TRAVERS SMITH

Financial Services and Markets

Fundamental change for the fund industry: AIFM Directive finalised

On 11 November 2010 a European Parliament vote settled the text of the controversial Alternative Investment Fund Managers Directive, bringing to a close some 18 months of negotiations. The text now adopted is the result of extensive, fierce and often intensely political debate between the European Commission, Member States and EU parliamentarians. Whilst the industry has worked hard (and, in some areas, successfully) to influence and improve the Directive, much of it remains unjustified, wholly unsatisfactory or unclear. The issues have been deeply politicised and the legislative process has been opaque. There will be unforeseen and likely unpalatable consequences of this. What is certain is that the Directive will usher in fundamental change for managers and investors alike.

The Directive is also notable for being the first under which the powers recently conferred on ESMA, the European Securities and Markets Authority, are being put to extensive use. Since ESMA will develop many of the detailed procedures that firms must follow under the Directive (e.g. the forms required to obtain authorisation), there will be less flexibility at a national level. ESMA is based in Paris and is part of the new European regulatory supervisory structure, with a European Banking Authority based in London and the equivalent for the insurance industry in Frankfurt. These new bodies have significant powers and, as the FSA has itself said, domestic regulators will become "the European supervisory arm of a centralised European policy decision-making process".

In the text below we have referred to various dates, and in Appendix 1 we set out an indicative timeline for the Directive. These are based on our current best guess at the likely timetable, assuming that the official text is, as is currently expected, published in June 2011 though this may change.

This note sets out our current understanding of the Directive. This may change over time because the full meaning of many of the provisions is not yet clear. Further guidance is expected as Europe moves towards implementation.

What happens now?

The Council of the European Union (the **"Council"**) has approved the text. It has been scrutinised by legal and linguistic experts. The official version is published in the Official Journal of the European Union. The Directive "enters into force" 20 days after that, likely to be in July 2011.

The Directive will not become law in Member States for a further two years. Nonetheless, firms should start thinking now about how the Directive may impact them. There are no transitional or grandfathering provisions, except in relation to some firms who are planning a relatively quick exit from the industry.

Firms should also remain alert to further developments, as there is much work still to be done by ESMA and the European Commission (the **"Commission"**) in detailing many of the Directive's requirements in guidelines or delegated acts. "Delegated acts" are another form of European legislation. They are commonly referred to, including in this note, as "Level 2" measures (the Directive itself constituting "Level 1"). It has been reported that there could be as many as 97 topics to be addressed in delegated acts. This will be a mammoth task, the scale of which both illustrates the number of areas of uncertainty and indicates the complexity of the legislation.

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Introduction

The Directive forms part of the EU's single market agenda. It creates a scheme under which EU fund managers are authorised in their own Member State in accordance with EU standards and are then permitted to market their funds to professional investors across the EU in reliance on a passport (i.e. they do not need a licence in other Member States). The Directive also makes provision for non-EU funds (and funds managed by non-EU managers) to be marketed in the EU. These provisions were hotly debated and are described in more detail below.

Scope

The Directive will regulate fund managers who manage alternative investment funds ("**AIF**"). It therefore applies to *managers* and only indirectly regulates the AIF they manage. It does not generally regulate or restrict the assets in which an AIF can invest, except in relation to securitisations.

Many directives in the financial services field apply lighter provisions to transactions involving professional counterparties. The AIFM Directive takes a very different approach. It betrays a developing attitude amongst regulators that professional investors are not as professional as has previously been accepted, and accordingly need protection from themselves.

Firms will need to understand the nature of the arrangements that will constitute an AIF, as well as how to identify the entity that will be regarded as the "manager" (or "**AIFM**"). The location of the AIFM and the AIF (EU or non-EU) will have a considerable impact on the effect of the Directive. Unless an exception applies, the Directive applies to:

- EU AIFM who manage EU or non-EU AIF (regardless of whether or not they market them in the EU);
- non-EU AIFM who manage EU AIF; and
- non-EU AIFM who market their AIF in the EU.

As explained below, not every investment manager will be the AIFM. In many structures, particularly for UK hedge fund managers, the UK manager will not be the AIFM. Where the AIFM and the AIF are both outside the EU, the only relevance of the Directive will be its restrictions on marketing within the EU.

Other persons affected by the Directive

The Directive will directly regulate AIFM. However, it will also govern a number of matters concerning the operation and constitution of AIF. Specific provisions are relevant to depositaries, sub-custodians, prime brokers and valuers. These persons will need to ensure they fully understand the Directive's indirect impact on them.

Investment firms, such as brokers and placement agents, will not be allowed directly or indirectly to offer or place AIF units or shares with EU investors unless those units or shares can be marketed under the Directive. This prohibition is similar to a concept that appeared in the very first draft and which then disappeared for most of the debate. Whilst the exact implications are not clear, we believe it was reintroduced as an anti-avoidance provision in the context of the debate over the marketing of non-EU funds to EU investors (see section headed "*Marketing the AIF*" on page 8 below).

A recital provides that an AIF may only be listed on an EU stock exchange if the AIFM is itself permitted to market the AIF in that Member State.

What is an AIF?

The scope of the Directive will be potentially much wider than the "fund" concept as currently understood in many Member States. The key elements of an AIF are that:

- it is a "collective investment undertaking" (other than a UCITS fund);
- which raises capital;
- from a number of investors;
- for investment in accordance with a defined investment policy, for the benefit of those investors.

It is not clear, but it appears that two investors may be sufficient to constitute an AIF. There is no express requirement for risk spreading, so in some cases arrangements relating to a single asset could be caught. The exact parameters remain unclear. An AIF may be open or closed ended and constituted as a company, a trust, under a contract or a statute or in any other legal form. There is no need for a formal "vehicle" for there to be an AIF.

The core concept of "collective investment undertaking" remains undefined. We would, however, expect it to be interpreted as it is elsewhere in European law, e.g. in the Prospectus, Transparency and UCITS Directives and MiFID (although, even in those

contexts, there is no settled interpretation). We consider it to capture at least those arrangements that would meet the definition of a "collective investment scheme" under the Financial Services and Markets Act 2000, as well as investment trusts, venture capital trusts, some other corporate structures, and potentially certain types of carried interest scheme, co-investment scheme and structured product.

The definition of AIF does not include segregated managed accounts, family offices and similar private investment vehicles, joint ventures, insurance contracts, certain securitisation SPVs, employee participation schemes, employee savings schemes or holding companies. "Holding company" is specifically defined. Whilst it has a narrower meaning in the Directive than it does under general company law, we believe that this is for anti-avoidance reasons and that it is not intended to bring typical acquisition structures into the definition of an AIF.

Who is the AIFM?

An AIF can have only one AIFM. Once it has been established that there is an AIF, there has to be an AIFM. The only issue in some cases will be establishing who it is. It may be an external third party manager or, alternatively, could be the AIF itself. Both cases will fall within the Directive's scope. The Directive has different effects depending on whether the AIF and/or the entity that is the AIFM is established within or outside the EU.

Internally managed AIF

An AIF is internally managed when its governing body elects not to appoint an external AIFM. An AIF that is internally managed will itself be authorised as the AIFM. Thus, for example, an investment trust that has not appointed an external manager will itself become the AIFM under the Directive.

External AIFM

Where an AIF is not internally managed, the AIFM is the legal person appointed by or on behalf of the AIF to be responsible for managing it. In this context, "managing" the AIF means providing portfolio management and risk management services. Risk management involves identifying, measuring, managing and monitoring all risks relevant to the AIF's investment strategy. Many managers will not have been explicitly appointed to provide risk management services. However, since every AIF must have an AIFM, the AIF might be deemed to be internally managed if this responsibility is not given to an external manager expressly. This would result in the AIF itself requiring authorisation.

Firms which have portfolio and risk management responsibilities will therefore have to consider whether they are appointed "by…or on behalf of the AIF". This will depend on the contractual arrangements for the AIF. If a firm is appointed by or on behalf of the AIF, then it will be the AIFM. If it is only a delegate of the person so appointed, it will not be the AIFM.

This distinction will be particularly important for UK "managers" of non-EU AIF. There will be some, particularly in the hedge fund community, who are truly delegates of a non-EU manager and they will not be AIFM within the meaning of the Directive. The Directive does not change their regulatory status. Most of these firms are likely to be investment firms within the meaning of MiFID. There will be other managers who will need to look carefully at the AIF's constitutional documents in order to ascertain their status. Some firms may wish to consider the structure of their fund(s) to see if any aspects could or should be clarified or changed to affect the application of the Directive to their activities. Firms will also need to consider the impact of any changes on their tax position.

The Directive will also change the position of some firms who are currently treated, in the UK at least, as being investment managers within the scope of MiFID. At present, a firm that is only appointed by the fund to provide investment management services is likely to be a MiFID investment manager. This will no longer be the case for firms which are appointed by or on behalf of an AIF to provide portfolio and risk management services. A recital states that an AIFM that has been appointed to manage an AIF is not to be deemed to be providing MiFID portfolio management, but instead collective portfolio management under the AIFM Directive. This (together with the restrictions mentioned below on AIFM activities) will mean that some managers will no longer be MiFID firms. A firm cannot be both a MiFID firm and an AIFM.

The AIFM, once identified, is responsible for ensuring compliance with the Directive even if certain requirements are outside its power to control. There is here a recognition that fund structures differ and that, for example, the power of appointment of a depositary will not necessarily be with the AIFM.

If at any time there is non-compliance with a Directive requirement that is outside the AIFM's control, the AIFM must immediately inform its regulator. If the AIF is an EU AIF, the AIFM must additionally notify the AIF's competent authority. If the AIFM is unable to procure compliance, the AIF may no longer be marketed in the EU and (unless the AIFM is a non-EU AIFM managing a non-EU AIF) the AIFM must resign.

Exemptions

The Directive expressly exempts supranational institutions (such as the World Bank or the European Investment Bank), national central banks, certain bodies or institutions for occupational retirement provision, national, regional and local governments and bodies or other institutions which manage funds supporting social security and pension systems. Certain securitisation special purpose entities as well as employee participation schemes and employee saving schemes are also exempted, together with AIFM that manage funds with only the AIFM or the AIFM's group companies as investors (provided that the group companies are not themselves AIF).

The exemptions in the Directive are not particularly helpful for two different reasons. Some entities are exempted when it is difficult to see in any event how they could be caught. Other specific exemptions are narrow, e.g. for certain securitisation vehicles, and so it is not clear whether similar vehicles which are outside the precise definition are caught. The way in which the Directive has developed means that there is no coherent plan to the exemptions. We think therefore that what can be read into the exemptions is limited, and that each arrangement must be looked at on its facts and adopting a purposive construction of the Directive.

Partial exemption for AIFM managing small AIF

A partial exemption from the Directive requirements is available for AIFM managing AIF with assets under management which in total do not exceed:

- €500 million, provided the AIF are not leveraged and investors have no redemption rights for the first five years; or
- €100 million (including assets acquired through leverage).

An AIFM wishing to rely on this exemption must be satisfied that its aggregate assets under management across all AIF for which it is the AIFM do not exceed the limits. Level 2 measures will define the exemption's precise scope (for example, how assets under management are to be calculated and over what period they should be measured).

AIFM relying on the exemption will be subject to registration and limited regulatory reporting requirements, though Member States will have discretion to require more. They will not benefit from the Directive's management or marketing passports (see sections headed "*Managing cross-border*" and "*Marketing in Member States via the passport*" on pages 22 and 9 below) unless they choose to opt in to the entire Directive and comply with its requirements in full. If they do not opt in, it appears that the AIF they manage will be able to be marketed under national securities marketing laws. The Directive does not restrict national regimes in this respect.

