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Recap and Update: AIFM Directive for US Private Fund Managers

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Summary

After a long period of debate and implementation, the Alternative Investment Fund Managers Directive[1] ("AIFM Directive") is law in all EU jurisdictions. The AIFM Directive sets forth rules for the authorisation, operation and disclosure obligations for managers of alternative investment funds ("AIFs").

The AIFM Directive will apply to any US private fund manager (which would be defined under the AIFM Directive as an alternative investment fund manager or "AIFM") which:

(1) Manages one or more EU AIFs; or

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

The AIFM Directive will not apply to a US AIFM managing a non-EU AIF where that non-EU AIF is not marketed to investors in the EU. A US AIFM can accept an EU investor into a non-EU AIF without being subject to the AIFM Directive when the EU investor requests the marketing materials/subscription documents at its own initiative.

This Recap and Update covers the implications of the AIFM Directive for US AIFMs – whether they are marketing one or more non-EU AIFs to investors in the EU – or if they are relying upon reverse solicitation.[3]

Introduction

The AIFM Directive and its subordinate legislation set forth detailed rules for the operation and regulation of all AIFMs operating within the EU, including: conditions and procedures 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.

Scope of the AIFM Directive and Identifying the AIFM

The AIFM Directive applies to any US-based AIFM that is:

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

[2] 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.

[3] This Recap and Update does not assess the detailed reporting and other compliance obligations of a US AIFM managing an EU AIF. For more information on such arrangements, please contact the author.

(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 as to whether it is open- or closed-ended and irrespective as to its legal structure. Consequently, the AIFM Directive covers almost all funds — including hedge funds and private equity 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 – so 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 is not itself a "letter-box entity" (see below)), they will be a delegated portfolio manager and not the AIF's AIFM.

Delegation by an AIFM: 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 AIFM Directive's subordinate legislation 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;

[4] Undertakings for the Collective Investment of Transferable Securities (UCITS) are EU regulated funds, akin to mutual funds.

[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.

(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; or

(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.

Private Placement Marketing in the EU by US AIFMs

Threshold Conditions

For a US AIFM to be able to market an AIF in those EU countries which permit the private placement of AIF interests[6], three conditions must be complied with:

(1) *Disclosure*: The US AIFM must comply with certain of the disclosure and transparency provisions in the AIFM Directive:

(a) Making a private placement memorandum and/or other fund documentation (such as the due diligence questionnaire and investor newsletter(s) (whose contents must be 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).

(b) 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 no later than six months following the end of the AIF's financial year. This document 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 paid by the US AIFM to its staff (including disclosure of the total amount of carried interest payments paid by the AIF to the US AIFM) and the aggregate amount of remuneration broken down by senior management and members of staff of the US 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).

[6] Private placement rules have not been harmonized across the EU, so the rules differ from country to country. Most significantly, some countries do NOT permit non EU AIFs to be privately placed to investors in their jurisdiction with the most notable countries being France, Italy and Spain.

(c) Reporting to the regulator in the EU country or countries where the AIF is marketed[7] (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") in AIFs managed by the AIFM and the type of AIF(s) being managed:

(i) On a half-yearly basis — for AIFMs managing portfolios of AIFs whose AUM in total:

(A) Are over EUR 100 million but less than EUR 500 million — where the AIF uses leverage; or

(B) Are between EUR 500 million and EUR 1 billion — where the AIF does not use leverage and does not permit redemption rights for a period of five years following the date of initial investment;

(ii) On a quarterly basis — for AIFMs managing portfolios of AIFs whose AUM in total exceed EUR 1 billion;

(iii) On a quarterly basis — for AIFMs managing portfolios of AIFs whose AUM in total including any assets acquired through use of leverage, in total exceed EUR 500 million; and

(iv) On an annual basis — by AIFMs in respect of each unleveraged AIF under their management which, in accordance with its core investment policy, invests in non-listed companies and issuers in order to acquire control.

(2) *Cooperation*: Appropriate information exchange agreements 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. Such arrangements are in place between the US authorities and those of the Cayman Islands, the British Virgin Islands and all jurisdictions of the EU.

(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." The US, Cayman Islands and British Virgin Islands are all cooperative countries.

If any of these "minimum" conditions are not satisfied, then a US AIFM would not be able to continue to market interests in the AIF to investors in the EU.

[7] E.g., if marketing in the UK the disclosures would have to be made to the Financial Conduct Authority.

