KING & SPALDING

Client Alert

Financial Services Regulation Practice Group

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## The Alternative Investment Fund Managers Directive—a guide for US managers

The EU Alternative Investment Fund Managers Directive (AIFMD) has now been in force for several months. This overview note is aimed at US managers who have not yet had to get to grips with the AIFMD but will need to raise funds in Europe in due course. You will be able to take the benefit of the practical experience King & Spalding lawyers have had to date in helping clients navigate the new AIFMD regime.

### What the Directive covers

The AIFMD requires that EEA based "alternative investment fund managers" (AIFMs) must have specific authorisation to manage and market "alternative investment funds" (AIFs), complying with strict operating and organisational requirements imposed on both the manager and (indirectly through obligations imposed on the manager) the AIFs it manages. AIFMs and AIFs based outside the EEA are prevented from marketing to investors in the EEA unless mandated requirements are satisfied.

EEA member states were required to implement the AIFMD into national laws from 22 July 2013. From that date (save for states allowing a transitional period) management and marketing of AIFs in the EEA must be in compliance with the new requirements of the AIFMD. Unfortunately approaches to implementation of the AIFMD within member states are far from uniform. For example, Germany chose to overhaul its entire system of fund management regulation, introducing the Capital Investment Act (Kapitalanlagegesetzbuch "KAGB") bringing in some rules unique to Germany over and above AIFMD requirements accompanied by (not yet finalised) respective new tax provisions.

The definition of AIF is very broad covering any vehicle or contractual arrangement for collective investment by participants, including both closed and open ended companies. It is capable therefore of capturing not just investment funds (save funds authorised under the EU UCITS directives) but also various special purpose and asset acquisition vehicles, such as debt issuers, unless these are appropriately structured. EU legislators intended the AIFMD to be a harmonising measure, whereby an AIFM that obtained authorisation in any one EEA member state could freely market AIFs in all member states without needing separate registration in each state (an EEA wide "passport"). In practice differing interpretations and implementation of AIFMD between member states are currently adding to complexity.

The AIFMD permits the marketing of AIFs to professional investors only but each member state is given discretion whether to allow AIFs also to be marketed to retail investors in that jurisdiction and, if so, stricter requirements for marketing to retail investors may be imposed. By way of example, the UK will allow AIFs to be marketed to high net worth and sophisticated individuals but not to other retail investors. Plainly this is a different regulatory direction of travel from the US JOBS Act.

### How are US managers affected?

For the time being US based managers must ensure that their marketing of AIFs into EEA states is done in accordance with the local law of each relevant state; it is not yet possible for AIFMs based outside the EEA to become authorised under the AIFMD and so take advantage of the marketing passport across the EEA. This may become possible in a second wave of implementation from around 2016 but that is

dependent upon the outcome of further opinions and deliberations by the EU regulatory bodies. This note deals only with the situation prior to this second wave implementation.

A US based lead manager cannot simply nominate a local EEA sub manager or adviser to become authorised under the AIFMD and so benefit from the passport. This is because the AIFMD recognises a single lead manager with overall responsibility for portfolio management and risk management of each relevant AIF as the entity (the AIFM) that is eligible to become authorised. Consequently, if the EEA is an important market, a US based manager should consider whether there is value in now setting up a new EEA based manager and EEA incorporated funds. It is the current intention of EU legislators that from around 2018/2019, once the EU passport has been available for non EU managers for some time, national private placement regimes will be abolished. At that time authorisation under the AIFMD will be obligatory for US managers that wish to market to EEA investors.

**Marketing under national private placement regimes—still some important AIFMD compliance requirements**

AIFMD still imposes minimum requirements if a non EU AIFM is to market non EU AIFs[1] into an EEA state under a national private placement regime or other relevant local law. These are:

1. appropriate cooperation arrangements must be in place between the relevant regulators/supervisory authorities of the countries of establishment of the AIF and AIFM and the regulator of the member state where marketing is to take place; and

2. the country of establishment of the AIF and AIFM must not be listed by the Financial Action Task Force as a Non Cooperative Country and Territory; and

3. transparency and reporting requirements of the AIFMD, together with special requirements for private equity funds, must be complied with in respect of each AIF to be marketed; and

4. application may be required to the local regulator to appear on its register of non EU AIFMs/AIFs marketing in that jurisdiction.