Exemption for AIFM of certain closed ended AIF in run-off or with a limited life

In addition to the partial exemption for AIFM managing small AIF, there is an exemption for AIFM that solely manage closed ended AIF which either:

- make no further investments after the Directive's transposition date (i.e. July 2013); or
- have a lifespan which will expire within three years from the transposition date (i.e. by July 2016) and closed their subscription period before the Directive came into force (i.e. July 2011).

An AIFM falling within the second bullet above will, however, need to produce annual reports for its AIF and comply with Directive requirements for AIFM managing AIF that acquire substantial stakes in EU companies (see sections headed "*Annual reports*" on page 24 and "*Acquisition of substantial stakes in EU companies*" on page 28 below).

Limits on AIFM activities

The Directive places significant limitations on the activities that can be carried on by the AIFM, and this may force some firms to restructure. Firms will therefore need to analyse what they currently do and how it will be classified under the Directive.

Internally managed AIF

Internally managed AIF are only permitted to manage their own assets, administer and market their own fund and carry on activities related to the underlying assets of the fund. They cannot become authorised as the external AIFM of another AIF.

External AIFM

As noted above, the external AIFM is the entity that provides (directly or through a delegate) both portfolio management and risk management services to its AIF. External AIFM may only engage in:

- the management, administration and marketing of the AIF for which they are the AIFM;
- activities relating to the assets of the AIF;
- the management of UCITS funds; and
- a limited range of other activities (see below).

"Activities relating to the assets of the AIF" is defined as "performing 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 it has invested in". This should allow AIFM of private equity and real estate funds to continue most, if not all, of the activities they currently carry on in relation to their investees.

Member States may authorise an external AIFM also to:

- be a discretionary portfolio manager; and
- if its authorisation covers discretionary management, as "non-core" services:
    - provide investment advice;
    - provide custody in relation to units of collective investment undertakings;
    - receive and transmit orders (arrange deals).

In providing these additional services the AIFM will be subject to certain MiFID provisions, though it will not be authorised under MiFID. An AIFM will not be able to carry on any other activities or services (except as an inherent part of being the AIFM for its own AIF), such as the execution of orders or underwriting or the provision of placing services. An EU AIFM will not be able to provide placing services for an affiliate.

These various restrictions may lead to some restructuring of groups and the creation of additional legal entities for specific purposes.

Regulators

The Directive designates certain regulatory and other authorities in particular Member States as the lead regulatory point of reference for an AIFM. For an EU AIFM, this authority will be in its home Member State. The home Member State of an EU AIFM is the Member State in which it has its registered office. The Directive also makes provision to identify which Member State authority is to be the point of reference for a non-EU AIFM, and this will be in the non-EU AIFM's "Member State of reference". There are complex provisions which determine the "Member State of reference" for non-EU AIFM. We have produced a summary of these provisions, which we would be happy to provide to clients on request. For simplicity, we refer in this note to an AIFM's EU competent authority as its "regulator".

The Directive also refers in places to the "competent authorities" of an AIF. This may (for example) denote a financial services regulator or supervisor, or a trade ministry. In this note, we use the terminology used in the Directive.

Authorisation

Is authorisation required under the Directive?

The table below summarises the circumstances in which an AIFM must become authorised under the Directive:

	Is authorisation required even if no EU marketing?	**Is authorisation required where EU marketing is via national private placement?**	**Is authorisation required where EU marketing is via the passport?**
EU AIFM*/ EU AIF** *e.g. AIFM has its registered office in England, AIF is an English limited partnership*	Yes	N/A	Yes
EU AIFM/ non-EU AIF *e.g. AIFM has its registered office in England, AIF is a Delaware limited partnership*	Yes	Yes	Yes++
Non-EU AIFM/ EU AIF *e.g. Guernsey AIFM, AIF is an English limited partnership*	Yes†	Yes†	Yes‡
Non-EU AIFM/ non-EU AIF *e.g. US AIFM, AIF is a Cayman fund*	No	No	Yes‡

* An "EU AIFM" is an AIFM that has its registered office in the EU.

** An "EU AIF" is an AIF which has its registered office and/or head office in the EU or is authorised or registered in the EU.

++ But note that the passport will not be available until October 2015.

† But note that the authorisation requirement will not apply until October 2015.

‡ But note that: (a) the authorisation requirement will not apply until October 2015; and (b) the passport will not be available until October 2015.

Appendix 2 contains a summary of the preconditions to marketing and managing AIF, including authorisation requirements, for each case set out in the table above.

When must authorisation be obtained?

EU AIFM

The Directive is likely to have effect in Member States in July 2013. However, an EU AIFM already operating before that date will have a further year (i.e. until July 2014) to obtain authorisation and become compliant with the Directive's requirements.

Non-EU AIFM

A non-EU AIFM must become authorised under the Directive to manage EU AIF or to market EU or non-EU AIF in Member States. However, this authorisation requirement will not apply until September 2015.

Until then, a non-EU AIFM will be permitted to manage EU AIF and market AIF in the EU in accordance with national private placement rules. When the AIF is marketed in the EU, the AIFM will need to comply with the Directive's annual report, investor disclosure (in relation to EU investors) and regulatory reporting requirements as well as (if relevant) the requirements applying to AIFM who acquire substantial stakes in EU companies.

The authorisation process

Where must an AIFM become authorised?

An EU AIFM must become authorised in its home Member State (i.e. the Member State in which it has its registered office).

A non-EU AIFM must become authorised in its "Member State of reference" (see section headed "*Regulators*" on page 6 above).

What does the process involve?

The application process will involve the AIFM submitting a considerable volume of information to its regulator. Firms already authorised (e.g. by the FSA) will have to apply again, although it is hoped that the fact that the FSA already has much of the information will facilitate the process. The information required will include:

- details of:
    - the AIFM's remuneration policies, compliance procedures and arrangements in relation to delegation, valuation, liquidity risk management and depositaries;
    - any fees, charges and expenses borne by investors;
    - any preferential treatment granted to investors (e.g. in a side letter), although the investor's identity need not be disclosed; and
- certain details in respect of the AIF, including:
    - the AIF rules or instruments of incorporation; and
    - details of the risk profile of the AIF, the policy on use of leverage and any arrangements for collateral or the re-use of assets.

ESMA may develop technical standards for what information must be provided and in what form. The AIFM must notify any material change to the information in advance to its regulator.

The regulator has three months to determine an application for authorisation that is complete, though it can extend this period by a further three months if it considers an extension necessary and notifies the AIFM. The AIFM can start managing AIF as soon as its authorisation is granted (though, if any information was missing from its application, it may need to wait for up to a month longer).

The preconditions for granting authorisation broadly reflect the MiFID provisions requiring assessment of the suitability of the persons who conduct the business, the controllers and any close links. The AIFM must also have its head office and registered office in the same Member State.

Marketing the AIF

The Directive establishes a framework to regulate the offer or placing of shares and units in AIF. It does this by directly restricting marketing by or on behalf of the AIFM and also regulates offer or placing activities by some other market participants. There will be considerable debate as to the scope and meaning of these marketing provisions. This may yet be an area where Member States' interpretations will differ.

Definition of marketing

Marketing is defined as:

> "any 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 in the Union".

An AIFM may only market an AIF to EU investors if it is authorised by a relevant EU regulator or complies with national private placement regimes. MiFID investment firms and their non-EU equivalents, such as brokers and placement agents, are only allowed directly or indirectly to offer or place shares or units of AIF to or with EU investors if and to the extent that the shares or units can be marketed in accordance with the Directive. It is not entirely clear what this means. We believe, however, that it is an anti-avoidance measure. If so, it would mean that such a firm is not permitted to offer or place interests in a non-EU AIF to EU investors, on behalf of the AIFM, if the AIFM would itself be prohibited by the Directive from marketing those same interests. The Directive appears not to restrict an investor (or its agent) from engaging in secondary market transactions.

The Directive does not restrict professional investors who wish to invest in AIF on their own initiative, nor does the final text impose due diligence obligations on investors in AIF (as once seemed possible). However, the concept of "own initiative" investing is potentially very narrow. In addition, the Commission will conduct a review in 2017 of the working of the Directive which will include an assessment of the need to impose tighter due diligence requirements on European professional investors investing on their own initiative in non-EU financial products, including non-EU AIF.

Marketing to professional investors

The Directive provides a framework for marketing to professional investors. The definition of professional investor is adopted from MiFID. It is already unsatisfactory in a MiFID context and it is even less appropriate in a fund context. Whilst institutions such as investment firms, banks, insurers and pension fund management companies will qualify as "professional", other firms and individuals who are currently treated as professional fund investors because they understand and/or are experienced in fund investments will not meet the restrictive criteria to qualify as professional under the Directive. In particular, firms will not be able to treat a prospective investor as "professional" solely on the ground of the investor's knowledge, experience and ability to understand the risks involved. Prescriptive quantitative tests will need to be met. This will rule out many high net worth or sophisticated individuals.

Marketing to retail investors

Each Member State can decide if it permits marketing of all or certain types of EU and/or non-EU AIF to retail investors and impose conditions if it does. There is no passport for marketing to retail investors. It further appears that Member States may not allow an AIF to be marketed to retail investors on their territory unless the AIF is "managed in accordance with" the Directive. The effect of this seems to be that AIF managed by non-EU AIFM cannot be marketed to retail investors in the EU between 2013 and 2015 unless, perhaps, they fall below the size thresholds set out on page 5 above. Where an EU AIFM is partially exempt, the marketing of its AIF is a matter for national securities marketing laws.

If a Member State allows marketing of only certain types of AIF to retail investors, then a recital indicates it will have to assess on a case by case basis whether a specific AIF is of the type that may be marketed to retail investors. This suggests that, in some EU Member States, AIF will need individual approval for marketing to retail investors. This will be an unwelcome burden for AIFM and will result in more work for regulators.

If a Member State allows certain types of AIF to be marketed to retail investors, then it cannot discriminate between AIFM established in that Member State and those established in other Member States, and it cannot impose stricter requirements on AIF established in other Member States than it does on its domestic funds. However, there are no limits as to what can be required if a Member State permits the promotion of non-EU AIF to retail investors.

Marketing an EU AIF in the Member State where its AIFM is authorised

EU AIF managed by an EU AIFM (including feeder funds where the master AIF is an EU AIF managed by an EU AIFM) can only be marketed to professional investors in accordance with the Directive.

An EU AIFM can market an EU AIF to professional investors in its home Member State if it first provides its regulator with certain information about each EU AIF that it intends to market (including a copy of the PPM and fund documentation). The regulator must

inform the AIFM within 20 working days whether it may commence its marketing activities. If there is a material change to any of the information supplied, the AIFM must give written notice of the change at least one month before implementing any planned change and immediately after any unplanned facts trigger a change. Since this would include changes to documents such as the PPM, the requirement does not fit with the established approach to private placement.

If the EU AIF is a feeder fund, this marketing right only applies if each master AIF is also an EU AIF managed by an EU AIFM.

These requirements will not apply for so long as an AIF is marketed with a valid prospectus which was drawn up under the Prospectus Directive before the Directive's transposition date (i.e. July 2013).

Marketing in Member States via the passport

The Directive provides a passport mechanism whereby an AIFM can market its AIF to professional investors in other Member States (i.e. other than the one in which it is authorised) without having to become authorised in those Member States.

The passport for EU AIFM marketing EU AIF comes into effect with the Directive (i.e. July 2013).

There will be at least a two year delay after the Directive is implemented before a passport is available for EU AIFM marketing a non-EU AIF or for non-EU AIFM marketing non-EU or EU AIF. A great deal of political energy was devoted to this issue. Nevertheless, the legislation necessary to make the non-EU passport effective will not be made until ESMA has issued an opinion that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk which impede extending the passport in this way. There is therefore still the potential for delay and politics to enter the debate.

Even when the passport is extended certain criteria will need to be met. These additional criteria are summarised in the table below.

