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A legal update from Dechert's Financial Services Group

AIFMD: Impact on US Investment Advisers

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Introduction

This *OnPoint* considers the impact of the EU Alternative Investment Fund Managers Directive (“AIFMD”)¹ on US based investment advisers. Much of what it covers is equally applicable for investment advisers and managers based in other non-EEA² jurisdictions.

It is intended as a supplement to our other publications and materials on AIFMD. Readers looking for a more comprehensive overview of AIFMD, or a more detailed explanation of some of the concepts referred to in this *OnPoint*, should [check our AIFMD resources](#).

This note gives a general overview only as at June 2013 and cannot substitute for bespoke legal advice. Many rules are still in draft and in flux. Transitional reliefs, *de minimis* or other exemptions and differences in implementation approach and timing as between EEA member states mean that the application of these concepts can differ materially as between different investment advisers.

¹ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

² “EEA” refers to the European Economic Area which comprises the member states of the European Union (“EU”), plus Iceland, Liechtenstein and Norway. There are currently 27 EU member states, but this will increase to 28 on 1 July 2013 if Croatia joins the EU as expected. Application of the AIFMD will extend to all 31 EEA member states.

Terms Explained

AIF

An “Alternative Investment Fund” or “AIF” is defined broadly to include most kinds of pooled investment vehicles — other than UCITS funds — that raise capital from investors. Subject to certain (limited) *de minimis* and other exemptions, this will catch most hedge funds, private equity funds, fund of funds, private funds in other asset classes such as debt, real estate and infrastructure, as well as other vehicles such as registered mutual funds.

AIFM

Identification of each AIF’s “Alternative Investment Fund Manager” or “AIFM” is of fundamental importance, yet for many structures this is a complex task requiring careful advice. In very broad summary, the AIFM is the primary entity providing portfolio and/or risk management services to the AIF. In some circumstances, an AIF may be regarded as “self-managed” and be both the AIF and the AIFM.

An AIFM may be established in the EEA (an “EEA AIFM”) or outside the EEA (a “non-EEA AIFM”).

Overview: Four key ways that US investment advisers are affected by AIFMD

AIFMD starts to take effect from 22 July 2013, subject to certain transitional arrangements. In broad terms, it will affect US investment advisers engaged in the following activities:

- **Marketing funds in the EEA.** AIFMD will change the way that fundraising is regulated throughout the EEA. This will be relevant to virtually all sponsors of AIFs (whether they are open or closed ended, listed or unlisted) which are actively marketed to EEA investors. This is discussed further under “**Marketing Funds in the EEA**” below.
- **Managing EEA funds.** US investment advisers managing EEA domiciled AIFs will need to reassess whether they can continue to do so from this July, and on what terms. This is discussed further under “**Managing an EEA domiciled AIF**” below.
- **Sub-advising a fund managed by an EEA AIFM.** US investment advisers which sub-advise or provide investment services to an EEA AIFM may be drawn into AIFMD compliance requirements by new rules on delegation applying to the AIFM. This is discussed further under “**Sub-Adviser to an EEA AIFM**” below.
- **Delegating to an EEA sub-adviser.** Any US fund manager that delegates portfolio or risk management in relation to an AIF to a European entity will need to consider carefully whether it or the European entity would be categorised as the fund’s sole AIFM. If the European entity is categorised as the AIFM it would be obliged to apply virtually all of the AIFMD’s provisions in relation to the AIF. This is discussed under “**Delegating to an EEA based sub-adviser**” below.

Marketing funds in the EEA

From 22 July 2013, subject to certain transitional arrangements, new rules will apply in relation to the “marketing” of AIFs to investors domiciled in or with a registered office in the EEA.

Whereas EEA AIFMs will be permitted access to a UCITS-style pan-EEA marketing passport allowing the marketing of EEA AIFs to professional investors, US and other non-EEA AIFMs will not have access to this, at least for the first two years.

In relation to US and other non-EEA AIFMs, individual member states have a free hand to decide whether to permit private placement and, if so, to determine the extent of their rules in this area - and the results will vary member state by member state. Certain member states are expected to be very restrictive in this regard, some will be permissive. For those permissive member states that do permit marketing by private placement (the so called “national private placement regimes”), there will be new regulatory filing, reporting and disclosure requirements.

Accordingly, once AIFMD takes effect from 22 July 2013, US investment advisers wishing to raise capital from European investors for AIFs they manage (typically Cayman, Delaware, or other non-European funds) will have a number of options, each of which is discussed in more detail below. See also the Q&A section at the end of this *OnPoint* for guidance on some specific marketing scenarios, such as communication with existing investors.

