Schulte Roth&Zabel

AIFM DIRECTIVE

Briefing

Implications of the AIFM Directive for Non-EU Fund Managers

May 2013

Summary
The Alternative Investment Fund Managers Directive ("AIFM Directive") was agreed in November 2010, came into force in the European Union ("EU") on 21 July 2011 and must be implemented into the national law of all EU countries by 22 July 2013. The AIFM Directive sets forth rules for the authorisation, operation and transparency (i.e., disclosure requirements) of managers of alternative investment funds ("AIFs"). The AIFM Directive will apply to any non-EU private fund/hedge fund manager (which would be defined under the AIFM Directive as an alternative investment fund manager or "AIFM") that:

(1) Manages one or more EU AIFs; or

(2) Markets[1] one or more AIFs (EU or non-EU) to investors in the EU.

The AIFM Directive will not apply to a non-EU AIFM managing a non-EU AIF where that non-EU AIF is not marketed to investors in the EU. A non-EU AIFM can accept an EU investor into a non-EU AIF without being subject to the AIFM Directive when the EU investor initiates the approach.

This *Briefing* covers the implications of the AIFM Directive on a non-EU AIFM that is marketing one or more non-EU AIFs to investors in the EU and the issues that may affect the non-EU AIFM's operations and EU marketing activities.

Introduction
The AIFM Directive is merely a framework and requires that the European Commission ("Commission") should prepare detailed rules on a large number of the topics covered by the AIFM Directive in the form of subordinate legislation. Many[2] of the detailed rules, which expand upon the principles set forth in the AIFM Directive's initial framework, were adopted by the Commission on 19 Dec. 2012 in the form of a delegated regulation (the "Delegated Regulation").[3] The Delegated Regulation and the other subordinate legislation

[1] Under the AIFM Directive, "marketing" means a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the EU.

[2] Not all of the Level 2 Measures were adopted by the Commission on 19 Dec. 2012; several significant elements of the subordinate legislation still need to be adopted — most notably the new remuneration rules for AIFMs operating within the EU.

[3] See http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf. In implementing the detailed rules in the form of an EU regulation, the Commission has ensured that every country of the EU will have the same requirements for the management and marketing of AIFs as an EU regulation, once it comes into effect, is the *de facto* law of every country of the EU — without needing to be implemented or adopted into national law.

under the AIFM Directive are known as the “Level 2 Measures” (with the AIFM Directive itself sometimes also referred to as “Level 1”).

The Delegated Regulation expands in detail upon several principles in the AIFM Directive: conditions and procedure for the determination and authorisation of AIFMs (including the capital requirements applicable to AIFMs), operating conditions for AIFMs (including rules on remuneration, conflicts of interest, risk management, liquidity management, investment in securitisation positions, organisational requirements, rules on valuation), conditions for delegation, rules on depositaries (including the depositary’s tasks and liability), reporting requirements and leverage calculation, and rules for cooperation arrangements and other issues relating to AIFs and AIFMs which are established outside the EU. The Delegated Regulation has been adopted into EU law.

Scope of the AIFM Directive and Identifying the AIFM
The AIFM Directive will apply to any non-EU AIFM that is:

(1) Marketing one or more AIFs to investors in the EU; or

(2) Managing one or more EU AIFs.

An AIF is defined as any collective investment undertaking (other than a UCITS[4]) which 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. Any such fund will fall within the definition of an AIF irrespective of whether it is open- or closed-ended and irrespective of its legal structure. Consequently, the AIFM Directive covers almost all funds — including hedge funds/private funds.

Each AIF within the scope of the AIFM Directive must have a single identified AIFM. An AIF can be either “externally or internally managed.” An AIF will be internally managed where the management function (see below) is undertaken by the governing body (board of directors) or by an internal resource (such as if the AIF is managed by its own employees). In the typical hedge fund/private fund structure this will not be the case. Where a third party undertakes the management function, the AIF would be deemed to be “externally managed.” Where the AIF is internally managed, the AIF is itself the AIFM. Where it is externally managed, the external manager is the AIFM.

