Another Milestone for the AIFMD – Time for Non-EU Private Equity Advisers to Take Stock?

The Alternative Investment Fund Managers Directive ("AIFMD") was published on June 8, 2011. It introduces a Europe-wide regime aimed at regulating the activities of those who manage and market alternative investment funds, such as private equity funds ("Funds"). The AIFMD has been in the public domain for over a year and its immediate impact has yet to be felt. However, on November 16 the European Securities and Markets Authority ("ESMA") took the first legislative step towards the implementation of the AIFMD by presenting its technical advice on the AIFMD implementing measures ("Technical Advice") to the European Commission ("Commission"). The Technical Advice addresses issues which are relevant to non-EU advisers, including "Third Countries", general provision for managers, authorization and operating conditions and transparency requirements and leverage.

Executive Summary and Next Steps for Advisers

This Technical Guidance brings the AIFMD's impact closer and represents an opportunity for U.S. and other non-European private equity advisers to consider or reconsider the AIFMD's impact:

- For an adviser or manager considering any fund-raising in the EU, it will need to ensure that this fund-raising is completed by July 21, 2013 to avoid the need to comply with the AIFMD's fund-raising requirements.
- These include specific requirements relating to portfolio companies where those companies are private European Union ("EU") companies – advisers raising funds after July 21, 2013 will need to pay special attention to the question of whether the funds make European investments.
- In light of the requirement for any vehicle, including a feeder vehicle, which is established in the EU to have a manager which complies with the AIFMD (an "AIFM") from July 2014, the adviser may need to reconsider the structure of existing funds with fund vehicles established in the EU.
- An adviser with a subsidiary in the EU will need to consider whether that subsidiary will become subject to the AIFMD and may need to reconsider the structure of its business by July 2014.

Fund Raising in Europe after July, 2013

From July 22, 2013, the AIFMD will apply to anyone who wishes to market a Fund to a professional investor in or into any country located in the European Union (a "Member State").

Reverse Solicitation

The AIFMD will not apply where any investor in a Member State approaches an adviser or manager, *i.e.* marketing by reverse solicitation. This means that a professional investor will be able to continue to invest in the Fund by approaching the adviser provided the adviser has not solicited the investor prior to the approach. The AIFMD does not contain much guidance on precisely when a professional investor may have made a reverse solicitation so advisers will need to approach the question of reverse solicitation with caution.

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Conditions for Active Solicitation

Even where an adviser cannot rely on reverse solicitation, there will be no need for the adviser to be authorized in any Member State until at least July 2018. However, from July 22, 2013 the following conditions will need to be satisfied on a Member State by Member State basis:

- "Appropriate co-operation arrangements" will need to be in place between the Fund manager's regulator and the Member States in or into which the adviser wishes to market the Fund and the regulators in the jurisdiction in which the Fund is located. The Fund manager's jurisdiction cannot have been designated by the Financial Action Task Force as a non-co-operative country or territory (the "Home Regulator Requirements").
- The adviser will need to comply with each Member State's private placement rules ("Member State Private Placement Requirements").
- The adviser will need to ensure that specific requirements related to the Fund itself are satisfied ("AIF Transparency Requirements"); and
- The adviser will need to ensure compliance with requirements related to deals, which the Fund that it has marketed undertakes, in a 50% percent or greater owned portfolio company which has its registered office anywhere in the EU or whose shares area admitted to trading on an EU exchange ("EU Portfolio Company Requirements").

From July 22, 2015 until July 21, 2018, an adviser can choose between (a) marketing a Fund on the Member-State-by-Member-State basis in reliance on the Member State Private Placement Requirements or (b) by becoming authorized in a Member State. This second option would permit the adviser to market Funds in other Member States, without the need for further authorization, in reliance on the "EU Passport".

From July 22, 2018, the Adviser will need to be authorized in a Member State but will enjoy rights under the "EU Passport". (The authorization requirements are discussed below.)

