LATHAM & WATKINS

Analysis

Key Considerations in Running an AIFMD Compliant Investment Fund

The Alternative Investment Fund Manager Directive (AIFMD[1]) will soon become effective across the EU. AIFMD, contrary to what the title suggests, will affect far more businesses than just 'alternative' investment fund managers located in the EU.

AIFMD will affect all managers of non-UCITS funds located in the EU as well as a many non-EU managers managing and marketing their funds to EU investors from non-EU jurisdictions (such as the US, Switzerland, the Channel Islands, Cayman Islands and the British Virgin Islands). AIFMD forms part of the EU's regulatory arsenal aimed at tackling what it understands to be part of the 'shadow-banking' system. AIFMD is based on the premise that certain activities of the shadow-banking have the potential to amplify risks through the EU financial system. AIFMD is yet another cornerstone reform of the financial services sector, together with initiatives such as EMIR and MiFID II, forming part of the EU's ultimate aim of creating a 'single European Rulebook' in financial services with a view to enhancing financial stability and investor protection.

This article summarises the key changes to the alternative investment fund space to inform fund managers, investment firms and their service providers so that they can review their existing operations and make the necessary adjustments prior to AIFMD's expected entry into force in the middle of 2013.

Who will it affect?

AIFMD aims to introduce a harmonised regulatory framework for all managers of non-UCITS[2] funds (AIFMs[3]) operating in the EU. An AIFM includes any legal or natural person whose regular business is to manage one or more alternative investments funds e.g. a collective investment undertaking[4]) (AIFs). AIFMD applies irrespective of where the AIF is established. As a result AIFMD will affect:

- *EU AIFMs:* (which are AIFMs with their registered office in one Member State of the EU who manage and/or market one or more non-EU AIFMs or EU AIFMs); or
- *Non-EU AIFMs who manage and/or market EU AIFs*: to investors domiciled in the EU*;* or
- *Non-EU AIFMs who manage and/or market non-EU AIFs* to investors domiciled in the EU.

Each AIF must have at least one AIFM. Structurally AIFMD recognises that an AIF may be 'internally managed' e.g., where the *AIF itself* is the AIFM such as an investment trust, or an externally managed structure where the AIFM is

appointed by the AIF. AIFMD will regulate a number of funds and managers that were not previously regulated within the EU, either because they were not within the scope of MiFID, were unregulated collective investment schemes or because they could avail themselves of certain regulatory exemptions to MiFID that are not available under AIFMD[5].

AIFMD has often been likened to raising the drawbridge on 'Fortress Europe' in that it firmly delineates which funds, including feeder funds[6], are situated in (and thus permitted to operate in) the EU and those that are not. As a result AIFMs that manage an AIF, in a master-feeder structure, with globally domiciled investors may need to restructure to permit access and marketability of the AIF to EU investors in an AIFMD-compliant manner as well as separately replicate the same fund outside of the EU for access by non-EU investors. AIFMD does not regulate EU investors investing in AIFs but it does impose certain monitoring obligations on investors.

Any restructuring of fund structures or corporate groups may affect the existing tax treatment of the fund and the AIFM. Additionally any proposed changes should also be considered in light of the larger regulatory picture and trends in the funds market such as the increasing 'mutualisation' of 'alternative funds[7]' that have already either re-domiciled from offshore to onshore and/or become UCITS compliant. In any event, these changes impact both the buy and sell side.

Definition of Managing

'Managing' for the purposes of AIFMD means performance of at least portfolio management and/or risk management services to one or more AIF. Portfolio management and risk management are considered AIFMD 'core services'. Firms will need to assess which entities in their structure carry out portfolio and/or risk management activity and whether the AIF needs formally to (re-)appoint that entity or if any further regulatory authorisations or permissions are required to comply with AIFMD. Firms will also want to ensure that entities that are not required to become AIFMD compliant do not inadvertently become subject to it. Funds of funds (FoF) may need to take additional steps. According to the UK's FSA and the European Private Equity and Venture Capital Association (EVCA), the FoF manager will be the AIFM and not necessarily the underlying fund managers. Any assessment of structure may affect the tax position in addition to the regulatory structure.

In practice this means that any (a) MiFID exempt firm and (b) MiFID firm with regulatory permissions of 'investment management' wishing to provide investment management services to an AIF will need to apply to the respective national regulators to become authorised as an AIFM and also be formally appointed by the AIF to provide collective portfolio management services under AIFMD. There will however be some MiFID exempt and/or MiFID firms that may remain in the fund structure and undertake complementary activity, such as corporate finance type activity, or a person solely providing investment advice etc., and therefore not require AIFMD compliance. If a firm's activity does not trigger an AIFMD compliance obligation that firm would sit outside the scope of AIFMD and continue to be regulated by MiFID or other relevant frameworks.

A firm that is authorised for AIFMD services may not, however, also be authorised as a MiFID investment firm. Equally a MiFID investment firm may not manage an AIF on the basis of its MiFID permissions.

AIFMD and MiFID may overlap in some areas. According to the FSA and the EVCA, provision of investment advice by a firm to an AIFM is an area that is likely to remain a MiFID activity. If investment advice is provided to an AIF then this would constitute an AIFMD non-core service and trigger AIFMD compliance obligations.