The management function: “Managing” an AIF means providing at least portfolio management services and risk management services for one or more AIFs.

(1) Portfolio management means managing portfolios of financial instruments on a discretionary basis in accordance with a client’s (i.e., the AIF’s) mandate.

(2) Risk management involves identifying, measuring, managing and monitoring all risks relevant to the AIF’s investment strategy.[5]

Firms which have portfolio and risk management responsibilities for an AIF should assess whether they have been appointed by or on behalf of that AIF or if they are merely a delegate of the person so appointed (see below); if they are only a delegate of another entity (which it not itself a “letter-box entity” (see below)), they will be a delegated portfolio manager and *not* the AIF’s AIFM.[6]

[4] An EU regulated fund, akin to a mutual fund.

[5] Many management agreements and investment management agreements relate wholly or mainly to the portfolio management activities required for the AIF and, consequently, many fund managers will not have been explicitly appointed to provide risk management services to an AIF.

[6] EU fund managers that are delegates of a non-EU AIFM manager would be identified as investment firms under the Markets in Financial Instruments Directive ("MiFID"). However, most EU AIFMs will almost certainly be registered and authorised in the EU as MiFID investment firms — an AIFM that has been appointed to manage an AIF will not to be deemed to be providing MiFID "portfolio management," but instead "collective portfolio management" under the AIFM Directive. A firm cannot be authorised as both a MiFID firm and as an AIFM.

Delegation by an AIFM:[7] An AIFM is allowed to delegate certain of its functions as long as in doing so it does not delegate so many functions that it would longer be considered to be the manager of the AIF and would be defined as a "letter-box entity." The Delegated Regulation clarifies that an AIFM would be deemed a letter-box entity and would no longer be considered to be the manager of the AIF in *any* of the following situations:

(1) The AIFM no longer retains or does not have the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;

(2) The AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the implementation of the general investment policy and investment strategies;

(3) 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

(4) 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.

Firms which provide portfolio or risk management services will therefore have to consider whether they have been appointed "by or on behalf" of the AIF — and, consequently, whether they are the AIFM — or whether they are only a delegate of the AIFM that was appointed by or on behalf of the AIF.

Application to sample management group structures: *Cayman manager & Singapore-based investment manager*: In this structure, if the Cayman manager has limited substance (including not having any employees) it would likely be defined as a letter-box entity. As a result, it would be the Singapore-based investment manager that would be defined as the AIFM as it would be the sole entity within the management group that had substance and could actually conduct the risk management and the portfolio management activities. If the Cayman manager had substance and employees and retained the risk management function, with oversight of the portfolio management activities conducted by the delegated investment manager in Singapore, it would be possible to define the Cayman manager as the AIFM.

US manager & UK-based investment manager: In this structure, if the US manager has substance and personnel and retains the risk management function and some of the portfolio management function, with only a portion of the portfolio management function delegated to the UK investment manager the US manager would be likely to be viewed as a bona fide manager and not as a letter-box entity. As a result, the US manager would likely be defined as the AIFM and the UK-based investment manager/sub-adviser would merely be a delegate.

Cayman manager & UK, US and Hong Kong co-investment managers: In a structure such as this, if the Cayman manager has no real substance and the risk management and portfolio management has all been delegated to the co-investment managers, the Cayman manager would be likely to be defined as a letter-box entity. As a result, an analysis would have to be undertaken to assess which of the UK, US and Hong Kong entities conducts the majority of the risk management and portfolio management functions; one would need to consider where the chief investment officer is located, where the risk management function is located and where the majority of the investment decisions are made. Every case would have to be assessed on its own facts and circumstances to assess which entity was the AIFM for the relevant AIF — and it may be possible, where the US and Hong Kong co-investment managers are true co-investment managers with comparable roles, to select which of the co-investment managers is defined as the AIFM for the AIF.

