

private investment funds lawflash

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AIFMD's Impact on Non-EU Managers of Non-EU Alternative Investment Funds

With AIFMD taking effect, non-EU alternative investment fund managers should be aware of a new regime governing their marketing of such funds into the EU—the AIFMD's private placement overlay.

On 22 July, the deadline passed for EU¹ member states to implement the Alternative Investment Fund Managers Directive (AIFMD) into local law. Member states that met the deadline include the Czech Republic, Cyprus, Denmark, Germany, Ireland, Luxembourg, Malta, the Netherlands, Slovakia, Sweden, and the United Kingdom. Those that missed the deadline must continue to progress towards implementation. AIFMD establishes an EU-wide harmonised framework for monitoring and supervising risks posed by alternative investment fund managers (AIFMs)² and the alternative investment funds (AIFs)³ they manage.⁴ AIFMD requires the authorisation of AIFMs and contains provisions relating to how AIFMs conduct their business, transparency, and marketing. In return, AIFMD confers on an authorised AIFM both a pan-EU managing passport and a pan-EU marketing passport. It also regulates the marketing of AIFs in the EU by non-EU AIFMs.

Background

The path to implementation has been long, with the first version of the draft directive published in April 2009. Following a protracted negotiation phase at the EU level, the final and heavily amended text of the directive entered into force on 21 July 2011.

AIFMD applies to EU AIFMs who

- manage one or more AIFs (irrespective of domicile); and
- market⁵ their AIFs to EU professional investors.⁶

EU AIFMs are subject to the full rigour of AIFMD from 22 July 2013, subject to a transitional regime for AIFMs existing before 22 July 2013. These AIFMs have until 22 July 2014 to apply for authorisation under AIFMD and to continue to market AIFs in the EU under national private placement regimes (NPPRs). Once authorised under

1. In this LawFlash, "EU" refers to the 28 member states of the European Union, plus Iceland, Liechtenstein, and Norway. The formal name for that grouping is the "European Economic Area".

2. "AIFM" means a legal person whose regular business is managing one or more AIFs.

3. "AIF" means a collective investment undertaking, including investment compartments thereof, 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 and which is not a UCITS fund. This definition will cover most hedge funds, private equity funds, private funds investing in other alternative asset classes, fund of funds, and US-registered mutual funds.

4 "Managing AIFs" means performing at least portfolio management or risk-management functions.

5. "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]".

6. A professional investor is an investor who is considered to be a professional client or who may, on request, be treated as a professional client within the meaning of the Markets in Financial Instruments Directive, Annex II Directive 2004/39/EC (MiFID).

AIFMD, EU AIFMs may only market EU AIFs⁷ in the EU using the passport. EU AIFMs may market non-EU AIFs (including EU feeder AIFs with a non-EU master AIF) in the EU under NPPRs until at least 2018 and may be given passports in 2015.

AIFMD applies extraterritorially to non-EU AIFMs who market AIFs to EU professional investors. From Q3/Q4 2015, non-EU AIFMs who manage EU AIFs will be required to be authorised under AIFMD in their chosen member states of reference in 2015, whether or not they market to EU professional investors.

Non-EU AIFMs may be given a passport to market AIFs to EU professional investors in 2015. If so, non-EU AIFMs who wish to use the passport must be authorised under AIFMD in their chosen member states of reference and must comply with the various regulatory requirements that authorisation implies, including those relating to financial resources, disclosure and transparency, limits on leverage, the appointment of a depository, and remuneration. If the passports are provided, it will be the first time an EU single-market directive has granted non-EU-based businesses pan-EU passports.

Non-EU AIFMs managing non-EU AIFs and not marketing them in the EU are not subject to AIFMD.

