AIFMD Implementation – What Should Non-EU Private Fund Advisers be doing?

The Alternative Investment Fund Managers Directive ("**AIFMD**") has been in the public domain for over two years. However, various legal measures, both at European Union ("**EU**") and at individual EU Member State ("**Member State**") level, implementing the AIFMD have recently been finalized or are now near final, including the "Level 2" regulation supplementing the AIFMD ("**AIFMR**"). Further, the European Securities and Markets Authority ("**ESMA**") has recently published various draft "regulatory technical standards" and has finalized its Guidelines on Sound Remuneration Policies ("the **Remuneration Guidelines**").

Although the key principles governing AIFMD were enshrined in November 2011, these recent developments give a better idea of the duties which AIFMD will impose on managers that are alternative investment fund managers ("**AIFMs**") with the meaning of the AIFMD. This alert communicates the impact of AIFMD on non-EU managers ("**Advisers**") of hedge funds, private equity funds and other alternative investment funds ("**Funds**") that raise funds or are otherwise active in the EU.[1]

Executive Summary and Checklist of Next Steps for Non-EU Advisers

- Advisers who plan to **market** Funds into any Member State after **July 21, 2013** will need to:
  - Determine whether marketing can be structured such that any marketing undertaken after July 21, 2013 is at the initiative of the relevant European investors.
  - Check and monitor the status of co-operation arrangements that need to be in place between a relevant Member State competent authority ("**Regulator**"), the Adviser's Regulator and the Regulator in the jurisdiction of the Fund.
  - Check and monitor whether the AIFMD is to be implemented in any Member State in such a way that that goes beyond the minimum requirements of the AIFMD, e.g., by restricting reliance on existing private placement requirements.
  - Review the contents of any private placement memorandum or other marketing materials to ensure that they comply with the AIFMD's investor disclosure requirements.
  - Put in place systems and controls for preparation of an annual report to investors which complies with the requirements in the AIFMD and the AIFMR and which the Adviser would need to make within four months of the end of the Fund's financial year.[2]
  - Put in place systems and controls for completion of reports to Member State Regulators in compliance with the AIFMD and AIFMR.[2]
  - Put in place systems and controls for preparation of the periodic disclosure to investors required by AIFMD relating to assets which are subject to special arrangements arising from their illiquid nature (if applicable).[2]

[1] As a basic threshold, any Advisor who directly or indirectly manages a Fund with assets under management that exceed either (i) €500 million, where the Fund is unleveraged and has no redemption rights for at least five years, or (ii) €100 million in all other cases, will need to consider whether the AIFMD applies to its activities.
[2] The actual timing for making the various disclosures will depend on the rules made in each Member State to give effect to these requirements of the AIFMD.

- Put in place systems and controls for preparation of the regular disclosure to investors required by AIFMD on changes to maximum levels of leverage (if applicable).[2]
- Review and monitor implementation of the provisions of the AIFMD governing the obligations of AIFMs managing Funds which acquire control of non-listed companies and issuers (the "**EU Private Equity Specific Provisions**").

- Advisers who have an office in a Member State which provides advisory or any services to or for the benefit of a Fund (irrespective of where that Fund is established/registered) will need to consider whether the activities of that office would render it an AIFM and, if so:
  - make an application for that office to be authorized by the applicable Member State Regulator by **July 21, 2014** and prepare themselves for full compliance with the AIFMD, including, for example, the rules on disclosure of remuneration and the appointment of a depository; and
  - consider to what extent management functions can be delegated to an entity outside the EU which would not itself be subject directly to the AIFMD – in this respect, the delegation would have to comply with the AIFMD delegation provisions as amplified by the AIFMR. In particular, the delegation would have to be such that it did not render the AIFM a "letter box entity".
- Advisers who have any Fund established/registered in a Member State which is managed by the Adviser will need to consider whether the AIFMD would require the Adviser or some other entity to be registered as an AIFMD AIFM and comply with the AIFMD. In this respect, the AIFMD does not yet provide a mechanism for a non-EU entity to be the AIFM for an EU Fund. However, it is likely to do so from **late 2015** when the "authorization of non-EU AIFMs intending to manage EU Funds and/or market Funds managed by them in the EU" provisions are intended to come into effect. (This is confirmed by the Treasury's proposed implementation of the AIFMD in the UK.)

Note: from **late 2015 until late 2018**, an Adviser will be able to choose between (a) marketing a Fund on the basis set out in the executive summary above (the "**Member-State-by-Member-State Option**") or (b) becoming authorized in a Member State, which would enable the Adviser to market Funds in other Member States without the need to be authorized in those Member States (the "**Passport Option**").

From **late 2018 onwards**, only the Passport Option will be available and 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.

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 EU (a "**Member State**").

