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Financial Services and Markets

Alternative Investment Fund Managers Directive: Overview

The final form of the Alternative Investment Fund Managers Directive is now known. Whilst there will be extensive secondary legislation to be made, the basic principles and quite a lot of detail are now set in stone. 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 and unclear. The only consolation is that, at times during the legislative process, it was even worse than it is now.

This note provides a general overview of some of the key elements. We have set out our current understanding of the Directive, which may change over time as the full meaning of many of the provisions is not yet clear and further guidance is expected as the European Union and Member States move towards implementation.

A more detailed note is also available here.

In the text below we have referred to various dates, and in the Appendix 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 published in March 2011. The European Commission has indicated that publication will be in February or March 2011, though this may change.

The Directive has been made at a time when new European supervisory bodies are being formed and is the first Directive under which the powers recently conferred on ESMA, the European Securities and Markets Authority, are being put to extensive use. ESMA will develop many of the detailed procedures firms must follow under the Directive. ESMA will be based in Paris and is part of the new European regulatory supervisory structure, which will see a European Banking Authority based in London and the equivalent for the insurance industry in Frankfurt. These new bodies will have significant powers and, as the FSA has said, domestic regulators will become "the European supervisory arm of a centralised European policy decision-making process".

Comment

The original proposal was a response to a range of different issues, given impetus by the financial crisis and associated scandals. At a global level, the G20 made specific commitments on the registration and oversight of hedge funds. In the EU, the European Parliament adopted reports by MEPs Poul Nyrup Rasmussen and Karl-Heinz Lehne which were highly critical of the hedge fund and private equity industries and put the Commission under enormous political pressure to propose a Directive to regulate them.

Some of the Directive's provisions are not just political, but are a direct response to perceived gaps in the current regulatory structure. The fact that EU investors (both professional and retail) were exposed to Madoff (seen as a US fund) through funds based and/or marketed in the EU clearly influenced the debate, particularly in relation to issues such as marketing, custody and valuation of investments. Regulators around the world have for some time now considered that professional investors need protection; that they are not as sophisticated as they like to think they are.

The Directive, in order to be adopted, had to be approved by both the Council of the European Union (i.e. national governments) and the European Parliament. The Council position is determined by majority voting. Whilst the UK had by far the most at stake, it was isolated on almost all the major issues and had no veto. For a long time the Council and the Parliament had significantly different positions on key issues and there has been an intensive period of negotiation over the last few months to reach a text that both could approve.

Few were willing to listen to arguments based on cost (including cost to investors), unnecessary bureaucracy, or impact on existing practices. Many prominent European parliamentarians are deeply hostile to the private equity industry and the strong socialist influence has ensured that the final Directive contains many provisions designed to make life more difficult for funds which take control of European companies. On the other hand, the European Parliament championed the cause of fair and equal access to the EU market by non-EU countries.

Some of the effects of the Directive will be deliberate, others will be unforeseen. The focus on a few major issues and the desire to bring things to a close (as the Directive is just one of many pieces of financial services legislation in the European pipeline) means that there has not been time for considered thought to be given to the overall impact. It is undoubtedly the case that the Directive will increase costs for fund managers, funds and investors, will reduce the ability of the funds industry to be fleet of foot because of the bureaucracy which will be imposed on it. The Directive may significantly affect the ability of retail investors to access collective products which are not UCITS funds. Perhaps the biggest winner will be the insurance industry, since insurance contracts are expressly excluded, so they can continue to be sold to retail investors and be the means by which they obtain the benefits of collective investment.

The marketing passport will not be available to non-EU firms and non-EU funds at the same time as it is available to EU firms. It is not clear whether Member States can permit non-EU funds to be marketed to retail investors. Private placement will be the means for AIFM to access professional investors for at least two years after implementation but the Directive lays down minimum requirements for private placement regimes, and so accessing EU markets in this way will mean that some level of compliance with Directive requirements is necessary. It remains to be seen whether the Directive will ultimately increase or decrease the attractiveness of offshore financial centres.

The Directive affects existing funds as well as funds raised after it comes into force. It does not fit with the commercial and practical realities of marketing and operating different types of fund.