	EU AIFM/ Non-EU AIF	**Non-EU AIFM/ EU AIF**	**Non-EU AIFM/ Non-EU AIF**
AIFM is subject to full Directive requirements?	Yes	Yes	Yes
Requirement for authorisation in the EU?	Yes	Yes	Yes
Requirement to designate a "legal representative" in Member State of reference?	No	Yes	Yes
Requirement for information exchange agreements (including in relation to tax)?	Yes	Yes	Yes
Requirement that non-EU jurisdiction(s) is/are not on FATF's list of Non-Cooperative Countries and Territories (NCCTs)?	Yes	Yes	Yes
AIFM's local law must not prevent effective supervision?	N/A	Yes	Yes

Passporting procedure

The AIFM must notify its regulator of its intention to market an AIF to professional investors in other Member States, together with certain documents and details about the AIF (including the PPM and fund documentation). The regulator must transmit this within 20 working days of receipt to the relevant authorities of the Member State where the AIF will be marketed and notify the AIFM that it has done so. The AIFM can only market cross-border from the date it receives this notification.

The information provided must include information on the arrangements made for the marketing of the AIF and the Directive provides that these arrangements shall be subject to the laws and supervision of the host Member State (i.e. the Member State into which the AIF is marketed). It is not clear what this will mean in practice but it probably means at least that local marketing laws (e.g. as to content or format of marketing) may apply even when there is the passport. This, together with some of the criteria set out in the table above, might be thought of as a "visa" which must be obtained before the passport can be used in a particular Member State.

Any material change to the particulars must be provided to the AIFM's regulator at least one month before implementing the change (or immediately after the change, if it was unplanned). Since this would include changes to documents such as the PPM, the requirement does not fit with the established approach to private placement.

Marketing in Member States via national private placement regimes

EU AIF managed by an EU AIFM (including feeder funds where the master AIF is an EU AIF managed by an EU AIFM) can only be marketed to professional investors in accordance with the Directive. This means that, from July 2013, they can no longer be marketed to professional investors via national private placement regimes. They can however be marketed to retail investors if permitted by Member States as described above.

Non-EU AIF and EU AIF managed by a non-EU AIFM can be marketed to professional investors in Member States pursuant to national private placement rules. This option is likely to be available until late 2018.

The Directive significantly limits the freedom of Member States to develop or keep their own private placement regimes for placing to professionals. An AIFM wishing to market pursuant to Member States' national regimes must still comply with certain (and sometimes full) Directive and other requirements. These are summarised in Appendix 2. Member States may impose stricter rules on a national basis.

Capital requirements

An AIFM will be required:

(i) to have a minimum amount of "initial capital" and, if it is an external AIFM, of "own funds";

(ii) to maintain qualifying professional indemnity insurance or additional own funds to cover professional negligence liability; and

(iii) to invest own funds in liquid assets or assets readily convertible to cash and not in "speculative positions".

An AIFM which is also authorised as a UCITS management company under the UCITS IV Directive will only be subject to the requirements in (ii) and (iii) (as the UCITS Directives set the initial capital and own funds requirements for this type of investment manager).

Firms subject to the AIFM Directive and the CRD

MiFID investment firms are subject to the capital requirements set out in the Banking Consolidation Directive and Capital Adequacy Directive, collectively known as the Capital Requirements Directive (**"CRD"**). A firm cannot be both a MiFID firm and an AIFM. As explained above an AIFM may be authorised to perform certain MiFID services, but this authorisation will be under the AIFM Directive and not as such under MiFID. Former MiFID investment firms which become AIFM will in future be subject to capital requirements imposed by the AIFM Directive. They will also remain subject to capital requirements imposed under CRD if they are authorised to perform discretionary portfolio management. CRD is due to be updated in 2013, so the CRD requirements are expected to change.

What are "initial capital" and "own funds"?

In the CRD, these concepts are used to determine which items qualify as regulatory capital for banks, other deposit takers and investment firms. "Initial capital" and "own funds" are two ways of measuring what are essentially "shareholder funds" (after deducting adjustments, e.g. for losses).

Items included as "initial capital" (e.g. share capital and audited profits) may also be included within "own funds" for the purposes of meeting capital requirements. For instance, if a firm has fully paid up ordinary share capital of £250,000, this amount can count both towards meeting the initial capital test and towards meeting the own funds test. They are not cumulative.

Certain types of preference shares and subordinated debt can be counted towards "own funds" at present, but this part of the CRD may well be amended before the Directive comes into force. Any amendment to the CRD definitions is likely to affect which items an AIFM will be entitled to include within initial capital or own funds. Under current UK FSA rules implementing the CRD provisions, limited liability partnerships are able to treat capital contributions by members as initial capital and own funds if the LLP agreement imposes significant restrictions on withdrawal and payment of capital, the distribution of profits and the payment of drawings.

Initial capital requirement

An internally managed AIF will be required to maintain initial capital of €300,000.

An AIFM managing external AIF will have to maintain initial capital of €125,000.

Own funds requirement

An internally managed AIF will not be subject to minimum own funds requirements, save to the extent this is required (if at all) to cover professional negligence risks (see below).

An AIFM managing external AIF will have to maintain own funds equal to the higher of:

(a) one quarter of fixed annual overheads; and

(b) 0.02% of the amount by which the total value of portfolios under management exceeds €250 million, subject to a cap of €10 million.

The requirement in (a) is derived from the CRD. Accordingly we expect the FSA's implementation provisions relating to this requirement to follow the current requirements imposed on BIPRU limited licence firms. This means that fixed overheads would include (amongst other things) salaries, guaranteed bonuses and rent.

Member States have discretion to allow the requirement under (b) to be reduced by up to 50% if a bank or insurer has guaranteed the balance.

Additional requirements to cover professional negligence risks

In addition to the initial capital and own funds requirements described above, external AIFM and internally managed AIF must also hold either:

- appropriate professional indemnity insurance; or
- a further amount of own funds to cover potential liability for professional negligence.

The Commission must specify at Level 2 which professional negligence risks must be covered by professional indemnity insurance. The Commission must also specify the conditions for determining: (i) whether a professional indemnity insurance policy is appropriate; and (ii) the amount of own funds required to meet these risks.

This type of requirement is not applied to UCITS managers or to MiFID investment managers subject to the CRD. The only type of manager to whom this requirement will be applied by EU directives is an AIFM.

Use of own funds

Own funds must be invested in liquid assets or assets readily convertible to cash in the short term, and may not be invested in speculative positions. This restriction prevents an AIFM from using own funds as working capital.

This type of restriction is not applied to UCITS managers or to MiFID investment managers subject to the CRD. The only type of manager to whom this requirement will be applied by EU directives is an AIFM.

We believe that this restriction should be construed as applying only to balance sheet assets held as a result of the subscription of own funds in order to meet capital requirements imposed by the Directive, as opposed to all of an AIFM's own funds.

Will a firm's capital requirements reduce or increase as a result of the Directive?

This will depend on the capital requirements that currently apply to the entity which will become the AIFM.

For most FSA authorised private equity and real estate managers which are currently outside the scope of any EU financial services directive, the Directive will impose significantly higher requirements. Some UK firms are both "operators" of collective investment schemes and "exempt CAD firms" (adviser/arrangers) and so have an own funds and initial capital requirement of €50,000. These firms will also see their capital requirements increase significantly. For some it may be worthwhile restructuring their activities to separate out the advisory/arranging business.

AIFM which are currently MiFID investment firms classified as BIPRU limited licence firms and which remain authorised to perform discretionary portfolio management will be required to comply both with the Directive and CRD.

Remuneration

The Directive will impose restrictions on the amount and form of remuneration that an AIFM can pay senior staff. The Directive will require an AIFM to put in place remuneration policies and practices for certain senior staff, designed to promote sound and effective risk management and not to encourage risk taking which is inconsistent with the risk profiles and rules of its AIF.

For some AIFM (in particular many private equity and real estate managers), these requirements will be entirely new. Other types of AIFM – namely those who are currently BIPRU firms (which will cover many hedge and debt fund managers) – will become subject to a similar set of remuneration requirements from 1 January 2011, when the FSA implements the remuneration requirements in the CRD. The Directive remuneration requirements are based on, but not identical to, those in the CRD.

The practical impact of the AIFM Directive requirements will accordingly differ between those firms who are dealing with this type of regulation for the first time and those who need to determine what the differences are between the CRD and AIFM Directive requirements. The main question for both types of AIFM will be whether the prescriptive requirements in the Directive for aligning risk with pay require changes to the AIFM's pay arrangements.

Which staff must be covered?

An AIFM's remuneration policies and practices must cover any categories of staff whose professional activities have a material impact on the risk profile of the AIF it manages. Depending on their impact on risk, these might include:

- senior management;
- "risk takers";
- employees whose remuneration takes them into the same bracket as senior management or risk takers; and
- "control functions".

"Risk takers" and "control functions" are both left undefined. "Risk takers" might capture, for example, individuals involved in taking investment decisions for the AIF. "Control functions" might include legal, compliance, human resources and risk management staff.

ESMA is required to issue guidelines on the application of the remuneration provisions. It is possible that these guidelines could widen the application of certain of the requirements beyond these categories of staff. It is likely that they will be based in part on the guidance to be issued in respect of banks and investment firms under the CRD by ESMA's sister organisation (CEBS, now the European Banking Authority).

What is "remuneration" for these purposes?

The Directive does not define "remuneration", but does state that the requirements apply to:

(a) remuneration of any type paid by the AIFM;

(b) any amount paid directly by the AIF, including "carried interest"; and

(c) any transfer of shares or units of the AIF.

"Carried interest" is defined as "a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF and excluding any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF".

The implications of applying the remuneration principles to "carried interest" and "any transfer of shares or units of the AIF" are unclear. Much work will be required before firms are able to understand the consequences for their carried interest and co-investment arrangements. The detailed requirements, based on those in the CRD, have been insufficiently adapted to make it clear how they apply to arrangements in which the value of an interest grows over time (as opposed to having a substantial readily-calculated value at the outset). It is to be hoped that ESMA and national regulators will have regard to the fact that the stated aim of this part of the Directive is to regulate amounts awarded by way of "remuneration", rather than to regulate any form of investment, and that they will recognise that many existing carried interest and co-investment arrangements already satisfy the policy objective for effective risk management and alignment of interests.

What are the requirements?

An AIFM must comply with a number of principles when establishing and applying its remuneration policies and practices. The overarching requirement is for the AIFM to have a remuneration policy that is consistent with and promotes sound and effective risk management. It must include conflicts avoidance measures and must be in line with the business strategy, objectives, values and interests of the AIFM and its AIF or AIF investors. The policy and its implementation must be periodically reviewed.

Key additional requirements include:

- requirements for fixed remuneration (e.g. salary) and variable remuneration (e.g. bonus) to be appropriately balanced;
- restrictions on the amount of variable remuneration that can be paid without deferral (at least 40% and, in some cases, 60% of variable remuneration must be deferred over at least three years);
- provisions on the payment and vesting of deferred amounts, depending on the AIFM's financial situation and the performance of the relevant individual, business unit and AIF;
- provision for the contraction (or non-payment) of variable remuneration due where the AIFM or the AIF performs poorly, and for claw-back of amounts already paid;
- requirements for at least 50% of variable remuneration to be paid in units or shares in the relevant AIF (or similar instruments), which should also be subject to an appropriate retention policy; this 50% requirement is subject to limited adjustment (e.g. where the AIFM manages multiple AIF);
- requirements in relation to performance-related remuneration, so that (for example) the assessment of performance:
    - includes risk adjustment mechanisms;
    - takes account of non-financial as well as financial criteria;
    - is set in a "multi-year framework appropriate to the life cycle of the AIF"; and
    - is based on a combination of individual performance and performance of the business unit, AIF and the AIFM as a whole;
- restrictions on guaranteed variable remuneration (e.g. guaranteed bonuses); and
- requirements for staff in control functions to be compensated by reference to objectives linked to those functions (i.e. independently of the performance of business areas they control).