Reverse Solicitation

The AIFMD will not apply where any investor in a Member State approaches an Adviser, 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 managers will need to approach the question of reverse solicitation with caution.

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 with respect to any Fund offering in the EU by a non-EU AIFM:

- The Adviser will need to comply with each Member State's private placement rules ("**Member State Private Placement Requirements**");
- Appropriate co-operation arrangements will need to be in place between the Fund Adviser's regulator, 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 Adviser's jurisdiction cannot have been designated by the Financial Action Task Force as a non-co-operative country or territory (the "**Home Regulator Requirements**", which are discussed in more detail below); and
- The Adviser will need to ensure compliance with the specific Fund-related requirements governing (a) the contents of any private placement memorandum or other marketing materials, (b) the preparation of an annual report, (c) the submission of reports to Member State Regulators that comply with the AIFMR, (d) periodic disclosure to investors relating to assets which are subject to special arrangements arising from their illiquid nature (if applicable) and (e) regular disclosure to investors of changes to maximum levels of leverage (if applicable) ("**Fund Information Requirements**", which are discussed in more detail below).
- Where the Adviser manages a Fund which makes majority investments in any non-listed company that has its registered office in the EU, it will also have to take note of the EU Private Equity Specific Provisions.

Member State Private Placement Requirements

The Member State Private Placement Requirements will be determined on a Member-State-by-Member-State basis and, as is the case today, the private placement rules in one Member State may be different from those in another Member State. In particular, an Adviser may not be able to market a Fund in a Member State because (a) the existing rules in such Member State do not permit the marketing of a Fund without registration of the Fund or the appointment of a locally authorized entity to undertake the marketing, or (b) the existing rules in such Member State will be changed in response to the implementation of the AIFMD to require registration of the Fund or the appointment of a locally authorized entity to undertake the marketing. In Germany, for example, the rules will undergo some change.

The Home Regulator Requirements

Articles 113 to 116 of the AIFMR govern the Home Regulator Requirements and set out the details of the cooperation arrangements that may be entered into between the Member State competent authority and the authority or authorities in the Adviser's and Fund's home jurisdictions, including agreements to exchange information for supervision, enforcement and other purposes and to carry out on-site inspections.

Some jurisdictions, including the United States, the Cayman Islands and Jersey, already have cooperation arrangements with various Member States, and regulators and governments in other jurisdictions have already expressed a commitment to satisfying whatever requirements may be imposed under the AIFMD. Moreover,

the regulators in jurisdictions, such as the United States, the Cayman Islands and Jersey, are signatories to the IOSCO MMOU which may help the process. Nevertheless, ESMA and the Member State authorities will still have to put in place cooperation arrangements by July 21, 2013. Advisors should confirm that the jurisdictions in which they operate or have formed Funds will be party to cooperation agreements by the deadline.

Fund Information Requirements

For each Fund that an Adviser markets in or into a Member State, the Adviser will be required to put in place systems with respect to the following:

Private Placement Memorandum or Other Marketing Materials

These will need to contain information relating to the items identified in Article 23 of the AIFMD, which include a description of: the investment strategy and objectives of the Fund; professional indemnity insurance; any delegated functions; valuation procedures; fees, charges and expenses; how the AIFM ensures the fair treatment of investors, and the latest annual report referred to below. Although Advisers may, as a matter of market practice, already provide these types of disclosure, from July 22, 2013, these will now be required by statute.

An Annual Report

The Adviser will have to provide an annual report which complies with Article 22 of the AIFMD as amplified by Articles 103 to 107 of the AIFMR to investors and to the Regulator in each Member State into which it markets the Fund within four months of the end of the Fund's financial year. The Annual Report will have to contain financial and accounting information prepared in accordance with the accounting standards in the Fund's jurisdiction of incorporation. The Annual Report will also have to contain:

- a report on the activities of the most recent financial year;
- any material changes in information (that is, information that would be likely to cause a reasonable investor to reconsider its investment in the Fund); and
- disclosures regarding the remuneration of the entity that would be deemed to be the AIFM of the Fund, including any carried interest or performance fee/performance allocations and general information governing remuneration policies, and (following Chapter XIII of the ESMA Remuneration Guidelines) detailed information regarding the AIFM's remuneration policies and practices for members of staff whose professional activities have a material impact of the risk profile of the Funds which have been marketed into the relevant Member State.

Reports to Member State Regulators

The Adviser will have to make "regular" reports to the Regulator in each Member State into which it markets the Fund which comply with Article 24 of the AIFMD as amplified by Article 110 of the AIFMR. Required disclosures include the main instruments in which the Fund is trading, the markets of which the Fund is a member or where it actively trades, and the diversification of the Fund's portfolio. The AIFMR provides a *pro forma* reporting template in Annex IV on which the Regulators in each Member State can base their reporting forms (the "**Template**"). The regularity with which an Adviser would be required to report will depend on the amount of assets under management ("**AUM**") or the nature of the assets in which the Fund invests.

