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European Regulation of Fund Managers: AIFM Directive Agreed and Adopted

On November 11, 2010, after 18 months of uncertainty and heated argument, the European Parliament adopted a final, agreed text of the European AIFM Directive. Due to be implemented across the EU by the beginning of 2013, the AIFM Directive will have far-reaching implications for investment managers, their funds and service providers – whether located in, or outside, the EU. This note looks in detail at the provisions of the AIFM Directive and its consequences for the global funds industry.

Executive Summary

The Alternative Investment Fund Managers Directive (the "Directive") was adopted by the European Parliament (the "Parliament") on November 11, 2010. It is almost unrecognisable from the original draft proposed in April 2009 by the European Commission (the "Commission"). After translation into the various languages of the EU, the Directive will formally enter into force, for European law purposes, at the beginning of 2011. But its provisions will only "bite" once Member States in the EU have passed their own legislation to implement the Directive – a process to be completed by the beginning of 2013.

The Directive's ambit is startling. For the first time, EU fund managers will be subject to pan-European regulation. Alternative investment funds ("AIFs") located in the EU will be capable of being marketed across Europe, by EU managers, on a "passported" basis, which will obviate the need for the existing and costly country-by-country legal analysis of marketing restrictions to which fund managers have become used. The *quid pro quo* is that EU fund managers will be – among other things – subject to detailed reporting and disclosure requirements, required to defer large portions of bonuses to key staff, and restricted as to delegation and use of service providers.

However, the Directive is not concerned only with EU managers. It also results in meaningful (albeit indirect) regulation of funds. Access to European investors will be restricted for funds managed by non-EU managers and even for many non-EU funds that are managed by EU managers. A marketing passport may become available for non-EU managers in the future, but only if those non-EU managers agree to submit themselves to the provisions of the Directive, and *de facto* European regulation, as a result.

Unfortunately – and partly a consequence of the stringent disagreements that littered the path of the Directive to adoption - numerous provisions are in framework form only, requiring the Commission or the new European Securities and Markets Authority ("ESMA") to flesh out the detail over the coming months and years. As an example, managers of funds that

employ leverage "on a substantial basis" will have important additional reporting requirements. Yet it is left to the Commission to adopt rules explaining what "on a substantial basis" means. There are so many examples in the Directive of this need for secondary rules that the full picture of the Directive's practical implications cannot yet be viewed with certainty.

Key highlights of the Directive are as follows:

- Implementation of Directive across the EU by early 2013.
- Compulsory regulation of EU alternative fund managers.
- Lighter "registration only" regime for smaller fund managers.
- Regulated managers will be subject to capital requirements, and detailed disclosure and reporting obligations.
- Additional disclosure and other obligations for managers of (i) funds engaged in substantial leverage and (ii) funds acquiring significant stakes in companies.
- Restrictions on the ways in which a regulated manager can remunerate its staff (including by requiring large percentages of bonuses to be deferred).
- Allows funds to be marketed to professional investors across the EU with a "passport" – but initially only available to EU managers of EU funds.
- For non-EU managers and non-EU funds, different marketing regimes to be phased in and out over the next eight years. A marketing "passport" is eventually expected to be available, but will effectively require a non-EU manager to be regulated under, and comply with, the entire Directive as if it was an EU manager.
- Managers required to ensure that each fund has a depositary for holding assets. Restrictions on location of depositary and near-strict liability for the depositary.
- Managers can only delegate if certain conditions are satisfied, and the manager's liability to the fund and investors can never be affected by delegation.
- Managers required to set leverage limits for each fund and demonstrate that those limits are reasonable. Member States may in exceptional circumstances impose leverage limits on a manager.
- Numerous provisions of the Directive to be fleshed out by rules to be adopted over the coming months.

Each of these points is explored in detail in the following note.

Table of Contents

Page

What is an AIFM?

The Directive applies to alternative investment fund managers ("AIFMs") that are:

- Located in the EU, or
- Located outside the EU and either manage EU funds or market funds (whether EU or non-EU) into the EU.[1]

An AIFM is a legal person whose regular business is managing one or more alternative investment funds ("AIF"). The definition of "AIF" is intentionally broad, capturing any collective investment undertaking that "raises capital from a number of investors with a view to investing it in accordance with a defined policy for the benefit of those investors".[2] The Directive explicitly says that "it is of no significance" what the legal structure of the fund is, or whether the fund is open-ended or closed-ended.[3] Nor would it appear to matter what the underlying assets are (e.g., securities, commodities, real estate, etc.).

As noted an AIFM has to be "managing" one or more AIFs in order for it to be subject to the Directive. In the original draft of the Directive, there was no suggestion as to what "managing" meant. In the final version, however, it is clearly stated that "managing" means performing one or both of the following functions: portfolio management or risk management.

A fund may have only one AIFM (although, of course, that AIFM will be able to delegate its powers in accordance with the terms of the Directive).[4]

Specific Exemptions

Due to the breadth of the definition of "AIFM", a number of specific types of entities have been carved-out and are exempt entirely from the Directive. The Directive does not apply to holding companies, central banks, pension funds investing only their own money, or securitisation special purpose entities.[5] In addition, the Directive will not apply to a fund manager that only manages funds whose sole investors are the manager or its parent or subsidiary undertakings - provided that none of those is an AIF itself.[6]

Those exemptions are not as numerous as might be desirable. Some commentators had very reasonably been lobbying for an amendment to the draft Directive that would make clear that a vehicle was only captured in the definition of "AIF" if the capital raised by that vehicle was used for "investment purposes", to avoid inadvertently capturing vehicles set up purely for commercial purposes.[7] No such amendment was made. As a result, there are question marks over a number of entities – such as offshore debt issuers – which could conceivably be captured. This is the case even if such entities do not have third party managers appointed since, under the Directive, an AIF can be self-managed (i.e., a company itself can be an AIFM, if the directors of that company take investment decisions). It is imperative that these wrinkles are definitively ironed out

1 Directive, Article 2.

2 All definitions in the Directive are set out in Article 4.

3 Directive, Article 2(1).

4 Directive, Article 5.

5 Directive, Article 2(2).

6 Directive, Article 3(1).

7 See, for example, "Analysis of certain core areas of the Alternative Investment Fund Managers Directive which are capable of giving risk to significant legal uncertainty", published in January 2010 by the Financial Markets Law Committee. At the date of writing, a copy of the paper is available at: http://www.fmlc.org/papers/Issue145Report.pdf.

through secondary rules and guidance developed and published during the period until the Directive takes effect across the EU, currently planned for early 2013.

Lighter Regime for Smaller Fund Managers – Registration Only

The Directive provides for a less onerous regime for a manager that:

- Manages AIFs with assets under management of less than EUR 100 million; or
- Manages AIFs with assets under management of less than EUR 500 million, but only if those AIFs are unleveraged (this does not include leverage at portfolio company level) and investors are not permitted to redeem their investments for five years.[8]

This lighter regime is recognition that only in aggregation could smaller fund managers ever give rise to systemic risks.

A fund manager falling within either of these categories is only required to "register" with regulators (rather than seek "authorisation"), although it can choose to opt in to the entire Directive and become authorised, if it wishes. Under the Directive, a registered fund manager will be required to regularly provide its regulator with information regarding investment strategies, the main instruments in which the manager is trading, and the principal exposures/concentrations of the AIFs that it manages.[9]

Registration would avoid most of the burdensome restrictions and requirements to which an authorised AIFM will be subject. However, this comes at a cost, because the principal benefit of the Directive – the ability to market funds on a passported basis across Europe – is not available to registered managers. Indeed, the Directive says that registered managers will not benefit from any rights under the Directive at all. The result is that it is difficult to see any basis on which a registered (as opposed to fully authorised) manager can market its funds into the EU. As a result, only smaller fund managers with limited national businesses are likely to want to rely on the registration approach as it stands. Given that the Commission is required to implement rules around the registration regime (including, in particular, how a fund manager will be treated when its assets under management occasionally exceed and/or fall below the thresholds[10]), one would expect further clarification on this point.

Authorisation

Unless exempt or registered (or already regulated in the EU – as discussed below in this section), an EU AIFM will be prohibited from managing an AIF unless it is authorised under the Directive. AIFM will need to be authorised at the time that the Directive is implemented across the EU (expected to be by the beginning of 2013). An application for authorisation must be submitted to the regulator in which the AIFM has its registered office. That regulator will then have three months (extendable, in its discretion, to up to six months on a case-by-case basis) to consider the application.

8 Directive, Article 3(2).

9 Directive, Article 3(3).

10 Directive, Article 3(6)(a) and (b).

What activities can an AIFM perform?

As well as managing AIFs, an AIFM may be permitted by its regulator to manage UCITS funds,[11] provide investment advice, arrange deals and provide safe custody, although these activities will require separate permissions and will not be automatically granted to an AIFM.[12] An "internal manager" - i.e., a self-managed AIF - will not be able to carry out any activities other than in connection with the management of that AIF.