Proportionality

There is flexibility for an AIFM to take a proportionate approach, by complying with the principles "in a way and to the extent that is appropriate to [the AIFM's] size, internal organisation and the nature, scope and complexity of [its] activities". As noted above, ESMA must produce guidelines on sound remuneration policies and these may elucidate the principles themselves and the scope for AIFM to comply on a proportionate basis. CEBS published similar guidance in relation to firms subject to the CRD in December 2010, and ESMA may base its guidelines in part on this.

Remuneration committee

An AIFM that is "significant in terms of its size or the size of the AIF it manages" will also be required to have a remuneration committee. The members of the remuneration committee (including its chair) must be non-executives.

Disclosure requirements

An AIFM applying for authorisation will be required to disclose details of its remuneration policies and practices to its regulator.

The AIFM must also prepare an annual report in respect of each EU AIF it manages and each AIF it markets in the EU, and this must contain certain information in relation to remuneration (see section headed "*Annual reports*" on page 24 below).

Depositary

What is the depositary for?

The depositary concept is borrowed from the UCITS Directives. The European Parliament's glossary for the AIFM Directive (prepared for the benefit of the press) neatly summarises the purpose of the depositary, defining it as:

> "a legally separate organisation, where the formal documents showing who owns shares, bonds, etc. can be kept safely."

The glossary explains that a depositary typically has three core functions:

- the safekeeping of the assets of the AIF;

- the day-to-day administration of the assets of the AIF; and
- the control of the AIF's operation (compliance with investment policies and receipt of funds from, and payment of funds to, investors).

The need to have a single depositary for each AIF performing these roles will represent a significant change for many fund managers and an opportunity for custody providers. Some of the tasks carried out by the depositary in relation to assets other than quoted securities will be duplicated between the AIFM and depositary because an AIFM needs to perform these tasks as part of the investment process.

The European Parliament's press release of 11 November 2010 summarises the purpose of the depositary provisions as: "to prevent further Madoff-style scandals".

Does the Directive regulate depositaries?

The Directive does not regulate depositaries in the same way as it regulates AIFM. Depositaries are not required to become registered under the Directive. Rather, the Directive sets out the functions which a depositary must perform and the circumstances in which a depositary will be liable for causing loss to investors, the AIF and/or the AIFM. It is the AIFM which is responsible for ensuring a depositary is appointed in accordance with the requirements of the Directive for each AIF it manages.

Is a depositary always required?

An earlier version of the text, adopted by the European Parliament in May 2010, disapplied the depositary requirements for real estate and private equity funds or where the AIFM is "non-systemically relevant". This exemption has not survived. However, a depositary is not required in relation to a non-EU AIF that is:

- managed by a non-EU AIFM and marketed in the EU via national regimes (as opposed to being marketed under the passport, once available); or
- managed by an EU AIFM but not marketed in the EU.

Where a non-EU AIF is managed by an EU AIFM and marketed in the EU via national regimes, a depositary must be appointed, but the detailed Directive provisions on depositary liability, delegation and who can be a depositary (see below) do not apply. They will apply however once the passport is used.

Appointment

There must be a written contract of appointment. The Commission will establish requirements for its content at Level 2. The Directive appears to leave open the possibility that the counterparty to the contract could be either the AIF or the AIFM. As the AIFM is responsible under the Directive for ensuring that the depositary is appointed in a manner which complies with the Directive's requirements, it is likely that the AIFM will wish to be a party to the contract irrespective of whether it formally appoints the depositary.

Who can be a depositary?

A depositary for an EU AIF must be:

(a) an EU credit institution (e.g. an EU bank);

(b) a MiFID investment firm subject to the same CRD capital requirements as credit institutions (in UK FSA terminology, these are the requirements applied to BIPRU full scope firms); this would include investment banks but exclude most investment managers and agency brokers; or

(c) a prudentially regulated and supervised institution of a type that (at the date the AIFM Directive enters into force, i.e. July 2011) is eligible to be a UCITS depositary under the UCITS IV Directive.

In effect the principal provider of depositary services for an EU AIF will have to be an EU bank or EU investment bank. An EU branch of a non-EU bank will not qualify.

For a non-EU AIF, the depositary may also be a non-EU entity "of the same nature" as one within (a) or (b) above, provided that it is subject to effectively enforced prudential regulation and supervision to the same effect as that under EU law. Whether or not prudential regulation and supervision in a non-EU country meets these standards will depend on criteria to be established by the Commission at Level 2.

Additional flexibility is intended to be provided for (primarily) private equity and real estate AIF whose investors have no redemption rights for five years from the date of their initial investment. It is to be hoped that national regulators will allow all private equity funds

to take advantage of this exemption given that it is clearly drafted for that purpose. The depositary to such an AIF may be an entity (e.g. a notary, lawyer or registrar) which:

- carries out depositary functions as part of professional or business activities;
- is subject to mandatory professional registration recognised by law, to legal or regulatory provisions or to rules of professional conduct; and
- can furnish sufficient financial and professional guarantees.

No clarity is offered as to what may constitute "sufficient financial and professional guarantees", other than a high-level statement that they must enable the depositary to meet its commitments and effectively perform its functions as depositary. There may be practical difficulties in complying with Directive requirements where a depositary wishes to delegate to one of these entities. This option is therefore only likely to be useful for simple structures not requiring extensive sub-custody arrangements.

Where these types of entity do act as depositaries, they will need to comply with the same requirements as are prescribed for bank and MiFID investment firm depositaries, other than regulatory capital requirements. They will also be subject to the same level of liability. It remains to be seen whether professional organisations will wish to offer this service under the AIFM Directive. It is possible that Member States will develop bespoke regimes to encourage new entrants to this market.

Who cannot be a depositary?

An AIFM cannot be a depositary. However, it appears that a member of the AIFM's group could be a depositary (provided it fulfils the requisite requirements).

A prime broker cannot be depositary to an AIF that is its counterparty unless:

- it has "functionally and hierarchically" separated the performance of its depositary functions from its tasks as prime broker; and
- any potential conflicts of interest are properly identified, managed, monitored and disclosed to the AIF investors.

This restriction does not, however, prevent a depositary delegating custody tasks to a prime broker.

Where must the depositary be established?

The Directive imposes limits on who may be a depositary based on where it is established. A depositary is "established" where it has its registered office and in each jurisdiction where it has a branch.

EU AIF

The depositary of an EU AIF must either have its registered office or a branch in the AIF's home Member State (being the Member State where the AIF was first authorised or registered or, if it is not authorised or registered, where it has its registered office and/or head office).

The competent authorities will have some discretion, until four years from implementation of the Directive, to allow a depositary to be established in another Member State if it is an EU credit institution.

Non-EU AIF

The depositary of a non-EU AIF must either have its registered office or a branch in the AIFM's home Member State (or Member State of reference, in the case of a non-EU AIFM). Alternatively, the depositary may be established in the non-EU country in which the AIF is established if the following conditions are met:

- co-operation and information exchange arrangements must be in place between the depositary's supervisor, the AIFM's regulator and the regulator in each Member State where the AIF is intended to be marketed;
- OECD-compliant tax information exchange agreements must be in place between the depositary's jurisdiction, the AIFM's home Member State and each Member State where the AIF will be marketed;
- depositaries in the country where the depositary is established must be subject to effectively enforced prudential regulation and supervision to the same effect as that under EU law; the Commission must adopt criteria at Level 2 to determine this;
- the depositary's jurisdiction must not be listed by FATF as a Non-Cooperative Country or Territory; and
- the depositary has agreed to:

- accept liability to the AIF or AIF investors on the basis the Directive provides (see below); and
- comply with the Directive requirements relating to delegation by depositaries.

The qualifying conditions apply at all times. It is of course possible that after the initial appointment, one or more of the qualifying conditions ceases to be fulfilled. This would result in the AIFM being in breach of its obligations under the Directive.

Depositary functions and duties

The Directive prescribes a range of functions and duties for depositaries and places substantial restrictions on their ability to delegate. A depositary must:

(a) hold in custody the financial instruments belonging to the AIF that:

- can be physically delivered (e.g. physical share certificates and bearer instruments); or
- can be registered in a "financial instruments account", in which case the depositary's obligation is to register the instruments in a non-pooled segregated account opened in the name of the AIF (or the AIFM on its behalf) in the depositary's books; and

(b) for all other assets of the AIF, verify whether the AIF (or the AIFM on its behalf) has ownership of the asset and, if so, maintain a record evidencing ownership.

The boundary as to which assets fall within (a) and which in (b) is not clear and depends on Level 2 legislation. It is likely to be affected by debates still to be had over a separate EU legislative initiative concerning securities laws generally. These custody and asset verification functions can be delegated, subject to certain conditions.

The depositary also has the following functions which cannot be delegated. It must:

(c) ensure that AIF cash flows are properly monitored;

(d) ensure all investor subscription payments and all funds are received and booked in segregated accounts with:

- a central bank;
- an EU credit institution;
- a bank authorised in a non-EU country; or
- another entity "of the same nature", which is subject to effectively enforced prudential regulation and supervision to the same effect as that under EU law;

(e) ensure transactions in AIF units or shares are carried out in accordance with applicable national law and the AIF rules;

(f) ensure AIF shares or units are valued in accordance with applicable national law, the AIF rules and Directive valuation requirements (see section headed "*Valuation*" on page 19 below);

(g) carry out the AIFM's instructions, unless they conflict with applicable national law or the AIF rules;

(h) ensure timely remittance of consideration for transactions in AIF assets;

(i) ensure AIF income is applied in accordance with applicable national law and the AIF rules;

(j) act independently, honestly, fairly and professionally and in the interest of the AIF and AIF investors.

Limits on delegation

If the conditions listed below are complied with, a depositary may delegate the custody and asset verification functions (i.e. functions (a) and (b) above). Most global custody agreements do not treat sub-custodians as delegates of the main custodian. The relationship is not usually seen as involving an outsourcing. The Directive brings about a change to this position. It is clear that, if the depositary of an AIF uses a network of sub-custodians, they are its delegates. The corollary of this is that the principal depositary is responsible to the AIF for them, unless the sub-custodian accepts a direct liability to the AIF and the AIF investors (see below). Custodians that provide depositary services to AIF will need to revisit their sub-custody agreements.

Delegation of the sub-custody and asset verification functions is permitted, provided that:

- the purpose of the delegation is not to avoid Directive requirements;

- the depositary can show an "objective reason" for delegating;
- the depositary exercises due skill, care and diligence in the selection, appointment, periodic review and ongoing monitoring of its delegate; and
- the depositary ensures, on an ongoing basis, that its delegate:
    - has appropriate structures and expertise;
    - if it will have sub-custody of financial instruments, is subject to:
        - effective prudential regulation (including capital requirements) and supervision; and
        - periodic external audit;
    - segregates the depositary's client assets from its own assets and those of the depositary;
    - does not re-use AIF assets without informing the depositary in advance and obtaining the prior consent of the AIF (or the AIFM acting on its behalf); and
    - performs the delegated functions in compliance with the standard of care required by the Directive for depositaries.

Further delegation by the depositary's delegate ("sub-delegation") is permitted, provided that the criteria for delegation are also met in relation to the sub-delegation.

These requirements are more onerous than those currently applying under FSA rules (and MiFID custody standards), as these existing regimes recognise the reality of what can be achieved with custody arrangements in certain jurisdictions. Nevertheless, the Directive does make some provision in acceptance of this. Where the law of a non-EU country requires that a local entity holds certain financial instruments in custody and there are no local entities that satisfy the delegation requirements, a local entity may be appointed provided that:

- the AIF investors are informed prior to their investment; and
- the AIF (or the AIFM on its behalf) instructs the depositary to delegate to that sub-custodian.

The text allows the appointment of a local entity if the only Directive requirements which are not met are those requiring prudential regulation and/or supervision, and external audit. The other delegation requirements must be met.

