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AIFMD

Application of the AIFMD to Non-EU Alternative Investment Fund Managers (Part One of Two)

By John Adams, Nathan Greene, Christian Gloger and Christine Ballantyne-Drewe, *Shearman & Sterling LLP*

The European Union's (EU) Alternative Investment Fund Managers Directive (Directive or AIFMD) comes into force July 2013 and is likely to impact every private fund manager worldwide who either markets a fund into the EU or manages certain EU funds after that date. The preparation required can be significant, and this two-part series is designed to help non-EU private fund managers understand the steps they must take to prepare for effectiveness of the AIFMD. Part one provides an overview of what is widely referred to as the Directive's "Stage I." During Stage I, non-EU managers will not be fully authorized under the Directive, but nonetheless can be subject to many parts of the Directive as a result of their activities touching the EU. Part two (to be published in an upcoming issue of The Hedge Fund Law Report) looks ahead to "Stages II and III," which come into effect in 2015 or later. Those later stages contemplate a transition to full authorization under the Directive by all fund managers that are subject to the Directive's jurisdiction.

Executive Summary

Starting July 22, 2013,[1] non-EU fund managers who market their funds to professional investors in the EU will be subject to many parts of the Directive. For a non-EU firm getting ready to address the Directive, steps that will have to be undertaken include:

- Organizational Mapping. Develop an inventory of the funds in one's organization that might be "Alternative Investment Funds" (or AIFs) for purposes of the Directive – these generally will be any pooled investment vehicle that is not regulated under the EU's UCITS Directive. The inventory then should identify which entity is the "Alternative Investment Fund Manager" (or AIFM) for each AIF. When necessary (and if possible and cost-effective to do so), this process may lead a firm to consider restructuring its advisory arrangements so that the most suitable entity is treated as the AIFM.
- Sales Mapping. Consider which EU Member States are the highest priority sales targets for the organization and its internal or external marketers and then closely track the Directive's implementation in each of those jurisdictions – this is important because the Member States have a reasonable amount of discretion in how they will address different parts of the Directive.
- Disclosure Reviews. Conduct a "health check" of the AIF offering documents to be used in the EU on and after July 22, 2013 – the documents will be checked against a list of specified disclosures that will be required by the Directive going forward.
- Reporting. Assess preparedness for required investor and governmental ongoing reporting.

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- Large-Holder Rules. Understand, if one's AIFs take large positions in public or private EU companies, the Directive's new large-holder reporting and "anti-stripping" requirements.
- Cooperation Agreements. Track progress towards the implementation of required "cooperation agreements" between regulators in non-EU countries where either an AIFM or the AIF is established and regulators in the EU Member States where the AIF is established or where marketing takes place.
- Blocked Jurisdictions. Confirm that no AIF or AIFM in one's organization is established in a jurisdiction listed as a "Non-Cooperative Country and Territory" by the Financial Action Task Force (due to money laundering, terrorist financing or related concerns). These are blocked jurisdictions for purposes of the Directive.

That these requirements are now just around the corner is still not widely understood. To the contrary, with its convoluted history and long phase-in periods, the Directive always has been seen as "next year's problem." Thus, a first task for a firm addressing the Directive may be simply to assure that the organization is sensitized to the reality that there is less and less lead time remaining.

Organizational Mapping – Identifying AIFs

The Directive views investment funds, globally, as falling into one of two categories. The fund is either a UCITS fund (an undertaking for collective investment in transferable securities) governed by the UCITS Directive or it is an AIF. A UCITS fund is a particular type of EU-domiciled regulated fund that is often retail in nature. By definition, all other types of funds (unless they benefit from an exemption in the Directive) will be AIFs and therefore captured by the Directive.

Organizational Mapping – Identifying AIFMs

In general, an AIFM is an entity that performs either portfolio management or risk management functions for an AIF. Identifying which entity is the AIFM under the Directive's definition is a crucial first step to take, as the Directive's compliance obligations generally fall on the applicable AIFM instead of the fund.

The identification process is complicated by the following factors.

- An AIF can only have one AIFM under the Directive.[2]
- An AIF can be either internally managed or externally managed. An internally managed AIF is one whose management functions are performed by the governing body or any other internal source of the AIF. All other AIFs are externally managed. An internally managed AIF itself is the AIFM for the fund (with the further result that the AIFM's compliance requirements will be limited to that AIF).
- An entity that performs portfolio management or risk management is not an AIFM if the performance of either function is done under a delegation arrangement with an AIFM. Thus, the delegating party remains the AIFM.[3]

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Application of the Directive to Non-EU AIFMs

This article focuses on the application of the Directive to non-EU AIFMs, which are defined as AIFMs that do not have a registered office in any EU Member State. As already suggested, a non-EU AIFM falls within the scope of the Directive if it markets any AIFs in the EU and/or manages EU AIFs.[4]

- Marketing. 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 professional investors domiciled or with a registered office in the EU. For a further discussion of marketing under the AIFMD by non-EU managers, see "Former OCIE Chief Lori Richards and other PwC Partners and Managers Discuss the Mechanics of the AIFMD and Its Impact on Marketing by U.S. Hedge Fund Managers," The Hedge Fund Law Report, Vol. 6, No. 10 (Mar. 7, 2013). Consequently, the Directive itself does not restrict a professional investor from seeking out, on its own initiative, funds and managers located anywhere – in what is referred to as a so-called "reverse solicitation." There is, however, considerable uncertainty as to the views of the individual Member States on where to draw the line between marketing and reverse solicitation.
- Managing EU AIFs. An EU AIF means an AIF authorized or registered in an EU Member State or that has its registered office and/or head office in a Member State.