What will the application involve?

An application for authorisation under the Directive will involve providing the relevant regulator with a broad swathe of information about the AIFM's organisation, structure and ownership, and the funds that it manages or intends to manage. That information is similar to that required for other regulated entities in Europe and will include:

AIFM

- The identities of the shareholders/members of the AIFM;
- Details of the AIFM's structure;
- Details of how the AIFM intends to comply with the provisions of the Directive;
- The AIFM's remuneration policies; and
- Details of any delegation.

Funds managed or intended to be managed by the AIFM

- Details of investment strategies, use of leverage and risk profiles;
- The "fund rules or instruments of incorporation";
- Details of the arrangements made for appointing a depositary; and
- All information that is required to be disclosed to investors under the Directive (this is generally the sort of information that one would expect to see in an offering memorandum).

No explanation is given as to what the "fund rules or instruments of incorporation" are, but this appears to be intended to capture the constitutional documents of the fund (such as a limited partnership agreement). The provision of these documents to regulators as a matter of course constitutes a significant departure from current practice for fund managers.

Granting of authorisation

A regulator will not grant authorisation to an AIFM unless it is satisfied that:

- The AIFM will be able to comply with the Directive;
- The AIFM has sufficient regulatory capital (discussed below in the section on Initial Capital and Own Funds);

[11] Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities.

[12] Directive, Article 6(4).

- Those running the AIFM are of "sufficiently good repute" and are "sufficiently experienced" in relation to the investment strategies being pursued by the funds managed by the AIFM;
- The shareholders/members of the AIFM are "suitable"; and
- The AIFM's head office and registered office are located in the same Member State.

When granting authorisation to an AIFM, a regulator is able to restrict the scope of that authorisation to certain investment strategies (presumably it will do so when it is of the view that those running the AIFM have sufficient experience only in relation to particular strategies).

As a caveat to the above, ESMA is given an overarching power to develop regulatory standards that will detail when an EU regulator must refuse authorisation of an AIFM due to the ability of that regulator to effectively supervise the AIFM being compromised (for example, by close links between the AIFM and other persons).[13] One recurring feature of the Directive is that ESMA, the new European regulator, is being given authorities and powers that one might not have expected to have been given to its predecessor, the Commission of European Securities Regulators ("CESR").[14]

Managers already regulated in the EU?

Investment firms already regulated in the EU under MiFID[15] and banks authorised under the Banking Consolidation Directive[16] will not be required to separately seek authorisation under the Directive to provide investment services such as individual portfolio management in respect of AIF.[17] However, investment firms will only be able to market AIFs across the EU to the extent that they are capable of being marketed under the Directive (effectively meaning that an AIFM that is already regulated will be treated in the same way in relation to marketing as an AIFM that seeks authorisation under the Directive).

Passporting

Once an EU AIFM has been authorised, it may market any EU AIF to professional investors in the country in which the manager is domiciled upon notification to its regulator.[18] Where the fund is a feeder AIF, the right to market is subject to the condition that the master fund is also an EU AIF which is managed by an authorised EU AIFM. Marketing may begin as soon as the regulator informs the EU AIFM that it may start marketing – the regulator has 20 days to consider the notification. The only reason for preventing an AIFM from marketing an EU AIF is where it does not comply with the Directive.

Where an EU AIFM wishes to market any EU AIF in another Member State (i.e., activate the passport), the AIFM's regulator must pass onto regulators in each relevant Member State details of the funds that the AIFM wishes to market.[19] Marketing in

[13] Directive, Article 8(3) and 8(6).

[14] Please see previous note published by Shearman & Sterling on the new EU architecture.

[15] Directive 2004/39/EC.

[16] Directive 2006/48/EC.

[17] Directive, Article 6(8).

[18] Directive, Article 31.

[19] Directive, Article 32.

this case may begin as soon as the regulator sends those details to the regulators in the relevant Member States where the funds are to be marketed – the regulator has 20 days in which to send the notification.[20]

An EU AIFM may also manage any EU AIF which is established in another Member State, either directly or by establishing a branch in the AIF's country. The AIFM needs to notify its regulator of the Member State in which the fund is established, the fund intended to be managed and the services it intends to perform. If the EU AIFM intends to establish a branch in the other Member State it must also provide its regulator with information showing the organisation structure of the branch and contact details for the fund. Regulators in the AIF's country may not impose any additional conditions to those set out in the Directive on the EU AIFM.[21]

Reverse Solicitation

The Directive explicitly states that marketing is only caught if that marketing is done "at the initiative of the AIFM or on behalf of the AIFM".[22] The inclusion of such a "reverse solicitation" caveat has been the subject of intense lobbying by the fund management industry and others (including large investors). In practice, it means that the Directive in no way restricts an investor from seeking out, on its own initiative, funds and managers located anywhere.

Initial Capital and Own Funds

Every EU AIFM must meet capital requirements.

Initial Capital

On the question of initial capital requirements, the Directive distinguishes between self-managed AIFs and all other fund managers. A self-managed AIF must have an initial capital of EUR 300,000 (or equivalent).[23]

All other AIFM must have initial capital of at least EUR 125,000 *plus* 0.02% of the amount by which the AIFM's assets under management exceed EUR 250 million. This is subject to a cap: an AIFM will never be required, under the Directive, to have initial capital of more than EUR 10 million.[24] These capital requirements are the same as those imposed upon managers of UCITS funds, and are a good example of where something that has previously been applied in the context of retail funds is being translated straight across into the unregulated funds sphere.

If an AIFM is subject to the European Capital Adequacy Directive[25] (for example, if it manages UCITS funds), then its capital requirements will be whichever is the greater of (i) its capital requirements under that directive; and (ii) its capital requirements under the above calculation.

Under certain circumstances, a Member State may allow an AIFM to only meet part of its initial capital requirement (subject to a minimum of 50%), if it has in place a guarantee provided by a bank/insurance company.[26]

[20] Directive, Article 32(3).

[21] Directive, Article 33.

[22] Directive, Article 4.

[23] Directive, Article 9(1).

[24] Directive, Article 9(2) and 9(3).

[25] Directive 2006/49/EC.

Own Funds

All AIFM must have adequate funds to cover potential professional liability risks or have adequate professional indemnity insurance resulting from activities the AIFM may carry out.[27] The Commission is required to adopt rules providing more detail as to what risks, and what insurance, will be appropriate for AIFM.

Honesty, Integrity and Treating Investors Fairly

The Directive contains a number of principles with which an AIFM is expected to comply at all times.[28] The principles are generally high level, requiring that an AIFM (for example) act honestly, and with due skill, care and diligence in conducting its activities (i.e., the traditional standards applied to a fiduciary). It is worth highlighting two of the principles in particular.

Acting in whose interests?

A fund manager located in the UK will be familiar with the idea that it is the fund - and not the investor - that is treated as its client for most UK regulatory purposes. It is to the client that the manager owes the majority of its duties.

Under the Directive, an 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.

Frequently, interests of the AIF, all of its investors and the "integrity of the market" will be aligned. However, it is possible to think of numerous scenarios in which the interests of the AIF might differ from the interests of investors – and, of course, occasionally some investors' interests will differ from others' interests (for example, when investors wish to leave the fund or in the use of gating). At the same time, an AIFM must at all times act in the best interests of the "integrity of the market" and treat all of its investors fairly. Regarding the acting in interests of integrity of the markets, how will such AIF core AIF investment activities as shorting, leverage, derivatives, concentrations etc. be viewed? As the U.S. "flash crash" demonstrated, good faith trading by one or a few market participants can trigger unexpected impacts.

The Commission is required to adopt rules specifying the criteria by which regulators will determine if an AIFM has complied with these requirements.[29] Managers will be hoping that those rules are detailed enough to assist an AIFM in juggling its duties and answering the simple question: in whose interests am I supposed to act and when? Regardless, the range of interests to be considered will assure uncertainty at times.

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[26] Directive, Article 9(6).

[27] Directive, Article 9(7).

[28] Directive, Article 12.

[29] Directive, Article 12(1).

Remuneration

The original draft of the Directive said nothing about how an AIFM should remunerate its staff. That is not the case with the final, adopted Directive, which contains detailed remuneration provisions[30] that are largely based on the Financial Stability Board/G20 standards. These are also being implemented through new EU rules on remuneration policies for credit institutions and investment firms.[31] For the first time, a fund manager will be legally required to (i) implement remuneration policies that do not promote undue risk taking, and (ii) reward its employees in a certain way (for example, by deferring payment of bonuses).

Remuneration policies

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. That will include all senior management, risk takers (including persons making investment decisions), people undertaking "control functions" (such as people involved in decision making processes) and any other employees who, while not falling within one of those categories, nevertheless are paid an amount that takes them into the same remuneration bracket as the senior management and risk takers.