Liability of depositary

The depositary will be liable to the AIF or its investors for certain losses. In the course of negotiation of the Directive, there was a debate over whether the depositary should have "no fault" or "strict" liability for losses or whether its liability should be fault-based. The final version of the Directive imposes each type of liability on the depositary, depending on the type of loss.

Strict or "no fault" liability

Where financial instruments held in custody are lost, the depositary is obliged to return identical financial instruments or the corresponding amount to the AIF (or the AIFM on its behalf) without undue delay.

However, there are two exceptions to this liability.

The first is where the depositary can prove that the loss resulted from an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. The Commission will define the scope of this "force majeure" type exclusion at Level 2. In the meantime, a Directive recital indicates that it would not cover (for example) fraud by one of the depositary's employees.

The second exception applies where financial instruments held by a sub-custodian are lost and the depositary:

- has agreed in writing with the AIF (or the AIFM on its behalf) that the depositary may (in a written contract with the sub-custodian) transfer its liability for lost assets to the sub-custodian; and
- can prove that:
    - it has met all of its obligations under the Directive in relation to the delegation; and

- it has a written contract with the sub-custodian which effects the transfer of liability to the sub-custodian and makes it possible for the AIF (or, on its behalf, the AIFM or the depositary) to claim against the sub-custodian in respect of the loss.

Most sub-custodians do not accept direct liability to the underlying clients of a depositary, so if the depositary is to transfer its liability it is likely that it will have to change its agreements with its sub-custodians. It is doubtful whether this is commercially feasible.

Additional criteria must be met where the sub-custodian is one in respect of which the preconditions for delegation have been disapplied.

Fault-based liability

The depositary is also liable to the AIF or AIF investors for "all other losses" suffered by them as a result of its negligent or intentional failure to perform its obligations.

Extent of no fault and fault-based liability

At present, most depositaries exclude liability for indirect and consequential losses and some cap or restrict the value of their financial liability. It appears that they cannot cap or restrict their liability under the Directive. We believe that the concept of loss "resulting" from acts etc. should be construed as referring to loss resulting directly from those acts.

Restrictions on the depositary

The Directive prohibits a depositary from:

- re-using AIF assets without the prior consent of the AIF (or the AIFM acting on its behalf); and
- conducting activities in relation to the AIF that may create conflicts of interest, unless:
  - it has "functionally and hierarchically" separated those activities from its depositary tasks; and
  - any potential conflicts of interest are properly identified, managed, monitored and disclosed to AIF investors.

Prime brokerage arrangements

An AIFM which uses prime brokers must:

- exercise due skill, care and diligence in selecting and appointing the prime broker; and
- enter into a written contract with the prime broker which deals with the possibility of AIF assets being transferred or re-used (to the extent permitted by the AIF rules).

Details of the contract are to be provided to the depositary and, before they invest, to AIF investors.

As noted on page 15 above, a prime broker may be appointed as an AIF's lead depositary subject to meeting certain conditions relating to conflicts management and the separation of functions.

Alignment with UCITS IV

The Directive expressly acknowledges the differing investment strategies and investor bases of AIF and UCITS. It is expressed as being "without prejudice to" future alignment of the roles and responsibilities of AIF and UCITS depositaries (as had at one time been tabled).

Disclosures to investors and regulators

An AIFM applying for authorisation must disclose details to its regulator of the depositary arrangements, including any delegation by the depositary (see also the section headed "*Limits on delegation*" on page 16 above). This will mean that AIFM will require depositaries to disclose their sub-custody arrangements and keep the AIFM updated with changes.

The competent authorities of the AIF or AIFM can require a depositary to provide them with information which it obtains when undertaking its duties.

Investors must be informed, pre-investment, of any agreement to transfer liability to a sub-custodian for loss of custody assets (and any changes to this must be notified to investors without delay).

Valuation

For each of its AIF, an AIFM is required:

- to have procedures for proper and independent valuation of the AIF's assets; and
- to ensure that the net asset value per share or unit issued by the AIF is calculated (the **"NAV calculation"**) and disclosed to investors.

Valuations may be performed by the AIFM or a professional external valuer. Much of the detail relating to valuations will be determined by the Commission at Level 2.

Valuation rules and procedures

The rules applicable to the valuation of the AIF's assets and the NAV calculation are those laid down in the country in which the AIF has its registered office, or the AIF rules and/or instruments of incorporation. (This may mean that there is a choice to be made here, though this is not explicit.) The NAV calculation must be performed and disclosed in accordance with the AIF rules and applicable national law. The Commission must specify additional criteria at Level 2 for asset valuation and the NAV calculation.

Valuations must be performed impartially and with all due skill, care and diligence.

It is not clear how the "share or unit" concept is to be applied in the context of AIF which issue neither shares nor units (of the sort contemplated by the Directive), such as private equity or real estate AIF structured as limited partnerships.

Details of the valuation procedures for an AIF (including pricing methodology and methods for valuing hard-to-value assets) must be made available to investors before they invest, and this information must be updated to reflect any material changes. This information must also be provided to an AIFM's regulator when the AIFM applies for authorisation.

Valuations must be disclosed to investors in the manner required by the AIF rules.

Valuation frequency

Valuations must be performed at least once a year. For closed ended AIF, valuations must also be carried out whenever there is an increase or decrease in the AIF's capital. "Capital" is not defined for this purpose. One reasonable interpretation in the context of an AIF structured as a limited partnership would be that "capital" roughly corresponds to "commitment". On this approach, capital would increase when a new commitment is made to an AIF and decrease when an investor ceases to have any investment in the AIF.

For open ended AIF, the frequency of valuations must be appropriate to the AIF's issuance and redemption policy and the assets in which it invests (and will be further addressed by the Commission at Level 2).

Who can perform valuations?

An AIFM may perform valuations itself, or arrange for an independent external valuer to perform this function. External valuers cannot sub-delegate.

An AIFM that carries out its own valuations must ensure independence between the valuation and portfolio management functions. This may be particularly difficult for small AIFM. The AIFM must also put in place measures to mitigate conflicts of interest arising in connection with in-house valuation (e.g. arising from its remuneration policy) and to prevent undue influence on staff.

Member States can require an AIFM which carries out its own valuations to have them and/or its valuation procedures verified by an external valuer or, where appropriate, an auditor.

Appointing an external valuer

A number of conditions must be met where an external valuer is appointed.

- The external valuer must be independent from the AIFM, the AIF and any other person that is closely linked to the AIFM or the AIF.
- The AIFM must notify the appointment to its regulator, which (in certain circumstances) can require a different external valuer to be appointed.
- The AIFM must also be able to demonstrate that:
    - the appointment:

        - is "objectively justifiable" (Level 2 will clarify what this means);
        - does not inhibit effective supervision of the AIFM or its ability to act in investors' best interests; and
        - can be terminated immediately when this is in the interest of investors;
    - the external valuer:
        - is subject to mandatory professional registration or rules of professional conduct;
        - can furnish sufficient professional guarantees (to be further specified by the Commission at Level 2);
        - is capable of performing, and is qualified to and has sufficient resources to perform, the valuations;
        - was selected with all due care;
        - can be effectively monitored and instructed by the AIFM; and
    - the external valuer's relevant staff are sufficiently experienced and of good repute.

An AIF's depositary may act as its external valuer, provided that:

- it "functionally and hierarchically" separates its depositary and valuation functions (the meaning of this is to be clarified at Level 2); and
- potential conflicts of interest are properly identified, managed, monitored and disclosed to investors.

Liability issues

An AIFM will be responsible for valuations to the AIF and its investors, whether or not an external valuer is appointed.

External valuers will be liable to the AIFM for losses suffered by it as a result of the external valuer's negligence or intentional failure to perform valuations.

Level 2 issues

The Commission must specify at Level 2:

- criteria for the procedures for asset valuation and the NAV calculation;
- the professional guarantees to be given by an external valuer; and
- criteria for open ended AIF valuation frequency.

Delegation

The Directive imposes requirements on an AIFM when delegating any of the AIFM functions (being portfolio and risk management, AIF "administration" (as defined in Annex I to the Directive), marketing and activities related to the assets of the AIF). Specific additional restrictions apply when delegating portfolio management or risk management functions. The requirements and restrictions do not apply where purely administrative or technical functions are delegated.

Disclosures to investors and regulators

An AIFM applying for authorisation will be required to disclose its delegation arrangements (including the identity of the delegate and a description of any potential conflicts of interest) to its regulator. An AIFM must then give its regulator advance notice of any new delegation.

Details of any delegation of AIFM functions, the identity of the delegate and a description of any potential conflicts of interest must be made available to AIF investors before they invest. This information must be updated to reflect any material changes.

Obtaining consent from regulators

An AIFM's regulator must give prior consent to delegation of portfolio or risk management, unless the delegate is both authorised or registered and supervised for the purposes of asset management.

Liability

Delegation does not affect the liability of an AIFM for the matters delegated.

General requirements relating to delegation of AIFM functions

The following requirements apply:

- any delegation must be justifiable "with objective reasons";
- the AIFM must be able to demonstrate that the delegate:
    - is capable of performing, qualified to perform and has sufficient resources to perform, the functions delegated;
    - was selected with all due care; and
    - can be effectively monitored and instructed by the AIFM;
- the delegation:
    - must not inhibit effective supervision of the AIFM or its ability to act in investors' best interests; and
    - must be capable of immediate termination when this is in the interest of investors; and
- the delegate's relevant staff must be sufficiently experienced and of good repute.

An AIFM must not delegate its functions to the extent that, in essence, it is no longer the manager of the relevant AIF (i.e. it becomes a "letterbox entity"). Level 2 measures will specify when an AIFM would become a "letterbox entity". This concept is borrowed from the UCITS Directives.

Sub-delegation

Delegation by a delegate or sub-delegate ("sub-delegation") is generally permitted, provided that:

- the AIFM has consented in advance;
- the AIFM has given prior notice of the sub-delegation to its regulator; and
- the requirements applicable to a delegation of the function are also met in relation to the sub-delegation.

The delegate must review the services provided by its sub-delegates on an ongoing basis. Additional restrictions apply to sub-delegation of portfolio or risk management.

Restrictions on delegating or sub-delegating portfolio or risk management

Additional restrictions apply when an AIFM delegates portfolio management or risk management. These functions may not be delegated or sub-delegated to:

- the depositary or any delegate of the depositary; or
- a non-EU undertaking, unless co-operation between that undertaking's supervisor and the AIFM's regulator is "ensured"; or
- any entity that is not both authorised or registered and supervised for asset management, unless the AIFM's regulator has given its prior consent; or
- any other entity whose interests may conflict with the AIFM or the AIF investors unless:
    - the entity "functionally and hierarchically" separates its delegated tasks from any other potentially conflicting tasks; and
    - the potential conflicts are properly identified, managed, monitored and disclosed to AIF investors.

An AIFM must review the services provided by its delegates on an ongoing basis.

Managing cross-border

An AIFM authorised in one Member State is able to provide management services to an AIF established in another Member State by using a passport under the Directive. It can provide the services either from its home Member State (or Member State of reference, for non-EU AIFM) or by establishing a branch in the Member State where the AIF is established.

EU AIFM will be able to take advantage of this passport from the Directive's transposition date (i.e. in July 2013). The passport is likely to become available to non-EU AIFM during 2015.

The AIFM must notify its regulator of its intention to manage EU AIF in other Member States and, if it proposes to establish a branch, must provide some further basic information. The regulator must transmit this within one month of receipt (or two months, if the AIFM will establish a branch) to the competent authorities in the AIF's Member State and notify the AIFM that it has done so. The AIFM can manage cross-border from the date it receives this notification. The host Member State is not able to impose additional requirements on the AIFM in respect of matters covered by the Directive.

Any change (whether or not material) to the particulars must be provided to the AIFM's own regulator at least one month before implementing the change (or immediately after the change, if it was unplanned).