There are a number of exemptions from AIFMD, including the following:

- AIFMD allows member states to establish a *de minimis* registration and reporting regime for AIFMs managing AIFs with assets under management that are below certain thresholds—so-called “small AIFMs”⁸—and allows them to impose additional requirements. Small AIFMs are not required to be fully authorised under AIFMD, may market AIFs they manage in the EU without compliance with the private placement overlay, and are not eligible for the passport under AIFMD unless they opt in by becoming fully authorised under AIFMD.
- Reverse solicitation or nonsolicited sales are exempt from AIFMD. Recital 70 of AIFMD states that AIFMD “should not affect the current situation, whereby a professional investor established in the [EU] may invest in AIFs on its own initiative”. With reference to the definition of “marketing” under AIFMD, the relevant offer or placement must be at the investor’s initiative rather than the AIFM’s.
- The definition of “marketing” under AIFMD is narrow and precise. Marketing activity outside the scope of the definition, including pre-marketing, is not covered by AIFMD.
- AIFMs who manage solely AIFs whose only investors are the AIFM or any related group company that is not an AIF are exempt under AIFMD.
- Holding companies and securitisation special purpose vehicles (SPVs).

Marketing of Non-EU AIFs in the EU by Non-EU AIFMs

Non-EU AIFMs may continue to market AIFs in the EU under NPPRs from 22 July 2013⁹ to at least 2018, subject to the AIFMD private placement overlay (PPO), which comprises the following:

- Transparency requirements for annual reports, disclosures to investors, and reporting to regulators
- Private equity requirements when AIFMs acquire major holdings in or are in “control” of an unlisted or listed EU company
- Cooperation agreements for systemic risk oversight between the regulators of the states in which marketing is to occur, the third country of the non-EU AIFM, and the third country of the non-EU AIF

7. EU AIFs are AIFs that are either (a) authorised or registered in a member state or (b) have their registered office and/or head office in a member state.

8. Broadly, small AIFMs are AIFMs who manage portfolios of AIFs whose total assets across all the AIFs they manage (a) do not exceed €500 million, where the portfolios of AIFs consist of AIFs that are unleveraged and have no redemption rights exercisable for five years from the date of initial investment in each AIF, or (b) do not exceed €100 million, including any assets acquired through use of leverage.

9. This date is subject to national implementation of the drafted transitional provision in article 61(1) of AIFMD, which may vary and should be checked beforehand. The transitional period expires on 21 July 2014.

- Requirements that neither the third country of the non-EU AIFM nor AIF may be listed as “non-cooperative” by the Financial Action Task Force (FATF)

AIFMD allows member states to impose stricter requirements for private placement in addition to those mandated under AIFMD. NPPRs may be abolished in 2018, leaving only the passport route to marketing AIFs to EU professional investors for both EU and non-EU AIFMs.

Transparency Requirements

ANNUAL REPORT

Non-EU AIFMs must provide an annual report for each AIF they market in the EU. The annual report must be made available to the regulator in each target member state and must be provided to EU investors on request. Audited annual reports must be made available no later than six months from the end of the financial year. The annual report must contain the following, amongst other things:

- A balance sheet or a statement of assets and liabilities
- An income and expenditure account for the financial year
- A report on the AIF’s activities over the financial year, e.g., an overview of investment activities or a summary of the portfolio and performance
- The total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff
- 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
- Where relevant, any carried interest paid by the AIF

DISCLOSURE TO INVESTORS

Mandatory pre-sale disclosures to investors include the following:

- The investment strategy, objectives, restrictions, and risks of the AIF
- Circumstances in which the AIF may employ leverage, including the types and sources of leverage permitted and any associated risks
- The AIF’s valuation procedure and pricing methodology
- Fees, charges, and expenses
- How fair treatment of investors is ensured

Mandatory periodic post-sale disclosures to investors cover the following:

- The percentage of the AIF’s assets subject to special arrangements arising from their illiquid nature
- New arrangements for managing liquidity of the AIF
- The current risk profile of the AIF and risk-management systems employed by the AIFM to manage those risks

Additional disclosures are required in the case of AIFs’ employing leverage.