Singapore and UK co-managers: In a structure like this, if the two managers are truly equal co-managers, with each having a co-chief investment officer and each entity having responsibility to manage half the portfolio and conducting half the risk management function, it would be necessary to assess all applicable factors to assess which entity was to be defined as the AIFM. In a scenario with a true 50:50 division of responsibilities, it might be possible for the two co-managers to elect which one was the AIFM.

[7] For more information on the delegation by AIFMs, see SRZ *Briefing, Operational Requirements for AIFMs*.

"Phased" Implementation for Non-EU AIFMs

The AIFM Directive is being implemented in phases, particularly those provisions applying to non-EU AIFMs. Initially, from 22 July 2013, the pan-EU marketing passport (which would allow an AIFM to market its AIF(s) to professional investors cross-border within the EU (without needing to consider private placement rules)) will only be made available to EU AIFMs with EU AIFs; all others will need to continue to use existing national private placement rules in each EU country (where these exist)[8] — subject to compliance with certain operational conditions and disclosure requirements (see below). In addition, it is possible that some EU countries may require the manager of an AIF domiciled in their country to become registered with the national regulator (although the details for any such registrations are still unclear given there is still over six months until the new rules come into effect on 22 July 2013).

In 2015, the AIFM Directive requires that the European Securities and Markets Authority ("ESMA") must assess the functionality and effectiveness of the marketing passport for EU AIFMs with EU AIFs and provide its opinion to the European Commission regarding whether or not the marketing passport should be extended to non-EU AIFMs and non-EU AIFs. If ESMA gives a positive opinion, then it is possible that the Commission could then make the marketing passport available to non-EU AIFMs. However, to obtain the marketing passport the non-EU AIFM would have to opt in to the AIFM Directive registration rules and would have to register in the EU country where it intended to conduct the majority of its marketing activities. Such AIFMs opting in to the registration requirements would be required to comply with all of the AIFM Directive's rules, including the rules in relation to depositaries,[9] regulatory capital,[10] remuneration,[11] leverage,[12] valuations[13] and other topics, and would also be required to have a legal representative or office within the EU country where the non-EU AIFM registered.

However, the possibility of registering in the EU in 2015, if it were to be made available to non-EU AIFMs, would be an optional registration; non-EU AIFMs would still be able, if they wished, to continue to use national private placement rules.

In 2018 ESMA is required to give a further opinion to the Commission on the functionality and effectiveness of the marketing passport for non-EU AIFMs. If ESMA gives a positive opinion, then, it is possible that, in early 2019, the Commission could repeal all national private placement rules in all EU countries in respect of AIF interests and could thereby require all AIFMs, when marketing any AIF in the EU, to become registered.

In summary:

(1) From now to 22 July 2013 — non-EU AIFMs may continue to use national private placement rules as they have in the past.

(2) 22 July 2013 to 2015 — non-EU AIFMs may only market in the EU in accordance with national private placement rules — subject to compliance with certain additional operational conditions and disclosure requirements (see below).

(3) 2015 to 2018 — non-EU AIFMs may either continue to use national private placement rules or they may opt in to the AIFM Directive to obtain the marketing passport (if available).

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[8] National private placement rules are not harmonised and are specific to each EU country. Furthermore, not all EU countries permit interests in AIFs to be privately placed to investors in their jurisdiction and some of those countries that currently do permit private placements of AIF interests to their investors are contemplating removing their private placement rules for AIFs — notably Germany, which has proposed that to be eligible for marketing by way of private placement, the AIF would have to be registered with the German regulator.

[9] For more information on the specific requirements relating to AIF depositories, see SRZ *Briefing, Depositary Requirements*.

[10] For more information on the specific requirements relating to an AIFM's regulatory capital, see SRZ *Briefing, AIFM Capital Requirements*.