AIFMs are permitted to provide non-core services but only in conjunction with permission under AIFMD to undertake 'core' portfolio and/or risk management services. The non-core services are set out in Annex I to the AIFMD. To summarise these non-core services include:

1. *Administration:* e.g., legal and fund management accounting services, record keepings services, customer inquiries, valuation and pricing, regulatory compliance monitoring, maintenance of unit, shareholder registers, management of income distributions and redemptions, contract settlements, marketing and asset servicing; or
2. *Marketing:* which the AIFMD defines as a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the EU; or
3. *Activities related to the assets of the AIF:* namely services necessary to meet the fiduciary duties of the AIFM, facilities management, real estate administration activities, advice to undertakings on capital structure, industrial strategy and related matters, advice and services relating to mergers and the purchase of undertakings and other services connected to the management of the AIF and the companies and other assets in which it has invested.

To further complicate matters, Member States may, unless their framework expressly permits, prohibit AIFMs from providing MiFID regulated activities, such as investment advice, custody and 'arranging' deals, which are integral to the business model of many EU-domiciled investment management firms. AIFMD provides that if a Member State permits an AIFM to carry out MiFID activity, it nevertheless may *not* be registered under MiFID.

Types of regulated firms

At a high level AIFMD creates the following types of firms:

1. AIFMD-compliant firms undertaking AIFMD regulated activities; or
2. AIFMD-compliant firms undertaking MiFID regulated activities but not subject to MiFID; or
3. MiFID-compliant firms undertaking MiFID regulated activities; or
4. UCITS AIFM firms i.e., an external AIFM that is also designated and authorised as a management company for one or more UCITS.

In order for a fund groups to undertake both MiFID and AIFMD activity, firms may need to split out the MiFID regulated activity to a vehicle with the specific purpose of undertaking MiFID regulated activity and which is authorised under MiFID to do so.

Exemptions

AIFMD exempts several activities from its coverage. First AIFMD excludes from the scope of its coverage family investment vehicles[8], holding companies[9], certain joint ventures[10] supranational institutions, national central banks, governmental bodies, certain social security and pension vehicles, certain occupational retirement vehicles, employee participation schemes and certain securitisation special purpose vehicles from its scope. Second, AIFMs that manage funds where the investors consist only of the AIFM and/or the AIFM's group companies are excluded. Third, AIFMs which manage AIFs that are closed-ended or in run-off mode, with no further investments before 22 July 2013 do not require AIFMD authorisation. Fourth, AIFMs which manage AIFs that expire on or before 22 July 2016 and are closed for subscription are subject to certain 'lighter-touch' annual reporting requirements and corporate governance requirements.

'Small' Managers Regime

'Small' AIFMs also are subject to a partial exemption. A small AIFM is one with assets under management (AUM) of less than € 500 million where the AIF does not employ leverage and has no redemption rights for the first five years, or where the AIF has less than € 100 million AUM but employs leverage to acquire assets. The € 500 million and € 100 million are measured as an aggregate of all of its AUM across all AIFs for which it is the AIFM. AIFMs that fall within the small manager regime are subject to lesser registration and on-going reporting requirements with the competent regulator. The small manager regime does not override any existing national requirements imposed by national financial regulators, and small managers will not be able to benefit from AIFMD EU passport (and may thus be limited to marketing their AIFs domestically). According to the ESMA advice on AUM certain adjustments will have to be applied to convert net asset value to meet EMSA's understanding of AUM. In particular, the use of netting may not be applied in the same manner as is common for calculation methodology. Firms may use historical asset valuations if these are less than 12 months old from the date of calculation. As such many firms may use their latest annual report as a basis of these calculations.

Main aims of AIFMD:

Authorisation and supervision of AIFMs: AIFM supervision is by the home state regulator i.e., the competent financial regulator in the Member State where the AIFM has its registered office. This must be the same state where its head office is located, or in the case of non-EU AIFMs the 'point of reference' where the AIFM is based. Firms which are already authorised by the UK Financial Services Authority (FSA) for example must re-apply for authorisation by July 2014 when the relevant AIFMD's transitional arrangements end. Rather unhelpfully this process will take place during the split of the FSA into the designated successor regulatory bodies[11] and as a result this process may be protracted irrespective of most of the information already being held by the regulator[12].

In any event, AIFMs requesting authorisation will need to provide details of the AIFMs remuneration policies, compliance procedures, outsourcing policies, liquidity risk management and depositary/custody arrangements, details of investors' fees, charges and expenses, and whether any investors have preferential treatment[13], details of the AIF including governance documentation including the AIFs risk profile, use of leverage and collateral management practices including rehypothecation practices;

Minimum capital requirements: AIFMs must have a minimum amount of initial capital/own funds (MCR) along with professional indemnity insurance or adequate funds to cover professional negligence claims. Such MCR must be invested in liquid assets or assets readily convertible to cash. AIFMs whose MCRs were previously calculated by reference to MiFID or the Capital Requirements Directive (CRD)[14] must ensure that MCR complies with AIFMD MCR requirements moving forward.

The AIFMD MCR requirement consists of the following:

1. An initial capital requirement of a minimum of € 125,000 for externally managed AIFM or € 300,000 for internally managed AIFM; and
2. An own funds requirement for externally managed AIFMs comprised of the higher of (A) one quarter of fixed annual overheads; and (B) 0.02 percent of the amount by which the total value of AUM exceeds € 250 million, subject to the own funds requirement being capped at € 10 million[15].

Practically the AIFMD MCR requirement means that the many investment managers will need to raise additional capital.[16]

Limits on leverage[17] *and economic capital:* AIFMD introduces limits (a) on the maximum level[18] of leverage that an AIFM may employ on behalf of each AIF; and (b) on the extent of the right of use to collateral[19] or guarantee that could be granted under the leveraging arrangements. Such limitations may, however, be varied by regulators, including ESMA. ESMA and the EU Commission are continuing to assess what appropriate "leverage" exactly is. AIFMD Regulation (as defined below) proposes that "substantial" leverage would exist where the ratio exceeds two times the net asset value of the AIF.