Items 1 and 2 should not be an issue for the usual fund incorporation jurisdictions as the necessary cooperation agreements have already been developed with many jurisdictions. For how to comply with items 3 and 4, read on. Unfortunately some member states are imposing additional requirements ("goldplating") above these minimum requirements mandated by the AIFMD. For example, it will be very difficult for non EEA AIFs to be promoted in France; Germany under the KAGB will require non EEA AIFMs to appoint a depositary and positive approval by the regulator is required before marketing can take place; Austria has an additional tax treaty condition for non EEA AIFs.

**Transitional relief may assist some US managers marketing during the next few months**

Some EEA member states (including the UK, Germany and France) are allowing a further period, until 21 July 2014, before compliance with AIFMD is required, provided that the AIFM concerned (meaning precisely the same entity) has marketed at least one AIF into that jurisdiction prior to 22 July 2013.

Provided this test is passed, for the UK this means that a US manager wishing to market AIFs to investors resident in the UK will not have to comply even with the minimum AIFMD requirements described above for marketing that takes place prior to 22 July 2014. In the UK the transitional relief even permits the launch of a new AIF, simply the usual local private placement requirements apply.

Unfortunately there is no uniformity across states allowing transitional relief on the triggers and tests for that relief to be available to non EU AIFMs and AIFs. In some states the availability of transitional relief will be much more limited than the UK position and may be dependent on the structure of the AIF. For

[1] Or indeed for a non EU AIFM to market EEA AIFs.

Germany, where a non EEA AIFM has been permitted to market a non EEA AIF in Germany prior to 22 July 2013, then until 21 July 2014 that existing AIF or AIFs can continue to be marketed to German investors in compliance with the laws in place prior to 22 July 2013 (irrespective of implementation of the AIFMD and coming into force of the KAGB) but new AIFs being launched must comply with KAGB in order to be marketed to German investors.

**Transparency requirements**

An annual report containing accounts audited in line with international accounting standards must be prepared for each relevant AIF no later than six months after the financial year end. This must include aggregate disclosure of remuneration paid to staff of the AIFM in that financial year, breaking out fixed and variable remuneration, breaking out a figure for senior management and staff whose actions have a material impact on the risk profile of the AIF and also disclosing receipt of carried interest. Though the relevant AIFMD provision states that the annual report must be provided to the regulator of the AIFM's "home" member state, in practice for non EEA AIFMs the annual report will likely be required to be provided to the regulators of each member state where marketing takes place. It must also be available on request to investors.

Mandated information must be provided to investors before they invest. The prescribed pre investment disclosure covers a range of items that would normally be provided about an AIF and its AIFM in an information memorandum or prospectus, though more detail than it has been customary to volunteer is required for some items (such as use of leverage, delegation and a requirement to disclose "all" fees, charges and expenses with their maximum amounts which are directly or indirectly borne by the investors), though perhaps not more detail than is typically required by institutional investors in due diligence questionnaires. However, some required disclosures are new or difficult to comply with, for example side letter disclosure (whenever an investor is given the right to obtain preferential treatment, a description of that treatment must be given, the type of investors who will obtain it and any legal or economic link they have with the AIF or AIFM).

Periodic/regular ongoing disclose must be given to investors about the percentage of assets subject to special arrangements for reasons of illiquidity (such as side pockets or separate share classes), risk profile of the AIF and risk management systems, any new arrangements for managing liquidity, changes to the maximum level of leverage, collateral reuse arrangements, guarantees and the total amount of leverage deployed.