REPORTING TO REGULATORS

For each AIF they market in the EU, AIFMs must regularly report on the following to regulators:

- The main instruments and markets, principal exposures, and most important concentrations
- The percentage of the AIF's illiquid assets that are subject to special arrangements
- Any new arrangements for managing the liquidity of the AIF
- The current risk profile (including market risk and liquidity profiles) 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
- The main categories of assets in which the AIF is invested, including the corresponding short-market value and long-market value, turnover, and performance during the reporting period

The reporting frequency is dependent on the size of the assets under management and varies between quarterly, half-yearly, and annually.

Private Equity Requirements

INVESTMENTS IN UNLISTED COMPANIES

Competent authorities must be notified of the proportion of voting rights held by an AIF in unlisted companies that have their registered office in the EU when the proportion reaches or crosses the thresholds of 10%, 20%, 30%, 50%, and 75%. When an AIF acquires, individually or jointly, control over an unlisted company, the AIFM managing the AIF must notify the following entities.

- The unlisted company (this notification must request that the board of directors inform the employee representatives)
- The shareholders of the company
- The home member state regulator of the AIFM

ASSET STRIPPING

AIFMD imposes restrictions on distributions (including dividends and interest on shares), capital reductions, share redemptions, or purchases of own shares by "controlled" portfolio companies during the first two years of ownership. An AIFM cannot facilitate, support, or instruct any of the above actions and must use its best efforts to prevent them.

Cooperation Agreements

The European Securities and Markets Authority (ESMA) has already approved 38 agreements on behalf of the 31 EU national regulators, with authorities from Albania, Australia, Bahamas, Bermuda, Brazil, British Virgin Islands, Canada, Cayman Islands, Channel Islands, Dubai, Emirates, Hong Kong, India, Isle of Man, Israel, Japan, Kenya, Labuan, Malaysia, Mauritius, Mexico, Montenegro, Morocco, Pakistan, Republic of Srpska, Singapore, Switzerland, Tanzania, Thailand, and the United States. In the United States, agreement has been reached separately with the Commodity Futures Trading Commission, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission. ESMA is still negotiating with the regulator in China.

Summary of Routes to EU Investors for Non-EU AIFMs

After 21 July 2013, non-EU AIFMs may consider the following options for reaching EU investors:

- Transitional arrangements. Existing fund-raising will continue on the pre-AIFMD basis up to 21 July 2014 depending on member state discretion.
- NPPRs, subject to the PPO and dependent on member state discretion and cooperation arrangements.
- Pre-marketing, which may still be subject to NPPRs even if outside AIFMD.

- Reverse solicitation.
- The pan-EU marketing passport. Prompt access to the passport will require the establishment of an EU AIFM managing EU AIFs and full compliance with AIFMD.

Other Impacts of AIFMD on US Investment Advisers (and Other Non-EU AIFMs)

US Sub-Advisers (Discretionary) to EU AIFMs

An EU AIFM who wishes to delegate to a US sub-adviser must satisfy the following conditions:

- The AIFM must justify the delegation objectively.
- The delegation must take the form of a written agreement.
- The delegation of portfolio management or risk management may only be conferred on authorised or registered advisers and, where that is not so, the AIFM's regulator must consent.
- Where portfolio management or risk management is delegated, there must be a cooperation arrangement between the regulator of the EU AIFM and the regulator of the delegate.
- The AIFM must demonstrate that the delegate has sufficient resources, that relevant staff are of sufficiently good repute and experience, and that the delegate is qualified and able to undertake functions.
- The AIFM must ensure that the delegate undertakes the delegated functions effectively and in compliance with its obligations as an AIFM under AIFMD.
- The AIFM must comply with detailed obligations to monitor, instruct, and supervise the delegate.

There is concern that the rules on delegation will require non-EU AIFMs to comply with the remuneration provisions of AIFMD.