General principles

Certain general principles apply to an AIFM both in relation to the way that its business is organised and controlled, and in relation to the conduct of its business. In both cases, the Commission must elaborate on the principles in Level 2 legislation. Many of the principles will be familiar to firms already authorised and regulated by the FSA. Some of the principles may seem relatively innocuous but similar provisions in MiFID were expanded on at Level 2 in ways which were unexpected.

Organisational requirements

An AIFM is required to comply with a number of high level organisational requirements. It must have:

- adequate and appropriate human and technical resources;
- adequate resources and procedures for running its business properly;
- sound administrative and accounting procedures;
- arrangements for protecting electronic data and for controlling how it is processed;
- record keeping arrangements in respect of transactions involving the AIF; and
- adequate internal control mechanisms, in particular for:
    - personal account dealing rules for staff;
    - the holding and management of investments for its own account; and
    - for ensuring that the AIF invests in accordance with the AIF rules or instrument of incorporation and relevant law.

The Commission will adopt Level 2 legislation to specify in more detail the procedures and arrangements required.

Conduct of business rules

The conduct of business principles applicable to an AIFM are as follows:

- It must act in the best interests of the AIF, or the investors in the AIF. It appears to be contemplated that these two ideas are synonymous. It is clear that the AIFM has to look to the interests of the investors as AIF investors, and not to their own individual interests.
- It must treat all AIF investors fairly (in their capacity as investors).
- It must act in the best interests of the integrity of the relevant market.
- It must act honestly, fairly and with due skill, care and diligence in conducting its activities.
- It must comply with all regulatory requirements applicable to its business (not only those deriving from this Directive).

Any AIFM that also provides discretionary management services in respect of a segregated portfolio is prohibited from investing client assets into the AIF it manages, unless it has the client's consent to do so.

Conflicts of interest

An AIFM is required to take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, prevent, manage and monitor and, where applicable, disclose those conflicts in order to: (a) prevent them from adversely affecting the interests of the AIF and its investors; and (b) ensure that the AIF it manages are fairly treated. In particular, it must take all reasonable steps to identify conflicts of interest between:

- the AIFM (including its staff, controllers and subsidiaries) and the AIF or AIF investors;
- one AIF (or its investors) and a second AIF (or its investors);
- one AIF (or its investors) and another client of the AIFM (e.g. a client in respect of a segregated discretionary management service);
- the AIF (or its investors) and any UCITS fund also managed by the AIFM (or the investors in the UCITS fund); and
- any two clients of the AIFM.

An AIFM is required to operate effective systems and controls designed to prevent such conflicts from adversely affecting the interests of the AIF (or investors).

To the extent that such systems and controls are not sufficient for the AIFM to be reasonably confident that risks of damage to investors' interests will be prevented, it must disclose the "general nature or sources of conflicts of interest" to them in advance.

These formulations are similar to those in MiFID, which have been implemented through FSA rules. However, the devil will be in the detail. We hope that when the Commission develops the requirements at Level 2, it will bear in mind that a conflict of interest can arise only where the AIFM (or its staff, controllers or subsidiaries) owes duties (contractual, fiduciary or imposed by legislation) which conflict with each other, or where the interests of the AIFM conflict with its duties. There is a need for precision in determining when such duties arise. The Directive's provisions which apply to AIFM that acquire control of companies appear to contemplate that conflicts may arise in circumstances where they would not usually be considered to exist, i.e. in the relationship between shareholder and investee.

An AIFM must segregate tasks and responsibilities which may be regarded as incompatible with each other or which have the potential to create systematic conflicts of interest.

The Commission will produce further legislation at Level 2 specifying the types of conflicts covered and the steps an AIFM is expected to take to identify, manage, monitor and disclose them.

Risk management

An AIFM is required to take the following measures under the broad heading of risk management:

- It must "functionally and hierarchically" separate risk management from portfolio management (and from other front office tasks). The Directive recognises that this may not be proportionate for some AIFM. Member States may therefore disapply this requirement provided there are adequate safeguards against conflicts of interest so that the risk management is independent, the AIFM's risk management process is effective, and the AIFM complies with the other requirements summarised below.
- It must implement adequate risk management systems to identify, measure, manage and monitor all risks associated with each AIF's investment strategy and to which each AIF is or can be exposed, and stress test the risks associated with investments.
- It must follow a documented and regularly updated due diligence process for investment.
- It must ensure that each AIF's risk profile corresponds to its size, assets, strategy and investment objectives.
- It must review its risk management systems at least once a year and adapt them whenever necessary.

The Commission will develop many of these requirements in Level 2 legislation.

Liquidity management

An AIFM must (except in relation to unleveraged closed ended AIF):

- adopt appropriate liquidity management procedures to ensure that the liquidity profile of each AIF's investments is aligned with the AIF's obligations, e.g. in relation to redemptions;
- ensure that each AIF's investment strategy, redemption policy and liquidity profile are consistent with each other;
- monitor each AIF's liquidity risk, including in light of regular stress tests against both normal and exceptional liquidity conditions.

The Commission will specify further detail at Level 2 in relation to an AIFM's liquidity management systems and procedures and the alignment of the AIF's liquidity profile with its investment strategy and redemption policy.

Investing in securitisations

There will be restrictions on investment by AIF in securitisations. These may relate only to loan securitisations but the position is not clear.

The Commission is obliged to set conditions which must be met by an AIFM and the "originator, sponsor or original lender" if the AIFM is to be permitted to invest on behalf of an AIF in securitisation instruments issued after 1 January 2011. These will include a requirement that the originator, sponsor or original lender retains at least a 5% net economic interest.

This provision is based on a requirement which has recently been inserted into the CRD to restrict the circumstances in which EU credit institutions (e.g. banks) may invest in securitisations. That provision applies to investing in any tranche in a securitisation, including any first loss tranche. The purpose of inserting a similar provision into the Directive appears to be to seek to achieve a "level playing field" between banks and fund investors on this issue, notwithstanding the fact that very different policy considerations should arise in the two circumstances. The penalty imposed on a bank for failing to comply with the securitisation investment requirements is to hold significantly higher capital against the investment. It is to be hoped that, in the context of AIF, policymakers take note of the fact that it is the AIF which makes the investment and so a penal capital treatment would not be appropriate.

The Directive amends the UCITS IV Directive to provide for equivalent restrictions on UCITS management companies in respect of investments by UCITS funds.

Annual reports

The AIFM must prepare an annual report in respect of each EU AIF it manages and each AIF it markets in the EU. This must be completed no later than six months following the end of the financial year (or possibly within four months for AIF subject to the Transparency Directive – see below). The annual report must be provided to:

- investors, on request; and
- the relevant EU competent authorities.

(Which competent authorities are relevant for these purposes depends on a number of factors.)

Content of the annual report

The annual report must include:

- the balance sheet or statement of assets and liabilities;
- an income and expenditure account;
- a report on activities;
- any material changes during the financial year to the information required to be disclosed to investors pre-investment;
- the total remuneration for the financial year split into fixed and variable remuneration paid by the AIFM, the number of beneficiaries and details of carried interest paid; and
- the aggregate amount of remuneration broken down by senior management and members of staff whose actions have a material impact on the risk profile of the AIF.

The Commission must make Level 2 legislation specifying the content and format of the annual report. It is therefore entirely possible that the final report will be subject to many more detailed requirements.

AIF subject to the Transparency Directive

AIF subject to the Transparency Directive (e.g. those whose shares or units are admitted to trading on an EEA regulated market) may fulfil their obligation to disclose the above details by including them within the public annual report required by the Transparency Directive. In this case, that report must be available within four (rather than six) months of the end of the financial year. If such details are not covered in the public annual report they must be included in a separate report made available only to investors and regulators, in which case the normal six month deadline applies.

Preparation and audit of accounting information

The accounting information in the annual report must be:

- prepared in accordance with the AIF rules and in accordance with accounting standards in the AIF's home Member State or (for non-EU AIF) the country where the AIF has its registered office; and
- audited by an EU auditor or (for non-EU AIF and where permitted by Member States) subjected to an audit meeting international audit standards in force in the country where the AIF has its registered office.

No alternatives are specified for AIF without a registered office.

Additional requirements where the AIF has a controlling interest in a non-listed company

The Directive will impose a number of requirements on an AIFM managing AIF which acquire "control" of companies. The AIFM may be required to make disclosures in the annual report of an AIF about each non-listed company over which the AIF has "control". Alternatively, the disclosures may be included in the annual report of the relevant non-listed company. For the detailed requirements, see the section on page 28 below headed "*Acquisition of substantial stakes in EU companies*".

Disclosure to investors

The Directive makes provision for disclosure to investors, both prior to their investment and thereafter. An AIFM is required to make the disclosures in respect of each EU AIF managed by it and each EU or non-EU AIF marketed by it in the EU.

Pre-investment disclosure

The information set out below must be disclosed prior to investment. Some of the items are similar to those traditionally covered in a private placement memorandum but others are likely to be new.

- A description of the main legal implications of the contractual relationship between the AIF and its investors.
- All fees, charges and expenses and of the maximum amounts of these which are directly or indirectly borne by investors.
- Details of how the AIFM ensures the fair treatment of investors.
- A description of any preferential treatment granted to investors (e.g. in a side letter) and the type of investors who obtain such treatment and their legal or economic links with the AIF or the AIFM (although the investor's identity need not be disclosed).
- If the AIF is a feeder fund, details of where any master AIF is established.
- If it is a fund of funds, details of where the underlying AIF are established.
- Details of the AIF's investment strategy and objectives, and the process for changing the investment strategy.
- The type of assets in which the AIF can invest, the techniques it may employ and all associated risks.
- Any investment restrictions.
- Details of the AIF's custody and sub-custody arrangements, and a description of any arrangements for the depositary to transfer its liability to a sub-custodian.
- The circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks, any restrictions on the use of leverage, the maximum level of leverage and information about any collateral or re-hypothecation arrangements.

- Details of any delegation of AIFM functions.
- Details of the AIF's valuation procedures and the latest NAV calculation or (for listed AIF) market price for AIF shares or units.
- Where available, the historical performance of the AIF.
- The AIF's latest annual report.
- The identity of the AIFM, the AIF's depositary, auditor and other service providers and a description of their duties and investors' rights.
- Details of the AIFM's liquidity risk management arrangements.
- The AIF's subscription and redemption procedures.
- A description of how the AIFM covers professional liability risks using own funds or professional indemnity insurance.
- Details of any prime brokerage arrangements.

Material changes to this information must also be disclosed to investors, and any change to depositary liability must be notified without delay. If the AIF is subject to the Prospectus Directive, there is no requirement to duplicate information set out in the AIF's prospectus.

Ongoing disclosures to investors

An AIFM must disclose to investors on a "periodic" basis:

- the percentage of AIF assets that are subject to special arrangements because they are illiquid (e.g. side pocket arrangements);
- any new liquidity management arrangements; and
- the AIF's current risk profile and the AIFM's risk management systems.

If the AIFM manages an EU AIF which employs leverage, or markets an AIF in the EU which employs leverage, it must on a "regular" basis disclose the total amount of leverage employed by the AIF and any change to the maximum level of leverage permitted as well as any re-hypothecation rights or any guarantee granted under the leveraging arrangement.

The Commission will specify the ongoing disclosure requirements in further detail at Level 2, including the frequency of the "regular" disclosure obligations in relation to leverage.

Regular reporting to regulators

The following reports must be made regularly by an AIFM to its regulator:

- the principal markets and instruments on and in which it trades;
- the principal exposures and most important concentrations of each of the AIF it manages;
- the main categories of assets in which the AIF is invested;
- the percentage of assets in each AIF which are subject to special arrangements because they are illiquid (e.g. side pocket arrangements);
- any new liquidity management arrangements;
- the risk profile of the AIF and the risk management tools employed to manage market risk, liquidity risk, counterparty risk and other risks including operational risks; and
- the results of the stress tests required by the Directive in respect of position risk and liquidity risk management.