Investment restrictions: Under AIFMD, AIFs may not invest in a securitisation transaction unless the so-called "skin in the game" requirements set out in the CRD have been met, bringing EU credit institutions, AIFs and UCITS funds under the same requirements.

Increased harmonised minimum standards of governance, conduct of business and risk management: AIFMD imposes enhanced obligations on AIFMs in several areas. These new obligations do not disapply existing obligations (such as best execution requirements for example) unless specified in AIFMD. AIFMD requires that an AIFM 'look-through' to the AIF's investors when determining whether a conflict of interest exists. Historically this rule only applied between a fund and a manager or between two funds advised by the same manager. The application of MiFID style rule on inducements may prove difficult to reconcile with private equity fee models[20]. In addition, AIFMD requires that the risk management function become a separate function subject to periodic monitoring that is formally and hierarchically separate from the AIFM's operating units, including the portfolio management function. AIFMD also goes beyond the existing rules in the area of liquidity management, both in terms of wider coverage and more prescriptive requirements[21]. AIFMs must also establish an internal framework of limits that reflect the level of the AIF's risk profile that has previously been disclosed to the investors. AIFMD imposes an obligation on AIFMs to adopt, maintain and regularly update a formal due diligence process when investing on behalf of the AIF, which must ensure that the systems and the controls can monitor and control the risks of each investment position of the AIF and their overall effect on the AIF's portfolio including the use of stress-testing[22].

Remuneration policies to curb excessive risk taking and practices: Controversially AIFMD follows the CRD's approach to remuneration policies[23] as it oblidges Member States to require AIFMs to have remuneration policies and practices for categories of staff (senior management, risk takers, control functions and any employees with comparable remuneration[24] to senior management) who have a material impact on risk profiles of the AIFM or the AIF. Annex II of AIFMD sets out required remuneration policies to be adopted and ESMA and the EBA are expected actively to contribute to the continued development of this area. AIFMD will, however, change a number of employment practices and perhaps see higher base salaries replacing bonuses. AIFMD requires that bonuses are to be predominantly paid in shares and are spread over the lifetime of a particular fund[25]. AIFMD also provides that guaranteed variable remuneration must be exceptional, primarily for hiring new staff, limited to the first year and subject to claw-backs.

Limits on AIFM's activities: AIFMs that manage only internally managed AIFs are only permitted to manage their own assets, administer and market their own fund and only carry on activities related to the underlying assets of the fund. As a result an AIFM that manages only internally managed AIFs could not also be a provider of investment advice or become an AIFM to another AIFM and/or an external AIF. AIFMs that manage externally managed AIFs may, assuming no Member State prohibition exists, provide MiFID regulated activities.

AIFMs and Prime Brokers: An AIFM using a prime broker[26] must exercise due skill, care and diligence in the selection and appointment of its prime broker Each Prime Brokerage Agreement (PBA**)** must be in writing and cover the circumstances under which an AIF's assets may be transferred or the prime broker can exercise rehypothecation rights[27]. The AIFMD does not specify particular circumstances but does impose disclosure obligations. The key terms of a PBA must be provided to the depositary and to the AIF's investors prior to any investment in the AIF. Prime Brokers may only act as a depositary to an AIF if the prime broker has separated its depositary functions from its prime broker functions. The separation of prime brokerage and depositary functions may require certain prime brokers to re-evaluate their business models, putting some under financial stress if they need to abandon the prime broker-prime custody model in favour of tri-party custody arrangements. These changes may in turn affect an AIFM's trading and financing costs.

AIFMs and the AIF's Depositary: The concept of a 'depositary[28]' stems from the UCITS Directives. Each AIF must have a single depositary. AIFMD does not directly[29] prompt registration of depositaries but it stipulates what functions a depositary must perform, what standards it must maintain and its strict liability for loss to the AIF, the AIFM and investors.

AIFMD recognises that the functions of a depositary include 'custody' of the AIFs' financial instruments. Financial instruments are distinguished in the AIFMD as (A) "financial instruments that can be held in custody" e.g., financial instruments capable of physical delivery and those that may be registered; and (B) "other assets"[30] e.g., non financial assets (real estate, infrastructure, certain physical commodities) and financial instrument not in book-entry form nor capable of physical delivery to the depositary. Certain OTC derivatives are likely to fall in to the "other assets" category.

The AIFMD specifies a number of duties of the depositary i.e. the typical duties of safekeeping and those of a fund administrator which include numerous functions that may not be delegated by the depositary such as cash flow reconciliation, investor payment processing, transaction processing and investment mandate compliance monitoring and valuation. Registered financial instruments must be registered in non-pooled segregated accounts in the name of the relevant AIF or the AIFM (acting on its behalf) in the depositary's books.

For the "other assets" category of financial instruments, depositaries have an obligation to verify that the ownership over the relevant assets effectively belongs to the AIF itself, or where relevant the AIFM acting on behalf of the AIF. This verification process must be based on information or documents provided by the AIF or the AIFM and, where available, on external evidence.

AIFMD recognises only certain types of entities as depositaries. For EU AIFs, depositaries must be:

- Credit institutions[31] authorised under Directive 2006/48/EC a.k.a. the recast CAD and with their registered office in the EU; or
- MiFID investment firms subject to the CRD[32] with their registered office in the EU providing the MiFID regulated activity of safekeeping and administration of financial instruments; or
- a depositary authorised under the UCITS Directive.

For EU AIFs a depositary will only be permitted where it is established in the same home Member State of the AIF. Transitional arrangements mean that the competent regulators of the home Member State of an AIF (or for non-EU AIFs, the home Member State of the AIFM) may allow credit institutions established in another Member State to be appointed as depositary until 22 July 2017.

