News Bulletin

November 17, 2010

The New EU Directive on AIFMs

On 11 November 2010, the European Parliament (the "EU Parliament") voted to approve the controversial new Directive on Alternative Investment Fund Managers (the "AIFM Directive") by an overwhelming majority (513 to 92 votes),[1] concluding many months of highly politicised and contentious negotiations among the European Union ("EU") regulators, individual Member States, and the industry.[2]

The AIFM Directive forms part of a number of EU regulatory initiatives stemming from the global financial crisis and aimed at improving investor protection and oversight of systemic risk. At the same time, it is also designed to create a single EU market for alternative investment funds ("AIFs"), similar to one which exists for undertakings for collective investments in transferable securities ("UCITS"). As such, it introduces a harmonised regulatory regime for the management and marketing of AIFs to professional investors in the EU, to be implemented by all Member States from January 2013.

The full implications of the AIFM Directive will largely depend on the Level 2 implementing measures ("delegated acts") which the European Commission (the "Commission") is mandated to adopt over the next four years, on the basis of advice from the new European Securities and Markets Authority ("ESMA"),[3] the successor to the Committee of European Securities Regulators.

Nevertheless, managers of hedge funds, private equity, and other firms falling within the scope of the AIFM Directive would be well-advised to start preparing for the fundamental changes which will impact their operations and consider their compliance costs and options, including possible restructuring.

We summarise below the key features of the new AIFM Directive.

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[1] The final adopted text will be made available in due course via a link in the EU Parliament webpage at http://www.europarl.europa.eu/news/public/focus_page/008-92568-001-01-01-901-20101108FCS92549-01-01-2006-2006/default_p001c004_en.htm. In the meantime, a provisional edition of the adopted text can be found at http://www.europarl.europa.eu/sides/getDoc.do?language=EN&type=TA&reference=20101111&secondRef=TOC.

[2] *See* Morrison & Foerster client alert: Update on the proposed AIFM Directive (25 February 2010), http://www.mofo.com/files/Publication/b75a43ea-af81-42eb-9c29-6a6ed92a397c/Presentation/PublicationAttachment/796feb3f-01be-4e8d-8c44-70f4953d27ae/100225AIFM.pdf.

[3] *See* Morrison & Foerster client alert: New EU financial regulatory framework (16 September 2010), http://www.mofo.com/files/Uploads/Images/100916-EU-Regulatory-Framework.pdf.

Scope and Definitions

The AIFM Directive applies to:

- all EU alternative investment fund managers ("AIFMs") managing any EU or non-EU AIFs; and
- all non-EU AIFMs managing an EU AIF or marketing any EU or non-EU AIFs in the EU.

An AIF is defined as any fund that is not regulated under the UCITS Directive.[4] It therefore includes hedge funds; private equity (i.e., large buy-out funds, mid-cap investment funds, and venture capital funds); real estate funds; commodity funds; infrastructure funds; and other types of funds in various legal forms. The definition of an AIFM is also wide, covering any legal person whose regular business involves managing (i.e., providing portfolio and risk management services to) one or more AIF.

However, the AIFM Directive will not apply to holding companies, financial vehicles in which the only investors are group companies, employee participation or saving schemes, pension fund managers (which are covered by the EU Pensions Directive),[5] or securitisation special purpose entities. In addition, a "small fund manager" which is regulated by its home Member State will be exempt from the majority of the provisions of the AIFM Directive, where the cumulative assets of the AIFs it manages do not exceed €100 million (or €500 million if it only manages unleveraged funds that may not be redeemed for the first five years).

Authorisation and Capital Requirements

All AIFMs must be authorised before they may start providing management services to EU or non-EU AIFs, unless an exemption applies. To obtain authorisation, an EU AIFM must apply to the competent authority of the Member State where it has its registered office ("home Member State") and submit detailed information to demonstrate its qualification and ability to fulfill the conditions of the AIFM Directive, including, *inter alia*: (i) the persons effectively conducting the business; (ii) the AIFM's shareholders or members and their holdings; (iii) the planned programme of activity, setting out the organisational structure of the AIFM; (iv) the remuneration policies and practices; and (v) any arrangements for the delegation of functions to third parties.

