



# The European Alternative Investment Fund Managers Directive—a non-EU Fund Manager’s Perspective

## Introduction

The European Member States must implement the Directive on Alternative Investment Fund Managers (the “AIFMD”),<sup>1</sup> which came into force on July 21, 2011, into their national laws by July 22, 2013. Once the Directive is fully implemented, non-EU AIFMDs that wish to offer interests in private placements will have new compliance and reporting responsibilities.

This briefing note will discuss the key obligations imposed by the AIFM Directive and the delegated regulation supplementing the AIFMD (the “Regulation”) on non-EU AIFMs managing or marketing AIFs in the EU.

The AIFMD is focused not only on fund managers (“AIFMs”) based in Europe, but extends also to the management of European alternative investment funds (“AIFs”) by non-EU AIFMs, as well as to AIFMs of EU and non-EU AIFs, wherever the manager is based, where those funds are being marketed within the EU.

On December 19, 2012, the European Commission also published the Regulation,<sup>2</sup> the purpose of which is to create a single EU rulebook for AIFMs by providing rules which will have automatic application across all the EU Member States. The Regulation contains rules which develop the principles established by the AIFM Directive in a number of key areas including:

- calculation of value of assets under management;
- calculation of leverage;
- professional indemnity insurance to be held by AIFMs;
- operational and conduct of business requirements for AIFMs, including rules on conflicts of interest, risk management, liquidity management, investment in securitisation positions, internal governance and organizational requirements, valuation and delegation of AIFM functions;<sup>3</sup>
- obligations and rights of depositaries;

<sup>1</sup> See the final adopted text at, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:01:EN:PDF>.

<sup>2</sup> See Morrison & Foerster client alert: The New EU Directive on AIFM (17 November 2010), <http://www.mofo.com/files/Uploads/Images/101117-New-EU-Directive-on-AIFMs.pdf>.

<sup>3</sup> See the final adopted text at, [http://ec.europa.eu/internal\\_market/investment/docs/20121219-directive/delegated-act\\_en.pdf](http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf).

- transparency requirements as regards investors and supervisory authorities; and
- cooperation arrangements with third countries.

The Regulation entered into force on April 11, 2013 and is to be effective from July 22, 2013.

### **What is an AIF?**

The concept of an AIF is very broad-reaching, and is defined as a collective investment undertaking (including investment compartments thereof) which are not UCITs funds, but which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. However, from that broad general definition, it expressly excludes entities and arrangements, such as segregated managed accounts, family offices, joint ventures, insurance contracts, certain special purpose vehicles and employee participation or savings schemes.

“AIFM” is defined very simply as meaning a legal person whose regular business is the managing of one or more AIFs.

It should be noted that there is no requirement for a fund or a manager to be established or based in the European Union in order to fall within these definitions.

However, an AIFM will not be caught by the majority of the provisions of the AIFMD if the aggregate assets of all AIFs under its management do not exceed EUR 500 million (in respect of unleveraged AIFs where investors cannot redeem within 5 years) or EUR 100 million (in respect of leveraged AIFs). Such AIFMs have only basic obligations in relation to registration and notification of certain information. However, they will not be able to take advantage of the EU passporting benefits under the AIFMD unless they decided to opt-in fully to the AIFMD’s requirements.

### **What does “Managing an AIF” mean?**

Managing an AIF involves performing portfolio management activities and/or risk management activities for an AIF.

Each AIF which is within the scope of the AIFMD must have a single AIFM, for the purposes of the AIFMD, although it can continue to utilise the services of multiple entities, in terms of management and administration activities. Therefore, if there are various entities which perform activities on behalf of an AIF that will fall within the scope of the AIFMD, it will be necessary to position one of those entities to perform the job of the AIFM and become authorised under the Directive. In order to structure the positioning of such an entity to be an AIFM, care must be taken to ensure that any delegation of responsibilities by that AIFM is not so extensive as to render that entity a letter-box entity, pursuant to the detailed rules in the AIFMD in this regard. A letter-box entity will not qualify to be the AIFM for an AIF. Note in this regard that the delegation of **all** management and administration functions must be compared against the AIFMD requirements—not just the portfolio management and risk management functions.

### **What are the restrictions on managing EU AIFs?**

An EU AIF is defined as one which is either authorised or registered in an EU Member State, or which has its registered office and/or head office in an EU Member State. A non-EU AIFM, *i.e.* an AIFM which does not have its registered office in an EU Member State, which intends to manage an EU AIF must acquire prior authorisation by the competent authorities of their Member State of reference. In this regard, the Member State of reference will vary depending upon such factors as whether one or more than one AIF is being managed and, if the latter,

whether the AIFs have different home Member States, as well as whether the AIFM is or is not intending to market one or more of the AIFs within the EU under the passport mechanism provided for by the Directive.