Notification / Registration with the Local Regulator

Assuming that these conditions are satisfied, then the US AIFM would have to file a notification or register with the relevant regulator(s) in the EU country or countries where the AIF is to be marketed. In the UK the notification process is satisfied by providing factual information regarding the US AIFM and the fund to be marketed in a spreadsheet and giving a representation that the disclosure obligations have been met. This spreadsheet is then emailed to the UK FCA and then within a few business days a confirmation will be emailed back to the US AIFM confirming that marketing may take place in the UK in accordance with UK private placement rules. Other EU countries which permit private placement marketing (including (but not limited to) the Netherlands, Luxembourg, Sweden, Finland, Denmark, and Ireland) have comparable registration processes, though few are as straightforward or as fast as in the UK and US AIFMs that wish to market in multiple EU jurisdictions should factor the costs of using local counsel and the potential delays caused by multiple registrations into their planning.

It is also worth noting that each EU country may impose stricter rules on non-EU AIFMs' marketing interests in AIFs to potential investors – with Germany and Denmark in particular being jurisdictions which have complex additional requirements, including the requirement to appoint a local "depositary" to oversee the AIF's custodians, as well as monitoring the AIF's cashflows, subscriptions and redemptions and other administrative activities conducted by the administrator and other service providers. As a result, the conditions referenced above may not be exhaustive and there could be additional requirements for marketing in any particular EU country.

Timing

It is anticipated that the private placement rules in EU countries (where these exist) should remain until at least the end of 2018, at which time the European Securities and Markets Authority ("ESMA") is required to report on whether the AIFM Directive's marketing passport (currently only available to EU AIFMs managing EU AIFs) is 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 was 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 US AIFM to market interests in its AIF in the EU from 2018 onwards, the US AIFM would have to become registered in the EU.

AIFM Directive Marketing – or Reverse Solicitation

The AIFM Directive explicitly states that marketing activities by an AIFM are only covered by the AIFM Directive's rules where the marketing is conducted "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 EU investor) is permitted under the AIFM Directive, meaning that EU investors may continue to seek out, on their own initiative, and contact US AIFMs about investing in non-EU AIFs. In such a situation the threshold conditions and the notification/registration requirements set forth above would not apply.

Given the exemption from AIFM Directive requirements if the US AIFM is only marketing pursuant to reverse solicitation inquiries from EU investors, it is important to clarify what AIFM Directive marketing actually is and what is meant by the concept of "reverse solicitation".

Marketing

The AIFM Directive defines "marketing" as 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 a registered office in the [European] Union.*" The use of the terminology "offering or placement" is critical, since if a US AIFM is not making an offering or placement it is not "marketing" and hence the requirement to have included all disclosures and make the necessary registration/notification filing would not yet apply. However, because the AIFM Directive gives no specific definition of either "offering" or "placement, it is left to each country to come up with its own interpretation, which has led to differences from country to country in the EU and has led to the notion of "pre-marketing" being distinct from marketing.

"Premarketing" is not a concept that is derived from or defined in the AIFM Directive, but it is clear that if a US AIFM is conducting activities that are not sufficient to be "marketing", as defined above, then that US AIFM will not have any AIFM Directive obligations. Therefore, the critical issue is where the line is between pre-marketing and marketing; unfortunately the position taken by EU regulators in response to this issue varies.

In the UK, the Financial Conduct Authority has been very clear that a draft or pathfinder version of a PPM is unlikely to be viewed as being sufficient to constitute an "offering or placement" and so cannot, by definition, be deemed to be AIFM Directive marketing, as long as the document cannot be used by a potential investor to make an investment in the fund. However, while simply keeping the PPM in draft form is unlikely to be "marketing", some commentators have suggested that if a prospective investor has the draft PPM and final version of subscription documents, they probably have enough information on the investment strategy and management approach to be able to make an investment decision – suggesting that the AIFM has actually made a direct or indirect offering or placement.

However, the UK's FCA is rare in its flexible approach to the concept of marketing and other regulators take a more hard-line approach as regards to the concept of marketing under the AIFM Directive:

- The Swedish FSA takes a view that if the fund has been established, *any* promotional activity (whether by telephone, in meetings, or the use of teasers, one-page summaries or draft documentation) can constitute AIFMD marketing.

- The German regulator, BaFin, has guidance linking the marketing question to whether a fund name, structure and investment strategy has been finalised.