Moreover, it must further provide information on the characteristics of each AIF it intends to manage, such as the investment strategies (including the types of underlying funds if the AIF is a fund of funds) and leverage policy, risk profiles and domicile, its fund rules or instruments of incorporation, the appointment of a depositary, as well as where the master AIF is established if the AIF is a feeder AIF. A "feeder AIF," defined as an AIF that invests (or otherwise has an exposure of) at least 85% of its assets in one or more other AIFs with the same investment strategies (each a "master AIF"), may only benefit from the marketing passport if the master AIF is also an EU AIF managed by an authorised EU AIFM.

An initial capital of at least €300,000 is required for an AIFM which is an internally managed AIF, and €125,000 is required for an externally appointed AIFM. In addition, an AIFM must have an additional amount of "own funds" (to be invested only in liquid assets) equal to 0.02% of the amount by which the value of the portfolios of AIFs it manages exceeds €250 million. However, the AIFM is not required to hold initial capital and additional own funds in excess of €10 million. Up to 50% of the additional own funds can be waived to the extent that the AIFM is covered by a financial guarantee (from an appropriately regulated EU credit or insurance institution).

[4] EU Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (85/611/EEC), http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1985/L/01985L0611-20050413-en.pdf.
[5] Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:235:0010:0021:EN:PDF.

Operating Conditions for AIFM

The AIFM Directive lays down detailed operational requirements in the following areas:

Remuneration

AIFMs subject to the AIFM Directive must implement remuneration policies and practices for their staff whose activities materially impact the risk profiles of the AIFs it manages, in accordance with the principles (set out in Annex II of the AIFM Directive) which are derived from the provisions of the proposed Capital Requirements Directive III ("CRD 3").[6]

The fixed component of the remuneration must represent a sufficiently high proportion of the total remuneration to allow for a flexible operation of the variable component of the remuneration. In addition, at least 50% of any variable remuneration must consist of units or shares of the AIFs concerned (or equivalent ownership interests), and at least 40% of any variable remuneration (or 60% where the variable component is particularly high) must be deferred for at least three to five years. Variable remuneration may only be paid or vested if justified in the financial situation of the AIFM as a whole (as well as the performance of the business unit, the AIF, and the individual employee) and must be "considerably contracted" (i.e., clawed back) in the event of "subdued or negative performance."

ESMA is mandated to produce guidelines on sound remuneration policies under the AIFM Directive, in cooperation with the new European Banking Authority ("EBA"), the successor to the Committee of European Banking Supervisors ("CEBS").

Conflicts of interest, risk and liquidity management

The AIFM must act honestly and fairly, with due skill, care, and diligence in conducting its activities and must act in the best interests of the AIF, its investors, and market integrity. To this end, it must operate effective arrangements and systems to identify and manage conflicts of interest, to identify and manage the risks associated with each investment strategy, and to monitor and manage liquidity risk. The AIFM must functionally and hierarchically separate its risk management and portfolio management functions.

Investments in securitisation positions

The Commission is mandated to prescribe the requirements which must be met by the relevant originator, the sponsor, or the original lender in order for an AIFM to be allowed to invest in securitisation instruments, including requirements to ensure that the originator, the sponsor, or the original lender retains a "net economic interest" of not less than 5%. This provision echoes the restrictions already imposed on investments in such positions by European credit institutions.

Valuation procedures

AIFMs must establish "appropriate and consistent procedures" to enable a proper and independent valuation of the assets of AIFs. The valuation procedures must ensure that assets are valued and the net asset value per share/unit be calculated at least once a year (and more frequently, where appropriate to the assets held by the AIF and the frequency of redemption). Valuation may be carried out by an independent external valuer, or by the AIFM itself, provided that the valuation task is functionally independent from management and remuneration

[6] CRD III is a directive forming part of a series of amendments of the Capital Requirements Directive (2006/48/EC and 2006/49/EC) in relation to credit institutions and investment firms. The European Commission's Proposal for a Directive amending Directives 2006/48/EC and 2006/49/EC capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies is available at http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf.

policy and the AIFM has measures in place to mitigate conflicts of interest and to prevent undue influence on employees.