Routes to European capital after 22 July 2013

1. **Transitional arrangements.** Certain jurisdictions (e.g. the UK and Germany) are expected to permit certain existing fundraising to continue under pre-AIFMD rules for up to a year.
2. **Private placement, where permitted.** Both the investor’s home state (e.g. where it is domiciled or where its registered office is located) and/or the location in which marketing takes place could be relevant in determining which rules apply to any given scenario. The availability of this route is dependent on, amongst other things: (a) the relevant member state permitting such marketing at all (some will not); and (b) the relevant co-operation arrangements with competent authorities where the AIF is established having been entered into. Significant additional compliance requirements will also apply.
3. **Non-Solicited Sales.** The acceptance of investors on a “passive” or “reverse solicitation” basis will fall outside the AIFMD restrictions on marketing. The relevant offer or placement must be at the investor’s initiative rather than that of the investment adviser or any agent of the investment adviser. Such sales may include those initiated via capital introduction events, investment consultants and other third parties, if structured properly.
4. **Outside scope marketing.** Some “pre-marketing” is outside scope. Also, marketing investment opportunities that are outside the scope of AIFMD (e.g. managed accounts or UCITS) is not restricted by AIFMD.
5. **Access the EEA marketing passport.** This will require the establishment of an EEA AIFM and EEA AIF and accordingly will involve full AIFMD compliance.

Route 1: Rely on transitional arrangements

Certain jurisdictions (the UK and Germany included) are expected to allow US investment advisers and other “third country” AIFMs, to continue pre-existing marketing campaigns under transitional arrangements. These arrangements are expected to continue up to July 2014.

In order to rely on transitional arrangements, US investment advisers will need to know the eligibility criteria in each relevant jurisdiction. Transitional reliefs may only be available if investment-ready fund documentation has been made available to investors in the jurisdiction prior to 22 July 2013.

Accordingly, any US investment advisers looking to take advantage of such transitional arrangements will need to consider now whether any additional steps are necessary in order to ensure that they can get the benefit of these reliefs.

We are monitoring the availability of these reliefs closely and can advise further as required.

Route 2: National private placement regimes

No EEA single market for marketing by US managers

The term “private placement” in an AIFMD context refers generally to marketing to professional investors without a passport. As at present, the permissibility (or otherwise) of private placement in any given EEA member state by US AIFMs will be a matter for the national law of that member state. The final position to be adopted by many EEA member states is still evolving. However, with some potentially significant exceptions, we broadly expect member states which are currently restrictive to stay restrictive and those which are currently permissive to preserve some form of private placement regime. As a whole, however, we expect the kaleidoscope of formal and informal private placement routes reflecting laws or practices of long standing to be replaced with a more formal set of private placement regimes or outright prohibitions on marketing. This heightens the level of regulatory scrutiny and consequently the level of marketing discipline required from promoters and their agents.

Importantly, given the volume of investors in the UK, the regime in the UK will remain broadly permissive of private placement. This position is set out in draft HM Treasury regulations, which have been the subject of industry consultation but which at the time of writing have not been made final.

We are monitoring the position in all EEA member states closely. For more information on how Dechert can help with your European marketing compliance requirements, please contact the authors or any member of our AIFMD team.

Co-operation arrangements

A pre-requisite for private placement under AIFMD is that the relevant EEA member state concerned must have in place “co-operation arrangements” with the regulators in the jurisdiction of the AIF and of the AIFM (if non-EEA). ESMA³ is coordinating these arrangements by negotiating with non-EEA regulators.

At the time of publication, ESMA has announced its approval of co-operation arrangements with 34 regulators, including the SEC and Federal Reserve (but, notably, not the CFTC), as well as the Cayman Islands Monetary Authority and others. This is a key step in securing the availability of the private placement route for US investment advisers marketing non-EEA funds in Europe.

The co-operation arrangements are embodied in template Memoranda of Understanding (MoUs) which now need to be converted into bilateral agreements signed by each EEA securities regulator and the relevant non-EEA authorities. Whilst we expect that many of the key regulators will sign these MoUs prior to 22 July, it is likely that some will not.

³ European Securities and Markets Authority.

Registration procedure

US investment advisers qualifying as non-EEA AIFMs are likely to need to register private placements in member states in which they are marketing by way of private placement. This will involve filing certain documentation about the AIF and the non-EEA AIFM with the applicable national regulator and may take the form of a notification/registration or application for approval, depending on jurisdiction.

New disclosure requirements

When marketing (as defined by the AIFMD) under national private placement regimes, a US investment adviser will be subject to the new compliance requirements described below.