Three-Stage Timeline

The Directive contemplates a three-stage timeline as shown in the diagram below.

		Stage I	**Stage II**	**Stage III**
	Current state of play	July 22, 2013 to 2015	2015 to 2018	2018 and onwards
Marketing in the EU Requires Compliance with	National Laws	National Laws with Directive Minimum Require-ments	Choice: National Laws with Directive Minimum Require-ments or Full Directive (marketing passport available)	Full Directive (marketing passport available and national private placement regime may potentially be abolished)
Management of an EU AIF Requires Compliance with	National Laws	National Laws	Full Directive (marketing passport available)	

Timeline Stage I (July 22, 2013 – 2015)

The first stage of the Directive regime concerning non-EU AIFMs will begin July 22, 2013 and end in 2015 at the earliest. During this period, non-EU AIFMs may continue to manage EU AIFs in compliance with national laws of the EU Member States, but must attend to new marketing requirements. In particular, during this period, non-EU fund managers can market an AIF in the EU only in compliance with the national private placement regime (NPPR) of each individual Member State in which it wishes to market.

Under the NPPR, applicable national laws must be complied with as well as certain minimum requirements of the

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Directive that we detail below. It should be noted that an individual Member State can impose whatever additional rules on marketing it wishes. This could even extend to a complete prohibition of marketing by a non-EU manager – a particularly problematic outcome if it should come to pass because, at present and absent the NPPR, there is literally no other means for a non-EU AIFM to actively offer AIFs in the EU.

Directive's Stage-1 Minimum Requirements (1) – Transparency

If subject to the Directive, a non-EU AIFM must meet mandated transparency requirements. These include:

- Annual report requirements.
- Specified disclosures to investors.
- Periodic filings with regulators of each EU Member State where marketing takes place.

For a non-EU AIF, the investor-facing disclosure requirements of the Directive address only disclosures owed to EU investors. That said, many firms will find it unattractive (either commercially or legally) to maintain two separate sets of disclosures – one targeted at an EU audience under the Directive and the other targeted at non-EU investors. Thus, many firms can be expected to make the Directive's required disclosures across their business and without regard to the geographic location of their investors.

Annual Reports to EU Member State Regulators and Investors

To be eligible for the NPPR, a non-EU fund manager must prepare an annual report, in respect of each EU AIF that it manages as well as each non-EU AIF that is marketed in the EU. The report must be provided to the competent authorities of the non-EU fund manager's member state of reference and, if applicable, the home Member State of the AIF. Upon request, the annual report also must be provided to an AIF's investors.

The following are principal items that must be included in these annual reports:[5]

- Balance and income sheets. A balance sheet and an income and expenditure account for the financial year. The layout, nomenclature and terminology of line items should be consistent with the accounting standards applicable to or the rules adopted by the AIF and with the applicable legislation (either in the third country where the AIF is established or in the EU home Member State of the AIF).
- Narrative overview of results. A report on the activities of the financial year, including at least a fair and balanced overview of past investment activities, the AIF's portfolio at the period end, the AIF's performance and any material changes.
- Material changes. Material changes in information previously disclosed to investors. A change is material for this purpose if there is a substantial likelihood that it would cause a reasonable investor to reconsider its investment.
- Remuneration to the firm. Overall remuneration paid to the non-EU AIFM's staff, broken down into fixed and variable remuneration as well as the number of beneficiaries and, where relevant, the carried interest paid by the AIF.
- Remuneration to personnel. The aggregate amount of remuneration broken down by senior management and members of staff whose actions have a material impact

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on the risk profile of the AIF. To be clear, the Directive does not require disclosure in the annual report as to specific amounts paid to individuals identified by name. There is concern, however, that a reader may be able to "reverse engineer" some of this information to the level of named individuals.

Disclosures to Investors

For each AIF managed by a non-EU AIFM (other than non-EU AIFs that are not marketed in the EU), the non-EU AIFM must provide investors with a wealth of information prior to investment. Much of this information already will be included in a typical offering memorandum in use in the industry today. But the Directive's requirements can be viewed as setting a mandated "floor" on the contents of an offering memorandum, at least as used with EU investors. The Directive also is sufficiently prescriptive that its requirements as to descriptions of certain categories of information (such as those relating to side letters) will go beyond current market practice.