[11] For more information on the specific requirements relating to AIFM remuneration, see SRZ *Briefing, AIFM Remuneration Rules*.

[12] For more information on the specific requirements relating to the use of leverage in AIFs, see SRZ *Briefing, Operational Requirements for AIFMs*.

[13] For more information on the specific requirements relating to valuations, see SRZ *Briefing, Operational Requirements for AIFMs*.

(4) 2018 onwards — if ESMA gives a positive opinion and the Commission abolishes private placement rules, all AIFMs would be required to become registered in the EU to market to EU investors.

Operational Conditions and Disclosure Requirements for non-EU AIFMs Conducting Private Placements

For a non-EU AIFM to be able to market an AIF in those EU countries which permit the private placement of AIF interests, three conditions must be complied with:

(1) Disclosure: The non-EU AIFM must comply with certain of the disclosure and transparency provisions in the AIFM Directive:

(a) Making available to EU investors (on request) and to the regulators of those EU countries in which the AIF is being marketed an annual report for each non-EU AIF which it markets in the EU[14] no later than six months following the end of the AIF's financial year — which must contain (i) a balance sheet or a statement of assets and liabilities, (ii) an income and expenditure account for the financial year, (iii) a report on the activities of the financial year, and (iv) disclosures in relation to the remuneration and management fees paid by the non-EU AIFM to its staff (including disclosure of the total amount of carried interest payments made by the AIF to the non-EU AIFM) and the aggregate amount of remuneration broken down by senior management and members of staff of the non-EU AIFM whose actions have a material impact on the risk profile of the AIF (i.e., portfolio managers and others whose decisions could cause the AIF to suffer loss).[15]

(b) Making a private placement memorandum and/or other fund documentation (such as the due diligence questionnaire and investor newsletter(s) (whose contents are compliant with the prescriptive requirements of the AIFM Directive)) available to investors before they invest, as well as notifying them of any material changes in that information (for example, information on all fees, charges and expenses directly or indirectly borne by investors and the maximum amounts thereof, and details of any preferential treatment provided to an investor).[16]

(c) Reporting to the regulator in the EU country or countries where the AIF is marketed[17] (using the prescribed risk reporting form annexed to the Delegated Regulation covering (i) updated details of the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature (i.e., side pocket arrangements), (ii) any new arrangements for managing the liquidity of the AIF, (iii) the current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk, and (iv) information on the main categories of assets in which the AIF has invested). The frequency of the reporting requirements to each of the relevant EU regulators will depend on the total assets under management ("AUM") managed by the AIFM — where the AUM is less than EUR 500 million the reporting is required to be semi-annual, and where the AUM is EUR 500 million or greater the reporting must be performed quarterly.

(2) Cooperation: Appropriate information exchange agreements (described in the AIFM Directive as "appropriate cooperation arrangements for the purpose of systemic risk oversight"), which are aligned with international standards, must be in place between the regulator(s) of the EU country or countries where the AIFs are marketed, as well as the regulator(s) of the country where the AIF itself is established and the regulator of the country where the non-EU AIFM is established — i.e., for a US AIFM (a registered investment adviser), the SEC.[18]

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[14] This must be provided to investors on request and also be made available to the regulator(s) in the EU country or countries where the non-EU AIF is marketed.

[15] For more information on the specific requirements relating to the annual report, see SRZ *Briefing, Disclosure and Reporting Rules*.

[16] For more information on the specific requirements relating to contents of the private placement memorandum, see SRZ *Briefing, Disclosure and Reporting Rules*.

[17] E.g., if marketing in the UK the disclosures would have to be made to the Financial Services Authority, if marketing in France the disclosures would have to be made to the Autorité des marchés financiers, if marketing in Spain the disclosures would have to be made to the Comisión Nacional del Mercado de Valores etc.