Leverage reporting

There are additional reporting obligations for an AIFM which manages AIF that employ leverage "on a substantial basis". The Commission will define what is meant by "on a substantial basis" at Level 2. It appears that where an AIFM meets this test, the

leverage reporting requirements could apply in respect of all its AIF (i.e. not just those employing any or substantial leverage), which would be disproportionate. It is hoped that this will also be clarified by the Commission. For non-EU AIFM the reporting obligations are limited to the EU AIF they manage and the non-EU AIF which they market in the EU.

Reporting is required by the AIFM on:

- the overall level of leverage employed by each AIF it manages, with a breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives;
- the extent to which each AIF's assets have been re-used under leveraging arrangements; and
- the identity of the five largest sources of borrowed cash or securities for each of the AIF managed by the AIFM, and the amount of leverage received from each of those entities for each of the AIF managed.

An AIFM must also provide, on request:

- a list of the AIF it manages for the end of each quarter; and
- a copy of the annual report for each AIF (see section headed "*Annual reports*" on page 24 above).

Regulators may require additional information where necessary for the effective monitoring of systemic risk. ESMA also has power to "request" regulators to impose additional reporting requirements. This power appears to be exercisable in exceptional circumstances and where required to ensure the stability and integrity of the financial system, or to promote long term sustainable growth (whether or not there are exceptional circumstances). ESMA's power in this area is therefore potentially very wide indeed.

The Commission will make further legislation at Level 2 to provide further detail on these reporting obligations.

Leverage

Leverage is defined as:

> "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 derivative positions or by any other means".

There is little clarity on the exact scope of the "leverage" concept, though the Commission is to clarify in Level 2 legislation what constitutes leverage and how leverage is to be calculated. By way of an anti-avoidance mechanism, it is expressed to include "any financial and/or legal structures involving third parties controlled by the relevant AIF". A recital makes clear that this is not intended to capture leverage at the level of a private equity portfolio company.

Limits on leverage

An AIFM must set a maximum level of leverage in respect of each AIF it manages and set the extent of any hypothecation rights or guarantees that may be granted under a leveraging arrangement. In doing this it must take into account:

- the type of AIF, its strategy and the scale, nature and extent of the AIFM's activity in the markets concerned;
- the sources of leverage and the need to limit exposure to any one counterparty;
- any relationships with other financial services institutions which could pose systemic risk;
- the extent to which the leverage is collateralised; and
- the asset liability ratio.

The AIFM must be able to demonstrate that the leverage limits it has set are reasonable and are complied with at all times.

Member State regulators are required to use the leverage information provided by the AIFM (see the section on page 26 above headed "*Regular reporting to regulators*") to assess the extent to which the use of leverage contributes to the build up of systemic risk in the financial system, or risks of disorderly markets or risks to the long term growth of the economy.

If it is considered necessary in order to ensure stability and integrity of the financial system, the AIFM's regulator may impose limits on the leverage that a particular AIFM may employ or set other restrictions on the management of the AIF.

The leverage information received by an AIFM's regulator will be made available to other Member State regulators, ESMA and the European Systemic Risk Board. ESMA has the power to determine that the leverage employed by an AIFM, or by a group of AIFM, poses a substantial risk to the stability and integrity of the financial system. If ESMA makes such a determination then it can issue

advice to the AIFM's home Member State regulator specifying remedial measures (which may include leverage limits). The AIFM's regulator is not obliged to comply with ESMA's advice but, if it does not, it must give reasons for this. ESMA may decide to publish the fact that the regulator has not complied with its advice as well as the reasons given.

Disclosure to investors

As noted in the section headed "*Disclosure to investors*", on page 25 above, an AIFM is required to make certain disclosures to investors about the use of leverage.

Acquisition of substantial stakes in EU companies

Scope - which AIFM are caught?

The Directive's provisions apply in relation to one or more AIFM where a substantial stake is acquired by:

- a single AIF;
- multiple AIF under an agreement aimed at acquiring control, managed by one AIFM; or
- multiple AIFM co-operating on the basis of an agreement under which their AIF jointly acquire control.

The Directive imposes disclosure obligations on the acquisition of major holdings (starting at 10% of voting rights) in non-listed EU companies. It imposes more onerous obligations on AIFM whose AIF acquire "control" of EU companies (whether or not listed). There are also requirements designed to prevent so called "asset stripping" of EU companies controlled by AIF.

These requirements apply to EU AIFM (including AIFM exempt from most Directive requirements because they manage limited lifespan closed ended AIF that ceased marketing by July 2011). They will also apply to non-EU AIFM who wish to market their AIF to EU investors via national private placement regimes and (from mid-2015) to non-EU AIFM marketing in the EU via the passport.

These provisions will have a particular impact on private equity and venture capital funds, their portfolio companies and target companies. Some hedge and other alternative investment fund managers will also need to consider the provisions carefully because they begin to apply at relatively low levels (i.e. 10% of voting rights) and they apply not only in relation to operating companies but also in relation to certain SPVs.

Member States are entitled to apply stricter rules on a national basis in respect of investment in companies in their territories. This means that notwithstanding the minimum standards imposed under the Directive, an AIFM will need to consider local disclosure and "asset stripping" requirements on a jurisdiction by jurisdiction basis.

Scope - which investees are caught?

These provisions apply only in relation to holdings in companies whose registered office is in the EU. The Directive applies different requirements depending on whether the company is an "issuer" (being a company whose securities (e.g. shares or bonds) are admitted to trading on an EEA regulated market within the meaning of MiFID) or a "non-listed company". A non-listed company is one which has no traded securities, or might have securities admitted to trading exclusively on markets (such as the UK Alternative Investment Market (AIM) or on PLUS Markets) which are not EEA regulated markets.

The obligations do not apply where the investee is:

- a special purpose vehicle established to buy, hold or administer real estate; or
- a small or medium-sized enterprise, i.e. one which employs fewer than 250 people in the EU and has either or both of: (a) an annual net turnover not exceeding €50 million; or (b) a balance sheet total not exceeding €43 million.

Disclosure of acquisition of voting rights

An AIFM must notify its regulator when an AIF's interest in the voting rights of a non-listed company reaches, exceeds or falls below 10%, 20%, 30%, 50% or 75%, specifying what the precise voting interest is.

Obligations on AIFM which acquire "control"

What is "control"?

The test for control depends on whether the company is a "non-listed company" or an "issuer".

Non-listed companies

"Control" of a non-listed company refers to control of more than 50% of the non-listed company's voting rights. Voting rights must

also be taken into account for these purposes if they are held by any subsidiary undertaking of the AIF, or by individuals or others acting in their own name but on behalf of the AIF.

Issuers

"Control" of an issuer refers to the threshold for a mandatory bid under the Takeovers Directive. This will vary between Member States. For the purposes of the Directive, the relevant level of control is determined by the Member State in which the company has its registered office. In the UK, this threshold is currently set at 30% of voting rights. In some other Member States, the threshold is set at another level (e.g. one third of voting rights).

What information must be disclosed?

Once control is reached, the AIFM is required to provide certain information.

Non-listed companies

When control of a non-listed company is reached, the AIFM must notify its regulator, the company and any other shareholders whose details are accessible to the AIFM. This notification must be made at the latest within 10 working days and must set out:

- what voting rights the AIFM has;
- the conditions under which control has been obtained including the identity of the shareholders involved and persons entitled to exercise voting rights on their behalf;
- the chain of undertakings through which voting rights are held, if applicable; and
- the date on which control was reached.

It must also make "available" to the company and those shareholders its intentions as to the company's future business and the likely repercussions on employment, including any material change in the conditions of employment.

The AIFM must ask the company's board of directors to pass on the information set out above without undue delay to employee representatives or (if there are none) to the company's employees directly. The AIFM is obliged to use best efforts to ensure that the board passes it on.

The AIFM must also provide its regulator and the AIF investors with information on how the acquisition has been financed.

Non-listed companies and issuers

When control of a non-listed company or an issuer is reached, the AIFM must make available to its regulator, the company and any shareholders whose details are accessible to the AIFM:

- the identity of the AIFM that have control;
- its policy for preventing and managing conflicts of interest, in particular between the AIFM, the AIF and the non-listed company or issuer, including information about the safeguards established to ensure that any agreement between the AIFM or the AIF and the company is at arm's length; and
- the policy for external and internal communication relating to the company, in particular as regards employees. It is not yet clear who must maintain this policy or what it must provide.

The AIFM must ask the company's board of directors to pass on the information set out above without undue delay to employee representatives or (if there are none) to the company's employees directly. The AIFM is obliged to use best efforts to ensure that the board passes it on.

In relation to non-listed companies, Member States can also require this information to be disclosed to the "national competent authorities of the non-listed company". This is undefined, but would seem to refer to an authority (perhaps the trade ministry or company registrar) in the Member State where the non-listed company has its registered office.

Confidentiality

An AIFM will not be required to ensure that the company's board passes information to employee representatives or employees if this would seriously harm or be prejudicial to the company. The AIFM must assess whether this would be the outcome by reference to "objective criteria".

Where, in the legitimate interest of the company, information is provided to employee representatives in confidence, they should not (subject to national law) be permitted to disclose this information to employees or others unless those persons are themselves

bound by confidentiality obligations. This replicates the position under existing EU employment rights legislation. It is however a fairly toothless provision, since it is not possible in practice to prevent disclosure and there is little point generally in pursuing employee representatives for breach.

Annual reports

An AIFM must also make the disclosures listed below about each non-listed company over which an AIF individually or jointly has control. As noted on page 24 above in the section headed "*Annual reports*", these disclosures may be included either in the annual report of each relevant AIF or in the annual report of the non-listed company (or both). The disclosures are:

- a fair review of the development of the company's business over the period covered by the annual report;
- an indication of important events since the end of the financial year;
- an indication of the company's likely future development; and
- details of any acquisitions of own shares.

The disclosures must be made within six months of the end of the financial year of the relevant AIF or, if earlier, when the annual report of the non-listed company is drawn up in accordance with national law.

If the information is included in the AIF's annual report, the AIFM must also use best efforts to ensure this information is made available to all employee representatives by the relevant non-listed company's board.

If the information is included in the non-listed company's own annual report, the AIFM must use best efforts to ensure the board of the company makes the information available to all employee representatives or (where there are none) to the company's employees directly. The AIFM must then also ensure the information is made available separately to investors in the AIF.

"Asset stripping"

The Directive contains a provision which is directed at so-called "asset stripping". This provision requires that, when an AIF individually or jointly acquires control of an issuer or non-listed company, for 24 months following the acquisition of control the AIFM must use its best efforts to prevent (and it is prohibited from voting in favour of or otherwise facilitating or supporting) any distribution, capital reduction, share redemption or acquisition of own shares relating to:

- any distribution to shareholders by the company, where net assets are or would become lower than: (i) the amount of subscribed capital; plus (ii) undistributable reserves;
- any acquisition by the company of its own shares if this would have the effect of reducing its net assets below the same limit; or
- any distribution to shareholders by the company which would exceed the amount of the company's distributable profits at the end of the previous financial year (plus profits brought forward and distributable reserves), net of any losses and any amount moved to undistributable reserves.

There are a number of limited exemptions for acquisitions of own shares and capital reductions.

These restrictions appear to be triggered only on the first acquisition of "control" and not when moving through a higher control threshold. However, they will still be very unwelcome to private equity and venture capital AIFM in the context of: (a) acquisitions of target companies with cash on balance sheet; (b) acquisition-related or other portfolio company reorganisation; and (c) transactions relating to portfolio companies relatively close to an anticipated exit date (for example, a round of follow-on investment, a share-for-share exchange or a bolt-on investment). If any such transaction triggers "control" of a particular company (directly or through a subsidiary), then the 24 month clock begins to tick in relation to that company and this may complicate an exit. Private equity and venture capital AIFM will need to consider the impact of these provisions on their plans when structuring transactions.

