AIFMD – What Actions Should Non-EEA Private Fund Managers Be Taking Now?

The Alternative Investment Fund Managers Directive ("**AIFMD**"), which governs alternative investment fund managers ("**AIFMs**"), required EU Member States ("**Member States**") to implement the AIFMD into national law as of 22 July 2013. AIFMD was duly implemented by the majority of EEA Member States[1] as of that date, with others[2] implementing later or planning to implement at varying points this year. Following implementation, the transitional provision in the AIFMD has exempted many non-EEA private fund managers from compliance with the AIFMD until the transitional period ends on 22 July 2014.

This Alert considers the steps non-EEA managers ("**Managers**") of hedge funds, private equity funds and other alternative investment funds (including, for this purpose, US mutual funds) ("**Funds**") that raise funds or are otherwise active in the EEA should now be taking.

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

- Managers that are currently marketing Funds into any Member State in reliance on the transitional relief on a "private placement" basis will either need to stop marketing before 22 July 2014 or consider the new conditions for marketing in that jurisdiction that will apply at the end of the transitional period. These vary by jurisdiction and usually involve a form of registration or notification with the regulator in the relevant jurisdiction. Some Member States impose an additional requirement for a depositary, even though this is not strictly required by the AIFMD. Managers that anticipate marketing their Funds to EEA investors after 22 July 2014 should start planning now for the registrations or notifications that will be required.
- Managers will need to consider the obligations under AIFMD that will arise by virtue of marketing a Fund in any Member State after the end of the transitional period (the "**Private Placement AIFMD Obligations**"). These are mandated by the AIFMD and cover disclosure and reporting to investors, reporting to the regulators in the applicable Member States, certain disclosure provisions triggered by acquisitions of stakes in EEA companies and anti-"asset stripping" provisions relating to EEA companies.
- Managers that have to date relied on a "reverse solicitation" approach in their offering of interests to EEA investors – thereby taking them outside AIFMD – will need to consider whether that approach can continue after 22 July 2014, and if so, whether enhanced compliance procedures are desirable.
- Managers will need to put in place systems for the preparation of a fund annual report that complies with the AIFMD (including a section on remuneration disclosure) and ongoing disclosures to investors. Marketing triggers these obligations.
- Managers will need to consider the requirements of the AIFMD regulatory reporting regime, which has some parallels with Dodd-Frank's Form PF. In particular, Managers should determine the first date when they will need to file regulatory reports in respect of the Funds that they have marketed and consider the systems needed to generate the data for the reports. Marketing triggers this obligation.
- Managers that wish to market a UCITS fund on a private placement, rather than "passporting" basis, will also be affected by the new private placement regimes.

[1] The European Economic Area (EEA) comprises the 28 member states of the European Union plus Iceland, Liechtenstein and Norway.
[2] Belgium, Norway and Spain are expected to implement the AIFMD in 2015.

- A Manager should calculate the total assets under management ("**AuM**") of all its Funds. The AIFMD is designed only to apply where the aggregate AuM exceeds EUR100m (or a higher threshold of EUR500m where the Manager manages private equity and similar unlevered closed-ended funds). However, due to different approaches to implementation of the AIFMD in Member State law, exemptions intended for "sub-threshold" Managers have not been granted in most cases to non-EEA Managers marketing in a Member State. Note that a sub-threshold Manager marketing the UK can take advantage of the sub-threshold exemption.

Fundraising in Europe after July 2014

Marketing

Subject to transitional relief, AIFMD has applied from 22 July 2013 to any Manager that markets a Fund to an investor in a Member State. The AIFMD enables each Member State to permit non-EEA AIFMs to market to professional investors in their country, subject to compliance with the Private Placement AIFMD Obligations (mentioned above).

Private Placement Regimes

The current private placement regimes of certain Member States that have implemented AIFMD can be grouped as follows:

- France and Italy: no private placement regime available.
- Germany and Denmark: registration with regulator required; Fund must appoint a depositary.
- Austria: registration with regulator required; Fund must appoint a legal representative in Austria.
- Sweden, Finland and Luxembourg: registration with regulator required.
- UK, Ireland and Netherlands: notification to regulator required.