Pre-Investment Disclosure

The information below must be disclosed to investors prior to their investment:

- A description of the investment strategy and objectives of the AIF, the types of assets in which the AIF may invest, the techniques it may employ and all associated risks and investment restrictions.
- A description of the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks and any restrictions on the use of leverage.
- A description of the procedures by which the AIF may change its investment strategy or policy.
- Information on where any master AIF is established and, in the case of a fund of funds, where the underlying funds are established.
- The identity of the AIFM, the AIF's depositary (or custodian), auditor and any other service providers.
- A description of the main legal implications of the contractual relationship entered into for the purpose of investment.
- A description of any material arrangements of the AIF with its prime brokers.
- A description of the AIF's liquidity risk management, including redemption rights in both normal and exceptional circumstances.
- A description of all fees, charges and expenses and the maximum amount of those that will, directly or indirectly, be borne by investors.
- A description of how the AIFM provides for fair treatment of investors. The description must include not only any ability to give side letters, but also the specific details of the actual preferential treatment and the type (but not the identity) of investors receiving such treatment.
- The latest net asset value of the AIF or the latest market price of the units or shares of the AIF.
- The historical performance of the AIF, where available.[6]

All information contained in a prospectus of an AIF will be deemed to have been disclosed. The Directive permits information to be included in both a prospectus and in a separate disclosure document if that is the firm's preference, though, again, there may be practical reasons why a firm will prefer a single package of information.

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Ongoing Disclosure

- *Liquidity and Risk Management*: As part of the periodic reporting to investors for an AIF, a non-EU AIFM will need to disclose the percentage of the AIF's assets subject to special arrangements (for example, side pockets, gates or other similar arrangements) arising from their illiquid nature and the risk profile (such as the most relevant risks to which the fund is or could be exposed) of the AIF. The disclosure must be made at least as frequently as required by the AIF's constitutional documents or at the same time as the prospectus and offering document. In any event, the disclosure must be made at least at the same time as the annual report is made available. A non-EU AIFM also must notify an AIF's investors whenever it makes changes to its "liquidity management systems and procedures" and, accordingly, must immediately notify investors when it activates gates, side pockets or similar special arrangements or when it decides to suspend redemptions.
- *Material Changes*: Material changes to any information previously provided must be disclosed to investors. The Directive does not specify any frequency in general, but any changes to a depositary's (custodian's) liability must be disclosed to investors immediately.
- *Leverage Disclosure*: A non-EU AIFM must regularly disclose to investors details of leverage actually used by any EU AIF it manages or any AIF it manages which is marketed in the EU. The disclosure must be made at least as frequently as required by the AIF's constitutional documents or at the same time as the prospectus and offering document. In any event, the disclosure must be made at least at the same time as the annual report is made available.

Reporting to Regulators

Separate from the required disclosures to investors, the Directive envisages a non-EU AIFM providing the regulator in each EU Member State in which the AIF is marketed with a significant amount of information as summarized below. As part of the "Level 2 measures" released in December 2012, the European Commission produced a uniform form for this reporting.[7]

Information provided to one EU Member State may be accessible by other Member States under an information exchange mechanism, and it is specifically considered that information about leverage (described below) in fact will be made widely available from one regulator to the next. All exchanged information must be treated confidentially, but certain exceptions exist. A Member State may disclose the information where the disclosure is "necessary for legal proceedings" or when disclosure is permitted by the EU Member State regulator which passes on the information.

Information to Be Reported for All AIFs

A non-EU AIFM must provide EU Member State regulators with information on (i) the principal markets and instruments in which it trades and (ii) the principal exposures and concentrations of each EU AIF that it manages and each managed non-EU AIF that is marketed in the EU. On request, a manager also must provide a quarterly list of all AIFs that it manages.

Information to Be Reported for All EU AIFs and All Non-EU AIFs Marketed in the EU

A non-EU AIFM must provide EU Member State regulators with the following information for each AIF marketed in any EU Member State:

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- The percentage of assets that are treated in a special way (for example, subject to side pockets or gates) due to their illiquid nature.
- Any new liquidity arrangements in place for managing the AIF (for example where gates, side pockets or similar special arrangements are activated or where redemptions are suspended).
- The risk profile (such as the most relevant risks to which the fund is or could be exposed) of the AIF and tools employed by the manager to manage risk.
- The main categories of assets.
- The results of stress tests, if any.

Information to Be Reported for AIFs which Use Leverage "on a Substantial Basis"

An AIF uses leverage "on a substantial basis" when its exposure, as calculated according to the commitment method, exceeds three times its net asset value. The test incorporates both actual leverage represented by bank or margin borrowing and implicit leverage in derivative or trading techniques. AIFMs managing AIFs which employ leverage on a substantial basis are required to make the following information available to the regulators in each EU Member State where the AIFs are marketed:

- The overall level of leverage employed by each AIF it manages.
- A breakdown between leverage generated through borrowing and the use of derivatives respectively.
- Details of re-use (rehypothecation) of assets under leveraging arrangements.
- The identity of the five largest sources from which cash or securities are borrowed together with the amounts borrowed.