An AIFM's policies and practices must promote sound and effective risk management and must not promote or encourage risk taking which is inconsistent with the risk profiles or fund rules of the AIF that is managed. The remuneration policies must be reviewed at least annually.

Compensation of staff

One of the most radical aspects of the Directive is that it prevents AIFM from compensating their staff in certain ways. In particular:

- At least 40% of bonuses (at least 60% if the bonus is "particularly substantial") must be deferred over a period - the Directive suggests three to five years as a minimum - 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;
- Bonuses so deferred must vest no faster than on a pro-rata basis;
- 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. This requirement does not apply if AIF management comprises less than 50% of the total portfolio managed by the AIFM;
- In general, bonuses (including any deferred portion) should only be paid/vest if to do 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;
- 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;
- Staff members engaged in control functions must be compensated in accordance with achievement of objectives linked to their functions, and not the performance of the business areas that they control;

[30] The remuneration provisions are set out in Article 13 and Annex II of the Directive.

[31] CRD III comprises amendments to the Banking Consolidation Directive and the Capital Adequacy Directive.

- Fixed and variable components of total remuneration must be appropriately balanced for all employees;
- The fixed component of an employee's remuneration package must represent a sufficiently high proportion of total remuneration as allows the operation of a fully flexible policy on bonuses, including the possibility to pay no bonuses at all;
- Where remuneration is performance-related (i) both financial and non-financial criteria is taken into account and (ii) that remuneration is based on a combination of the performance of the individual, and of that individual's business unit, and of the AIFM's overall results; and
- Any "golden parachute" payments in connection with early termination of an employment contract must not "reward failure".

A key objective is to ensure that AIFMs do not structure the way in which staff are paid in a way that avoids the Directive's requirements. To that end, bonuses cannot be paid through vehicles or by utilising methods that avoid the requirements of the Directive, and remuneration covers amounts paid by the AIF (including carried interest) as well as the AIFM itself.

Certain details of the remuneration of an AIFM's staff must be included in the annual report that an AIFM prepares for each AIF – see the section below on Transparency for further details.

Conflicts of Interest

Many existing EU managers will already be familiar with, and subject to, the provisions of MiFID that relate to conflicts of interest. The requirements under the Directive are similar, although they are more particularly tailored to conflicts that might arise in the context of fund management.[32] An AIFM will be required to take all reasonable steps to identify conflicts of interest that arise between (i) the AIFM and an AIF it manages, (ii) one AIF and another AIF, (iii) an AIF and another client of the AIFM, (iv) two of the AIFM's clients, and (v) an AIF and a UCITS managed by the AIFM.

An AIFM must have arrangements in place and take all reasonable steps to identify, prevent, manage and monitor conflicts of interest so as to prevent the possibility of those conflicts adversely affecting the interests of the AIF and its investors. If those arrangements are insufficient to ensure that investors will be protected, the AIFM must clearly disclose the conflicts of interest to investors *before* undertaking business on their behalf.

The Commission is to adopt legislation which sets out the types of conflicts of interest that will need to be addressed by an AIFM and the steps that an AIFM will be expected to take in order to comply with its obligations under the Directive.

Liquidity Management

The Directive approaches liquidity management from two angles: first, by placing operational requirements on an AIFM, and secondly, by requiring an AIFM to report to its regulator as regards the liquidity of its AIFs.

For each AIF, the AIFM must ensure that regular stress tests are conducted under expectations of both normal and exceptional conditions that will allow it to assess the liquidity risk of the AIF and monitor the liquidity risk of the AIF. In

[32] Directive, Article 14.

addition, the investment strategy, liquidity profile and redemption policy of an AIF must be "consistent", taking into account the risk profile of the AIF.[33] This does not apply to unleveraged, closed-ended AIFs.

An AIFM must provide its regulator, for each EU AIF it manages and each AIF it markets into the EU, with information relating to those AIFs including the percentage of assets subject to special arrangements due to their illiquid nature, any new arrangements for managing liquidity, the results of the stress tests that are periodically performed and the main categories of assets in which the AIF are invested.[34]

Valuation

The original draft of the Directive required that each AIF appoint an external "valuator" that would be responsible for regularly valuing the assets of the AIF. Two key criticisms of that requirement were that (i) in many cases, the person that was most likely to be able to properly value an AIF's assets would be the manager itself, and (ii) different funds needed different treatment when it came to valuation of assets (for example, a private equity fund might need valuation to take place much less frequently than a hedge fund).

The final Directive attempts to address both of those issues.

Who can perform the valuation function?

The valuing of assets can be performed either by the AIFM itself, or by an external valuer. If the AIFM is to perform that role, then it must ensure that valuation activities are functionally independent from the AIFM's portfolio management activities.[35]

If an external valuer is preferred, then the AIFM must be able to demonstrate that the valuer is subject to professional registration or similar, and is able to provide sufficient professional guarantees to be able to effectively perform the valuation.[36] Appointing an external valuer is also seen under the Directive as a "delegation", so all the requirements regarding delegations (discussed below) will need to be satisfied.

The Directive imposes additional obligations on both internal and external valuers – for example, an external valuer cannot delegate their valuation functions[37] (although they can engage in outsourcings provided they remain responsible for the function). Also, an internal valuation may be subject to independent auditing at the request of the AIFM's regulator.[38]

When do assets need to be valued?

The "net asset value per share or unit" of an AIF must be calculated at least once a year, and must be disclosed to investors in accordance with that AIF's constitution.[39]

[33] Directive, Article 16.

[34] Directive, Article 24(2).

[35] Directive, Article 19(4).

[36] Directive, Article 19(5).

[37] Directive, Article 19(6).

[38] Directive, Article 19(9).

[39] Directive, Article 19(3).

For open-ended AIFs, additional calculations must be carried out at a frequency which is "appropriate to the assets held by the fund and its issuance and redemption frequency". So, presumably, a trading fund with monthly subscriptions and redemptions will be expected to have its assets valued at least monthly – although the Commission is required to adopt rules explaining what the Directive actually does require.

For closed-ended funds, additional calculations must be carried out whenever there is an increase or decrease in the AIF's capital. That would seem to suggest that, for example, a private equity fund structured as a limited partnership that admits a new investor will be required to value its assets at that time. But the amount paid by such a new investor would not necessarily have to match (and in fact it would be unusual for it to match) the net asset value of a limited partnership interest – however that would be calculated – so this requirement would seem to be purely a matter of transparency for investors. Again, details surrounding the calculation of the net asset value per share/unit are left to the Commission to develop by adopting rules in due course.

Delegation

Another part of the original draft of the Directive that caused significant concern for fund managers related to delegation. In particular, the original draft contemplated that an EU AIFM could only delegate management functions to another EU AIFM. The final Directive is slightly more liberal on that point, although there are other aspects of the rules on delegation (such as an AIFM's strict liability) which will require fund managers to take great care in delegations and which will inform negotiations of contracts.

Prior to delegating

Before any delegation can take effect, the AIFM must notify its regulator.[40] In the European Parliament's previous draft of the Directive, it had been suggested that the regulator could "reject" a notification (effectively meaning that the notification was in fact an approval process), but this has been dropped from the final text.

Conditions applicable to delegations

The following conditions must be satisfied in relation to any delegation:[41]

- The AIFM must be able to objectively justify its entire delegation structure;
- The delegatee must have sufficient resources to perform the tasks, and staff of good repute with sufficient experience;
- Where the delegation is of management functions, the delegatee must be either (i) authorised or registered as an asset manager (apparently anywhere), and supervised as a result or (ii) approved in advance by the AIFM's regulator;
- Delegation of management functions to an entity in a non-EU country will only be permitted if "co-operation" between the AIFM's regulator and the regulator of the non-EU entity is ensured;
- Management functions may not be delegated to an AIF's depositary. Those functions may also not be delegated to any other entity whose interests might conflict with those of the AIFM or investors in an AIF, unless (i) that entity has

[40] Directive, Article 20(1).

[41] Directive, Article 20(1).

segregated the management functions from its other functions and (ii) the potential conflicts of interest have been properly identified, managed, monitored and disclosed to the AIF's investors;

- The AIFM must be able to effectively monitor the delegation, give instructions to the delegatee, and cancel the delegation with immediate effect, if that would be in the interests of investors; and
- The delegation must neither prevent the AIFM acting in the best interests of investors, nor prevent the effective supervision of the AIFM by its regulators.

In addition, an AIFM may not delegate functions to the extent that either it can no longer be considered to be the manager of the relevant AIF, or the AIFM becomes a "letter-box entity".[42] The Commission is required to produce rules that specify when the AIFM would have delegated to such an extent.