### **In what circumstances is an AIFM permitted to market an AIF within the EU?**

A non-EU AIFM which intends to market an AIF (whether an EU AIF or a non-EU AIF) within the EU pursuant to the passport mechanism provided for by the Directive (which is expected to become available from 2015), will at that point require authorisation by the competent authorities of the AIFM's Member State of reference.

Determining the Member State of reference in these circumstances is complex and depends on factors such as how many AIFs are being marketed and in how many different Member States, as well as whether the AIF itself is or is not authorised or registered in a Member State. The Directive acknowledges that in certain cases it is possible for an AIFM to have more than one Member State of reference and in such cases, the AIFM must submit a request to the competent authorities of all the possible Member States of reference in order for them to jointly decide which will be the one Member State of reference.

"Marketing" in this context means a direct or indirect offering or placement, at the initiative of the non-EU AIFM or on behalf of the non-EU AIFM, of units or shares of an AIF that it manages to or with investors domiciled or with a registered office in the EU.

As the AIFMD explicitly states that marketing is only caught if marketing is performed at the initiative of the non-EU AIFM or on behalf of the non-EU AIFM, the AIFMD will not apply where any investor in the EU approaches a non-EU AIFM, *i.e.* a reverse solicitation. This means that a professional investor will be able to continue to invest in an AIF by approaching the non-EU AIFM provided that the non-EU AIFM 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, and therefore non-EU AIFMs will need to approach the question of reverse solicitation with extreme caution.

### **When will the restrictions on marketing AIFs in the EU become effective?**

Currently a non-EU AIFM may, in many EU Member States, market an AIF to professional investors using the national private placement regime in the relevant EU Member State.

From July 22, 2013 (*i.e.* the deadline for transposition of the AIFMD into the domestic law of each of the EU Member States), a non-EU AIFM that markets an AIF in the EU may continue to make use of any national private placement regimes in EU Member States, provided that certain minimum conditions are satisfied as follows:

- compliance with the obligations of an AIFM under Articles 22 to 24 of AIFMD, regarding submission and publication of an annual report for each AIF managed/marketed by it, the disclosure to investors, pre-investment, of key information relating to each AIF and regular reporting of key information to the competent authorities of each Member State in which it markets AIFs;
- cooperation arrangements and information exchange agreements must be in place between (a) the competent authorities of each EU Member State where the AIF is to be marketed; (b) the competent authority/supervisory authority of the member state/third country domicile of the AIF; and (c) the supervisory authority of the country where the non-EU AIFM is established. This is to ensure that information on the AIF and its non-EU AIFM can be exchanged efficiently to allow the competent authorities of the relevant EU Member States to carry out their supervisory duties effectively under the Directive; and

- at the time of marketing, neither the AIF nor the AIFM is authorised or registered in a country which is listed as a “Non-cooperative Country and Territory” by the Financial Action Task Force on anti-money laundering and terrorist financing (“FATF”).

In relation to the UK’s national private placement scheme, the UK Treasury has recently confirmed that any non-EU AIFM which is already marketing an AIF in the UK as at July 22, 2013, may continue to market the AIF in the UK up until July 22, 2014, without the need to comply with the above minimum conditions. Thereafter, though, it will need to be in full compliance in order to carry on its UK marketing activities.

The European Security and Markets Authority (“ESMA”) is required to report to the European Commission by July 2015 on the functioning of national private placement regimes, and the possible extension of the AIFMD’s passport regime to non-EU AIFMs. By 2018, ESMA must report on whether national private placement regimes should be abolished, and if they are abolished by the European Commission, then from 2018, a non-EU AIFM may only market AIFs to EU investors if it obtains an AIFMD “passport” with respect to its marketing activities. With a passport, a non-EU AIFM will enjoy the same access as an EU AIFM provided that it complies fully with the AIFMD.<sup>4</sup>

If any of the minimum conditions for utilising existing national private placement regimes is not satisfied by the non-EU AIFM by the date of national transposition of the AIFMD, then (except as noted above in respect of the UK) a non-EU AIFM cannot thereafter continue to market an AIF to EU professional investors. Further, non-EU AIFMs who want to market their AIFs in the EU pursuant to an existing private placement regime will have to monitor whether the necessary co-operation arrangements between the relevant EU and non-EU competent authorities are put in place by July 22, 2013. Finally, EU Member States may impose rules on any AIFM (EU or non-EU) that are stricter than those in the Directive, in respect of the marketing of non-EU AIFs to investors in their territory.