For non-EU AIFs the only entities qualifying under AIFMD as depositaries are those third-country equivalents of a credit institution or a MiFID investment firm which subject to the CRD and provided that it would also satisfy an equivalence criteria of appropriate regulatory supervision.

For non-EU AIFs managed by an EU AIFM there is no requirement to appoint a single depositary and the EU AIFM may not offer the services so must continue to appoint an appropriate service provider for safekeeping of assets such as a custodian, trustee, prime broker, fund administrator or transfer agent and these entities may be established in or outside of the EU. The relevant entity is required to be subject to effective prudential regulation and supervision which have the 'same effect' (which is an undefined term) as EU law and are effectively enforced. AIFMD is silent on whether these functions could be provided by an affiliate entity of the AIFM's group.

AIFMs will need to review their current depositary and custody arrangements against these criteria[33] to ensure compliance, and make any adjustments to those arrangements that might be necessary.

Issues may arise for EU branches of non-EU financial institutions or custodians who are not a credit institution, a MiFID investment firm or a UCITS compliant depositary.

Limited exemptions for certain types of depositaries do however exist. For AIFs that have no redemption rights exercisable for five years from the date of initial investment and that invest in assets that do not require to be held in custody (e.g. many private equity and/or real estate AIFs) a discretionary exemption is embedded in AIFMD's recitals for Member States to permit a notary, a lawyer, a registrar or another entity to be appointed to carry out depositary functions provided that the person is subject to suitable legal, regulatory or standards of professional conduct and guarantees. This exemption, however, only relieves such a qualifying depositary from the prudential capital requirements under AIFMD but not from the on-going regulatory and liability provisions.

Equally, sub-custodians holding cash in local markets may need to satisfy an equivalence test with AIFMD's prudential and supervisory requirements. Depositaries and outsourced sub-custodians are prohibited from rehypothecating assets without the specific prior consent of the AIF or the AIFM on its behalf.

AIFMD imposes on the AIFM and the depositary a fiduciary duty to act honestly, fairly, professionally, independently and in the interest of the AIF and the investors of the AIF. AIFMD also provides that a depositary shall be strictly liable to the AIF and/or to its investors for depositary's or third party's loss of a financial instrument and shall be required to return an equivalent financial instrument without undue delay. This liability does not arise where the loss is proven to be beyond reasonable control. The depositary is further liable for other losses suffered by an AIF or its investors as a result of depositary's negligence or intentional failure. Finally, AIFMD specifies how liability should be apportioned between a depositary and any sub-custodians. These rules will likely result in changes to the terms on which parties do business, as historically many of these issues would typically have been dealt with differently in the PBA or the custody agreement.

Independent valuation of AIF assets: AIFMD also imposes more formal asset valuation requirements on AIFs. Where valuations are performed by the AIFM internally, the AIFM's internal 'valuation function' must be independent from its internal portfolio management function. AIFMs will also need to establish an internal audit function. Any externally appointed valuers, the external valuer must be independent from the AIF, the AIFM and any person with close links to the AIF or AIFM. External valuers cannot sub-delegate the valuation function.

Additionally, a depositary appointed for an AIF may not be an external valuer, unless that depositary's valuation function is separated from its depositary functions and any potential conflicts of interest are properly identified, managed, monitored and disclosed to the AIF's investors. As a result, many fund administrators which historically have performed valuation, reconciliation and custody functions may need to re-structure their service offering into fully segregated lines of business.

Lastly, prior to appointing an external valuer, the AIFM must demonstrate that the external valuer and its staff are appropriately regulated and have sufficient resources as well as sufficient financial and 'professional guarantees'[34] prior to appointment of the valuer. The external valuer must be periodically monitored by the AIFM.

Outsourcing: AIFMD's outsourcing rules are stricter than those in MiFID in several respects. AIFMD requires that an AIFM justify its "entire delegation structure on objective reasons". In addition the AIFM must be satisfied that the outsourced service provider has sufficient resources and good experience and that the staff are of sufficiently "good repute".

Portfolio management and/or risk management functions must only be outsourced to entities appropriately authorised and registered, and in relation to third-country undertakings only to those entities with appropriate cooperation agreements between the relevant regulators.

Depositaries may be required to treat third parties, such as brokers appointed by AIFMs, collateral agents and central counterparties, as outsourced delegates of the custody function whenever these third parties hold most financial instruments of an AIF as collateral for either party to a particular transaction.

AIFMD also addresses sub-delegation, which is only permitted where the AIFM has consented in advance, the AIFM has given prior notice to its regulator and the sub-delegate can be monitored by and meet the same standards as those of the outsourced service provider.

Increased investor transparency: AIFMD places an increased emphasis on specific content of annual reports, and the granularity of such reports, to investors regarding each AIF, including increased transparency regarding remuneration, valuation methodology, outsourced service provider compliance and investors' rights, liquidity risk management, redemption rights, breakdown of all fees and charges borne by investors, disclosure of how the AIFM ensures fair treatment of investors or the existence and type of preferential treatment for a particular type of investor and their legal or economic links with the AIF or AIFM, identity of prime broker and material arrangements, including any rehypothecation rights, that have been granted. In addition AIFMs must inform investors of certain arrangements regarding the depositary's liability together with any changes thereto. AIFMs must, for each of the EU AIFs they manage and market in the EU, periodically disclose to investors the percentage of the AIF's assets that are subject to special arrangements arising due to illiquidity[35], any new arrangements for managing the AIF's liquidity, the current risk profile of the AIF and its risk management systems. EU AIF's employing leverage are required to disclose to investors on a regular basis any changes to the maximum leverage ratio, total amount of leverage employed[36] and any rehypothecation rights under the leveraging arrangement. The AIFM must also privately disclose all of the foregoing to its home state regulator.