Delegation of AIFM functions

An AIFM may delegate its functions to third parties to increase efficiency of its conduct of business, provided that it gives prior notice to the competent authorities of its home Member State and satisfies certain conditions. These include the delegate being appropriately authorised or approved, where the delegated function includes portfolio management or risk management, and such functions may not be delegated to the depositary or its delegates. However, any such delegation should not prevent the AIFM from being supervised effectively nor affect its liability to the AIF and its investors. Where the delegate is a third country (i.e., non-EU) undertaking, there must also be cooperation arrangements between the regulators of the AIFM's home Member State and the delegate's country of establishment.

Depositary and its liability

An AIFM must appoint a depositary, which must be independent of the AIFM and meet requisite criteria. Only an EU-domiciled credit institution, investment firm, or firm permitted to act as a depositary for a UCITS may be appointed as the depositary for an EU AIF. A single depositary will generally be required to hold, in segregated accounts, the assets of each AIF, monitor the cash flow of the AIF, ensure that transactions involving AIF shares or units comply with national law, and act in the best interests of the AIF and its investors.

The depositary must be established in the home Member State of the relevant AIF. Non-EU AIFs may appoint depositaries based in their home jurisdictions, subject to certain conditions, including (i) a cooperation and information exchange agreement between the competent authorities of the AIFM, of the member states where the AIFs are to be marketed, and of the depositary's home jurisdiction; and (ii) equivalent prudential regulation (including minimum capital requirements) and supervision of the depositary in its home country.

Depositaries will be strictly liable to AIF investors for losses suffered as a result of negligent or intentional breach of their obligations, although in limited circumstances liability for a loss of financial instruments may be transferred by contract to a delegate of the depositary (e.g., sub-custodian). If a depositary intends to transfer liability to a third party delegate, it must enter into a written contract allowing the AIF or AIFM to claim damages against the third party delegate.

Transparency and Disclosure Requirements

For each EU AIF it manages and each (EU or non-EU) AIF it markets in the EU, an AIFM must make the following disclosures:

Annual reports of AIFs

The AIFM must make available an annual report for each AIF (within four months of the financial year end), which must include (i) a balance sheet (or an asset and liability statement); (ii) an income and expenditure account; (iii) a report on activities for each financial year; and (iv) the total amount of remuneration and its breakdown among senior management and risk-taking staff. The Commission has been mandated to adopt additional rules specifying the content and format of the annual report.

Disclosure to investors in AIFs

The AIFM must ensure that AIF investors receive adequate information before making the investment, including, *inter alia*, descriptions of: (i) the AIF's investment strategy and objectives; (ii) any use of leverage (e.g., types of

leverage permitted and the associated risks, restrictions, collateral, and asset re-use arrangements, and the maximum level of leverage permitted); (iii) investment procedures; (iv) procedures for issue and sale of units/shares and valuation procedure and pricing methodology; (v) liquidity risk management (including redemption rights); (vi) arrangements with the depositary, auditor, and any other service providers; and (vii) all fees, charges, and expenses.

Where the AIF employs leverage, the AIFM must also regularly disclose to investors: (i) any changes to the maximum level of leverage; (ii) any right to re-use collateral or any guarantee granted under the leveraging arrangement; and (iii) the total amount of leverage employed.

Regular reporting to home Member State competent authorities

The AIFM must provide its home Member State competent authority with information in relation to each AIF concerning (i) the percentage of each AIF's assets which are illiquid and therefore subject to special arrangements; (ii) any new arrangements for managing liquidity; (iii) the risk profile of the AIF and the risk management tools employed; (iv) the main categories of assets in which the AIF has invested; and (v) the results of liquidity risk stress tests. Upon request, the AIFM must also provide to its home Member State authority an annual report for each financial year (within four months of its end) and, for the end of each quarter, a detailed list of all AIFs it manages.

Where the AIF employs leverage on a substantial basis, it must also make available to its home Member State competent authority (i) the overall level of leverage employed; (ii) a breakdown between the leverage from borrowings of cash or securities and the leverage embedded in financial derivatives; and (iii) the extent to which the assets have been re-used.