Strict Liability of AIFM

The AIFM's liability *vis-à-vis* an AIF and its investors is not affected by any delegation (i.e., it is not possible for an AIFM to absolve itself of responsibility for the acts and omissions of a delegatee).[43]

Further delegation by a delegate?

Third party delegates generally will themselves be able to sub-delegate, provided that the same conditions discussed above are satisfied as regards the sub-delegation, and the AIFM gives its prior consent to that sub-delegation. Again, the AIFM's regulator must be informed before the sub-delegation can become effective.[44]

Depositaries

The AIFM must ensure that, for each AIF that it manages (with the notable exception of non-EU AIFs that are not marketed in the EU), a single depositary is appointed to hold the AIF's assets.[45] While there must be a "single" depositary, some strategies and/or asset classes may require a web of sub-depositaries, and this is generally permitted (see Delegation by a Depositary below).

Who can act as a Depositary?

The basic rule is that only the following entities can act as depositaries:

- EU credit institutions (i.e. banks);
- Other EU regulated entities that are authorised to provide custodial services and which meet certain capital requirements (i.e. custodians regulated under MiFID); and
- Other regulated entities that are allowed to act as depositaries under the provisions of the UCITS Directive.[46]

[42] Directive, Article 20(2).

[43] Directive, Article 20(2).

[44] Directive, Article 20(3).

[45] Directive, Article 21(1).

[46] Directive, Article 21(3).

However, for non-EU AIFs only, the depositary may be a bank or other regulated custodian located outside of the EU, provided that the entity is subject to regulation (including as to capital requirements) that is equivalent to EU law and that is "effectively enforced".

An AIFM cannot act as depositary. In addition, a prime broker will not be able to act as depositary (and vice versa) in respect of the same AIF unless the functions are clearly segregated and arrangements are in place to deal with potential conflicts of interest.[47]

These provisions of the Directive clearly fetter an AIFM's ability to select a custodian for a fund. However, they constitute a marked improvement from the original draft of the Directive, which required all depositaries to be EU banks and prevented any delegation by those depositaries – except to other EU banks. This, together with the delegation provisions, deals with previous regulatory shortcomings that allowed Madoff to act as both fund manager and custodian for the same fund, reporting as custodian on investments that did not exist.

Location of the Depositary

For an EU AIF, the depositary must be located in the same EU country as the AIF.[48]

For a non-EU AIF, the depositary must be located in one of the following:

- The same EU country as the AIFM;
- The "Member State of reference" of the AIFM (discussed below in the section on Third Country Provisions – this is only relevant for non-EU AIFM which become subject to the provisions of the Directive as a result of their marketing or management activities in the EU); or
- The same country as the non-EU AIF, but only if all of the following conditions are satisfied:
  - Co-operation arrangements are in place between (i) the regulator of the depositary and (ii) regulators of the AIFM and the EU countries in which the funds are being marketed;
  - The depositary is subject to regulation (including as to capital requirements) that is "equivalent" to EU law and that is "effectively enforced" – the Commission will adopt rules expanding on the nature of these equivalence requirements;
  - The country in which the depositary is located is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force ("FATF");
  - Tax information-exchange agreements are in place between (i) the country in which the depositary is located and (ii) the EU countries in which the funds are being marketed or in which the AIFM is located;
  - The depositary is contractually liable to the AIF or its investors consistent with the terms of the Directive.

[47] Directive, Article 21(4).

[48] Directive, Article 21(5).

What does a Depositary have to do?

The depositary's primary role is to hold an AIF's assets. Assets that are capable of being held in custody must be registered in segregated accounts[49] opened in the name of the AIF. For any other assets, the depositary must verify the AIF's ownership and maintain appropriate records.[50]

The depositary cannot rehypothecate or re-use assets entrusted to it without the prior consent of the AIF or the AIFM.[51]

In addition to holding assets, the depositary is required to perform various functions that, in the context of alternative funds, might frequently have been the duties of the administrator or the manager, such as ensuring that (i) the AIF's cash flows are monitored, (ii) issues and redemptions of units/shares, and the valuation of those units/shares, are performed in accordance with applicable law and the AIF's constitution, and (iii) the income of an AIF is "applied in accordance with" applicable law and the AIF's constitution.[52]

Liability of the Depositary

In most cases, the depositary's liability to the AIF (or to the investors in the AIF) is near-strict. That is, the depositary will be liable for the loss of assets held by it unless it can prove that "the loss is due to an external event beyond its control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary". In addition, the depositary will be liable for all other losses suffered by the AIF (or its investors) as a result of the depositary's negligence or intentional failure to comply with the Directive.[53]

In some circumstances (discussed below in this section) a depositary can delegate its custody functions to third parties.[54] In that scenario, the depositary will be able to avoid liability for the loss of assets if (i) the delegation has been properly carried out in accordance with the Directive and (ii) the contract delegating the safe custody function explicitly transfers liability to the third party, and that liability is enforceable against the third party by the AIF (or the AIFM acting on its behalf).[55]

The provisions relating to liability of a depositary are notable for being based upon the equivalent, existing rules for UCITS funds, and are another example of the Directive taking rules from the retail funds industry, and dropping them into the alternative funds industry, under the pretext of preventing systemic risk.

Delegation by a Depositary

A depositary may only delegate its obligation to hold assets (its custody function) and verify ownership of assets that cannot be held in custody.[56]

Any delegation to a third party must not be made with the intention of avoiding the requirements of the Directive. In addition, the depositary must be able to demonstrate objective reasons for the delegation, the depositary must exercise all

[49] According to the principles set out in Article 16 of Commission Directive 2006/73/EC implementing MiFID.

[50] Directive, Article 21(7).

[51] Directive, Article 21(9).

[52] Directive, Article 21(8).

[53] Directive, Article 21(10).

[54] Directive, Article 21(10).

[55] Directive, Article 21(12).

[56] Directive, Article 21(10).

due skill, care and diligence in selecting and monitoring the third party and the depositary must ensure that the third party meets detailed operational requirements that are similar to those to which the depositary is itself subject. Those requirements include that the third party (i) is regulated and (ii) is periodically subject to external audit.

The original draft of the Directive required that all assets be held in the EU by an EU bank. One criticism of this approach was that this would effectively prevent funds from acquiring assets in certain countries that required, as a matter of local law, assets (such as shares in local companies) to be held by a local custodian. The final Directive does permit a depositary to delegate to such a local custodian, of course, on the basis of the general delegation rules discussed above. In certain limited circumstances, a local custodian may even be appointed even if that local custodian is not regulated or is not subject to periodic audit.[57]

The provisions of the Directive relating to depositaries are both complex and require amplification. The Commission is expected to develop rules covering a whole host of areas relating to depositaries, ranging from the content of the agreement appointing the depositary, to when a depositary will be considered to have "lost" assets.[58]

Transparency Requirements

The Directive imposes wide-reaching disclosure and reporting requirements on an AIFM (and, therefore, the AIFs that it manages, as a result). Regulators must be provided with annual reports on the AIFs, certain information must be disclosed by an AIFM to investors prior to investment in the AIFs, and an AIFM will also be required to regularly submit to regulators reports covering matters such as liquidity, leverage, and the principal exposures of each AIF.

The Directive provides for exchange of information between regulators. All such information exchanged must be treated confidentially, other than disclosures "necessary for legal proceedings" or, somewhat worryingly, where the regulator passing on the information informs the recipient regulator that such information may be disclosed.

Annual Report

The AIFM must provide regulators with an annual report in respect of each AIF that it manages (other than non-EU AIFs that are not marketed in the EU). The annual report will also need to be provided to investors in the relevant AIF, on request.[59]

The required content of the annual report will be fleshed out in rules to be adopted by the Commission. But at the very least, the following information will need to be included (note that all financial information will need to be audited):[60]

- Financial statements (balance sheet and an income and expenditure account);
- A report on the activities of the financial year;
- Material changes in information previously disclosed to investors;

[57] Directive, Article 21(10).

[58] Directive, Article 21(15).

[59] Directive, Article 22(2).

[60] Directive, Article 22(2).

- Overall remuneration paid to the AIFM's staff, broken down into fixed and variable remuneration; and
- Overall remuneration of staff whose action have a material impact on the risk profile of the AIF.

The remuneration figures to be disclosed are apparently aggregate; there does not appear to be a requirement in the annual report to disclose specific amounts paid to named members of staff.

Disclosure to Investors

For each AIF managed by an AIFM (other than non-EU AIFs that are not marketed in the EU), the AIFM must provide investors with a wealth of information prior to investment.[61] As a matter of practice, most of this information will already be provided to investors in the form of an offering memorandum. Some requirements (such as those relating to side letters) will, however, require a slightly different approach to that currently taken by fund managers.