The EU Member States explicitly are given the right to ask for additional information about leverage. The potential need to disclose the identities of lenders to EU Member State regulators will be of particular concern to investment banks as well as similar lenders who may not be used to providing to regulators their lending arrangements in such detail.

Directive's Stage-1 Minimum Requirements (2) – Cooperation Arrangements

For the stated purpose of systemic risk oversight, the Directive contemplates a network of intergovernmental cooperation agreements. In particular:

- When the AIF being marketed is an EU AIF, there must be cooperation arrangements between the competent authority of the EU Member State where the AIF is being marketed and the authorities of (i) the EU Member State where the AIF is established and (ii) the third country where the non-EU AIFM is established.
- Where the AIF being marketed is a non-EU AIF, there must be cooperation arrangements between the competent authority of the EU Member State where the AIF is being marketed and the authorities of (i) the third country where the AIF is established and (ii) the third country where the non-EU AIFM is established.

The European Securities and Markets Authority is charged with coordinating cooperation agreement negotiations between EU Member States and third countries. While that process remains opaque, regulators in most key funds industry jurisdictions have indicated that they are diligently working towards the agreed framework. As of the date of this publication, only Switzerland and Brazil have entered into cooperation arrangements with the EU.

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Directive's Stage-1 Minimum Requirements (3) – Fund/Manager Not Domiciled in Non-Cooperative Country and Territory

The NPPR will not be available to a non-EU AIFM when either the fund manager or the AIF is established in a country that is listed as a Non-Cooperative Country and Territory by the Financial Action Task Force. Being in a non-cooperative jurisdiction is thus a potential hard stumbling block. This is not, however, expected to be a problem for the large majority of non-EU fund managers.

Directive's Stage-1 Minimum Requirements (4) – Specific Obligations for AIFs Acquiring Stakes in Non-Listed EU Companies

The Directive provides that a non-EU AIFM must report an AIF's holdings in non-listed EU companies (other than small or medium sized companies or real estate SPVs) under certain circumstances.

When an AIF's holdings in a non-listed EU-domiciled company crosses specified thresholds (10%, 20%, 30%, 50% and 75%), the AIFM must report the change in holdings to the competent authorities of each EU Member State in which the AIF is marketed. These 10%, 20%, 30%, 50% and 75% thresholds are measured on an AIF-by-AIF basis – the AIFM does not have to aggregate positions held through various AIFs.

When the AIF acquires control of a non-listed EU-domiciled company (i.e., the AIF acquires more than 50% of the voting rights of the company), the AIFM must notify the company in question, its shareholders and the competent authorities in each Member State in which the AIF is marketed. The notification should include the following information:

- The resulting situation in terms of voting rights.
- The conditions subject to which control was acquired including, if applicable, the chain of undertakings to effectively hold voting rights.
- The date on which control was acquired.

An AIFM managing an AIF acquiring control of a non-listed company must also ensure that the AIF discloses its intentions with regard to the future business of the non-listed company and the likely impact on employment at the company in question and to the shareholders of the company. The AIFM managing the AIF also must use its best efforts to ensure that the board of the company makes this information available to the employees' representatives (if applicable) or the employees themselves.

Furthermore, the AIFM managing such an AIF must provide the regulatory authorities and the AIF's investors with information on the financing of the acquisition.

Finally, when an AIF acquires control of a non-listed EU company, there are certain additional disclosures that must be made in either the AIF's annual report or the annual report of the non-listed company. These include an indication of the company's likely future development as well as any important events that have occurred since the end of the financial year.

Directive's Stage-1 Minimum Requirements (5) – Specific Disclosures for AIFs Acquiring Control of Non-Listed EU Companies or EU Issuers

When an AIF acquires control of either (i) a non-listed EU company, or (ii) an EU issuer (which is an EU company admitted to trading on a regulated market), the AIFM must

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disclose to the company in question, the shareholders of the company and the competent authorities of each EU Member State in which the AIF is marketed:

- The identity of the AIFMs which either individually or jointly with other AIFMs manage the AIFs that have acquired control.
- The policy for preventing and managing conflicts of interest.
- The policy regarding how employees will be communicated with by the company or issuer.

Directive's Stage-1 Minimum Requirements (6) – Asset Stripping

For a period of two years after an AIF acquires control (either individually or jointly) of a non-listed EU company or an EU issuer, the non-EU AIFM managing such AIF must not facilitate or support (and in addition must use its best efforts to prevent) certain distributions, capital reductions, share redemptions and buy-backs that the Directive collectively characterizes as "asset stripping."