- The Danish FSA has specified that to avoid pre-marketing activities crossing the boundary and being considered 'marketing', no final PPM should be in existence at all in respect of the fund (not merely that a PPM is not provided to Danish investors). Once there is a PPM in existence, any approach by the AIFM to Danish investors would be considered as AIFM Directive marketing.

Reverse Solicitation

The AIFM Directive specifies that EU professional investors have the right to be able to reach out to non-EU AIFMs at their own initiative and to request information on non-EU AIFs. Consequently, marketing activities which are conducted by a non-EU AIFM at the request of the

EU investor will not be subject to AIFM Directive requirements. Unfortunately there is very limited guidance on the concept either in the AIFM Directive or in guidance from EU regulators. As a result, it is important that if a US AIFM wishes to rely on reverse solicitation requests from EU investors instead of filing/registering to conduct marketing, that those requests from EU investors must be true unsolicited contact by a potential EU investor and the US AIFM should not have provided information to the EU investor before the investor reached out to the US AIFM. However, in some circumstances, commentators have suggested that if a US AIFM had been in contact with the EU investor before the AIFM Directive took effect and then ceased to have any contact with the EU investor, if enough time had elapsed since the US AIFM's last communication before the EU investor asked more information, this might be sufficient to "re-set" the relationship and enable the subsequent request to be treated as a reverse solicitation – i.e., after a cooling off period. At the current time there is no formal guidance on this issue, so US AIFMs who were actively marketing in the EU before July 22, 2013 (when the AIFM Directive took effect) or July 22, 2014 (when the implementation transitional period expired) would be best advised to seek local law advice if they wish to rely on reverse solicitation rather than registering and complying with AIFM Directive disclosure requirements etc., as set forth above.

Any US AIFMs that are relying on EU investors approaching them and who intend to stay outside of AIFM Directive requirements because they are not "marketing" would be best advised to ensure that they maintain a very detailed audit trail/clear documented process showing that the EU potential investors reached out to the AIFM first – in case any applicable EU regulator ever challenges the AIFM to ask why they have not registered.

A Note Regarding AIF Platforms

The use of established third-party platforms has become increasingly popular since the AIFM Directive came into effect – principally because an AIF established in the EU with an EU AIFM has the benefit of a pan-European marketing passport. The key benefit of this passport is that country-by-country registrations are not required and once the AIF is established it can be marketed cross-border throughout the EU.

While setting up a sub-fund on a platform and becoming the sub-adviser to the EU AIFM has the benefit of the passport and is also a faster way to access capital in the EU than setting up an independent AIF, there are downsides in that platforms can work out expensive (the AIFM/platform operator usually charges on an AUM basis) and the US manager loses a degree of control over its sub-fund as it is only a sub-adviser to the EU AIFM, which must retain control and oversight over the US sub-advisers management activities. Furthermore, as a sub-adviser to an EU AIFM, the portfolio manager(s) managing the sub-fund may find that their compensation arrangements become subject to the strict requirements on bonus retention and clawback requirements mandated under the AIFM Directive. A US manager that wishes to explore the AIF platform option would be best advised to seek the advice of counsel.

Acquisition by an AIF of Major Holdings or Control of EU Private Companies

The following obligations do not apply to any US AIFM that conducts no marketing in the EU or which relies exclusively on reverse solicitation requests from EU investors. However, if a US AIFM markets its AIFs in any one country of the EU then the following obligations also become relevant if the AIF(s) they manage invest in EU private or public companies.

In addition to the existing statutory disclosure requirements for any persons holding certain percentages of EU public (i.e., listed) companies,[8] the AIFM Directive's rules on the acquisition of major holdings or control 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.

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

(1) Small- or medium-sized enterprises;[9] 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 one of more AIFs acquire, dispose of or hold shares of a private EU company, the AIFM managing the AIF(s) must notify the regulator of the relevant company 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 control holdings: When an AIF's holdings in an EU company are sufficiently high as to be deemed to be "control" (50 percent or more of a private EU company's voting rights or 30 percent or more of an EU public company's voting rights), 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, or in Italy to CONSOB, or in Spain to the CNMV 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

[8] 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 harmonization 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 FCA'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://fshandbook.info/FS/html/FCA/DTR/5/1).

[9] 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.

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.

Asset Stripping: When an AIF, either alone or jointly with other AIFs, acquires control of an EU company the AIFM managing the AIF(s) have an obligation for 24 months following the acquisition of control not to facilitate, support or instruct any distribution, capital reduction, share redemption and/or acquisition of its own shares by the company.

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