## **The Regulation**

### **Annual Reports of non-EU AIFs**

Under Article 22 of the AIFM Directive, non-EU AIFMs must provide to investors an audited annual report on the non-EU AIF.

The Regulation establishes criteria for the presentation of the non-EU AIF’s balance sheet or statement of assets and liabilities and of the income and expenditure account.<sup>5</sup>

The Regulation further sets out in more detail the content of the remuneration disclosure required within the annual report (*i.e.* the total amount of remuneration for the financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, the number of beneficiaries and (where relevant) carried interest paid by the AIF<sup>6</sup>). The AIFM is required to specify whether or not the total remuneration relates to any of the following:

- the total remuneration of the entire staff of the non-EU AIFM, indicating the number of beneficiaries;
- the total remuneration of those staff of the non-EU AIFM who are fully or partially involved in the activities of the non-EU AIF, indicating the number of beneficiaries;

<sup>4</sup> For more details of the contents of the AIFMD please see Morrison & Foerster client alert: The New EU Directive on AIFM (17 November 2010), <http://www.mofo.com/files/Uploads/Images/101117-New-EU-Directive-on-AIFMs.pdf>.

<sup>5</sup> Article 104-106 of the Regulation.

<sup>6</sup> Article 22(2)(e) of the AIFMD.

- the proportion of the total remuneration of the staff of the non-EU AIFM attributable to the non-EU AIF, indicating the number of beneficiaries.

In addition, non-EU AIFMs must disclose general information relating to the financial and non-financial criteria of the remuneration policies and practices for relevant categories of staff to enable investors to assess the incentives created and to understand the risk profile of the non-EU AIF and the measures adopted to avoid or manage conflicts of interest.<sup>7</sup>

The above is in addition to the disclosure required in the annual report as to the remuneration paid to senior management and other staff whose actions have a material impact on the risk profile of the AIF.<sup>8</sup>

### **Disclosure to Investors in non-EU AIFs**

Under Article 23 of the AIFM Directive, non-EU AIFMs must disclose key information regarding each AIF, including periodic disclosure of the percentage of the AIF's assets that are subject to special arrangements because they are illiquid, any new liquidity management arrangements and regular disclosures of the level of the AIF's leverage.

With respect to illiquid assets the Regulation now provides that non-EU AIFMs must disclose: (i) an overview of any special arrangements in place including whether they relate to side pockets, gates or other similar arrangements; (ii) the valuation methodology applied to assets which are subject to such arrangements; and (iii) how management and performance fees apply to these assets.

In the case of any new arrangements for managing the AIF's liquidity, AIFMs must notify investors of any material changes to management systems and procedures, as well as of activated gates, side pockets or similar special arrangements or where they decide to suspend redemptions.<sup>9</sup>

Further AIFMs must disclose the risk profile of the AIF and the main features of the risk management systems employed to manage the risk exposure of the AIF.<sup>10</sup>

With respect to leverage, AIFMs must disclose to investors information on changes to the maximum level of leverage calculated in accordance with the gross and commitment methods of calculating the AIF's exposure (as provided in Articles 7 and 8 of the Regulation), and any right of re-use of collateral or any guarantee under the leveraging arrangements.<sup>11</sup>

### **Reporting to Competent Authorities of Member State of Reference**

Article 24 of the AIFM Directive provides that a non-EU AIFM will be required to report to the competent authority in each EU Member state where an AIF is marketed by it or on its behalf, information regarding the main markets in which it trades, regarding the financial instruments it trades, and the principal exposures and concentrations of all the AIFs managed by the non-EU AIFM.

<sup>7</sup> Article 107 of the Regulation.

<sup>8</sup> Article 22(2)(e) of the AIFMD.

<sup>9</sup> Article 108 of the Regulation.

<sup>10</sup> Article 23(4)(c) of the AIFMD.

<sup>11</sup> Article 109 of the Regulation.

The Regulation clarifies that in each country in which marketing takes place each non-EU AIFM will be required to provide the following information when reporting to the competent authorities:

- the main instruments in which it is trading, including a break-down of financial instruments and other assets, including the AIF's investment strategies and its geographical and sectoral investment focus;
- the markets of which it is a member or where it actively trades;
- the diversification of the non-EU AIF's portfolio, including, but not limited to, its principal exposures and key concentrations;
- the percentage of the non-EU AIF's assets which are subject to special arrangements;
- any new arrangements for managing the liquidity of the non-EU AIF;
- the risk management systems employed by the non-EU AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk; and
- the current risk profile of the non-EU AIF.