The Home Regulator Requirements

In the "Third Country" provisions of the Technical Advice, ESMA sets out the details of the co-operation arrangements between the Member State competent authority and the authority which regulates the non-EU adviser or manager, including agreement to exchange information for supervision, enforcement and other purposes and to carry on on-site inspections. ESMA suggests that it centrally negotiate a multilateral memorandum of understanding based on existing international standards, in particular the IOSCO Multilateral Memorandum of Understanding, to avoid different bilateral arrangements. These arrangements would be executed as joint agreements between all the Member State regulators and third country regulator involved.

Some jurisdictions, such as the Cayman Islands and Jersey, already have co-operation arrangements with various Member States and regulators and governments in various jurisdictions have already expressed a commitment to satisfying whatever requirements may be imposed under the AIFMD. The challenge for ESMA and the Member State authorities is to put in place the arrangements by July 21, 2013.

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AIF Transparency Requirements

For each Fund that an adviser markets in or into a Member State, the manager will be required to:

- produce an audited annual report and provide it to investors and competent authorities;
- make specific disclosure to investors including information on the AIF's investment strategy and objectives, the main legal implications for the AIF, the various parties providing services to the AIF, valuation procedures and pricing methodology, liquidity risk management processes (to the extent that these would be relevant), fees, charges and expenses, and measures to ensure the fair treatment of investors; and
- make various reports to competent authorities including the actual risk profile of the AIF and the main categories of assets in which the AIF is invested.

The Technical Guidance suggests that the frequency of reporting be tailored according to the assets under management of the AIFM, according to the following thresholds: (a) For those AIFM whose AUM is below EUR 100 million, reporting will be required annually; (b) For AIFM managing between EUR 100 million and EUR 1.5 billion reporting will be required semi-annually; (c) For AIFM managing more than EUR 1.5 billion reporting will be required Additionally, those AIFM falling within (b) shall for each AIF that is larger than EUR 500 million, report quarterly in respect of that AIF. The Technical Guidance provides a reporting template.

While private equity fund managers may, as a matter of contract or market practice, already be subject to the first two requirements, the AIFMD will place these on a legislative footing. A manager's compliance with these requirements will no longer be a matter for private negotiation.

Portfolio Companies and Deal Structures

The AIFMD imposes various duties on the manager of a Fund marketed in a Member State where the Fund either individually or jointly on the basis of a control agreement, acquires more than 50% of the voting rights of a non-listed company that has its registered office in the EU whose shares are not admitted to trading on a regulated market. An AIFM's investments in companies established outside the EU will, therefore, not be subject to the EU Portfolio Company Requirements, which in some cases echo the requirements that currently apply to public companies in many EU Member States:

- Notification of the acquisition of major holdings and control on non-listed companies – as part of the notification, the manager must request the board of directors to inform the employee representatives or employees, without undue delay, of the AIF's acquisition of control.
- Disclosure in the case of acquisition of control to the EU portfolio company itself – this includes information regarding the AIF's intentions with respect to the future business of the company and the likely repercussions on employment and conditions of employment.
- Additional information regarding the Fund exercising control of any EU portfolio company – this must contain at least a fair view of the development of the company's business and also give an indication of, amongst other things, the company's likely future developments.

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- "Asset stripping" – the AIFMD contains restrictions on distributions, capital reductions, share redemptions and/or purchases of own shares by controlled portfolio companies during the first two years of a Fund's ownership. In the context of the acquisition of an EU portfolio company, a manager may need to give consideration to (a) whether the payment by the company of any fees or expenses, intra-group restructurings, the manner in which any debt is to be serviced and (b) any "upstream" payment obligations from the portfolio company under a security arrangement.

The AIFMD creates various provisions governing leverage including that for financial or legal structure involving third parties. The Recitals to the AIFMD make it clear that the leverage which exists at the level of a portfolio company is not to be included for private equity or venture capital legal or financial structures. The Technical Guidance reflects this.

Impact on Funds – Feeder Vehicles Located in Europe

In addition to marketing issues, the general partner or other manager of a Fund, which has a vehicle used for making investments in all or part of the Fund, authorized or registered or with a registered office in a Member State, will need to consider whether it needs to become authorized under the AIFMD. If so and subject to certain transitional provisions for Funds that make no further investments or Funds that "expire" by July 21, 2016, it would need to do by July 21, 2014.