The EU Private Equity Specific Provisions

The AIFMD imposes various duties on Advisers to 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. 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 of 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 Fund's acquisition of control.
- Disclosure in the case of acquisition of control to the EU portfolio company itself – this includes information regarding the Fund'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 give an indication of, amongst other things, the company's likely future developments.
- "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) the payment by the company of any fees or expenses, (b) intra-group restructurings, (c) the manner in which any debt is to be serviced, and (d) any "upstream" payment obligations from the portfolio company under a security arrangement.

The AIFMD includes various provisions governing leverage. 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. Neither the AIFMR nor any ESMA measure have sought to dilute this.

Advisers with Offices in Member States

An Adviser with an EU-based subsidiary or affiliate which provides services with respect to a Fund may need to reexamine such arrangements. In particular, the EU-based subsidiary will need to consider whether any arrangement would render it an "EU 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 manager will need to consider whether this arrangement will trigger 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 still unclear on this.

Where an Adviser concludes that its subsidiary is an EU AIFM, it will need to consider whether the EU subsidiary should become authorized by the applicable Member State Regulator and if so will need to make the necessary application by **July 21, 2014**. An Adviser should also consider to what extent existing fund or management structures could be changed, for example, by delegating functions to an entity outside the EU which would not itself be subject directly to the AIFMD, and should also put in place any such arrangements by July 21, 2014.

Authorization Requirements

Where an Adviser decides that an EU subsidiary or some other entity within the EU should be designated and authorized as an EU AIFM, then various requirements will apply, many of which already apply, in practice, to the EU subsidiaries of an Adviser which are authorized under the Markets in Financial Instruments Directive ("**MIFID**") or the individual Member State regimes ("**Local Regimes**"). These include fitness and properness requirements, systems and controls requirements and conduct of business requirements. The following are more important new requirements under AIFMD in addition to those that already exist, in practice, under MiFID or the Local Regimes:

- *Regulatory Capital and Prudential Requirements*: An EU AIFM appointed as external manager of one or more Funds will be required to hold initial regulatory capital of at least €125,000. Additional capital will be required for any EU AIFM that manages Funds in excess of €250m. The EU AIFM will also have to ensure that any Fund and underlying assets are appropriately, consistently and independently valued on a regular basis. The EU AIFM will also be responsible for implementing adequate risk management systems and due diligence processes when investing on behalf of the Fund. It will also have to employ an appropriate liquidity management system to monitor the Fund's liquidity risk, as appropriate, including regular stress tests.
- *Depositaries*: An EU AIFM will be required to appoint a depositary that is separate from the Adviser. For hedge funds, a prime broker may be a depositary provided that conflicts of interest are managed. In the case of a Fund that does not have redemption rights in the first five years and does not generally invest in non-listed companies in order to potentially acquire control over them, the depositary may be an entity which carries out the depositary function as part of its professional or business activities. The duties of the depositary will include safekeeping of assets, asset verification, cash-flow monitoring, handling investor subscriptions, and ensuring that transactions are carried out and valued in accordance with national law.

Delegation

As above, managers may need to consider whether and what changes need to be made to Fund documentation to avoid the need for a Member State-based subsidiary or affiliate to be authorized or to 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 sub-managers or advisers, as the AIFMD permits an AIFM to delegate its functions, including "portfolio management" and "risk management" but only to the extent that the AIFM does not as a result become a "letter-box entity" within the meaning of Article 21 of the AIFMD.

Article 82 of the AIFMR amplifies Article 21 by identifying the situations where an AIFM would be deemed to be a "letter-box entity". These include situations where the AIFM: (a) is no longer able to effectively supervise the delegated tasks and manage the risks of the delegation; (b) no longer has the power to take senior management decisions or perform senior management functions (in particular, in relation to the implementation of investment policies and strategies); (c) loses (or can no longer exercise) its contractual rights to inquire, inspect, have access to, or give instructions to, its delegates; or (d) delegates the performance of investment management functions to an extent that "exceeds by a substantial margin the investment management functions performed by the AIFM". In this respect a Regulator would assess the entire delegation structure including taking into account criteria such as the assets managed under delegation, the

assets invested in, and the importance of those managed under delegation to the risk and return profile of the Fund, the importance of the assets managed under delegation for the achievement of the Fund's investment goals, the geographical and sectoral spread of the Fund's investments, the risk profile of the Fund, the investment strategies pursued, the types of tasks delegated, the configuration of delegates/sub-delegates, their geographical sphere of operation and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM.

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If you have any additional questions about the AIFMD or other European laws or regulations, please contact **Anand Damodaran** at anand.damodaran@ropesgray.com or **Katerina Sandford** at katerina.sandford@ropesgray.com.