Introduction of an EU "passport": AIFMD introduces a framework for marketing to professional clients[37] i.e. sophisticated investors who meet certain quantitative and qualitative thresholds. The EU marketing "passport" for professional investors[38] takes affect from 22 July 2013 for EU AIFs. AIFMs marketing an AIF to professional investors in any Member State outside the home state must use the AIFMD marketing passport instead of the national private placement regimes from that

date. An AIFM wishing to use the passport must notify its regulator of its intention to market and submit the required documentation to the home state regulator for consideration. An EU AIFM in the inception stage of launching a fund who wishes to raise funds from professional investors in another Member State will need to use the marketing passport.

Procedurally, the home state regulator must, within 20 business days of receipt, transmit the documentation to the relevant Member State in which the AIF is to be marketed and provide confirmation to the AIFM. The AIFM may only market in that Member State after the date it has received notification of its ability to market. The AIFMD passport does not however, prohibit an AIFM from acting on reverse enquiries from investors. Any material changes to the marketing material must be provided to the home state regulator at least a month before the change is to take effect, or immediately if the change is unanticipated.

AIFMD provides no formal EU passport for marketing to retail investors (i.e. any investor who is not a professional investor or an eligible counterparty). Marketing to retail investors will continue to be regulated by each individual Member State irrespective of whether the AIF is an EU or non-EU AIF or whether the AIFM is marketing locally or cross-border into that Member State. National regulators may impose restrictions or obligations over and above[39] those in AIFMD on any AIFMs that market to retail investors.

Restrictions on management and marketing[40] of non-EU AIFs: Neither MiFID investment firms nor credit institutions (including those outside of the EU) may market an AIF to EU investors if the related AIFM is not permitted to market to those EU investors under AIFMD. The marketing of listed AIFs will continue to be conducted under the relevant Prospectus Directive rules. AIFMD will most likely have a high impact on existing distribution models.

In the case of a non-EU AIFM, much will also depend on whether there is a cooperation agreement between the EU jurisdiction in which the AIFM wants to market and the non-EEA jurisdiction where the AIFM/AIF is domiciled. For non-EU AIFMs managing an EU AIF the AIFM must make an application to the relevant Member State of reference. As an example, a Jersey domiciled fund manager with an affiliate office in the UK (i.e. its Member State of reference) wishing to manage a Luxembourg domiciled AIF will need to make an application to the UK's FSA prior to managing that Luxembourg fund from the UK on a cross-border services basis. Alternatively should that non-EU AIFM wish to establish a branch in Luxembourg to manage the Luxembourg AIF, a detailed branch application would need to be submitted to the FSA who would then process the passport application and notify the Luxembourg CSSF as host Member State regulator.

Passive marketing and reverse solicitation remain outside the scope[41] of AIFMD. This scope exception may, in conjunction with reliance on the national private placement regimes (which will be available until 2018), and prior to the availability of the EU passport process for non-EU AIFMs (which will be available from 2015) provide non-EU AIFMs a viable, if constrained, mechanism to market within the EU. However marketing activity conducted via a marketing or distribution agent within the EU, or one that targets EU investors, would be within the scope of AIFMD.

Portfolio and/or risk management may only be outsourced by an EU AIFM to a non-EU AIFM where that the non-EU AIFM is a manager that is appropriately regulated in the non-EU jurisdiction.

The table below summarises the foregoing requirements:

Manager/Managing one or more:	**Authorisation required where no marketing in EU?**	**Authorisation required using EU professional investors national private placement regime to?**	**Authorisation required where using EU marketing passport?**
EU AIFM/ EU AIFs	Yes	N/A	Yes
EU AIFM/non-EU AIFs[42]	Yes	Yes	Yes, but NB the EU marketing passport will not be available for marketing the non-EU AIF until at least September 2015
Non-EU AIFM/EU AIFs	Yes, but NB the EU marketing passport will not be available for marketing the non-EU AIF until at least September 2015	Yes, but NB: A) The EU marketing passport will not be available for marketing the non-EU AIF until at least September 2015; B) The EU Member State's national private placement rules for professional investors will expire mid-2018	Yes, but NB: A) The authorisation requirement applies from earliest September 2015; B) The passport will be available from earliest September 2015
Non-EU AIFM/Non-EU AIFs to investors located in the EU	No	No, NB: The EU Member State's national private placement rules for professional investors will expire mid-2018	Yes, but NB: A) The authorisation requirement applies from earliest September 2015; The passport will be available from earliest September 2015
Non-EU AIFM/Non-EU AIF to investors outside the EU	Not in scope of AIFMD but certain national EU Member States' regulatory restrictions may apply		

Obligations on AIFMs managing AIFs which acquire control of non-listed[43] *companies or issuers*[44]*:* AIFMD imposes a number of investment governance requirements on AIFMs and AIFs which jointly or individually (A) attempt; or (B) actually acquire control of (1) non-listed companies; or (2) issuers. These rules do not apply to small to medium sized enterprises[45] or SPVs that hold real-estate. The AIFMD is silent on what happens if an investee company ceases to be a small to medium sized enterprise or a real estate SPV during the life of the AIF investment.

AIFMD requires that AIFMs notify the competent authorities in the home Member State where the relevant non-listed company held by the AIF is located any time when the AIF's holding reaches, exceeds or falls below the thresholds of 10, 20, 30, 50 and 75 per cent of the company's voting rights. Such notice must be delivered no later than 10 working days after the date on which the threshold has changed. This level of control, and any notification requirements, may also be supplemented

by existing national transparency and disclosure reporting obligations. For this purpose "control" is defined as any stake that controls more than 50 percent of the voting rights of the relevant company.