Pre-Investment Disclosure

The information required to be disclosed pre-investment includes:

- A description of the investment strategy and objectives of the AIF;
- Details of any master/feeder structures and of underlying funds (in the case of a fund of funds);
- The types of assets in which the AIF may invest, and the techniques that may be employed (and any associated risks);
- Details of when, and to what extent, leverage may be used;
- Details of any arrangements permitting rehypothecation/re-use of assets (for example, in a prime brokerage agreement or in the depositary agreement);
- An explanation of the circumstances in which the AIF's investment strategy can be changed;
- An explanation of the main legal implications of the contractual relationship entered into by the investor;
- The identities of the depositary, auditor and other service providers, and details of any delegation;
- Descriptions of valuation procedures and of liquidity risk management (including how redemptions of shares/units will operate in normal and exceptional circumstances);
- A description of all fees, charges and expenses and how much of those will, directly or indirectly, be borne by investors;
- An explanation of how the AIFM "ensures a fair treatment of investors" and a description of any preferential treatment given to an investor (for example, in a side letter), as well as information regarding that investor's "type" (but not its identity, which was suggested in an earlier draft of the Directive);
- The latest net asset value of the AIF or the latest market price of units/shares; and
- The historical performance of the AIF (where available). It is not clear how current the historical performance needs to be in order to comply with this requirement.

[61] Directive, Article 23(1).

Where the AIF issues a prospectus, all information contained therein will be deemed to have been disclosed and only that information required by the Directive in addition to the information within the prospectus will require separate disclosure.[62]

Ongoing Disclosure

Leverage: details of leverage *actually* used by the AIF will also have to be disclosed to investors "on a regular basis".[63] The Commission will adopt rules explaining what this means.

Liquidity and risk management: information on the liquidity of the AIF's assets, the AIF's risk profile and its risk management systems will need to be provided to investors "periodically".[64] Again, the Commission is tasked with developing rules surrounding this obligation.

Material changes: the AIFM must disclose any material changes to any information previously provided to investors.[65] No frequency is specified, other than in relation to changes to a depositary's liability - in which case investors must be notified immediately.[66]

Reporting to Regulators

Quite separate from the required disclosures to investors, the Directive envisages an AIFM providing the regulator where it is authorised with a significant amount of information. The information required to be reported to regulators is summarised below.

The theory is that, armed with comprehensive information about alternative funds, their exposures, concentrations, leverage and liquidity, EU regulators will be able to rapidly identify systemic risk and act accordingly. In practice, it is eminently possible that regulators will instead be overwhelmed with information, much of it irrelevant. That could be counterproductive and actually make it harder to identify systemic risk. Some EU regulators had made that very point themselves during the course of negotiating the text of the Directive. The "hat tip" to this concern is that the Directive requires the Commission to develop rules surrounding the information to be disclosed to investors. Those rules must "take into account the need to avoid excessive administrative burden" for regulators.[67]

Information to be reported – all AIFs

An AIFM must provide regulators with information on the principal markets and instruments in which it trades, and on the principal exposures and concentrations of each AIF that it manages.[68]

On request, the AIFM must also provide a quarterly list of all AIFs managed by the AIFM.[69]

[62] Directive, Article 23(3).
[63] Directive, Article 23(5).
[64] Directive, Article 23(4).
[65] Directive, Article 23(1).
[66] Directive, Article 23(2).
[67] Directive, Article 24(6).
[68] Directive, Article 24(1).
[69] Directive, Article 24(5).

Information to be reported – all EU AIFs and all non-EU AIFs marketed in the EU

An AIFM must provide regulators with the following information for each AIF:[70]

- The percentage of assets that are treated in a special way due to their illiquid nature;
- Any new liquidity arrangements in place for managing the AIF;
- The risk profile of the AIF and tools employed by the AIFM to manage risk;
- The main categories of assets; and
- The results of stress tests.

Information to be reported – AIFs using leverage "on a substantial basis"

Additional information will need to be disclosed to regulators if leverage is employed "on a substantial basis" by an AIF.[71] What amounts to a "substantial" amount of leverage will be left to the Commission to determine by developing rules on the issue. Where that is the case, though, regulators will need to be provided with information on:

- The total amount of leverage employed by each AIF;
- A breakdown between borrowing and leverage generated through the use of derivatives;
- Details of any rehypothecation/re-use of the AIF's assets; and
- The identity of the five largest sources of borrowed cash/securities, and the amounts borrowed.

EU Member States may choose to ask for additional information, whether *ad hoc* or periodic. The requirement that the identities of lenders be disclosed to regulators will be of particular interest to investment banks and other lenders who will not necessarily be used to having detail of their lending arrangements provided to regulators in such detail.

Information that regulators receive in respect of leverage is to be made available to all other EU regulators.

Leverage (and restrictions on leverage)

The Directive does not impose any flat limits on leverage.

Instead, an AIFM is required to set limits for each AIF that it manages. The AIFM must be able to demonstrate compliance with those limits, and that the limits are reasonable.[72] The AIFM is also required to satisfy the leverage-related reporting described above.

In addition, EU Member States will be able to impose limits on the amount of leverage that an AIFM can employ, but only where such a measure is necessary to "ensure the stability and integrity of the financial system". In conjunction with this,

[70] Directive, Article 24(2).

[71] Directive, Article 24(4).

[72] Directive, Article 25(3).

ESMA may advise an EU Member State to impose leverage limits.[73] If the EU Member State fails to comply with the "advice", then ESMA is empowered to "name and shame" the Member State concerned.[74]

Specific Obligations: AIFs Acquiring "Control" of Companies

These additional obligations are likely to be of particular relevance for private equity funds. The Directive imposes both (i) additional requirements to report to regulators whenever an AIF reaches certain levels of interest in any unlisted or listed company (other than small and medium sized enterprises and real estate SPVs), (ii) detailed disclosure and reporting obligations on an AIFM whenever one or more of it AIFs (individually or jointly by agreement) acquires "control" (more than 50% of voting rights) of such a company, and (iii) restrictions on so-called "asset stripping", discussed separately below.

Reporting Requirements: Thresholds

An AIFM must notify its regulator whenever the voting rights held by an AIF reach, exceed or fall below the thresholds of 10%, 20%, 30%, 50% and 75% of a company.[75] To an extent, this disclosure requirement reflects the current position in relation to listed entities and 'close links' reporting requirements already in place for fund managers. But these new reporting requirements expressly extend to unlisted companies. Quite what a regulator might do with information about a fund's minority interest in a private company remains to be seen.

Additional Obligations: Control

Whenever an AIF acquires (individually or jointly with another AIF by agreement) more than 50% of the voting rights in a *listed or unlisted* company, the AIFM must make available to the company, its shareholders and to the AIFM's regulator:[76]

- The identity of the AIFM;
- The policy in place to prevent and manage conflicts of interest that might arise (for example between the AIFM, the AIF and the company); and
- A communications policy dealing, in particular, with communicating as regards employees.

The AIFM must also request, and use best efforts to ensure, that the company's board provides the above information to employees.

Whenever an AIF acquires (individually or jointly with another AIF by agreement) more than 50% of the voting rights in an *unlisted* company, the AIFM must also:[77]

- Notify the company, the company's shareholders and the AIFM's regulators of that fact;
- Include in that notification detail of the AIF's interest in the company, and an explanation of what the acquisition of "control" means for voting rights in the company;
- Request, and use best efforts to ensure, that the company's directors inform the employees of the company of the above;

[73] Directive, Article 25(5).

[74] Directive, Article 25(8).

[75] Directive, Article 27(1).

[76] Directive, Article 28(1).

[77] Directive, Article 29(1).

- Reveal its intentions as to the future business of the company, including any consequences for employees; and
- Include in its annual report relating to the relevant AIF additional information relating to matters such as the company's likely future development.

Asset Stripping

The final Directive contains provisions that are contained under the emotive title "Asset Stripping".[78] Not included in the original text, the language was included after fierce lobbying by certain members of the European Parliament. The provisions are only applicable where an AIF (individually or jointly) acquires control of a company (listed or unlisted).

Where control is acquired by an AIF, then the AIFM must, for a period of two years, generally try and prevent (and particularly not support or vote in favour of) certain distributions, capital reductions, share redemptions and buy-backs, which would result in (i) the net asset value of the company being less than the company's capital and reserves, or (ii) in the case of a distribution, that distribution being an amount greater than the company's available net profit.

An AIFM will often wish to appoint its principals to the board of an investee company. In those circumstances, those principals will be subject to fiduciary and other duties owed to the company and its shareholders - some of which may conflict with the "asset stripping" requirements placed on the AIFM by the Directive. Close attention will need to be paid to the interaction between these duties and requirements, during the implementation phase of the Directive.

Third Country Provisions

Perhaps the most divisive aspect of the draft Directive during the last eighteen months has been its treatment of third country (i.e., non-EU) managers and funds. Opinions have varied wildly, with some suggesting that non-EU managers should have no access to the EU investor market at all, and others arguing that non-EU managers should have precisely the same access as EU managers.