The above regime will take effect when an EU AIFM becomes authorised under AIFMD. Up to 21 July 2014, the effective dates may vary depending on national implementation of the transitional arrangements. In the UK, the regime will not take effect until 22 July 2014 unless a UK AIFM becomes authorised under AIFMD before then. Other member states may follow the UK or instead require compliance with the regime on a "best efforts" basis throughout the transitional period.

US Advisers Delegating to EU Sub-Advisers (Discretionary)

US managers of AIFs investing in Europe through an EU sub-adviser must consider the issue carefully, with particular reference to costs, and should note the following:

- Whether the EU sub-adviser will be classified as the AIFM of the non-EU AIF. If so, the sub-adviser will be subject to AIFMD structural and operational constraints.
- EU AIFMs of non-EU AIFs marketed in the EU must ensure the AIF has appointed a depositary and must comply with certain other requirements.
- In contrast, a non-EU AIFM need only comply with the PPO.

UK Implementation of AIFMD

The UK government transposed AIFMD into national law before the July 22 deadline. The majority of AIFMD provisions, particularly those applicable to AIFMs, were implemented via rules of the Financial Conduct Authority (FCA), which succeeded the Financial Services Authority on 1 April 2013. UK government regulations were used to amend primary and secondary legislation and supplement FCA's powers as the UK regulator of AIFMs.

Exercising its discretion in favour of a lighter touch, the UK government chose

- not to impose any additional requirements for non-EU AIFMs of non-EU AIFs above the AIFMD minimum;

- to allow EU and non-EU small AIFMs to market AIFs in the UK, subject merely to registration of the AIF with FCA and disclosure obligations (as discussed below) to FCA; and
- not to apply the private equity requirements to small AIFMs “in order to support a competitive market for private equity AIFMs”.

UK Regime Governing Marketing of AIFs in the UK by Non-EU AIFMs

A non-EU AIFM must give written notification to FCA before marketing an AIF managed by it. The notification must include a statement confirming that the following conditions have been met:

- The AIFM is the legal person responsible for complying with the implementing provisions relating to the marketing of the AIF.
- The AIFM complies with the transparency requirements under AIFMD in relation to the AIF to be marketed.
- If applicable, the AIFM complies with the private equity requirements under AIFMD in relation to the AIF to be marketed.
- Written cooperation arrangements for systemic risk oversight are in place between FCA and the supervisory authorities where the non-EU AIFM is established and, if applicable, the third country where the AIF is established.
- The country where the non-EU AIFM and, if applicable, the country where the AIF is established are not listed as non-cooperative by FATF.

A non-EU small AIFM must give written notification to FCA before marketing an AIF managed by it. The notification must include a statement confirming that the following conditions have been met:

- The AIFM is the legal person responsible for complying with the implementing provisions relating to the marketing of the AIF.
- The AIFM is a small third-country AIFM.

In order to enable the FCA to monitor systemic risks effectively, the non-EU small AIFM must provide FCA with such information as the FCA directs on the main instruments in which it trades and the principal exposures and most important concentrations of the AIFs that it manages.

On 29 April 2013, the UK government announced a significant change in its approach to the implementation of the transitional arrangements under AIFMD, applying them not only to UK AIFMs existing before 22 July 2013 but also to existing non-UK EU AIFMs and existing non-EU AIFMs. A non-EU AIFM who marketed an AIF in any member state before 22 July 2013 will be able to rely on the transitional arrangements to continue marketing that AIF after that date in the UK for up to 12 months, expiring on 21 July 2014, without any requirement for compliance with the PPO or the notification process described above. Also, such a transitional AIFM will be able to market in the UK any AIF that is launched after that date until 21 July 2014.

Contacts

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the following Morgan Lewis lawyer:

London

William Yonge

+44 (0)20 3201 5646

wyonge@morganlewis.com

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