AIFMs must also notify (A) the non-listed company; (B) the readily identifiable shareholders of the non-listed company; and (C) competent home member state authorities of the AIFM with a breakdown of voting rights, the date on which and the conditions pursuant to which control was acquired, and must request the board of directors of the company to inform the employees' representatives and/or employees without undue delay of the acquisition of control by the AIF.

Furthermore the acquired company's employees and shareholders, and the AIFM's regulators, must be notified of the identity of the AIFM(s) managing the AIF that acquired the company[46], the proposed business/development plan of the AIF for the company and how it effects employment conditions, a communications policy e.g., an action plan for internal and external communications on plans regarding regards employees and conditions of employment. This information must also be disclosed to the investors in the AIF.

In addition the AIFM may not, for a period of 24 months following the AIF's acquisition of control, "asset strip" the company and any distributions may only be made in certain manner compliant with AIFMD.

AIFMD and UCITS: The UCITS Directives were drawn upon in various respects in developing AIFMD in order to harmonise to a certain extent the regulatory regime applicable to UCITS and non-UCITS funds. However, AIFMD does not regulate UCITS funds. Many fund managers will need to assess whether a particular fund may be better off as a UCITS fund or non-UCITS fund. One factor driving that determination will be whether the fund's investment strategy is compatible with the UCITS investments restrictions. It should be noted, however, that the UCITS "depositary" concept is more stringent than AIFMD's provisions.

Legislative process

AIFMD was published in the Official Journal of the European Union on 1 July 2011 entering into force on 21 July 2011. Each Member State must transpose AIFMD into national law by 22 July 2013.

In connection with the implementation of AIFMD, the European Securities and Markets Authority (ESMA) must draft a host of binding secondary measures, estimated to reach about 90 in total, such as Implementing Technical Standards (ITS) and Regulatory Technical Standards (RTS). Such measures will include describing the "small" managers regime, specifying the calculation criteria of leverage, specifying the calculation methodology for "own funds" and prudential capital requirements, details of the "skin in the game" requirements (which are likely to be similar to rules in CRD IV), describing acceptable valuation methodologies, specifying rules on outsourcing, specifying rules and standards of third-country co-operation agreements, specifying details on non-EU AIFM marketing access requirements, specifying details of the scope of extraterritoriality of AIFMD, and specifying details of the phasing out of national private placement regimes for non-EU AIFMs and non-EU AIFs.

In addition, the European Banking Authority (EBA) is working on RTS to finalise remuneration guidelines applicable to fund managers similar to the EBA's reforms of remuneration in credit institutions.

Finally, the European Commission also recently published a draft EU regulation[47] to facilitate AIFMD's implementation (the AIFMD Regulation). The AIFMD Regulation, which will also function as a useful way to 'mop up' loose ends in AIFMD or where there is a risk of national divergence, is expected to enter in to force in July 2013 concurrently with AIFMD. Controversially, the draft AIFMD Regulation in many ways goes beyond the original scope of AIFMD[48] and ESMA's

recommendations in particular areas. This 'legislative creep' has been criticised, and the AIFMD Regulation may be modified prior to final adoption.

These secondary measures and standards will then be adopted by the European Commission as delegated acts under AIFMD.

UK legislative response

The FSA as the current UK financial regulator has for some time maintained regulatory supervision of parts of the funds industry through regulation of MiFID activities and the regulation of operators of a Collective Investment Scheme (**CIS**) i.e., through the regulated activity of establishing operating or winding-up a (un) regulated CIS.

The FSA in conjunction with the UK finance ministry, the HM Treasury have been working closely together to create relevant legislation and the regulatory framework to transpose AIFMD in to law. AIFMD's transposition deadline, however, also coincides with the date by which the FSA must be split into two successor regulatory bodies. As a result, the UK rules adopting AIFMD may become final at a time of significant regulatory uncertainty.

In conclusion AIFMD will shake up the funds market in more ways than many market participants may have anticipated. Firms are encouraged to proactively meet these changes as soon as possible to ensure they are able to still capitalise on their core strengths and investment proposition.

Summary

In short, AIFMD will bring significant changes to the fund management industry within the EU. Areas in particular that fund managers will want to evaluate in light of the changes proposed in AIFMD include:

1. Assessing who will need to become an AIFM to carry out portfolio- and/or risk management activity and whether the AIF needs formally to (re-)appoint that entity or if any further regulatory authorisations or permissions are required to comply with AIFMD.
2. Assessing which entities will remain or will need to become MiFID firms to undertake particular activities.
3. Reassessing prudential capital arrangements of entities within a fund manager structure. Introduce enhanced management of liquidity and risk monitoring including leverage restrictions.
4. Amending investor facing documentation and periodic reporting business processes.
5. Adapting marketing and distribution processes to meet AIFMD compliance.
6. Revisiting PBAs and considering changes to the terms on which prime brokerage is provided to ensure AIFMD compliance including possible structural changes to custody arrangements.
7. Reassessing suitability custody providers and relationships with depositaries and/or valuers as well as re-documenting service agreements to ensure AIFMD compliance and securing best terms for the AIF and its investors.
8. Reassessing outsourcing arrangements and formal policies.
9. Introducing AIFMD compliant investment and disclosure procedures when acquiring relevant non-listed companies and issuers.
10. Implementing AIFMD compliant remuneration policies.

