with the disclosure requirements of the Directive (and any additional requirements of the relevant member states) and preparing any necessary supplementary disclosure document;
- establishing procedures and systems to ensure compliance with the required on-going periodic disclosure and annual report requirements, filing requirements and, if likely to be applicable, with the anti-asset stripping restrictions and requirements to notify controlling interests;
- considering the impact of the Directive's requirements on a marketing to EU investors which may commence before and be on-going as at 22 July 2013.

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