The private placement memorandum, or other marketing and disclosure material, will need to contain new AIFMD pre-sale disclosures. Some of the required disclosures will be of commercial interest to investors and, therefore, in documentation already – others will not. Required disclosures include (amongst others):

- investment strategy and objective (noting that regulators may not tolerate some of the very wide and non-specific disclosures in this regard that are currently used);
- redemption and liquidity management policies;
- professional indemnity insurance levels;
- delegated functions (including management and custody);
- valuation procedures;
- fees, charges and expenses;
- how the fair treatment of investors is ensured (including, potentially, detailed side letter disclosures);
- information on latest valuations and prices;
- information on historic performance; and
- latest annual report (this is where remuneration disclosures are contained – see below).

Required periodic “post sale” disclosure requirements include:

- material changes in information disclosed;
- the percentage of assets subject to special arrangements on liquidity;
- new arrangements for managing liquidity;
- the current risk profile of the AIF and risk management systems employed; and
- total leverage employed.

Such “post sale” disclosures may be required (and made) as part of an AIF’s annual reporting package, but may also need to be communicated more frequently in response to specific events.

Annual report (including remuneration disclosure)

The AIFM will need to make available to investors an annual report for each financial year, which will need to cover, amongst other things:

- balance sheet and income/expenditure statement;
- report on activities for the financial year;
- material changes to fund terms or disclosures during the financial year;
- total remuneration, split into fixed and variable remuneration paid by the AIFM to its staff (including the number of recipients);
- total remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF; and
- a breakdown of the total remuneration amounts in relation to each AIF, so far as practicable.

It is unclear at present whether particular jurisdictions will require such disclosures to be 'back-filled' in relation to preceding periods. We hope that regulators will be pragmatic about this.

Carried interest is seen as "remuneration" for the purpose of these disclosures. The position of profit distributions to equity owners of the business is less clear, but there is a danger that some such distributions might also fall within the scope of "remuneration". Accordingly, it can be seen that careful consideration as to which entity will be the AIFM is critical as this determines the disclosures required.

Transparency requirements: Europe's "Form PF"?

The AIFMD will introduce new regulatory reporting requirements for US investment advisers which either manage an AIF domiciled in the EEA or which market a non-EEA AIF within the EEA. Although reporting will be made to EEA national regulators, the European Commission has adopted a standard form template to be used throughout the EEA.

Some parts of the AIFMD reporting form have analogues in SEC Form PF, but many do not. In general, the AIFMD form is less focused than Form PF on reporting broken down by fund type. The AIFMD form has a common set of reporting requirements for all funds, regardless of fund type, although references to, for instance, long and short positions and counterparty risk indicate that it is primarily targeted at hedge funds (with some questions which may be difficult to answer for non-hedge funds). As a consequence, reporting by funds other than hedge funds (such as private equity and real estate) will take a very different form in the AIFMD form compared with Form PF.

Private Equity provisions

Managers of AIFs which acquire control positions in listed and unlisted companies in the EEA (e.g. most Europe-focused private equity funds) will, subject to certain exceptions, be required to comply with new provisions specific to private equity, including:

- A requirement to notify the company, shareholders and regulators of acquisitions of major holdings in unlisted companies when certain thresholds are passed (starting at 10%).

- A requirement to include additional information in the annual report (including future development plans).
- The so-called “asset stripping” provisions which restrict dividend recapitalisations and other returns of capital for the first two years of portfolio company ownership.

Application of “asset stripping” provisions to US AIFMs marketing in Europe

AIFMD imposes restrictions on distributions, capital reductions, share redemptions and purchases of own shares by a “controlled” portfolio company during the first two years of ownership of that company by an AIF, including one managed by a non-EEA AIFM.

The restriction affects only portfolio companies who have a registered office in the EU and that are not special purpose real estate companies or “small and medium enterprises”⁴.

Whether a portfolio company is “controlled” for these purposes depends on whether it is unlisted or listed. An unlisted company is generally “controlled” if the AIF holds more than 50% of voting rights. The test for when a listed company is controlled varies from member state to member state. In most EU member states, including the UK, a listed portfolio company would be “controlled” once 30% of voting rights are held.

The asset stripping restrictions apply to the AIFM rather than the portfolio company, and the AIFM is required to use “best efforts” to prevent any asset stripping steps from being taken. The restrictions are aimed at manipulating the value of a portfolio company through return of capital (e.g. a dividend recapitalisation) rather than outright disposals. Payments that are made out of certain line item reserves continue to be permitted.