Endnotes

[1] Directive 2011/61/EU available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

[2] A UCITS fund is a fund regulated per the UCITS Directive 2009/65/EC, as amended.

[3] The FSA estimates that certain charity pooled investment funds may be included in the definition of an AIF.

[4] Whilst "collective investment undertaking" is undefined in AIFMD, it is expected that the term will follow the same interpretation in other EU law such as the Prospectus Directive, MiFID, UCITS etc. That interpretation provides that a 'collective investment undertaking' must raise capital from investors (any 2 or more) and invest that capital in accordance with an investment mandate/policy for the benefit of those investors. There is no limitation on which legal forms or formality of the investment vehicle or whether the vehicle is open or closed-ended. It is irrelevant whether the AIF is constituted under the law of contract/trust law, under statute or any other legal form. In the UK a number of funds may currently be classified as an unregulated collective investment scheme (UCIS) and AIFMD will bring the UCIS in the scope of AIFMD. Generally most UK domiciled managers of UCIS will already be regulated as collective investment schemes (CIS). UCIS are typically funds that employ private equity or hedge fund strategies.

[5] The UK's pending Financial Conduct Authority in its "Approach to Regulation (June 2011)" publication estimates that in the UK the number of firms to be affected by AIFMD is ca. 2,100 investment managers and over 500 collective investment schemes. These figures do not include any presently unregulated entities.

The Financial Conduct Authority Approach to Regulation (June 2011) is available at:

www.fsa.gov.uk/pubs/events/fca_approach.pdf

[6] AIFMD defines a "feeder AIF" as an AIF that (A) invests at least 85 percent of its assets in units or shares of another AIF (i.e. the master AIF); (B) invests at least 85 percent of its assets in more than one master AIF where those master AIFs have identical investment strategies; (C) or has otherwise an exposure of at least 85 percent of its assets to such a master AIF.

[7] For 2012 the estimated number of hedge funds and funds of funds following hedge fund strategies was estimate at 9,647, just shy of 2007 levels. Of those funds many larger funds have converted hedge fund strategies into the confines of compliance of UCITS. These 'hedge fund' UCITS are often termed 'NEWCITS'. In addition other managers have, rather than conversion and redomiciliation onshore, opted to 'clone' their fund e.g. replicate the offshore's fund strategy in an onshore UCITS or other type of vehicle. AIFMD will undoubtedly accelerate this shift.

[8] Recital 7 to the AIFMD states that family investment vehicles are not considered AIFs. That said any investment management activity of such an entity may still be subject to the existing national and/or MiFID regulatory framework.

[9] Although "holding company" is defined as "a company with shareholdings in one or more other companies, the commercial purpose of which is to carry out a business strategy or strategies through its subsidiaries, associated companies or participations in order to contribute to their long-term value and which is either a company: (A) operating on its own account and whose share are admitted to trading on a regulated market in the Union; or (B) not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies, as evidenced in its annual report or other documents." The scope of this definition may be relevant for structured finance transactions and/or firms carrying out investment management or trading through vehicles in corporate form.

[10] Recital 8 to the AIFMD states that joint ventures (not defined) are not to be considered AIFMs. However some joint ventures could be AIFs.

[11] The FSA's DP 12/21 –"Implementation of the Alternative Investment Fund Managers Directive" which is a useful indication of the FSA's and the successor bodies' regulatory approach AIFMD states that the new Financial Conduct Authority will be the likely UK regulator for fund management and markets from 2013. Some AIFMs may by virtue of an AIFs AUM in turn be jointly regulated by the Prudential Regulatory Authority, the FCA's prudential regulatory counterpart DP 12/21 is available at:

http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf

[12] AIFMD permits the regulator an initial three months to consider the authorisation although this may be extended by a further three months if considered necessary. The authorisation assessment criteria is similar to the MiFID criteria e.g. suitability of conduct of business framework, controllers and any close-links. Importantly though in the UK, the Financial Services Bill 2012, contains provisions that permit the competent financial regulators to rescind a regulated firm's regulatory permissions if it ceases to

carry out a regulated activity. For example if a regulated firm has a permission to engage in investment advice for the financial instrument of a spread bet but fails to undertake economic activity that is covered by that regulatory permission, the financial regulators may rescind that permission.

[13] Such as those granted by way of a side letter.

[14] Directives 2006/48/EC and 2006/49/EC, both as amended.

[15] Member States have a national derogation to reduce the figure to be held by externally managed AIFMs by 50 percent if a credit institution or insurer has provided a guarantee for the balance.

[16] Most MiFID Investment Managers are subject to MiFID MCR of € 50,000.

[17] The term "leverage" means any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivatives positions by any other means."

[18] Based on an assessment of: (A) the type of AIF; (B) investment strategy; (C) sources of leverage; (D) close links and systemic risks; (E) counterparty exposure; (F) extent that the leverage is collateralised; (G) the asset liability ratio; (H) the scale and nature of the AIFM on the markets concerned.

[19] The European Markets Infrastructure Regulation (EMIR) has already introduced increased collateral requirements which favour high-quality and eligible collateral, an increasingly scarce and expensive commodity. Equally EMIR also alters how firms, and thus AIFMs on behalf of AIFs, interact and transact with their counterparties. The new EMIR requirements will generally impose higher economic and prudential costs on AIFMs as well as more stringent on-going compliance obligations.

[20] Certain limited partnership agreements, such as private equity firms, may list which types of transaction and monitoring fees (due from investee companies or other third parties) can/cannot be taken into account by the management group for the purpose of management fees and/or profit sharing arrangements.

[21] In the UK, the current FSA Rules require only certain types of MiFID investment firms to submit liquidity assessments. In addition to applying liquidity standards to all AIFMs, AIFMD also requires that liquidity profiles are consistent with redemption policies.