Levelling the playing field

As a result of these disclosure and "asset stripping" provisions, AIFM seeking to acquire control of EU companies (particularly non-listed companies) could be placed at a significant competitive disadvantage compared to non-AIF providers of capital, such as high net worth individuals, sovereign wealth funds, pension funds investing directly and non-EU AIFM or non-EU AIF which are not marketed in the EU. Whether this becomes a substantial disadvantage will depend in part on how the concepts are developed in Level 2 legislation.

A recital to the Directive invites the Commission to examine whether to extend the disclosure requirements (but apparently not the restrictions on "asset stripping") to other kinds of investor in EU non-listed companies and issuers (and how this might be achieved). The Commission is not required to take up this invitation and any proposal would require new Level 1 legislation.

For further information on these issues please contact one of the following partners in our Financial Services and Markets department or your usual contact at Travers Smith.

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

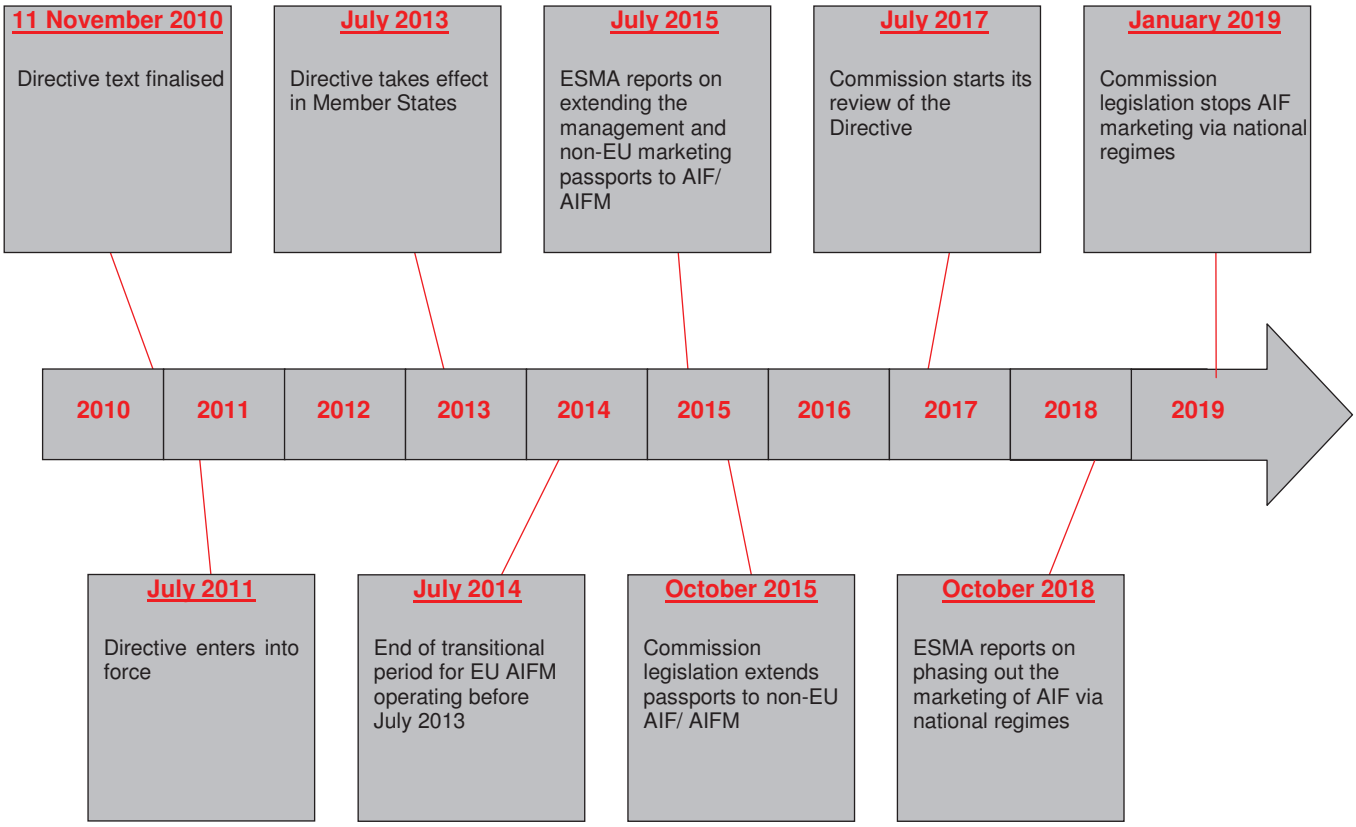
Margaret Chamberlain
margaret.chamberlain@traverssmith.com
+44 (0)20 7295 3233

Phil Bartram
philip.bartram@traverssmith.com
+44 (0)20 7295 3437

Jane Tuckley
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238

Tim Lewis
tim.lewis@traverssmith.com
+44 (0)20 7295 3321

Appendix 1: Indicative timeline



Appendix 2: Preconditions to managing and marketing AIF - a summary

Note

The tables in this Appendix are a summary only. Their application, in respect of marketing, is limited to professional investors. They do not take account of: (a) the partial or full exemptions provided for in the Directive (for example, for AIFM managing small AIF or AIFM of certain closed ended AIF in run-off or with a limited life); or (b) the transitional provision which gives AIFM already operating before July 2013 an extra year to obtain authorisation.

Part A: Conditions applying until (at least) October 2015

	No marketing in Member States	Marketing in Member States via national private placement regimes	Marketing in Member States with passport
EU AIFM / EU AIF	• Authorisation required. • Full Directive requirements apply.	N/A	• Authorisation required. • Full Directive requirements apply.
EU AIFM / Non-EU AIF	• Authorisation required. • Full Directive requirements apply (except depositary and annual report requirements). • Information exchange arrangements must be in place between the AIFM's regulator and the supervisory authorities of the country where the AIF is established.	• Authorisation required. • Full Directive requirements apply except the detailed depositary rules (although a depositary must still be appointed). • Information exchange arrangements must be in place between the AIFM's regulator and the supervisory authorities of the country where the AIF is established. • The AIF's jurisdiction must not be an NCCT. • Member States may impose stricter rules.	N/A

Non-EU AIFM / EU AIF	• Member States' national authorisation regimes apply.	• Only the following requirements apply:
		  ○ annual reports;
		  ○ disclosure to investors;
		  ○ regular reporting to regulators; and
		  ○ requirements on AIFM which acquire substantial stakes in EU companies.
		• Information exchange arrangements must be in place between the competent authorities in each Member State where the AIF is marketed and the AIF's Member State and the supervisory authorities of the country where the AIFM is established.
		• The AIFM's jurisdiction must not be an NCCT.
		• Member States may impose stricter rules.
			N/A

Part A: Conditions applying until (at least) October 2015 contd.

	No marketing in Member States	Marketing in Member States via national private placement regimes	Marketing in Member States with passport

Non-EU AIFM / **Non-EU AIF**	Outside scope.	• Only the following requirements apply:
		  o annual reports;
		  o disclosure to investors;
		  o regular reporting to regulators; and
		  o requirements on AIFM which acquire substantial stakes in EU companies.
		• Information exchange arrangements must be in place between the competent authorities in each Member State where the AIF is marketed and the supervisory authorities of the countries where the AIF and the AIFM are established.
		• The AIFM's and the AIF's jurisdictions must not be NCCTs.
		• Member States may impose stricter rules.
			N/A

Part B: Conditions applying from October 2015 (at the earliest)

	No marketing in Member States	Marketing in Member States via national private placement regimes	Marketing in Member States with passport
EU AIFM / EU AIF	• Authorisation required. • Full Directive requirements apply.	N/A	• Authorisation required. • Full Directive requirements apply.
EU AIFM / Non-EU AIF	• Authorisation required. • Full Directive requirements apply (except depositary and annual report requirements). • Information exchange arrangements must be in place between the AIFM's regulator and the supervisory authorities in the country where the AIF is established.	• Full Directive requirements apply except the detailed depositary rules (though a depositary must still be appointed). • Information exchange arrangements must be in place between the AIFM's regulator and the supervisory authorities in the country where the AIF is established. • The AIF's jurisdiction must not be an NCCT. • Member States may impose stricter rules.	• Authorisation required. • Full Directive requirements apply. • Information exchange arrangements must be in place between the AIFM's regulator and the supervisory authorities in the country where the AIF is established. • The AIF's jurisdiction must not be an NCCT. • OECD-compliant tax information exchange agreements must be in place between the AIF's home jurisdiction and: o the AIFM's home Member State; and o each Member State into which the AIF is marketed.

Part B: Conditions applying from October 2015 (at the earliest) contd.

	No marketing in Member States	Marketing in Member States via national private placement regimes	Marketing in Member States with passport
Non-EU AIFM / EU AIF	• Authorisation required in AIFM's Member State of reference. • Full Directive requirements apply. • AIFM must designate a Member State of reference and appoint a "legal representative" there. • Information exchange arrangements must be in place between the competent authorities in the AIFM's Member State of reference and the AIF's Member State and the supervisory authorities in the country where the AIFM is established. • The AIFM's jurisdiction must not be an NCCT. • An OECD-compliant tax information exchange agreement must be in place between the AIFM's home jurisdiction and its Member State of reference. • The AIFM's local law must not prevent effective supervision.	• Authorisation required in AIFM's Member State of reference. • Full Directive requirements apply. • AIFM must designate a Member State of reference and appoint a "legal representative" there. • Information exchange arrangements must be in place between the competent authorities in the AIFM's Member State of reference, the AIF's Member State and each Member State into which the AIF is marketed, and the supervisory authorities in the country where the AIFM is established. • The AIFM's jurisdiction must not be an NCCT. • An OECD-compliant tax information exchange agreement must be in place between the AIFM's home jurisdiction and its Member State of reference. • The AIFM's local law must not prevent effective supervision. • Member States may impose stricter rules.	• Authorisation required in AIFM's Member State of reference. • Full Directive requirements apply. • AIFM must designate a Member State of reference and appoint a "legal representative" there. • Information exchange arrangements must be in place between the competent authorities in the AIFM's Member State of reference and the AIF's Member State and the supervisory authorities in the country where the AIFM is established. • The AIFM's jurisdiction must not be an NCCT. • An OECD-compliant tax information exchange agreement must be in place between the AIFM's home jurisdiction and its Member State of reference. • The AIFM's local law must not prevent effective supervision.

Part B: Conditions applying from October 2015 (at the earliest) contd.

	No marketing in Member States	Marketing in Member States via national private placement regimes	Marketing in Member States with passport

Non-EU AIFM / **Non-EU AIF**	Outside scope.	• Only the following requirements apply:
		  ○ annual reports;
		  ○ disclosure to investors;
		  ○ regular reporting to regulators; and
		  ○ requirements on AIFM which acquire substantial stakes in EU companies.
		• Information exchange arrangements must be in place between the competent authorities in each Member State where the AIF is marketed and the supervisory authorities in the countries where the AIFM and the AIF are established.
		• The AIFM's and the AIF's jurisdictions must not be NCCTs.
		• Member States may impose stricter rules.
			• Authorisation required in AIFM's Member State of reference.
			• Full Directive requirements apply.
			• AIFM must designate a Member State of reference and appoint a "legal representative" there.
			• Information exchange arrangements must be in place between the regulator in the AIFM's Member State of reference and the supervisory authorities in the countries where the AIFM and the AIF are established.
			• The AIFM's and the AIF's jurisdictions are not NCCTs.
			• OECD-compliant tax information exchange agreements must be in place between the AIFM's Member State of reference and the AIFM's and AIF's home jurisdictions.
			• OECD-compliant tax information exchange agreements must be in place between the AIF's home jurisdiction and all Member States into which it is marketed.
			• The AIFM's local law must not prevent effective supervision.