Affected firms are likely to need more internal and high calibre compliance resource. In many cases they will need this to deal with both the AIFM Directive and the SEC registration regime.

When the Directive was first proposed we said that it had the potential to be Europe's Sarbanes-Oxley, driving investment and jobs out of Europe. We fear that will be the case.

Timing

The Directive is not expected to come into effect in Member States until March 2013. Different requirements are expected to take effect at intervals from 2013 to mid-2018. An indicative timeline can be found in the Appendix to this note.

Terminology

The use of terms such as "manager" and "fund" can cause confusion when used in the AIFM Directive context. In this note we use the terms "AIF" and "AIFM", as they have specific meanings for purposes of the Directive.

- "Alternative investment fund" or "AIF" means the fund itself. An AIF may be open or closed ended, constituted as a company, a trust, under a contract or a statute, or in any other legal form. It includes private equity, debt, real property, commodity, infrastructure, film, debt and hedge funds, as well as funds of funds and all other vehicles for collective investment which are not regulated UCITS funds.

- "Alternative investment fund manager" or "AIFM" means the legal person appointed by or on behalf of the AIF to be responsible for providing portfolio management and risk management services. In some cases there may be no such external person, and the AIF will itself be the AIFM.

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

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

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 States 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.

Scope

The AIF

The concept is very broad. From a UK perspective, the inclusion of certain closed ended UK companies makes it much wider than a "collective investment scheme". It appears that two investors may be sufficient to constitute an AIF. There is no requirement for risk spreading, so arrangements relating to a single asset could be caught. There is also no need for a "vehicle" for there to be an AIF. There are many issues of interpretation yet to be resolved.

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 AIFM and the AIF are established within or outside the EU. The AIFM is responsible for ensuring compliance with the Directive, even if certain requirements are outside its power to control.

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. 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 the AIF. "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.

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. 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. 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 need to consider the impact of any changes on their tax position.

For example, based on common structures currently in place:

- If the AIF is an English limited partnership, the AIFM will be either the general partner or a manager which has been appointed by the general partner on behalf of the fund to provide management services. Such an entity is likely today to be authorised in the UK as the operator of a collective investment scheme.

- If the AIF is a Cayman LLC, the LLC or the Cayman manager is likely to be the AIFM. A "manager" in Europe is likely to have had delegated to it the provision of some investment management services. In such a case, it will not be the AIFM.

Managers within the EU who are delegates of the appointed AIFM will remain as MiFID firms and not fall within the AIFM Directive. Investment advisers/arrangers, e.g. to overseas managers, will not be AIFM. These firms will be indirectly affected as the AIF which they advise can only be marketed in the EU as provided in the Directive.

Exemptions

There are some specific exemptions, including for certain securitisation special purpose entities, employee participation schemes, employee saving schemes and AIFM that manage funds with only the AIFM or the AIFM's group companies as investors.

Partial exemption for AIFM managing small AIF

A partial exemption 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).

These AIFM 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 management or marketing passports unless they opt in to the entire Directive. The AIF they manage will be able to be marketed under national securities marketing laws.

Limits on AIFM activities

The Directive places significant limitations on the activities that can be carried on by an AIFM. Internally managed AIF can only manage their own fund. External AIFM will only be able to engage in:

- the management, administration and marketing of the AIF for which they are the AIFM;

- activities relating to the assets of the AIF (this should allow private equity and real estate fund managers to continue most if not all of the activities they currently carry on with their investees);
- the management of UCITS funds;
- discretionary portfolio management; and
- (if authorised to provide discretionary portfolio management), as "non-core" services:
  - investment advice;
  - custody in relation to units of collective investment undertakings; and
  - arranging deals.

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

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 AIF it manages to or with investors domiciled in the Union".

The Directive provides the basis for marketing of AIF by or on behalf of the AIFM but it also restrains the ability of other market participants to promote investments in AIF. MiFID investment firms and their non-EU equivalents, such as brokers and placement agents, are only allowed to offer or place shares or units of AIF to EU investors (directly or indirectly) 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 that the provision 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. The Directive is silent on the position of retail investors investing on their own initiative but this may be a feature of the Directive being targeted at professional investors.