The final Directive's provisions are complex and, at times, occasionally even appear impenetrable. Different treatment is afforded to (i) EU managers of non-EU funds, and (ii) non-EU managers of non-EU funds. Different marketing regimes are envisaged for each over the coming eight years and thereafter.

These marketing regimes are discussed in detail below. First, an entirely separate "third country" issue – that of whether the Directive should apply at all to an EU AIFM managing a non-EU AIF that is not marketed at all into the EU – arises.

EU AIFM Managing a Non-EU AIF (no marketing in the EU)

Despite the fact that the AIF is neither marketed nor domiciled in the EU, an EU AIFM must comply with the entire Directive as regards that AIF (with the exception of the provisions relating to depositaries and annual reports). In addition, in order to even manage the AIF in the first place, there must be sufficient cooperation arrangements in place between the AIFM's regulator and the regulator of the country where the non-EU AIF is located.[79]

[78] Directive, Article 30(1).
[79] Directive, Article 34.

The cooperation agreements referred to above are required in order to facilitate the exchange of information between regulators. The Commission is charged with designing a common framework to facilitate the network of cooperation agreements between regulators that will undoubtedly "ramp up" over the coming months. This will clearly have implications for the management of Cayman, BVI and other funds based in tax havens by European fund managers.

Marketing

Introduction and Timetable

As noted previously, the marketing "passport" introduced by the Directive is – at least at first – only available to EU AIFMs in the course of marketing EU AIFs. AIFMs already have a 'passport' under MiFID for the lawful carrying out of fund management business throughout the EU, based on a single regulatory approval in a 'home' member state. However, disparate national fund marketing restrictions still apply. It is intended that these national marketing differences will now be gradually eliminated.

From early 2013 to early 2015, a "Private Placement Regime" will govern any marketing by (i) non-EU managers marketing funds into the EU and (ii) EU managers marketing non-EU funds into the EU. The Private Placement Regime will allow marketing into the EU, but the rules governing that marketing will vary on a country-by-country basis. This basically occurs with current practice and requirements except for (a) new Member State co-operation rules and (b) the need for the AIFM to comply with certain transparency requirements described below.

In early 2015, a "Passport Regime" is expected to be introduced in relation to non-EU managers and funds. That regime would allow non-EU managers and non-EU funds to be marketed across the EU. However, strict conditions will need to be satisfied in order to gain a "passport" and, in particular, non-EU managers will effectively have to become regulated in the same way as EU managers.

It is anticipated that for at least three years (2015 – 2018), the Passport Regime and the Private Placement Regime will then run in parallel. A manager will be able to choose which regime it uses to market funds.

From early 2018 onwards, it is expected that the Private Placement Regime will fall away. The Passport Regime will remain and be the only way that a non-EU manager or a non-EU fund can access the EU investor market.

It is possible that the Passport Regime will remain a theory only. It can only be introduced by future changes to national laws, on the basis of advice from ESMA. If the Passport Regime is never introduced, the Private Placement Regime will presumably survive indefinitely.

The Two Regimes Treat Non-EU AIFM and EU AIFM Differently

Non-EU AIFMs marketing funds into the EU on the one hand, and EU AIFMs marketing non-EU funds into the EU on the other, are treated slightly differently under the National Private Placement Regime and the Passport Regime. These differences largely reflect the fact that some requirements are clearly inapplicable for an EU AIFM, simply because the AIFM is located in the EU (such as the need for agreements to be in place between EU countries where marketing is taking place and the country where the AIFM is established). One common thread is that an AIFM may only market to professional

investors. Separate authorisation from each target Member State would be required before any AIFM could market any AIF to retail investors in the EU.[80]

The Private Placement Regime (from early 2013)

The Private Placement Regime will allow marketing into the EU on a country-by-country basis, with each country able to create its own rules about access to its market, subject to the below conditions being complied with at a minimum.

Conditions – Non-EU AIFMs only

In order to market funds under the Private Placement Regime, non EU-AIFM will have to comply with Articles 22-24 of the Directive in relation to the AIF being marketed.[81] These provisions contain reporting and disclosure requirements.

Article 22 requires an audited annual report to be given to regulators in the Member States where the AIF is marketed, and also given to investors on request (discussed above under "Transparency Requirements – Annual Report").

Article 23 requires the AIFM to make certain disclosures to investors, both pre-investment and on an ongoing basis (discussed above under "Transparency Requirements – Disclosure to Investors").

Article 24 places obligations on an AIFM to report to regulators in the Member States where the AIF is marketed (discussed above under "Transparency Requirements – Reporting to Regulators").

As a manager that is regulated under and subject to the Directive, EU AIFMs will already be required to comply with these requirements.

Conditions – all AIFMs

For all AIFMs seeking to market under the Private Placement Regime, two additional key requirements will need to be satisfied:[82]

- Co-operation arrangements will need to be in place between the AIFM's regulator and regulators in the country where the non-EU AIF is established (for non-EU AIFM, arrangements will also need to be in place with regulators of the non-EU AIFM itself); and
- The third country where a non-EU AIF, or as the case may be, manager, is established is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

In due course, the Commission will provide further detail regarding co-operation arrangements.

[80] Directive, Article 41.

[81] Directive, Article 40.

[82] Directive, Article 40 and 36.

The Passport Regime

(2015 to 2018 and thereafter?)

A Level Playing Field – If Introduced

The broad intention of the Passport Regime would be to treat all AIFs and AIFMs equally as regards marketing, wherever they are established. So a non-EU AIFM would be able to market a non-EU AIF across the EU in the same way as an EU AIFM markets an EU AIF. In order to benefit from that right, however, the non-EU AIFM would effectively have to become subject to the entire Directive like an EU AIFM (and *de facto* regulated as a result).

The Passport Regime would also require a non-EU AIFM to become *de facto* regulated, under the Directive, if it wished to manage EU AIFs.

Non-EU AIFM Managing and/or Marketing Funds

Regulated in "Member State of Reference"

Under the Passport Regime (2015 onwards, if introduced) prior to managing an EU AIF and/or marketing EU AIF or non-EU AIF in the EU, a non-EU AIFM must obtain authorisation from the regulator in its "Member State of Reference" (essentially that will be the non-EU AIFM's regulator in the EU).[83]

Which EU country is an 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.[84] As occurred in the similar scenario of the Prospectus Directive, 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 a regulator.

The non-EU AIFM must comply with all of the provisions of the Directive except for these relating to on EU AIFM's right to manage and market funds.[85] Effectively, therefore, the non-EU AIFM will become regulated under the Directive in the same way as an EU AIFM. This will mean that the non-EU AIFM will need to, among other things, meet capital and remuneration requirements and will be subject to detailed reporting and disclosure obligations, all discussed above in relation to EU AIFM.

Legal Representative Requirement

The non-EU AIFM must also have a legal representative in its Member State of Reference. The legal representative will be the point of contact of the AIFM in the EU, including for investors, and any official correspondence between EU regulators and the AIFM will go through the legal representative.[86] The legal representative will effectively act as a service of process agent within the EU.

Additional Conditions

The following conditions must also be satisfied before a non-EU AIFM can manage an EU AIF or market an AIF in the EU:[87]

[83] Directive, Article 37(1).

[84] Directive, Article 37(4).

[85] Directive, Article 37(2).

[86] Directive, Article 37(3) and (4).

[87] Directive, Article 37(9).

- The AIFM must convince the regulator in its Member State of Reference as to the AIFM's effective future marketing, by disclosing its marketing strategy to that regulator;
- Generally speaking, the supervision of the AIFM by the EU regulators must not be prevented by laws or regulations to which the AIFM is subject;
- Cooperation arrangements similar to those discussed above will need to be in place between regulators in EU countries and the regulator in the country in which the AIFM (and AIF, if non-EU) is located;
- The country where the AIFM (and AIF, if non-EU) is located must not be listed as a Non-Cooperative Country and Territory by FATF; and
- Tax-exchange agreements will need to be in place between EU countries and the country where the AIFM (and AIF, if non-EU) is located.

Process for Marketing AIFs

To be able to market an EU AIF within the EU to professional investors a non-EU AIFM must submit a notification to its Member State of reference where it intends to market the AIF in that country or in other Member States in respect of each fund it intends to market.[88]

EU AIFM marketing non-EU AIF

An EU AIFM that wishes to market a non-EU AIF under the Passport Regime will be subject to broadly the same conditions as non-EU AIFM marketing such funds, discussed above. But because the EU AIFM is already regulated under the Directive and is located in the EU, some requirements that apply to non-EU AIFM (such as the requirement that there be a tax-exchange agreement in place between the country where the AIFM is located and the EU country where the marketing is taking place) are clearly inapplicable and, as a result, the EU AIFM is not subject to them.[89]

Timetable

- November 11 2010: adoption of final, agreed Directive.
- Beginning 2011: Directive comes into force.
- 2011 - 2013: Business as usual, except in member states which implement before the deadline for implementation.
- Beginning 2013: Deadline for implementation of Directive in EU Member States. National Private Placement Regime commences for non-EU managers and EU managers of non-EU funds.
- Beginning 2015: Possible introduction of Passport Regime, alongside the National Private Placement Regime.
- Beginning 2018: Possible falling away of National Private Placement Regime, leaving Passport Regime in place.