[18] It is anticipated that ESMA will develop a pro forma reporting template listing the relevant minimum information which ESMA considers should be exchanged between regulators pursuant to cooperation agreements.

(3) FATF: Neither the non-EU AIFM nor the non-EU AIF should be established in a country which is listed by the Financial Action Task Force (FATF) on anti-money laundering and terrorist financing as a "Non-Cooperative Country and Territory."

If any of these "minimum" conditions are not satisfied after 22 July 2013, then a non-EU AIFM would not be able to continue to market interests in the AIF to investors in the EU.

It is worth noting that each EU country may impose stricter rules on non-EU AIFMs marketing interests in AIFs to potential investors in that particular country. Consequently, the conditions referenced above may not be exhaustive and there could be additional requirements for marketing in any particular EU country.

It is anticipated that the private placement rules in EU countries (where these exist) should remain until at least the end of 2018, when ESMA is required to report on whether the marketing passport is functional and effective and, consequently, whether private placement rules should be abolished or remain available to non-EU AIFMs who wish to conduct marketing to EU investors. If ESMA were to provide a positive opinion and if the European Commission were to abolish private placement rules in respect of interests in AIFs, this would mean that for a non-EU AIFM to market interests in its AIF in the EU, the non-EU AIFM would have to become registered in the EU.

Reverse Solicitations
The AIFM Directive explicitly states that marketing activities by an AIFM are only covered by the AIFM Directive's rules where the marketing is done "at the initiative of the AIFM or on behalf of the AIFM." "Reverse solicitation" or "passive marketing" (being marketing which is at the initiative of the prospective investor) will continue to be permitted under the AIFM Directive, meaning that EU investors may continue to seek out, on their own initiative, and contact non-EU AIFMs about investing in non-EU AIFs. In such a situation the requirements above would not apply.

Acquisition by an AIF of Major Holdings or Control of EU Private Companies
Notwithstanding whether or not the AIF is marketed into the EU, the AIFM Directive also includes certain disclosure requirements that AIFMs anywhere in the world will be required to comply with if the AIF(s) they manage invest in EU private companies.

In addition to the existing statutory disclosure requirements for any persons holding certain percentages of EU public (i.e., listed) companies,[19] the AIFM Directive's new rules on the acquisition of major holdings or control[20] of private EU companies where an AIF is a shareholder in an EU private company and those interests exceed certain thresholds. The rules apply where:

(1) An AIFM manages a single AIF which is acquiring control of a private EU company;

(2) Multiple AIFs managed by the same AIFM operate under an agreement aimed at acquiring control of a private EU company (i.e., where the AIFs are acting in concert); and

(3) An AIFM cooperates with one or more AIFMs on the basis of an agreement whereby it is intended that the AIFs managed by those AIFMs jointly acquire control of a private EU company.

[19] The rules, which were implemented across the EU in the Transparency Directive of 2004 (Directive 2004/109/EC of the European Parliament and of the Council of 15 Dec. 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC) (http://www.esma.europa.eu/system/files/TD__2004_109_CE_.pdf), generally require that disclosure is made to the issuer of the proportion of voting rights of the issuer held by the shareholder as a result of the acquisition or disposal where that proportion reaches, exceeds or falls below the thresholds of five percent, 10 percent, 15 percent, 20 percent, 25 percent, 30 percent, 50 percent and 75 percent. These thresholds are minimum requirements and the national law in EU countries may be different and impose more onerous obligations — such as in the UK where the FSA's disclosure and transparency rules generally require that a person must notify the issuer of the percentage of its voting rights he holds as shareholder or holds or is deemed to hold through his direct or indirect holding of financial instruments falling if the percentage of those voting rights reaches, exceeds or falls below three percent, four percent, five percent, six percent, seven percent, eight percent, nine percent, 10 percent and each one percent threshold thereafter up to 100 percent (http://fsahandbook.info/FSA/html/handbook/DTR/5/1).