Looking Ahead

As should be clear, there is significant work to do for a non-EU fund manager preparing for the Directive's July 22, 2013 compliance deadline. After July, there will be meaningful ongoing requirements that will require formalization and additions to the firm's information gathering, reporting and disclosure processes. Looking still further ahead, new requirements will come into force as soon as 2015 when the ability for non-EU fund managers to remain outside the Directive's authorization regime is expected to begin to fall away. Those "Stage II and III" requirements of the Directive will be the subject of part two of this article.

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[1] At the time of writing, there are indications that legislators in the United Kingdom (and possibly elsewhere) will allow non-EU managers to benefit from a transitional period lasting until July 22, 2014. If that approach is taken by legislators in any EU country, it would allow those managers to continue to market their funds into that EU country on the existing (pre-AIFMD) rules. Such an outcome is by no means guaranteed, however.

[2] The European Commission recently indicated that this provision in the Directive technically only applies to authorized managers (i.e., initially only EU managers). So theoretically, a fund managed by a non-EU manager could have more than one AIFM.

[3] There are complicated rules on what can and cannot be delegated that are beyond the scope of this article.

[4] There are limited exceptions. Certain family office vehicles may not be AIFs and, therefore, their managers may not be AIFMs. Likewise, certain "in-house" vehicles (e.g., an insurance company pool managed for the benefit of the company and its affiliates) may be AIFs, but their AIFMs will be exempted from the Directive.

[5] All the accounting information listed below must be audited.

[6] Please note that neither the Directive nor the Level 2 measures provides for how current the historical performance needs to be.

[7] The reporting template can be found at the end of the Level 2 measures at: http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf.

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By John Adams, Nathan Greene, Christian Gloger and Christine Ballantyne-Drewe, *Shearman & Sterling LLP*

As most fund managers who either market a fund into the European Union (EU) or manage certain EU funds now know, from July 22, 2013, the EU's Alternative Investment Fund Managers Directive (Directive or AIFMD) will impact many non-EU managers in potentially significant ways. The preparation required can be significant. As a result, we are offering this two-part series designed to help non-EU private fund managers understand the steps they must take to prepare for effectiveness of the AIFMD. In the first installment, we focused on the impact of the Directive during the period from July 2013 through 2015 – the period our article refers to as "Stage I," during which non-EU managers will not be fully authorized under the Directive, but nonetheless can be subject to many parts of the Directive, depending on the scope of their activities touching the EU. See "Application of the AIFMD to Non-EU Alternative Investment Fund Managers (Part One of Two)," The Hedge Fund Law Report, Vol. 6, No. 21 (May 23, 2013). In this second installment, we turn our attention to what our article refers to as the Directive's "Stages II and III," which are due to come into effect in 2015 or later, which contemplate a transition to full authorization under the Directive by all fund managers that are subject to the Directive's jurisdiction.

Timeline Stage II (2015 – 2018)

As a reminder, during "Stage I" (from July 22, 2013 through 2015), non-EU fund managers – referred to in the Directive as alternative investment fund managers or AIFMs – will not be (and presently cannot be) fully authorized under the Directive, but nevertheless may be subject to many of its requirements as a result of certain EU aspects of their activities. From as early as October 2015, non-EU fund managers marketing their funds – referred to in the Directive as alternative investment funds or AIFs – in the EU may have the option to become fully authorized under the Directive. While authorization comes with significant additional regulatory burdens, only an authorized AIFM can take advantage of the Directive's one "carrot" – a full marketing passport. The passport would allow the AIFM to market to professional investors throughout the EU via what should be a straightforward notice to the regulator in the AIFM's EU "Member State of reference" (a term we discuss in more detail below).

At present, there is no mechanism for a non-EU fund manager to seek authorization. That option is instead available only to EU fund managers. Whether the authorization option is extended to non-EU managers as part of the Stage II implementation depends on the outcome of reviews of Stage I by the European Securities and Markets Authority (ESMA) and the European Commission, which are expected in the second half of 2015.

For a non-EU fund manager managing EU AIFs, the question of authorization is especially significant. The Directive sets the groundwork for ESMA and the European

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Commission to conclude that authorization will be required for any firm managing an EU AIF. That requirement would take effect sometime in late 2015 or early 2016 and would be the case whether the EU AIF is marketed in the EU or not.

For a non-EU fund manager managing non-EU AIFs (and continuing to market those funds into the EU), it still may be an option under Stage II to forego authorization and the passport. The firm instead would continue to rely on the varying National Private Placement Regimes (NPPRs) for fund offerings in its target markets, as discussed in Part One of our Article. Whether the NPPR option will be viable depends, of course, on how flexible or inflexible those regimes become over time.

It also bears noting that some of the Directive's terms that apply to an authorized EU AIFM can impact on a non-EU firm that acts as a sub-advisor to the EU AIFM – regardless of the EU regulatory status of the sub-advisor. Significant examples of this "derivative jurisdiction" are in respect of the remuneration and delegation rules that we discuss later in this article.