Additional requirements

Some member states will impose additional compliance requirements in order to access national private placement regimes – for example, the requirement to appoint a depositary. We can advise further on these access conditions as required.

Route 3: Non Solicited Sales (reverse solicitation)

Non-solicited sales will not constitute marketing for the purposes of AIFMD. Accordingly, AIFMD does not restrict the ability of EEA investors to invest at their own initiative, notwithstanding that they may be domiciled or have a registered office:

- in a member state where private placements are permitted but the AIF has not been registered for private placement; or
- in a member state where private placements are not permitted.

Reverse solicitation is not about the investment adviser accessing investors, it is about investors accessing the investment adviser. Firms which adhere to that fundamental principle – and can back it up with evidence – should find they can still accept investment from EEA investors, unaffected by AIFMD. However, the concept of reverse solicitation will be approached differently by different regulators and, therefore, advice on its scope should be taken before relying on it. Almost by definition, the countries

⁴ Generally, companies with fewer than 250 EU employees and one of (i) net turnover less than EUR50mm or (ii) a balance sheet below EUR43mm.

where reverse solicitation is likely to be most relevant are those which are hostile to private placement - so care is advised.

Any manager looking to rely on reverse solicitation should maintain a robust compliance process which can also provide evidence that the sale was made on this basis. This is important not just in the context of regulatory compliance, but also given the private law actions that AIFMD breaches could give rise to (in short, the danger of an investor seeking to argue that the fund was “mis-sold” in breach of marketing restrictions and they are entitled to their money back).

Factors to consider:

- Are intermediaries acting on behalf of the AIFM, AIF, investor or their own account?
- Does the whole pattern of contact with both new and existing investors back up the reverse solicitation?
- Does the manner in which subscriptions are processed on behalf of the AIF back up the reverse solicitation?
- Are promotional and other materials and website content and procedures sufficiently robust?

Reverse solicitation is not a new concept - it has been relied upon for some time in various jurisdictions. The AIFMD does, however, throw a new focus on the topic so managers are well advised to review their understanding of the process and related sales procedures.

Route 4: Outside Scope Marketing

Pre-marketing may be excluded

Much of the “real world” marketing activity in connection with an AIF is likely to fall outside the concept of “marketing” as defined by AIFMD. This should be assessed in terms of an overall course of action rather than purely in terms of particular documents, but it does mean that certain documentation (such as flip-books or draft fund documentation) could potentially be communicated to investors without being deemed “marketing” for AIFMD purposes. This is helpful as it means that, for example, compliance with the registration, disclosure and transparency requirements attendant upon “marketing” could be deferred or potentially avoided.

It will be important for those relying on this concept to obtain clear guidance on the parameters of such “pre-marketing” in each relevant jurisdiction, along with associated rubrics and compliance procedures advisable to support the regulatory analysis. It is important to note that:

- such activities may well still be subject to national regulatory requirements (e.g. in the UK, such “pre-marketing” activities may well amount to regulated “financial promotion”); and
- unless there has been a “reverse solicitation”, marketing within the meaning of AIFMD may well be necessary in order to consummate the sale – thereby triggering registration and other compliance requirements in due course.

See also the Q&A section at the end of this *OnPoint* for further discussion on certain pre-marketing issues, including guidance on continuing discussions that are already in progress prior to 22 July.

Marketing non-AIFs

Discussions around managed accounts, UCITS and investment strategy or team generally, without reference to an AIF, in principle should be outside scope of AIFMD. Again, capital introduction events may have a role to play here, provided they are structured so as to avoid promotion of particular AIFs on behalf of their managers. Remember, however, that these activities are still potentially within the scope of other laws and regulations in member states which need to be complied with.

Please note, multiple managed accounts managed on a lock-step basis, or “funds of one” which do not contain appropriate restrictions on further investment, may constitute AIFs. Accordingly, careful structuring may be required to ensure that such arrangements remain outside the scope of AIFMD.

Route 5: EEA Passport marketing

The EEA passport, which allows AIFs to be marketed on a pan-European basis under an EEA “marketing passport” regime, will (initially, at least) only be available to EEA AIFMs in relation to EEA domiciled funds. Accordingly, US investment advisers looking to use the passport will need to establish an EEA AIFM, which will be subject to full compliance with the AIFMD. This can be done in a number of ways. The US adviser may already have an authorised affiliate in London or another European jurisdiction and could establish an AIFM in parallel to or in place of that entity. Alternatively, a self-managed AIF or local management company could be established in Ireland, Luxembourg or an alternative EEA jurisdiction. To the extent that the EEA AIFM delegates collective investment services to the US investment adviser, the matters discussed under “**Sub-Adviser to EEA Manager**” below will also be relevant.