[20] "Control" is defined as the holding of more than 50 percent of the company's voting rights.

The rules do not apply where the relevant private EU companies are:

(1) Small- or medium-sized enterprises;[21] or

(2) Special purpose vehicles with the purpose of purchasing, holding or administrating real estate.

Disclosure of holdings in private EU companies: The AIFM Directive requires that when an AIF (or multiple AIFs acting in concert) acquires, disposes of or holds shares of a private EU company, the AIFM managing the AIF must notify the regulator of the relevant company's EU country of the proportion of voting rights of the private company held by the AIF any time when that proportion reaches, exceeds or falls below the thresholds of 10 percent, 20 percent, 30 percent, 50 percent and 75 percent.

Notifications of major holdings: When an AIF's holdings in a private EU company reaches or exceeds 50 percent or more of the company's voting rights (which the AIFM Directive defines as "control," the AIFM must notify (1) the financial regulator in the country where the company is established (e.g., in the UK the notification would be made to the Financial Conduct Authority,[22] or in Italy to CONSOB,[23] or in Spain to the CNMV[24] etc.), (2) the company's board of directors, and (3) any shareholders whose details are available to the AIFM or can be made available by the private EU company or through a register to which the AIFM has or can obtain access.

The notification must be made within 10 working days of the 50 percent control level being reached or exceeded and must include (1) the date on which the control was acquired, (2) the number of voting rights held, and (3) the conditions under which control was acquired, including the identity of the shareholders involved and persons entitled to exercise voting rights on their behalf and, if applicable, the chain of undertakings through which voting rights are effectively held.

In its notification to the company, the AIFM must also request that the company's board of directors informs the company's employee representatives (or where there are none, the employees themselves) and pass on the disclosed information without undue delay. The AIFM is obliged to use best efforts to ensure that the board passes the information to the employees.

In addition, the AIFM must also disclose (1) the identity of the AIFMs which either individually or in agreement with other AIFMs manage the AIFs that have acquired control, (2) the AIFM's 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 (3) the policy for external and internal communication relating to the company, in particular as regards employees.

The AIFM Directive also includes requirements for certain disclosures in the EU private company's annual report and restrictions on asset-stripping. For more information, see *SRZ Briefing, Requirements for AIFMs When AIFs Invest in EU Private Companies*.

Timing

EU-based AIFMs may (depending on whether their EU jurisdiction of domicile opts to use it) have the advantage of a 12-month transitional period within which they must become authorised and otherwise comply with all the requirements of the AIFM Directive. However, non-EU AIFMs expressly do not get the benefit of any transitional provisions and must comply with the operational conditions and disclosure requirements when conducting private placements and the disclosure and notification rules relating to the acquisition of major holdings or control of EU private companies from 22 July 2013.

[21] As defined in Article 2(1) of the Annex to Commission Recommendation 2003/361/EC of 6 May 2003 (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:124:0036:0041:en:PDF) meaning those 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.

[22] The successor regulator to the Financial Services Authority in the UK since 1 April 2013.

[23] Commissione Nazionale per le Società e la Borsa.

[24] Comisión Nacional del Mercado de Valores.

Next Steps
At this stage:

(1) Non-EU fund managers should assess whether they have been appointed by or on behalf of the AIF and whether they are the AIFM or whether they are the delegate of an AIFM — to know to what extent the AIFM Directive rules will be applicable to them;

(2) If a non-EU fund manager concludes that it is the AIFM of a non-EU AIF, the non-EU AIFM should assess whether EU investors are an important part of its fund-raising activities and whether or not further marketing activities will need to take place in the EU; and

(3) If marketing will need to take place in the EU, then the non-EU AIFM should assess what changes it will need to make to its marketing materials and to its own operations and marketing activities.

For more information on the issues set forth in this *Briefing*, please contact your attorney at Schulte Roth & Zabel or one of the following attorneys: Christopher Hilditch and Steven Whittaker.

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