Timeline Stage III (2018 and Beyond)

No earlier than 2018, ESMA will provide a recommendation as to the desirability of terminating the NPPR entirely. If the European Commission adopts rules to terminate the NPPR, thereafter a non-EU AIFM wishing to market to EU investors will have no option but to become fully authorized under the Directive.

Exceptions and Exemptions

The Directive carves certain businesses – e.g., certain family offices – out of the Directive's scope entirely. Those full blown exemptions are beyond the scope of this article, but we discuss two limited exceptions below – one for smaller fund managers and another intended to balance (albeit to only a very limited degree) the impact of the Directive on firms subject to non-EU laws.

Lighter Regime for Smaller Fund Managers

For smaller managers, the Directive provides for a "registration" regime as a less onerous alternative to full "authorization." Registration will be available for a non-EU AIFM only if, and when, "Stage II" is implemented, though it is possible that individual Member States may seek to implement the registration regime on an expedited basis.[1] The lighter regime would apply to a manager that:

- Manages AIFs with aggregate assets under management of less than EUR 100 million; or
- Manages AIFs with aggregate assets under management of less than EUR 500 million, but only if those AIFs are unleveraged[2] (this does not include leverage at the portfolio company level) and investors are not permitted to redeem their investments for five years.[3]

Either threshold applies to a fund manager on an aggregate basis taking into account all the funds under management, regardless of whether the funds are marketed to or have EU investors. A manager taking advantage of this lighter regime will need to monitor its assets under management and apply for full authorization if and when the relevant threshold is breached (except where the breach is temporary – which for this purpose means that it is not remedied within three months).[4]

Opting for the lighter registration regime has an upside and a downside. The upside is meaningfully reduced regulation

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under the Directive. The downside is that the marketing passport that allows a firm to market AIFs throughout the EU is not available for registered AIFM. Registered AIFMs thus would be able to market in EU Member States only in accordance with the NPPR.

Limited Potential Exceptions from Full Scope of Directive for Non-EU Firms

While not relief from full authorization, the Directive contemplates a mechanism for rationalizing its requirements with non-EU laws. Particular exceptions may be made to the extent that compliance with a provision of the Directive is incompatible with compliance with a law to which a non-EU AIFM and/or a non-EU AIF is subject (the "Third Country Law"). The conditions for an exception are as follows:[5]

- It must be "impossible" to combine compliance with the Directive with compliance with a mandatory provision in the Third Country Law;
- The Third Country Law must provide for an equivalent rule having the same regulatory purpose and offering the same level of protection to the investors of the relevant AIF; and
- The non-EU AIFM and/or the non-EU AIF must in fact comply with the equivalent non-EU rule.

Authorization

Part One of our article discussed certain transparency requirements and obligations regarding AIFs acquiring control of EU companies. Those terms apply equally to fund managers relying on the NPPR and to authorized AIFMs. We discuss the major additional conditions for authorization below.

Designation of a Member State of Reference

Under the Stage II "passport" regime (2015 onwards, if introduced), prior to managing an EU AIF and/or marketing any AIF in the EU, a non-EU AIFM must obtain authorization from the regulator in its "Member State of reference," who will be the non-EU AIFM's designated primary regulator in the EU.[6]

Which EU country is a non-EU AIFM's Member State of reference will depend on factors such as the location of its EU AIFs and the EU countries in which the AIFM wishes to conduct marketing activities.[7] Non-EU AIFMs may be able to influence their choice of a Member State of reference through the timing of offerings in particular EU Member States or the submission of an application to an EU Member State regulator.

An authorized non-EU AIFM must have a legal representative in its Member State of reference, who effectively will act as a service of process agent within the EU. The legal representative also will be a point of contact of the non-EU AIFM in the EU, including for investors. Any official correspondence between EU regulators and the non-EU AIFM will go through the legal representative.

Initial Capital, "Own Funds" and Coverage of Professional Liability

<u>Initial Capital and Own Funds</u>

The initial capital requirement for an AIFM starts at EUR 125,000 and steps up with assets under management.[8] For assets under management above EUR 250 million, the AIFMD must have additional own funds equal to 0.02% of the excess amount, subject to a cap of EUR 10 million of

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initial capital.[9] If an AIFM has in place a guarantee provided by a bank or insurance company, an EU Member State may allow the AIFM to only meet as low as 50% of the additional own funds requirement.

Adequate Funds to Cover Potential Professional Liability

Further supplementing the above initial capital and own funds requirement, to cover the potential professional liability risks arising from professional negligence, an authorized non-EU AIFM must have either appropriate additional own funds or adequate professional indemnity insurance.[10] The potential liability risks to be covered are risks of loss or damage caused by the negligent performance of activities for which the AIFM has legal responsibility.[11]

General Principles of Honesty, Integrity and Treating Investors Fairly

Under the Directive, an authorized AIFM is required to:

- Act in the best interests of the AIF or the investors of the AIF it manages and the integrity of the market; and
- Treat all investors in its AIF fairly.