Marketing: practical steps

Generally:

- Understand marketing plans. What are the fundraising objectives over the next 12-24 months? In which jurisdictions and by which route are investors expected to invest?
- Review ongoing conversations with prospective investors. Consider whether any steps should be taken prior to 22 July and on what terms such discussions can continue afterwards.
- Understand whether anything needs to be done now in order to ensure that a transitional relief is available in a particular jurisdiction.
- Review marketing compliance procedures. Understand how evolving rules will be monitored.
- Review website compliance and communications with existing investors.

If private placement will be used:

- Consider who will be the AIFM, including potentially establishing a new entity. Everything flows from this.
- Monitor co-operation arrangement progress.
- Review relevant PPMs and related material for transparency compliance requirements. Will required information be disclosed in PPMs or in supplementary documents?
- Start to assess annual report and other provisions.
- Start to prepare for remuneration disclosure. Assess what remuneration and which funds are in scope for disclosure.
- Start to prepare for regulatory compliance requirements (transparency and regulatory reporting) in each relevant jurisdiction.

Managing EEA domiciled funds

There has been some uncertainty as to the terms on which non-EEA managers (including US investment advisers) will be able to continue to directly manage the portfolios of EEA domiciled AIF (e.g. Irish or Luxembourg domiciled non UCITS funds) from 22 July 2013.

This uncertainty arose because the provisions permitting non-EEA managers to apply for authorisation as AIFM under AIFMD will not come into force, if at all, until July 2015 at the earliest and AIFMD makes no express provision for such management to continue in the interim.

It is hoped that relevant member state regulators which currently permit such direct appointments will find a pragmatic solution to this impending issue that allows US investment advisers to continue to manage the EEA AIF without the need for such compliance with all of the provisions of AIFMD. Both Ireland and Luxembourg have recently indicated that they intend to facilitate this under transitional arrangements.

Alternative options may include the following:

- the EEA AIF could become a self-managed fund (and, therefore, itself be the AIFM) and delegate investment management functions to the US investment adviser; or
- an existing or newly established local management company could take on the role of AIFM and delegate investment management functions to the US investment adviser.

These two scenarios in effect involve an EEA AIFM managing the EEA AIF. This means that AIFMD will apply in full and will drive significant compliance requirements in relation to the AIF, the AIFM and, via the AIFMD delegation requirements, the sub-adviser. A full consideration of the impact of AIFMD on EEA managers is beyond the scope of this *OnPoint* but the matters discussed below under “**Sub-Adviser to an EEA Manager**” will be relevant as regards the US sub-adviser. In addition, the EEA AIFM must not be a “letter-box entity”, as discussed further below.

The position for private equity and other closed-ended funds that are hard-closed may differ and US investment advisers in this position should check the status of each such fund.

Anti Letter-box Provisions

Under AIFMD, an EEA AIFM is not permitted to delegate investment management functions (which are the (undefined) functions of “risk management” and “portfolio management”) to such an extent that it becomes a “letter-box entity” and can no longer be considered to be the manager of the AIF.

European regulations made under AIFMD set out a number of situations where an EEA AIFM will be deemed to have become a letter-box entity in relation to any delegation. In addition to a failure to properly monitor and supervise delegates, these include situations where:

- the AIFM no longer retains the necessary expertise and resources to supervise the functions delegated to a sub-adviser or effectively manage the risks associated with the delegation;
- the AIFM no longer has the power to take decisions in key senior management areas or perform senior management functions in relation to investment policy and investment strategies; and
- the AIFM delegates the performance of investment management functions to an extent which exceeds by a substantial margin the investment management functions performed by the AIFM.

This is determined on the basis of qualitative criteria which include, for example, whether the delegations are within a corporate group.

We are closely involved in this issue on a range of fronts and can advise on a more detailed basis how sufficient substance can be retained in terms of risk management and portfolio management functionality, as required.

Sub-adviser to an EEA manager

AIFMD will affect the operations of US investment advisers which undertake investment management functions and certain other so-called collective management functions in respect of the portfolios of EEA or non-EEA AIF under delegation (direct or indirect) from an EEA AIFM. Arrangements in scope include, for example, a non-EEA domiciled fund marketed to EEA investors, managed by an EEA AIFM and sub-advised by a US investment adviser, such as some of the bank sponsored platforms.

Investment management functions comprise the functions of risk management and/or portfolio management. There is no definition *per se* of what these functions are and therefore the scope of activities covered is potentially wide. Accordingly, US sub-advisers undertaking only aspects of risk management or portfolio management will potentially be in scope.