[88] Directive, Article 38(2) and (4) and Article 39(3) and (5).

[89] Directive, Article 35.

Commentary

The Directive principally governs the regulation of EU alternative fund managers. It does not regulate alternative funds themselves. However, many of its provisions will impact on the operation of such a fund, and non-EU managers will also be significantly affected by the Directive - principally as a result of the provisions relating to marketing in the EU.

Despite being hugely detailed and complex in some ways (such as the numerous marketing regimes that are expected to be phased in and out over the next eight years), the Directive still does not paint the full picture of EU regulation of alternative fund managers. Practically every section of the Directive provides for the Commission to produce rules that will further explain what that section of the Directive means in practice. So, while fund managers can be relatively certain of the basic rules that will govern their regulation in the EU, the devil - as always - will be in the detail.

The fact that there is a final Directive is something of an achievement in itself. At times it looked as though differences of opinion were too great to be capable of being resolved.

EU fund managers are already well aware of regulation and will be familiar with conduct of business, disclosure and reporting obligations, although the reporting anticipated here goes far beyond any current protocols. Of course, the Directive's provisions on these issues do not maintain the *status quo*, and will inevitably increase costs for service providers, managers and (likely as a result) investors. They will also impose additional administrative burdens on fund managers. A key departure from current practices is the way in which a fund manager remunerates its staff, which will be significantly impacted.

Custody and delegation arrangements may well need to be revisited. Internal governance structures may also need to undergo re-structuring, in light of the Directive's approach to matters such as valuation of fund assets. But given what had previously been mooted (including regulation of the funds themselves, and banning EU investors from investing in some non-EU funds - even where no marketing had taken place), it is probably fair to say that the Directive could have been a lot worse for the European fund management industry. And the marketing passport, available to EU managers of EU funds, should – but only for EU managers of EU funds initially – streamline and simplify the marketing of those alternative funds to institutional investors in the EU.

For non-EU managers and non-EU funds, the Directive presents a dilemma. For some, the opportunity that a marketing passport provides will prove too attractive to resist, and the establishment of an EU manager will be a priority. Others may choose to market on a country-by-country basis for the time being. But if, in 2018, the Passport Regime becomes the only available method for a non-EU manager to market its funds to EU investors, that manager will essentially have to choose between (i) regulation in the EU – whether of itself from afar, or by establishing an EU-regulated manager, or (ii) not marketing to EU investors.

Perhaps, as time goes by and the implications of the Directive in practice become clear, a decision will be taken to permanently retain both the Private Placement Regime and the Passport Regime for non-EU managers. That would provide a non-EU manager with the ability to opt into either regime, depending on which was the most appropriate for its business model. This would also avoid a possible consequence of a compulsory Passport Regime: EU investors ceasing to have meaningful access to those non-EU managers who decide that the costs of EU regulation outweigh the benefits, and pull out of the EU market completely. The Directive could, in that way, potentially be to the detriment of the EU investors that the Directive's treatment of non-EU managers is trying to serve and to the economy in Europe more generally.

Annex I: Delegated Acts to be adopted by the European Commission

The Commission is empowered to adopt delegated acts specifying detailed rules on many issues, including the following:

Leverage

Recital 14 and Article 4(3)

Methods of permitted leverage, including financial and/or legal structures including third parties controlled by the relevant AIF, where such a structure is specifically set up to directly or indirectly create leverage at the level of the AIF. How leverage is to be calculated.

Article 24(6)

When leverage is considered to be employed on a "substantial basis".

Exemptions - Article 3(6)

- How to calculate thresholds to determine if an exemption applies, and to treat AIFMs whose assets under management, including any assets acquired through use of leverage, in a calendar year occasionally exceed and/or fall below the relevant threshold;
- The obligation for small fund managers to register with their regulators and to provide information in order to effectively monitor systemic risk; and
- The obligations to notify competent authorities in the event the AIFM no longer complies with the conditions necessary to benefit from the lighter regime for smaller fund managers.

Initial Capital and Own Funds - Article 9(9)

- Risks that the additional own funds and/or professional indemnity insurance must cover;
- The appropriateness of additional own funds or the coverage of professional indemnity insurance; and
- The manner of determining ongoing adjustments of additional own funds or the coverage of professional indemnity insurance.

General Obligations - Article 12(3)

The criteria to be used by a relevant competent authority to assess whether the AIFM is complying with its General Obligations.

Conflicts of Interest - Article 14(4)

- Types of conflicts of interest that are relevant under the Directive; and
- Reasonable steps the AIFM will be expected to take in terms of structures and organisational and administrative requirements in order to identify, prevent, manage, monitor and disclose conflicts of interest.

Risk Management - Article 15(5)

- Risk management systems to be employed by AIFM as a function of the risks which the AIFM incurs on behalf of the AIF that it manages;
- Appropriate frequency of review of the risk management system;
- How the risk management function is to be functionally and hierarchically separate from operating units, including portfolio management function; and
- Specific safeguards against conflicts of interest in order to allow for the independent performance of risk management activities.

Liquidity Requirements - Article 16(3)

- Liquidity management systems and procedures so that they are reasonable in scope and effective in nature; and
- Alignment of investment strategy, liquidity profile and redemption policy to allow it to assess the liquidity risk of the AIF and monitor the liquidity risk of the AIF accordingly.

Valuation - Article 19(1)1

- The criteria concerning the procedures for the proper valuation of the accounts and the calculation of Net Asset Value per share or unit;
- The professional guarantees the external value must be able to furnish to effectively perform the valuation function; and
- The frequency of valuation carried out by open-ended funds which is appropriate to the assets held by the AIF and its issuance and redemption policy.

Delegation - Article 20(5)

- Conditions for fulfilling delegation requirements; and
- Conditions under which the management has delegated its functions to the extent that it becomes a letter box entity and therefore can no longer be considered to be the manager of the AIF.

Depositary

Article 21(5)(b)

The criteria for assessing that the prudential regulation and supervision of third countries are to the same effect as the provisions laid down in European law, and are effectively enforced.

Article 21(15)

- Particulars to be included in the standard agreement entered into with a Depositary;
- The criteria for assessing that the prudential regulation and supervision of third countries are to the same effect as the provisions laid down in European law, and are effectively enforced; and
- Conditions for performing depositary functions.

Annual Reports - Article 22(4)

The content and format of the annual report.

Disclosure to Investors - Article 23(6)

Disclosure obligations of the AIFM, including frequency of the disclosure.

Cooperation Arrangements - Article 39(11)

Measures relating to relevant cooperation arrangements and the design of a common framework to facilitate the establishment of cooperation arrangements.

Exchange of information relating to potential systemic consequences of AIFM activity - Article 51(3)

The content of the information to be exchanged having regard to the stability of systematically relevant financial institutions and the orderly functioning of markets in which AIFM are active.

Annex II: Member State Derogations

The Directive allows Member States to impose either lighter or stricter rules in certain circumstances by way of specific derogation or otherwise. If a Member State makes use of any derogation or option under Articles 6, 9, 21, 22, 28 or 41 of the Directive it must inform the Commission which will, in turn, make such information public.[90] A list of Member State options and derogations is set out here.

De Minimis Exemptions - Article 3

The Directive establishes two thresholds which, if met by a fund manger, would remove the manager from the full scope of the Directive. Under the Directive, such a manager would be required to register with its regulator, notify the regulator of the AIF it manages and provide certain information to the regulator. These provisions are applicable to managers which meet either of the two threshold conditions without prejudice to the stricter rules which Member States may impose.

Activities of AIFM - Article 6

The Directive provides AIFMs may only engage in certain activities. By way of derogation, Member States may allow an external AIFM to also undertake:-

- Management of portfolios of investments;
- Investment advice;
- Safe-keeping and administration of shares or units of collective investment undertakings; and
- Reception and transmission of orders in relation to one or more financial instruments.

However, if an external AIFM does undertake such activities, certain provisions of MiFID will apply to the provision of those services.

Initial Capital - Article 9

The Directive requires external and internal AIFMs to hold specified levels of initial capital and own funds. An AIFM is also required to hold additional own funds where the value of portfolios they manage exceeds EUR 250 million. However, a Member State may authorise an AIFM not to provide up to 50% of the additional own funds if the AIFM benefits from a guarantee of the same amount from a credit institution or insurance undertaking.

[90] Directive, Article 58.