Leverage Limits

Unlike the Commission's original proposal, the AIFM Directive does not empower the Commission to impose any general leverage limits. Nor does it regulate leverage at the AIF level. Instead, the AIFM must set the leverage limits for each AIF it manages and demonstrate that such limits are reasonable.

However, the competent authorities of the AIFM's home Member State, having given at least ten working days' prior notice to ESMA, the European Systemic Risk Board ("ESRB"), and the competent authorities of any relevant AIF, may impose limits on the leverage level that an AIFM may employ, in order to contain any resulting systemic risk or risks of disorderly financial markets.

Special Rules in Relation to Private Equity

Notification of major holdings in non-listed companies to home Member State authorities

An AIFM must notify its home Member State competent authority, when the voting rights in a non-listed company (i.e., an EU company whose shares are not admitted to trading on a regulated market in the European Economic Area) held by an AIF managed by it reach, exceed, or fall below 10%, 20%, 30%, 50%, and 75%.

Disclosure of acquisition of "control"

An AIFM managing one or more AIFs which acquire, individually or jointly, "control" of an EU company (excluding small and medium-sized enterprises and real estate special purpose vehicles) must notify the target company and its shareholders and the AIFM's home competent authority of the level of shareholding, the shareholders involved, and the date on which control was achieved. It must also request the company's board to inform the employees of the acquisition of control. The notification must include information on the identity of the controlling AIF, the AIFM, its conflicts of interest policy, and its communication policy regarding the

company, particularly as regards employees. Notably, they must also be provided with information on the AIFM's future intentions regarding the company and the likely repercussions for employees.

For non-listed companies, "control" is defined as more than 50% of the voting rights, and for this purpose the voting rights of related persons and persons acting in concert are taken into account. For public companies, control is defined by reference to the threshold set by each Member State under the EU Directive on Takeover Bids (2004/25/EC).[7]

To encourage private equity investors to develop longer-term strategies for the companies which they take over, such AIFM is also required to provide additional information—in either the annual report of the relevant AIF or that of the portfolio company—which include a "fair review of the development of the company's business," with indications of recent "important events," the company's likely "future development" and acquisition of own shares.

Asset stripping

The AIFM Directive contains provisions to counteract asset stripping by private equity firms, which was one of the most hotly debated issues in the negotiations. These rules will apply to AIFMs which (individually or jointly with other AIFMs) manage one or more AIFs which individually or jointly acquire control of an EU company.

During the first twenty-four months following an acquisition, the AIFM must not facilitate, support or vote in favour of, and must use its best efforts to prevent, any distribution, capital reduction, share redemption or acquisition of own shares which would violate the EU Second Company Law Directive[8] (i.e., where the company's net assets fall short of its subscribed capital and non-distributable reserves and any distribution would exceed the amount of available profits).

Marketing Activities by EU AIFMs

Upon authorisation, AIFMs will be permitted to market AIFs to "professional investors" only (as defined in MiFID)[9] across the EU under a pan-EU marketing "passport," subject to the following conditions.

- *EU AIFs* – subject to notifying its home Member State's competent authority, AIFMs may market EU AIFs cross-border to professional investors in all EU Member States.
- *Non-EU AIFs* – from 2015, EU AIFMs will also be permitted to market non-EU AIFs to professional investors throughout the EU, provided that there are cooperation and information exchange arrangements in place between the regulators of the AIFM and the non-EU AIF, to ensure effective oversight of systemic risks in relation to cross-border funds, and managers and other relevant conditions are met. Until 2018, EU AIFMs will also be able to rely on existing national private placement regimes to market non-EU AIFs. They must, however, still comply with the AIFM Directive in full (except for certain of the depositary requirements).

[7] EU Directive on Takeover Bids (2004/25/EC), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004L0025:EN:HTML.
[8] EU Second Company Law Directive (77/91/EEC), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31977l0091:EN:HTML.
[9] *See* Annex II of EU Markets in Financial Instruments Directive (2004/39/EC), http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf.