The definition of collective management functions is also wide and includes marketing functions, administration functions and other functions such as valuation.

Arrangements involving non-discretionary investment advisory services (i.e. where the US sub-adviser makes recommendations only and cannot exercise discretion over the portfolio) should be out of scope, if properly structured. Individual arrangements should be carefully reviewed in order to ensure that the functions performed by the US investment adviser are indeed out of scope.

How are US sub-advisers affected if delegation is “in scope”?

US sub-advisers are potentially affected in a number of ways:

1. Under AIFMD, an EEA AIFM which wishes to delegate (or continue to delegate) in scope functions to a US sub-adviser will need to satisfy a number of detailed conditions and requirements, including:
 - The AIFM will only be able to delegate to the extent it does not become a “letter box” entity (see “**Anti Letter-box Provisions**” above).
 - The delegation will need to be evidenced by a written agreement (see “**What will the written agreement need to cover?**” below).
 - The AIFM will be required to pre-notify the delegation to its EEA member state regulator and, potentially, obtain consents.
 - The AIFM will have to justify the entire delegation structure on objective grounds.
 - Delegation of portfolio management and risk management will only be permitted if the US investment adviser is registered or authorised for asset management and subject to supervision (e.g. registered with the SEC or CFTC).

- Delegation will only be permitted if co-operation arrangements are in place between the relevant EEA member state regulator and the US sub-adviser's supervisory authority (see "**Co-operation Arrangements**" on page 4 above).
2. The EEA AIFM will be required to be able to demonstrate that the US sub-adviser (delegate) has been selected with all due care and also that:
 - the delegate has sufficient resources to perform the delegated tasks;
 - the persons who conduct the delegate's business are of sufficiently good repute and experience; and
 - the delegate is qualified and able to undertake the relevant delegated functions.
 3. The AIFM will be required to ensure that the US sub-adviser undertakes the delegated tasks effectively and in compliance with its obligations as an AIFM under AIFMD. In connection with this, AIFMD imposes on the AIFM detailed obligations to monitor the delegation, to give instructions and supervise and review the delegation on an ongoing basis. Accordingly, the EEA AIFM may be forced to impose on the US sub-adviser a degree of indirect compliance with AIFMD. This could include requirements as to:
 - conflicts of interest policies (e.g. the EEA AIFM is required to ensure the delegate has conflict of interest policies and procedures in place corresponding to those required to be adopted by it under AIFMD);
 - risk and portfolio management functions;
 - valuation policies and functions;
 - the functional and hierarchical separation of personnel and reporting lines in relation to portfolio management, risk management and valuation functions, subject to principles of proportionality; and
 - reporting and transparency.
 4. US sub-advisers may also be subjected to certain requirements relating to remuneration (see "**Extension of remuneration requirements to US managers**" below).

Are sub delegations affected?

Yes, the EEA AIFM will be required to:

- impose on the US sub-adviser restrictions on its ability to further delegate functions without consent;
- submit pre-notification of any sub-delegation to its member state regulator; and
- impose similar compliance requirements to those discussed above throughout any sub-delegation chain.

What will the written agreement need to cover?

Most US sub-advisers will already have a written agreement in place evidencing a delegation. However, it is likely that EEA AIFM will wish to upgrade the scope of their delegation agreements to include some of these additional matters as well as, potentially:

- rights of inspection, access, monitoring and supervision;
- enhanced rights of termination on short or no notice;
- restrictions on sub-delegation by the US sub adviser; and
- disaster recovery assurances and obligations.

Furthermore, there are detailed requirements placed on the EEA AIFM to ensure the rights and obligations of the parties are clearly allocated in the agreement. As a result, agreements may need to become more detailed.

When will US sub-advisers be impacted by AIFMD?

The date from which an EEA AIFM will be required to comply with AIFMD, including the provisions on delegation, will depend on when the EEA AIFM is required to obtain authorisation under AIFMD. EEA AIFMs are required to seek such authorisation on and from 22 July 2013, subject to transitional provisions under which existing AIFMs may delay seeking authorisation for up to a 12 month period ending on 22 July 2014.

The UK has indicated that the transitional relief will be available to UK AIFMs, other EEA AIFMs and even non-EEA AIFMs for the full 12 month period. However, some other member states may place a requirement on EEA AIFMs seeking to rely on the transitional relief to nonetheless comply with AIFMD requirements on a “best efforts” basis from 22 July 2013.

Accordingly, US sub-advisers should engage with EEA AIFMs for whom they provide in-scope delegated functions and their advisers to agree a date from which compliance with the new arrangements will apply.