**Reporting requirements**

Somewhat more detailed information is required to be provided regularly to member state regulators with additional detail as follows:

- the main markets and instruments in which the AIFM trades on behalf of relevant AIFs specifying the markets and instruments in which it is most active and the principal exposures and concentrations;
- risk management tools used to manage relevant risks including market risk, liquidity risk, counterparty risk and operational risk;
- main categories of assets in which the AIF has invested;
- the results of any stress tests;
- for AIFs which use leverage on a substantial basis, the overall amount of leverage, a breakdown of leverage embedded in derivatives and that from borrowing cash or securities with details of reuse of assets, the five largest sources of borrowed cash and securities with the amount of leverage from each of those sources;

- quarterly a list of all AIFs managed by the AIFM;

- as discussed previously, the annual report for each relevant AIF must be provided.

**Registration requirements**

A variety of approaches are being taken by national regulators about the requirement for non EU AIFMs/AIFs to be registered locally before marketing can commence. In the UK it is intended that this is a mere notification process, with minimal information requested in the relevant form ("Article 42 form") and no requirement for the information submitted to be positively approved. Consequently a non EU AIFM is entitled to market the AIF(s) to UK based investors as soon as a properly completed notification form has been sent to the Financial Conduct Authority. In other jurisdictions the process is more onerous, so that it will take longer to obtain the necessary marketing registration before marketing can commence. For example, in Germany the application forms may be voluminous and positive approval must be granted by the local regulatory authority (BaFin) before marketing can commence. Time periods for obtaining approval may be several months. It is necessary therefore to plan well ahead of the targeted launch date for marketing in order to obtain the necessary registrations in time.

**Private equity funds**

An AIFM that manage AIFs whose purpose is acquiring control of non listed companies must:

- notify relevant member state regulators when the voting rights held (whether by a single AIF or jointly with others) in an unlisted company reach or fall below 10%, 20%, 30%, 50% and 75% threshold levels;

- when it acquires control (more than 50% of voting rights) disclose to the company, its shareholders and the relevant member state regulators specified information (the identity of the AIFM and AIF, its policy for managing conflicts of interest with the company; its policy for internal and external communications relating to the company as regards its employees; details of the nature of the control acquired; intentions as to the future conduct of the business and any likely repercussions on employment, including any material change in the conditions of employment);

- once it has acquired control, ensure that the AIF's and the company's annual report include a fair review of the development of the company's business at the end of the financial year, including an indication of important events post year end, likely future development of the company, and any acquisition of own shares. This information must be made available to AIF investors and to employees of the company before the earlier of six months following the end of the AIF's financial year or the release of the annual report of the non-listed company;

- asset stripping restrictions apply for two years after control has been acquired (these also apply to acquisition of control of listed companies). During this time the AIFM is required to use best efforts to prevent reductions in capital, share redemptions, acquisition of own shares and certain distributions (though in line with existing limits on distributions under EU law).

Once again, certain national regulators may gold plate above these basic requirements.

These requirements are not triggered for small/medium size companies (companies employing fewer than 250 people and which have an annual turnover not exceeding 50 million euros or a balance sheet total not exceeding 43 million euros) and for real estate holding special purpose vehicles.

**Exemption for assets under management below a threshold level**

In UK implementation "small" non EEA AIFMs escape from the majority of AIFMD requirements. Prior to marketing in the EEA they need only notify relevant local regulators of the identity of the AIFM and AIFs to be marketed and provide information to local regulators on the main instruments in which the

AIFM trades and the principal exposures and most important concentrations of the AIFs that it manages. This information is to enable local regulators to monitor systemic risk.

A "small" AIFM means an AIFM managing an aggregate value of portfolios of AIFs that does not exceed:

- 500 million euros where the AIFs are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF;
- 100 million euros in other cases, including any assets acquired using leverage.

Once again different states are taking different approaches on implementation of the scope of this partial exemption. In Germany only small German AIFMs are given the benefit of this exemption, not non-EEA AIFMs.

For further information on the matters covered in this alert please contact one of the following, or your usual King & Spalding contact.


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