Reporting frequency by non-EU AIFMs is stated by the Regulation to be as follows:

- on a half-yearly basis for a non-EU AIFM with aggregate assets under management of up to EUR 1 billion (such reporting required in respect of each AIF it markets in the EU);
- on a quarterly basis for a non-EU AIFM with assets under management above EUR 1 billion (such reporting required in respect of each AIF it markets in the EU);
- on a quarterly basis in relation to any AIF whose assets under management, including any assets acquired through use of leverage, exceed EUR 500 million; and
- on an annual basis in respect of each unleveraged AIF, under the management of a non-EU AIFM, which invests in non-listed companies and issuers in order to acquire control.

Notably Articles 6, 7 and 8 of the Regulation provide further clarity on what is meant by leverage and the basis on which firms must calculate leverage. This is of importance to non-EU AIFMs marketing AIFs in Europe because specific reporting requirements to the competent authorities of the Member State of reference are triggered when an AIF employs leverage on a substantial basis. Under the Regulation, as AIF is considered to employ leverage on a substantial basis when its exposure is over three times its net asset value.<sup>12</sup>

### **Co-operation arrangements**

To allow non-EU AIFMs to market AIFs in the EU, the AIFMD requires the appropriate cooperation arrangements to be in place with the relevant supervisory authorities of the third country in which the AIF is established, those of the country in which the AIFM is established and those of the EU Member States in which the AIF is to be marketed.

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<sup>12</sup> Article 111 of the Regulation.

The Regulation provides that cooperation arrangements shall be in writing and sets out the scope, form and objectives of the cooperation arrangements. The Regulation also requires cooperation arrangements to provide for such mechanisms, instruments and procedures as are necessary for the EU competent authorities to perform their duties pursuant to the AIFMD. Further the Regulation requires cooperation arrangements to include a data protection safeguard in line with Article 52 of the AIFM Directive.<sup>13</sup>

### **Plan of Action for non-EU AIFMs marketing AIFs in the EU**

In summary, a non-EU AIFM may currently market an AIF to EU professional investors under a Member State's private placement regime (*i.e.* as they can currently), so long as the individual Member State retains its regime. From the date of transposition of the Directive (*i.e.* no later than July 22, 2013) a non-EU AIFM can continue to use any Member State's private placement regime so long as it complies with the requirements in Articles 22 to 24 of the AIFM (as supplemented by the Regulation). In addition, a non-EU AIFM marketing an AIF in the UK as of such date may continue to do so for one year thereafter without complying with such requirements.

Non-EU AIFMs need to immediately begin to prepare for the implementation of the AIFM Directive in July 2013 as follows:

- consider all fund management activities in Europe to identify who might constitute an AIFM—for both sponsored and non-sponsored funds
- consider restructuring management activities/locations, if necessary;
- review all delegation arrangements in respect of management functions and benchmark against AIFMD requirements;
- identify all non-EU entities that perform delegated functions and identify progress of co-operation agreements;
- consider restructuring delegation of one or more functions, if necessary;
- determine the “Member State of Reference” *i.e.* the appropriate competent authority for compliance with the AIFM;
- prepare for and ensure compliance with transparency and disclosure obligations required by the AIFM and the Regulation with respect to investors and competent authorities of the Member State of reference in respect of each AIF that it intends to market in the EU;
- check that neither the EU country where the non-EU AIFM is established, nor the country where the AIF is established, is not listed as a Non-Cooperative Country and Territory by FATF;
- monitor private placement regimes in key distribution territories to anticipate and plan for any changes;
- consider full compliance with the AIFM to gain access to an EU passport after 2015; and consider further changes required to structure of AIF if access of non-EU AIFMs to national private placement regimes is terminated with effect from 2018.

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<sup>13</sup> Article 113-115 of the Regulation.

## Authors

Jeremy C. Jennings-Mares  
London  
+44 20 7920 4072  
[jjenningsmares@mofo.com](mailto:jjenningsmares@mofo.com)

Jay G. Baris  
New York  
+1 212 468 8053  
[jbaris@mofo.com](mailto:jbaris@mofo.com)

Afia Fening  
London  
+44 20 7920 4163  
[afening@mofo.com](mailto:afening@mofo.com)

## Contacts

Peter J. Green  
London  
+44 20 7920 4103  
[pgreen@mofo.com](mailto:pgreen@mofo.com)

Robert E. Putney, III  
New York  
+1 212 336 4451  
[rputney@mofo.com](mailto:rputney@mofo.com)

Isabelle Sajous  
New York  
+1 212 336 4478  
[isajous@mofo.com](mailto:isajous@mofo.com)

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