Since registrations (where required) can take several weeks, this should be planned for now.

Reverse Solicitation Exception

The AIFMD has prompted wholesale review by Member States of the desirability of their citizens investing outside the EEA. However, the AIFMD does not apply where an investor invests on its own initiative, and the Manager responds to the investor's request for Fund information (so-called "reverse solicitation"). The UK FCA has said that "a confirmation from the investor that the offering or placement of units or shares of the [Fund] was made at its initiative should normally be sufficient to demonstrate that this is the case, provided that this is obtained before the offer or placement takes place." However, the FCA notes that AIFMs should not be able to rely on such confirmations as a means to circumvent the AIFMD.

Unfortunately, neither the European Commission nor ESMA has published any guidance on what constitutes "reverse solicitation", meaning that it is left to the interpretation of each Member State regulator, few of whom have published any guidance themselves. Therefore, any Manager relying on a reverse solicitation should maintain a robust compliance process which can provide evidence that the subscription was made on this basis. Where a placement agent or other intermediary is being used, the compliance procedures must cover their activities as well, because they are acting at the initiative of the Manager (unless

shown otherwise). Compliance procedures are important in the context of regulatory compliance, potentially involving serious sanctions and fines against the Manager and its agents. They are also important in the light of the private law actions that AIFMD breaches could give rise to in some jurisdictions – the risk that an investor looking to exit from the Fund seeks to argue that the Fund was offered in breach of the AIFMD and that it is entitled to the return of its invested capital. This has concentrated the minds of our clients going forward.

What constitutes marketing?

Marketing is defined in the AIFMD as a "direct or indirect offering or placement…of units or shares of a [Fund]". The UK FCA considers marketing to take place only where a Fund's units or shares are "available for purchase" – essentially, the stage where the investor receives the Prospectus or PPM and the Subscription Form. In practical terms, many Managers have been able to conduct "pre-marketing" activities in Member States, such as investor meetings and the provision of draft documentation, without triggering compliance with registration requirements. Care is needed here because a number of Member States construe any promotional activities intended to attract new investors as marketing for the purposes of AIFMD.

Conversely, Managers that wish to finalise their marketing activities before the end of the transitional period will need to consider the stage they must reach with investors at that point, to avoid any activities they conduct with investors after the end of the transitional period comprising "marketing" under AIFMD and thereby triggering AIFMD compliance.

Co-operation arrangements

The AIFMD requires that co-operation arrangements (which are bilateral Memoranda of Understanding ("**MoU**") between a given EEA regulator and the regulator(s) of the non-EEA Fund and Manager) are in place as a condition of marketing taking place.

Depositary requirements

Germany and Denmark require the appointment of one or more entities to perform the AIFMD depositary function as a condition for marketing in those jurisdictions. The depositary performs the following functions: (i) monitoring of the fund's cash accounts (including reconciling the accounts with third-party records); (ii) safe-keeping of assets (which comprises either holding assets in custody, where such assets are normally held in custody, or verifying the fund's ownership of assets that are not normally held in custody); and (iii) oversight of matters such as the NAV valuation (if applicable), compliance with investment restrictions and calculation of distributions made to investors. There are two important points to bear in mind when appointing a depositary. The first is that more than one entity can perform the functions, meaning that any existing custody arrangement can satisfy the "safe-keeping" function. The second is that there may be scope to fulfil these functions by the depositary reviewing existing processes (such as cash reconciliation) rather than performing the function itself.

Any Manager that needs to appoint a depositary should take the following steps: (i) consider to what extent the fund's administrator and/or custodian (if any) are already performing these services and thereby between them satisfy the requirement; (ii) discuss with the fund's administrator or custodian (if any) its willingness to

perform any additional oversight functions required; and (iii) look at third-party service provider offerings that may offer the entire service, including services specifically tailored to closed-ended funds.