For advisers and managers, this means that they should examine the structure of existing funds to see whether there are any constituents of the Fund which could potentially require an entity within that structure to be authorized under the AIFMD. If so, the advisers and managers will need to consider whether and what changes are required to the Fund documentation to avoid the need for authorization or identify the entity to be designated and authorized as the "AIFM".

EU Based Subsidiaries of an Adviser – Revisiting Delegations of Power

The Member State based subsidiary or affiliate of an adviser which provides individuals to sit on the Fund manager's investment committee based outside the EU may need to examine its arrangements with the manager. In particular, the subsidiary will need to consider whether this, of itself, would render it an "AIFM" on the basis that it is performing the activity of "portfolio management". Moreover, where the subsidiary also provides "risk management" services, *e.g.* providing expertise to help assess the market risk within a particular Fund, the adviser will need to consider whether this triggered an authorization requirement under the AIFMD and what, in practice, this might mean. The outcome of this analysis will turn, in part, on whether one or both of the activities of "portfolio management" and "risk management" trigger an authorization requirement under the AIFMD. The AIFMD text is unclear on this.

As above, advisers and managers will need to consider whether and what changes need to be made to the Fund documentation to avoid the need for a Member State based subsidiary or affiliate to be authorized or address the consequences of the subsidiary's or affiliate's designation and authorization as the "AIFM". This may include revisiting any delegations of power from managers to advisers as the AIFMD only permits an AIFM to delegate its functions, including "portfolio management" and "risk management" but only to the extent that the AIFM does not become a "letter box entity". The Technical Advice suggests that an AIFM will become a "letter box" entity where the AIFM ceases to have the necessary expertise and resources to supervise and manage the risks of the delegated tasks effectively or to have the power to take decisions in key areas, such as investment policy and investment strategies.

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Authorization Requirements

Where an adviser and manager decide that an entity within a Fund structure is to be designated and authorized as an "AIFM", then various requirements will apply which include:

- The need for the AIFM to appoint a "legal representative" in its Member State of Reference ("MSR"). In essence, the MSR is determined by the Member State where the AIFM wishes to "develop effective marketing" or, in the case of being an AIFM by virtue of having an EU vehicle within the Fund structure, the location of that EU vehicle.
- Fitness and properness requirements.
- Capital requirements.
- Systems and controls requirements.
- The requirement to appoint a depositary, which in the case of a Fund that does not have redemption rights in the first five years and do not generally invest in issuers or non-listed companies in order to potentially acquire control over them, may be an entity which carries out the depositary function as part of its professional or business activities. This means that an AIFM will be able to appoint, for example, an attorney or similar professional to act as the depositary.

  In the context of private equity, a particular feature for depositaries emerging from the Technical Guidance is the requirement for a depositary to apply the safekeeping rules to the underlying assets in financial structures controlled by a Fund. Therefore, where a Fund forms a holding company which, in turn, invests in a portfolio company, the AIFMD will require the depositary to keep records for both the holding company and for the portfolio company. Moreover, if accepted, the Technical Guidance will require an adviser to inform a depositary of any asset transfer prior to such transfer imposing, in effect, an *ex ante* control by depositary on private equity transactions.
- Requirements and restrictions with respect to remuneration that apply both with respect to management and fees and with respect to carried interest.

Next Steps

Following presentation of the Technical Guidance, the Commission is expected to make further rules – the "Level 2 Measures" by July 2012. The Commission is not legally bound to follow the Technical Advice and has already indicated that it does not agree with all of ESMA's policy orientations. It will then fall to each individual Member State to transpose the AIFMD and Level 2 Measures into its laws to give legal effect to the AIFMD in that Member State.

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Ropes & Gray has prepared a detailed Q&A document which can be individually tailored to the particular needs of any client. If you have any additional questions about the AIFMD or other European laws or regulations or would be interested in receiving a more detailed Q&A document, please contact Andrew Henderson at andrew.henderson@ropesgray.com.

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