[22] Including stress-testing or benchmarking of the AIF's risk profile against its portfolio structure, investment strategy and corporate objectives.

[23] And some AIFMs could become subject to both CRD and AIFMD remuneration requirements.

[24] The term "remuneration" includes any type paid by the AIFM, any amount paid by the AIF (incl. carried interest) any transfer of shares or units of the AIF.

[25] The EVCA has stated that that at least 40 percent to 60 percent of variable remuneration is anticipated to be deferred over at least three years.

[26] The AIFMD defines a 'prime broker' as a credit institution, a regulated investment firm or another entity subject to prudential regulation and on-going supervision, offering services to professional investors primarily to finance or execute transactions in financial instruments as counterparty and which may also provide other services such as clearing and settlement of trades, custodial services, securities lending, customised technology and operational support facilities.

[27] In the UK, this obligation currently only applies to certain MiFID Investment firms engaged in "prime brokerage" activity. Consequently AIFMD places a corresponding obligation on the AIFM in addition to the prime broker.

[28] The EU has provided a generic definition for the purpose of the press: a "depositary" as a legally separate organisation, where the formal documents showing who owns shares, bonds, etc., can be kept safely." Typically its functions include: the safekeeping of the assets of the AIF, the day-to-day administration of the AIF, the control of the AIF's operation i.e., compliance with investment policies and payment flows to investors. In the pre-AIFMD market the term depositary in a fund context would cover both custodians and fund administrators. Equally, registrar or transfer agents would also be a "depositary" in the context of registered securities. For fixed income and unregistered securities the situation becomes more complicated.

[29] The concept may further be refined by the proposed Central Securities Depositary Regulation published 7 March 2012

[30] The Commission and ESMA are tasked with determining further parameters of what is covered by "other assets".

[31] Within the meaning of Directive 2006/48/EC

[32] Which includes most "investment banks" but excludes most investment managers and agency brokers. The AIFMD states that relevant MiFID investment firms must have an initial capital level of at least € 730,000.

[33] Offshore custodians in the jurisdiction in which the depositary is resident must also satisfy themselves that that jurisdiction has complied with tax information sharing agreements on standards equivalent to Art. 26 of the OECD Model Tax Convention. Furthermore the AIFMD Regulation requires that the AIFM in assessing the financial soundness of counterparties or prime brokers requires that such counterparties be able to and continue to comply with EU prudential requirements, thereby limiting such counterparties to EU domiciled entities.

[34] To be specified in forthcoming consultation papers. Professional indemnity insurance may be one element that would provide a professional guarantee.

[35] Such as "gating" or "side-pocketing" of investments. Further RTS are expected to address how AIFMs are required to report to the regulators and investors how the percentage of, valuation methodology of and application of management and performance fees to assets that are subject to special arrangements are to be applied.

[36] As well as where prompted by the regulator to justify that the leverage levels set for each AIF are reasonable and that the AIFM complies with the limits at all times.

[37] As defined in MiFID. The definition of what constitutes a professional investor is subject to change with the pending legislative reforms of MiFID.

[38] The definition of professional investors is the same as that under MiFID and includes both per se professional investors and those who may opt up to professional investor status. It is presently unclear as how the opt-up process will work for AIFMD purposes or what will happen to an investor in an AIF if it ceases to be a professional investor.

[39] However these restrictions may not be discriminatory and cannot be applied to an EU AIF established in another Member State and marketed on a cross-border basis to retail investors than are applied to an AIF (EU or non-EU) marketed domestically.

[40] AIFMD defines marketing as "a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled or with a registered office in the Union."

[41] Passive marketing and reverse solicitation will therefore remain subject to relevant national law. There is a risk that certain Member States, could as a matter of policy, make passive marketing or reverse solicitation more difficult so as to encourage marketing in accordance with the AIFMD.

[42] Particular attention should be given to feeder funds. If an EU AIF is a feeder fund which may cause it be treated differently than the corresponding non-EU AIF feeder fund irrespective of the EU AIF master fund being managed by the same AIFM. Marketing restrictions, on-going disclosure and regulatory reporting requirements, and the interaction with the depositary may differ as the EU AIF is subject to more stringent requirements than say a non-EU AIF being solely marketed to non-EU investors.

[43] The AIFMD defines 'non-listed company' as a company which has its registered office in the EU and the shares of which are not admitted to trading on a regulated market as defined in MiFID. NB this definition may be amended by the MiFID reforms.

[44] The AIFMD defines 'issuer' by cross referencing the definition used in in Directive 2004/109/EC a.k.a the Transparency Directive, which means a legal entity governed by private or public law, including a State whose securities are admitted to trading on a regulated market (although note this definition may change under the MiFID reforms) or in the case of depositary receipts the underlying issuer of the securities represented by depositary receipts.

[45] As defined in Commission Recommendation 2003/361/EC, which is an enterprise, employing fewer than 250 employees with an annual turnover net of value added and other indirect taxes not exceeding € 50 million and/or a balance sheet total not exceeding € 42 million. The assessment is determined on a consolidated basis referencing audited financial statements. Firms should consider whether a small to medium sized enterprise is also a "linked enterprise".

[46] Which will presumably be a pro forma document tailored specifically to the transaction. [A tailored pro forma? Does this really add anything?]

[47] Regulations automatically become part of a Member State's national law from the date of application

[48] The Alternative Investment Management Association, an Industry Body published a very helpful comparison in July 2012 of AIFMD Regulation: http://www.aima.org/objects_store/aifmd_divergences_from_esma_advice_-_aima_note_-_ec.pdf

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