AIFMD disclosure and reporting requirements

Once the Manager has met the "entry level" requirements of the Member States in which it wishes to offer the Fund to investors, it must then consider the Private Placement AIFMD Obligations. The obligations relating to investor disclosure and reporting, regulatory reporting and anti-"asset stripping" are set out in further detail below.

Investor annual report

The AIFMD requires that a Manager make available an annual report for each Fund it markets in the EEA no later than six months following the end of the financial year. There are various prescribed line items for the Fund's financial statements, and the annual report must contain prescribed items of disclosure relating to the Manager's remuneration (in aggregate and for various groups of individuals). The obligation applies in respect of the financial year in which the obligation arises.

Managers that market their Fund to EEA investors will need to prepare their first investor report no later than six months following the end of the financial year in which they conduct the marketing. So any Manager that markets in Europe on or immediately after 22 July 2014 will need to prepare its report by 30 June 2015 (assuming a 31 December financial year end).

Regulatory reporting

The AIFMD reporting form (known as Annex IV, as it is Annex IV to the AIFMD Level 2 Regulations) requires reporting to the relevant regulator of various information relating to both the Manager (for example, the principal types of investments it manages and where those investments are located or traded, and the total AuM of all its Funds) and the Fund (including details of its investment strategy, principal exposures and concentrations, detailed information on exposures and risk profile, the results of risk and liquidity management stress tests and leverage information for funds employing leverage on a substantial basis – much of this information is more relevant for hedge funds than private equity-type funds). In addition, regulators have the power to request additional information.

Private equity-type funds are subject to annual reporting. For hedge and other non-UCITS funds the reporting frequency is quarterly or six-monthly depending on the AuM of the Manager and the Fund. Assuming annual reporting, a Manager marketing in Europe on or immediately after 22 July 2014 will need to submit its first report by 1 February 2015.

The AIFMD reporting form has some similarities with the SEC's Form PF.

Investor disclosure

The AIFMD prescribes all the information that must be made available to investors before they invest. There is no prescribed format for making this information available, so there is some flexibility in the approach to meet these requirements. One approach is to include all the prescribed information in the Fund's

prospectus/PPM. An alternative option is to produce a "wrapper" that either sets out each item of information required by AIFMD or cross-refers to the relevant section of the prospectus/PPM.

There is also a requirement for certain periodic disclosures, for instance (in the case of hedge funds) the percentage of the Fund's assets that are subject to side pockets, gates or other similar arrangements. AIFMD prescribes the contents of these disclosures and when they must be made (typically at least when the AIF's annual report is made available to investors).

There is also a requirement for "material changes" to the information contained in the prospectus/PPM (or wrapper) to be made available to investors. It is as yet unclear the extent to which this would apply to preferential side letter provisions. There is no prescribed format for making these disclosures, but it could be included in or with the Fund's quarterly reports.

Anti-"asset stripping" and disclosure

The AIFMD also imposes restrictions on Managers that acquire stakes in unlisted EEA companies (above a certain SME size threshold). These comprise restrictions on "asset-stripping" – broadly speaking, within 24 months following the acquisition of control of an unlisted EU company by its Fund, a Manager: (i) may not facilitate, support, instruct or (if it can vote) vote for any distribution, capital reduction, share redemption and/or share buy-back; and (ii) must use its "best efforts" to prevent such actions.

There are also requirements for disclosure by the Manager to the EEA portfolio company, which are designed to ensure that any arrangements between the Manager and the portfolio company are on arm's length terms and that the employees of the portfolio company are aware of the Manager's intentions for the business.

AIFM Hosts and AIF Platforms

Managers that are interested in structuring an EU fund for their investors may consider using the services of an "AIFM host" or "AIF platform". In essence, these are European-authorized AIFMs that are willing to act as the AIFM to structures formed by a non-EEA Manager, fulfilling all the responsibilities of an authorized AIFM and appointing the non-EEA Manager as its delegated portfolio manager. Equally, opportunities exist for non-EEA Managers to be appointed to sub-funds of existing EEA AIF platforms. The advantages these structures confer are potential availability of the EEA marketing passport (making all private placement rules fall away) and the attractiveness to EEA investors of an EEA-managed and EEA-formed fund.