Third Country Regime for Marketing Activities by Non-EU AIFMs in the EU

The treatment of non-EU AIFMs marketing non-EU AIFs in Europe was one of the most contentious issues in the negotiations for the AIFM Directive. A compromise was finally reached between the EU Parliament and the EU Council in late October 2010.[10]

From 2015, a non-EU AIFM will be able to obtain a marketing passport and enjoy the same market access as an EU AIFM provided that it obtains prior authorisation by the competent authorities of its "Member State of reference," which will act as its "home" competent authority in the EU for the purposes of supervising their management and marketing activities. ESMA is empowered to conduct peer reviews of supervisory activities on an annual basis, to ensure that the authorisation and supervision of non-AIFMs are consistent throughout the EU.

To be authorised, a non-EU AIFM must have a legal representative in its Member State of reference and comply with the provisions of the AIFM Directive in full. Certain other conditions also apply, e.g., the home jurisdiction of the non-EU AIFM must have appropriate cooperation and (tax) information exchange arrangements with the competent authority of its Member State of reference.

If a non-EU AIFM, or a non-EU AIF marketed in the EU, would be subject, in its home country, to a requirement that conflicts with a provision of the AIFM Directive, the non-EU AIFM may be exempted from complying with the AIFM Directive provision, if it can demonstrate that compliance with both the AIFM Directive and its home jurisdiction regulations is not possible and it is already subject to an equivalent rule at home.

The determination of the Member State of reference will depend on detailed criteria based on the EU Member State(s) where the EU AIFs (or most of them) are established, authorised or registered, where the largest amount of assets is managed, where the non-EU AIFM intends to market the AIFs and/or "develop effective marketing." Where more than one Member State of reference is possible, the competent authorities of all the relevant Member States will jointly choose one for the non-EU AIFM. Upon receiving an application for authorisation, the competent authorities must assess the non-EU AIFM's choice of its Member State of reference and request ESMA to advise on the appropriateness of such choice.

Until 2018, non-EU AIFMs may also continue to make use of national private placement regimes, provided that certain minimum conditions are satisfied.

Marketing to Retail Investors

Member states may choose to permit the marketing of AIFs to retail investors in their own jurisdiction and impose stricter requirements at their discretion, though they may not impose stricter requirements on foreign funds than on their own domestic funds.

ESMA's Powers

ESMA may, subject to certain conditions, request that a Member State competent authority take any of the following measures:

- prohibit the marketing in the EU of AIFs managed by a non-EU AIFM or non-EU AIFs managed by EU AIFMs in certain circumstances; and/or

[10] *See* EU Parliament press release: Parliament sees its priorities through on hedge funds directive (26 October 2010), http://www.europarl.europa.eu/en/pressroom/content/20101025IPR90066/ and the Proposal for a Directive on Alternative Investment Fund Managers – text agreed in the trialogue between the EU Commission, Parliament and Council on 26 October 2010 (27 October 2010), http://register.consilium.europa.eu/pdf/en/10/st15/st15053-re01.en10.pdf.

- impose restrictions on non-EU AIFMs in relation to the management of AIFs (i) in case of excessive concentration of risk in a specific market on a cross-border basis or (ii) where their activities potentially constitute an important source of counterparty risk to a credit institution or other systemically relevant institutions.

Transitional and Grandfathering Provisions

An AIFM operating in the EU prior to 1 January 2013 (when EU Member State must implement the AIFM Directive) must bring its activities into compliance with the AIFM Directive, including submitting an application for authorisation within one year from such date, unless an exception applies.

Next Steps

The AIFM Directive will enter into force in January 2011 and thereafter Member States are given two years to implement the AIFM Directive by transposing it into their national laws.

Within two years of implementation, ESMA will report to the Commission, the EU Parliament, and the EU Council on the functioning of the passport system for EU AIFs and AIFMs, the possible termination of national private placement regimes, and the extension of the passport to non-EU AIFs and AIFMs.

The Commission is mandated to pass further legislation over the next four years, based on advice from ESMA, to ensure consistent interpretation and effective implementation of the rules by the Member States. The Commission will also conduct a general review on the application and scope of the AIFM Directive four years after it comes into force, including its impact on private equity and venture capital funds.

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