Furthermore, US sub-advisers may wish to consider compliance with certain aspects (e.g. remuneration reporting) from 1 January 2014 in order to tie in with financial reporting cycles.

Extension of remuneration requirements to US managers

There is concern that the rules on delegation will impose compliance with the remuneration provisions of AIFMD on US sub-advisers. Under the delegation rules, EEA AIFMs may require their sub-advisers to functionally separate remuneration structures as between those engaged in portfolio management, risk management, valuation and, potentially, other activities. In addition, in guidance issued in February, ESMA indicated that the AIFMD’s remuneration restrictions should be extended to entities to which EEA AIFMs delegate portfolio or risk management, and in relation to a delegate (such as a US based sub-adviser) that is not subject to regulatory restrictions on remuneration which are “equally as effective” as those in the AIFMD, the AIFM should put in place contractual arrangements to ensure there is no circumvention of the AIFMD remuneration rules.

Such a requirement could be interpreted to mean that in order for delegation from an EEA AIFM to a US sub-adviser to be lawful, the US sub-adviser would need to comply with the remuneration restrictions in AIFMD. These are onerous and include:

- a requirement to appropriately balance fixed and variable compensation, which could result in the fixed component needing to increase; and
- requirements for variable compensation to be deferred for between 3-5 years, payable partly in fund shares and subject to certain clawback provisions.

It remains to be seen whether the various EEA regulators will endorse this approach. ESMA's guidelines do not have the force of law and they arguably seek to extend the effect of AIFMD beyond what was envisaged by the primary legislation. As such, if they are applied as stated it is possible that their lawfulness will be challenged.

Guidance from national regulators may not be forthcoming and EEA managers will need to form their own view about the ESMA guidance and how to deal with their delegates on this point. Accordingly, US sub-advisers to EEA AIFMs should review their position carefully in the jurisdictions that will affect them and engage with their EEA principals and their advisers about the approach they intend to take in this regard. Any onwards delegation by the US sub-adviser should also be considered.

Practical steps

US sub-advisers to an EEA AIFM should:

- understand what the EEA AIFM's approach to the transitional period will be. If a UK AIFM, does it intend to make full use of the transitional period? If a non-UK AIFM, what level of compliance is required during the transitional period?
- review with the EEA AIFM the approach it intends to take in respect of applying remuneration restrictions to the US sub-adviser;
- understand what arrangements and procedures are to be put in place in terms of the delegation agreement and what compliance and operational changes will need to be implemented; and
- review their own sub-delegation arrangements.

Delegating to an EEA based sub-adviser

In cases where a US investment adviser appoints an EEA sub-adviser, the parties concerned will need to analyse which entity will be the AIFM. Whether such arrangements relate to group entities or third parties, the parties may wish to avoid the EEA manager being deemed the AIFM in relation to the fund concerned. This is a potential risk if the activities of the EEA sub-adviser involve portfolio management or risk management in relation to the AIF concerned.

US entities (including US mutual funds, real estate funds and all other non-UCITS managers) investing in Europe through an EEA sub-adviser will need to consider this issue carefully.

Why is it important whether the AIFM is in the EEA or not?

An EEA AIFM will be fully subject to AIFMD, which will impose a wide range of structural and operational compliance constraints on the AIFM as well as, potentially, its delegates – including in regard to remuneration policy. EEA AIFMs also need to ensure that even non-EEA AIFs marketed in the EEA have appointed a depositary and comply with certain other requirements, which may significantly increase operating costs. Non-EEA AIFMs, on the other hand, need only to ensure that the transparency, disclosure and reporting requirements (discussed earlier in this note) are observed.

AIFMs must do more than just give advice

If the activities of the EEA sub-adviser consist solely of non-discretionary investment advice (i.e. making recommendations but not exercising final investment discretion) this would not generally be considered “portfolio management”. Consideration would need to be given to any risk management performed by the EEA sub-adviser, but overall it is unlikely that it would be the AIFM. Restricting the sub-adviser’s activities to non-discretionary advice only may, therefore, be a workable solution. However, the more frequently traded the portfolio is, the harder this model will be to operate; particularly if decisions need to be made quickly to react to market news or movements. It is most commonly used at present (in the UK at least) in the context of private equity and other illiquid asset classes.

Is the ‘letter-box’ test applicable to US managers?