Remuneration and Compensation Rules

One of the most controversial aspects of the Directive relates to remuneration. Managers authorized under the Directive will be legally required to (i) implement remuneration policies that do not promote "undue risk taking" and (ii) reward employees in a certain way (for example, by deferring payment of bonuses as explained below). For non-EU firms, these remuneration provisions take on heightened significance in that guidelines have been published that, if ultimately adopted across the EU, would mean that those provisions would be imposed on a non-EU fund manager that acts as a sub-advisor to an authorized EU AIFM (i.e., even without the non-EU firm itself being authorized). In certain situations (based on size, internal organization, scope and complexity of activities), some of these remuneration provisions can be avoided. The terms of which elements can be "turned off" and to what degree are complex.

Remuneration Policies and Procedures

An authorized AIFM must have remuneration policies and practices for staff whose professional activities have a "material impact" on the risk profiles of the AIF they manage. These policies and practices must promote sound and effective risk management and must not promote or encourage risk taking inconsistent with the risk profiles or fund rules of the AIF that is managed. The implementation of the remuneration policy must be subject to specified internal reviews (to be performed at least annually) and generally must involve a designated internal remuneration committee.

Restrictions on Incentive Compensation

- At least 40% of bonuses must be deferred over a period which is (i) appropriate given the life cycle and redemption policy of the AIF concerned, and (ii) aligned with the nature of the risks of the AIF in question;
- Subject to the legal structure of the AIFM and its constitution, at least 50% of bonuses should consist of units/shares in the AIF in question, or equivalent ownership interests or instruments;
- In general, bonuses should only be paid/vest if to do

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so is both sustainable according to the AIFM's finances and justifiable by reference to the performance of the AIF in question, the individual concerned and his or her business unit; and

- Guaranteed bonuses must (i) be exceptional, (ii) occur only in the context of hiring new staff and (iii) be limited to the first year of employment.[12]

Liquidity Management and Related Stress Tests

Authorized fund managers are required, for each fund that they manage (save for unleveraged closed-ended funds), to employ an appropriate liquidity management system and adopt procedures which enable them to monitor the liquidity risk of the fund and to ensure that the liquidity profile of the investments of the fund complies with its underlying obligations.

Authorized AIFMs are required to regularly conduct stress tests (under both "normal" and "exceptional" liquidity conditions), which enable them to assess the liquidity risk of the funds and monitor the liquidity risk of the funds accordingly.

Delegation

The Directive's rules on delegation will necessitate a review of a firm's current advisory structures.

First, an authorized non-EU AIFM must notify the competent authorities of its Member State of reference before delegating to third parties the task of carrying out functions on its behalf.[13] In the context of fund management activities, this will include the appointment by an AIFM of any sub-advisor.

Second, a fund manager must not delegate its functions to such an extent that it becomes in essence a "letter-box entity." Under the European Commission's implementing regulation[14] (Regulation), if any of the following situations occurs, an AIFM will cross that "letter-box entity" line and then would cease to be considered as the manager of the AIF:[15]

- The AIFM is no longer capable of supervising the delegated tasks effectively and manage the risks associated with the delegation;
- The AIFM loses the power to make key decisions or perform senior management functions;
- The AIFM loses the contractual rights to direct the delegates' management activities; and
- The delegated management functions substantially exceed those retained by the delegating AIFM.

Ceasing to be treated as the AIFM to an AIF as a result of inappropriate delegation is significant. The consequences could vary depending on the circumstances but, by way of example, it may mean that the disqualified AIFM delegate is in fact the AIFM and requires authorization or has other obligations under the AIFMD.

Third, it is worth noting that these delegation provisions may be of interest to a non-EU fund manager or advisor even in advance of possibly seeking authorization under the Directive's Stage II. This is because the non-EU firm can be impacted by the Directive's delegation terms when it is appointed as a sub-advisor by an authorized EU AIFM (as with remuneration provisions, this is even without the non-EU firm itself being authorized). As a result, certain provisions of sub-advisory agreements to which an authorized

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AIFM is a party may need to be revisited. Among others, (i) the authorized AIFM needs to be able to terminate the sub-advisory agreement immediately if required by the best interest of the investors, (ii) a sub-delegation will be permitted only with the prior written consent of the authorized AIFM and (iii) the authorized AIFM will no longer be able to give general consent to sub-delegation in advance.

Depositaries

Rules regarding depositaries are a key component of the Directive. The Directive provides that an authorized fund manager must ensure that a depositary is appointed in accordance with the Directive and that the appointment must be made in writing.[16] The designated depositary can delegate its safekeeping functions to sub-depositaries when needed.[17]

Any financial institution that intends to act both as prime broker and depositary for the same AIF will be required to establish certain internal separations between the two functions. Furthermore, it must properly identify potential conflicts of interest, which must be managed and disclosed to the investors of the AIF. It is also possible for an AIF's prime broker to hold assets of the AIF as sub-custodian, if the depositary delegates custody functions to the prime broker. AIFs currently operating without a depositary will need to allow time to implement these arrangements into their current structures.