Depositary - Article 21

The Directive requires that a depositary be appointed for each AIF managed by an AIFM. The depositary must be a credit institution, investment firm or another entity permitted under the UCITS Directive. Member States may allow that for AIFs which:

- Have no redemption rights exercisable during the period of five years from the date of the initial investments, and
- Do not generally invest in assets that must be held in custody or invest in issuers or non-listed companies to potentially acquire control over such companies.

The depositary my be an entity which is subject to mandatory professional registration recognised by law and which can provide guarantees to be able to effectively perform the depositary function.

Audit Requirements for Annual Reports - Article 22

The Directive requires accounting information in annual reports to be audited by persons authorised to do so according to EU law. By way of derogation, Member States may allow an AIFM marketing a non-EU AIF to have the annual reports of that AIF audited according to international auditing standards in force in the country in which the AIF has its registered office.

Disclosure of Acquisition of Control - Articles 26 and 28

An AIFM which manages an AIF which acquires control over a non-listed company or issuer is required to make certain information available to the company concerned, its shareholders and the AIFM's regulator. Member States may additionally require the information to be made available to the regulator of the non-listed company.

Marketing of non–EU AIF by EU AIFM in the EU - Article 36

Member States may allow an EU AIFM to market a non-EU AIF or an EU feeder AIF to professional investors in their country only, provided that certain conditions are met by the AIFM. Member States are able to impose stricter rules on the AIFM.

Marketing by non-EU AIFM of AIF in the EU - Article 40

Member States may allow non-EU AIFMs to market an AIF they manage to professional investors in their country provided that certain conditions are met. Furthermore, Member States may impose stricter rules on such non-EU AIFMs in this regard. These options are intended to be optional.

Marketing of AIF by AIFM to Retail Investors - Article 41

Member States may permit AIFMs to market AIFs to retail investors in their country, regardless of whether the AIFs are marketed on a domestic or cross-border basis or whether they are EU or non-EU AIFs, subject to other EU law requirements. Stricter requirements can be imposed on the AIFM than the requirements applicable to AIFs marketed to professional investors under the Directive. However, stricter requirements may not be imposed on an EU AIF in another Member State marketed on a cross-border basis than on a AIF marketed domestically.

Annex III: Actions Required by ESMA

Powers

ESMA may define and regularly review guidelines for the competent authorities of the Member States on the exercise of their authorisation powers and on the reporting obligations by the competent authorities imposed by the Directive.

ESMA may request a competent authority to take any of the following measures, as it deems appropriate:

- Prohibit the marketing of shares or units in the EU of AIFs managed by a non-EU AIFM or of a non-EU AIF managed by an EU-AIF without the authorisation required under Article 37 or without the notification required under Articles 38 and 39, or, as the case may be, without being allowed to do this by the relevant Member State in accordance with Article 40;
- Impose restrictions on non-EU AIFMs relating to the management of AIFs in case of excessive concentration of risk in a specific market on a cross border basis; and
- Impose restrictions on non-EU AIFMs relating to the management of AIFs where their activities potentially constitute an important source of counterparty risk to a credit institution or other systematically relevant institutions.

ESMA may take a decision under the above if the following conditions are fulfilled:

- A substantial threat exists, originating or aggravated by the activities of an AIFM, to the orderly functioning and integrity of the financial markets or to the stability of the whole or a part of the financial system in the EU and there are cross border implications; and
- The relevant competent authority has not taken measures to address the threat or the measures that have been taken do not sufficiently address the threat.

In taking such measures, ESMA must ensure that:

- The threat to the orderly functioning and the integrity of the financial market or to the stability of the whole or a part of the financial system in the EU is effectively addressed or the action significantly improves the ability of the competent authorities to monitor the threat;
- There is no risk of regulatory arbitrage created in implementing such measures; and
- The efficiency of the financial markets is not at a detriment, especially insofar as liquidity and certainty are concerned, in a way that is disproportionate to the benefits of the measure.

Before renewing any such measure, ESMA must consult the European Systemic Risk Board (the "ESRB").[91]

[91] Directive, Article 46(7).

Draft Regulatory Technical Standards

In light of the above, ESMA may determine draft regulatory technical standards in relation to:

Types of AIFM

To ensure consistent application (Article 4).

Authorisation

- The information to be provided to competent authorities in an application for authorisation by an AIFM, including the programme of activity (Article 6).
- Standard forms, templates and procedures for the provision of information in authorisation applications (Article 7).
- Obstacles which may prevent the effective exercise of the supervisory functions by supervisory authorities (Article 8(6)).

Marketing and Managing – Standard Notifications

Under Articles 31, 33, 35 and 43, ESMA may specify the form and content of the standard model of notification letter and written notice required to be submitted to the competent authorities of a Member State

Marketing of non-EU AIF by EU AIFM with a Passport

Under Article 35 ESMA may specify conditions of the application of the measures adopted by the Commission regarding cooperation arrangements necessary to implement the passport regime, and identify cooperation agreements that are necessary to implement the Passport regime. In doing so ESMA will develop regulatory technical standards to specify the procedures for coordination of information, in order to ensure consistent harmonisation.

National Private Placement Regime for non-EU funds managed by EU AIFM

ESMA is charged with developing guidelines to determine the conditions of application of the measures adopted by the Commission regarding cooperation arrangements necessary to partake in the National Private Placement Regime (Article 36).

Authorisation for non-EU managers intending to manage EU funds or market funds in the EU

Under Article 37 Paragraph 22, ESMA may develop draft regulatory technical standards on the following in order to ensure the uniform application of Article 37, in relation to:

- The manner is which the AIFM should comply with the requirements laid down in this Directive, taking into account that the AIFM is established in a third country; and
- Conditions under which the law that a non-EU AIFM or a non-EU AIFM is submitted is considered to provide for an equivalent rule having the same regulatory purpose and offering the same level of protection to the relevant investors.

ESMA Supervisory Tasks

Additionally EMSA will be required to take action as listed below.

Determination of AIFM

Under Article 5 ESMA must keep a central public register identifying each AIFM authorised under the Directive.

Remuneration

Article 13 states that ESMA must ensure the existence of guidelines on sound remuneration policies that comply with the principles which are set out in Annex 2 of the Directive.

Transparency Requirements

Under Article 24, ESMA may request the competent authorities of the home Member State of the AIFM to impose additional reporting requirements. Article 25 states that ESMA must perform a facilitation and coordination role, and in particular try to ensure that a consistent approach is taken by the competent authorities of Member States and that after having received a notification with regard to any measure the competent authority of a Member State proposes to implement, ESMA will issue the competent authority of the Member State with advice about the measure that is proposed or taken.

Leverage

ESMA may determine that the leverage employed by an AIFM, or by a group of AIFMs, poses a substantial risk to the stability and integrity of the financial system and may issue advice to competent authorities specifying remedial measures to be taken (including limits on the level of leverage, which that AIFM, or that group of AIFMs, can employ) - Article 25 Paragraph 7.

Peer Review

Articles 37 and 37a specify that ESMA must, on an annual basis, conduct peer review analysis of the supervisory activities of the competent authorities in relation to the authorisation and the supervision of non-EU AIFM, and on the basis of the conclusions of the peer review, ESMA may issue guidelines and recommendations pursuant to Article 8 (conditions for granting authorisation) with a view to establishing consistent, efficient and effective supervisory practices of non-EU AIFM.

Coordination

Article 37 states that ESMA must fulfil a general coordination role and will develop criteria to ensure any third country law provides for a rule equivalent to the provisions for which compliance is impossible.

Exchange of Information

Under Article 37, ESMA must promote an effective bilateral and multilateral exchange of information between the competent authorities of the Member State of reference of a non-EU AIFM and the competent authorities of the home Member States of the AIFM concerned, with full respect of the applicable confidentiality and data protection provisions provided for in the relevant EU legislation.

Administrative Penalties

ESMA must produce an annual report on the application of administrative measures and imposition of sanctions in case of breaches of the provisions adopted in the implementation of this Directive in different Member States, in accordance with the provisions in Article 46.

Opinions

Two years after the date of implementation, ESMA will issue to the Commission, the Parliament and the Council an opinion on the functioning of the Passport Regime for EU AIFM managing and/or marketing EU AIF and advice on the application of the Passport Regime to the marketing of non-EU AIF by EU AIFM and the management and/or marketing of AIF by non-EU AIFM in Member States.

And further, three years after the date of entry into force of the delegated act introduced as a consequence of ESMA's decision under Article 63 outlined above, ESMA shall issue to the Commission, the Parliament and the Council an opinion on the functioning of the Passport Regime for EU AIFM managing and/or marketing EU AIF and advice on the application

of the Passport Regime to the marketing of non-EU AIF by EU AIFM and the management and/or marketing of AIF by non-EU AIFM in Member States, as per Article 63.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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