If the EEA manager needs to exercise discretion over the portfolio, this raises the possibility that it could be viewed as the AIFM in relation to the AIF concerned, notwithstanding that it does not contract directly with the AIF. The question the relevant member state regulator should be asking here is “does the EEA entity have the correct authorisation?” – or in other words “is it correct to conclude that it does not need to be authorised as an AIFM?”. Although the letter-box test is contained in EU legislation that is not directly applicable to US investment advisers, national regulators in Europe may apply letter-box principles in assessing “inward” delegation structures, whereby US entities delegate to entities in Europe. Accordingly, the EEA manager should be prepared to show that its lead manager in the US would pass the letter-box entity test (see “**Anti Letter-box Provisions**” above).

Practical steps: delegating to an EEA sub-adviser

- Review all mandates for the management of open and closed ended funds to identify any that are AIFs.
- Review management structures and identify the AIFM for each (including whether a new entity should be created for this purpose).
- If it is not intended for the EEA sub-adviser to be an AIFM, it will be necessary to review overall structure to ensure that this will not be the case, taking advice as appropriate.
- If the EEA sub-adviser will be an AIFM in any case (for example, because of other business it has), it will be important for the US investment adviser to understand how and to the extent that will impact the relationship.
- Consider the impacts of the identified management structure and how this interfaces with marketing plans.

Marketing Q&A

What if co-operation arrangements are not in place in time?

We expect that most will be. However, without a co-operation arrangement in place between all relevant regulatory authorities, the manager will need to:

- Rely on marketing transitional periods to the extent that these are available.
- Rely on reverse solicitation marketing.
- Rely on soft-marketing, brand marketing etc. to the extent permitted (although there may be a problem “closing” sales if this is the only option).
- Restrict marketing to non-AIF vehicles e.g. managed accounts, UCITS.

How do I track the position in different EEA member states?

Dechert has a dedicated team of lawyers focused solely on monitoring fund marketing rules. Talk to your regular Dechert contact or any member of our AIFMD team about how we can help, including our **World Compass – Global Blue Sky™** service team.

Can't I just use my EEA subsidiary to handle my European marketing?

This doesn't avoid the private placement restrictions or the need to register private placement for non-EEA funds. Once so registered, an EEA manager (which, if an AIFM, might need “extended permissions”) could however be involved in the marketing and in closing investors into the fund. If the EEA subsidiary is involved in the management of the fund, this could actually increase compliance requirements considerably.

Investment advisers seeking to use marketing intermediaries in Europe after July 22 can be held liable for the acts of an intermediary as if marketing directly and should therefore obtain appropriate comfort as to AIFMD compliance.

Does AIFMD restrict my communications with existing investors?

As a general matter, providing existing investors with information about existing funds in which they are invested (NAV statements, annual reports etc.) is unlikely to be marketing. Where PPM updates are provided (for informational or approval purposes) it would be prudent not to send subscription documentation (and it follows that where application forms have been integrated into PPMs these should be removed).

There is unlikely to be a reason under AIFMD why US managers should refuse any EEA investor seeking at its own initiative to increase its allocation to a fund. A pre-existing relationship between the fund and investor may be helpful in establishing that such approaches are at the initiative of the investor.

Anything communicated with a view to persuading investors to increase their allocation to an existing fund or invest in a new product warrants careful consideration. Although it may well fall short of marketing, this is technically a case by case analysis in each relevant jurisdiction. Our **World Compass – Global Blue Sky™** service considers common scenarios in this regard.

What about existing discussions with prospective investors?

Those currently engaged in marketing funds to European prospects will need to determine whether any steps need to be taken before 22 July in order to safeguard the investment adviser's ability to (i) continue discussions with prospective investors; or (ii) market new products to existing investors. The fact that dialogue with an investor is in process prior to July 22 does not avoid the need to ensure that follow-up marketing (including that investor's eventual subscription) follows one of the permitted routes to market, just like it would need to if the 'first contact' took place after 22 July. As noted above, a pre-existing relationship with the investor may be helpful in establishing that such approaches are at the initiative of the investor. There may well also be documentary steps that can be taken (for example, to re-enforce a reverse solicitation) but sponsors should beware "one size fits all" apparent solutions which may end up causing more harm than good.

What happens in 2015?

In due course it is envisaged that US managers may be able to apply for full authorisation under the AIFMD, and enjoy a pan-EEA marketing passport on equal terms with EEA managers. The AIFMD lays out a broad compliance framework and road map to permit this to happen. It is also envisaged that in 2018 or thereafter, such registration may be the only route to market in Europe, and any remaining national private placement regimes may be "switched off". Whether or not any of this actually happens, remains to be seen. For managers interested in forward planning, more information is available from our AIFMD resources or your usual Dechert contact.



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Dechert's Financial Services Group has approximately 160 lawyers across the United States, Europe, Asia and the Middle East.

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