Depositaries acting for EU AIFs must be established in the home EU Member State of the AIF. Depositaries for non-EU AIFs must be established in the third country where the AIF is established or in the Member State of reference of the non-EU AIFM managing the AIF.[18] Appointment of a depositary established outside of the EU is subject to the following additional requirements:

- The competent authorities of the EU Member States in which the units or shares of the non-EU AIF are intended to be marketed, and, if different, of the Member State of reference of the non-EU AIFM, have signed cooperation and exchange of information arrangements with the competent authorities of the depositary;
- The depositary is subject to effective prudential regulation, including minimum capital requirements, and supervision which have the same effect as EU law and are effectively enforced;
- The non-EU country where the depositary is established is not a Non-Cooperative Country and Territory;
- The EU Member State in which the non-EU AIF is to be marketed, and, if different, the Member State of reference of the non-EU AIFM, have signed a tax cooperation agreement with the third country where the depositary is established; and
- The depositary must by contract be liable to the AIF or to the investors of the AIF.

As to this last requirement, the liability regime for depositaries – it is near-strict liability, even for losses associated with a sub-custodian appointed by a depositary – has been an issue of continuing debate in Europe. The new requirement will be in stark contrast to current practice under which custodians often disclaim responsibility in a variety of circumstances. The expectation is that heightened liability ultimately will drive depositaries to charge higher fees than custodians currently charge.

The depositary is also subject to many other administrator-type duties, including monitoring subscriptions, redemptions

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and other cash flows of the fund. The manager, in turn, has statutory obligations to keep the depositary informed of these matters.

Additional Conditions to Authorization Specific to a Non-EU AIFM

The following additional conditions also must be satisfied by an authorized non-EU AIFM:[19]

- The non-EU AIFM must disclose its marketing strategy to the regulator in its Member State of reference,[20]
- Generally speaking, the supervision of the non-EU AIFM by the EU Member State regulators must not be prevented by laws or regulations to which the non-EU AIFM is subject (including the laws of the jurisdiction where the non-EU AIFM is established);
- Cooperation arrangements similar to those discussed in respect of the marketing rules covered in Part One of this article will need to be in place between regulators in EU countries and the regulator of the country in which the non-EU AIFM (and EU AIF, if applicable) is located;[21]
- The country where the non-EU AIFM (and AIF, if non-EU) is established must not be listed as a Non-Cooperative Country and Territory by the Financial Action Task Force; and
- Tax-exchange agreements will need to be in place between EU countries and the country where the non-EU AIFM (EU AIF, if applicable) is established.

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[1] On the face of the Directive, this lighter "registration" regime is only available as an alternative for managers that otherwise would be required to be fully authorized under the AIFMD (which means, in practice, that it would be available only to non-EU-domiciled managers from 2015 at the earliest). However, some Member States – such as the UK – appear to be taking the position that smaller non-EU managers also ought to be subject to a lighter regime than their larger counterparts from July 2013.

[2] An AIF is leveraged if the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities or leverage embedded in derivative positions or by any other means. Directive, Article 4(1)(v).

[3] Directive, Article 3(2).

[4] Regulation, Article 3.

[5] Directive, Article 37(2).

[6] Directive, Article 37(1).

[7] Directive, Article 37(4).

[8] The term "initial capital" in the Directive has the same meaning as that under Article 22 and 23 of Directive 86/635/EEC and includes: (i) all amounts that are regarded as equity capital subscribed by the shareholders or other proprietors and (ii) all the types of reserves listed in Article 9 of Directive 78/660/EEC. Different capital requirements apply to an internally managed AIF. As explained in Part One of this article, an internally managed AIF is one whose management functions are performed by the governing body or any other internal source of the AIF. All other AIFs are externally managed.

[9] Directive, Article 9(2) and 9(3). This is subject to a minimum own funds requirement equal to one quarter of the AIFM's fixed overheads for the previous year.

[10] Directive, Article 9(7).

[11] Regulation, Article 12.

[12] These provisions derive from similar provisions implemented by the EU for banks and other financial services firms. At the time of writing, the EU also is proposing to impose similar rules on, e.g., UCITS fund managers. It also is expected that the EU will introduce caps on the level of bonuses that can be paid.

[13] Directive, Article 20.

[14] Regulation No 447/2013.

[15] Regulation, Article 82.

[16] Directive, Articles 21(1) and 21(2).

[17] Directive, Article 21(11).

[18] Directive, Article 21(4).

[19] Directive, Article 37(9).

[20] Directive, Article 37(4).

[21] Since publication of Part One of this article, it has been announced that the European Securities and Markets Authority has, on behalf of EU member states, agreed cooperation arrangements with regulators in 34 non-EU jurisdictions – including the U.S., Singapore, Hong Kong and many of the traditional offshore fund centers.

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