Professional and retail investors

The Directive provides a framework for marketing to professional investors. 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. 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. Many high net worth or sophisticated individuals will not qualify as professionals.

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. It appears that Member States may not allow an AIF to be marketed to retail investors 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 3 above. Where an EU AIFM is partially exempt, the marketing of its AIF is a matter for national securities marketing laws.

Does my firm need to be authorised under the Directive to be an AIFM? Can my firm market in the EU the AIF it manages?

If your firm is an EU AIFM:

- it will need authorisation;
- if it manages an EU AIF it can use the marketing and management passport with effect from March 2013; it cannot use national private placement regimes; if a Member State so permits it can market the AIF to retail investors; and
- if it manages a non-EU AIF a marketing passport will not be available until at least 2015. Until then, it must use national private placement regimes, which will probably be phased out in 2018. If a Member State so permits, it can market the AIF to retail investors.

If your firm is a non-EU AIFM:

- if it manages an EU AIF it requires authorisation from the date certain provisions take effect, i.e. mid-2015;
- it does not require authorisation under this Directive to manage a non-EU AIF but it will require a form of authorisation if it wishes to use the marketing passport (see below);
- it must use national private placement regimes until a marketing passport becomes available (i.e. mid-2015); national private placement regimes will co-exist with the passport until 2018 but are then likely to be phased out; use of private placement means some compliance with Directive provisions is required;

- it cannot market non-EU AIF managed by it to retail investors in the EU either under private placement or the passport when it becomes available (unless, perhaps, they fall below the size thresholds set out on page 3 above). If it manages an EU AIF it will be able in principle to market to retail investors from 2015 (assuming it becomes authorised and Member States permit marketing to retail investors).

National private placement regimes

EU AIF managed by an EU AIFM can only be marketed to professional investors in accordance with the Directive. So from March 2013, they can no longer be marketed to professional investors via national private placement regimes. National private placement regimes must meet certain minimum conditions so that they are only available for:

- EU AIFM for non-EU AIF which comply with the Directive except for the depositary requirements;
- non-EU AIFM for non-EU AIF which comply with the Directive provisions for disclosures to investors and regulators, annual reports and the portfolio company requirements e.g. on "asset stripping";
- (until June 2015) non-EU AIFM for EU AIF which comply with the Directive provisions for disclosures to investors and regulators, annual reports and the portfolio company requirements e.g. on "asset stripping"; and
- (from June 2015) non-EU AIFM for EU AIF which comply with the Directive.

Additional conditions must be met concerning the status of the relevant non-EU country.

Marketing passport for non-EU AIFM and/or non-EU AIF

There will be a period when national private placement regimes and a marketing passport will co-exist for non-EU AIFM and non-EU AIF, but the intention is to phase out national private placement regimes once the passporting provisions are operative, probably by 2018.

The marketing passport requires compliance with the full Directive (unless, for a non-EU AIFM or AIF, it is impossible to comply and equivalent local rules in the AIFM's/AIF's jurisdiction apply instead). In addition, the non-EU country concerned must have entered into OECD-compliant tax information sharing agreements, and co-operation arrangements with relevant EU authorities, and it must not be a Non Co-operative Territory for anti-money laundering purposes. The Directive sets out a basis for identifying which Member State must grant the passport.

Passporting

Once authorised in its home Member State, the AIFM can manage funds established elsewhere in the EU and market its funds to professional investors in other EU Member States. An AIFM cannot market funds in other EU Member States without informing its own regulator in advance. Its regulator must notify the relevant authorities of the Member State where the fund will be marketed. The procedure for exercising the passporting right is bureaucratic, will introduce delays to the process and does not fit with the commercial reality.

Capital requirements

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".

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

"Initial capital" and "own funds" are two ways of measuring what are essentially "shareholder funds" (after deducting adjustments, e.g. for accrued losses and intangible assets such as goodwill). 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.

Initial capital requirement

An AIFM which only manages itself must maintain initial capital of €300,000.

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

Own funds requirement

An AIFM which only manages itself 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, including salaries, guaranteed bonuses and rent; 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.

Additional requirements to cover professional negligence risks

In addition, 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.

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 AIFM from using own funds as working capital. It is understood that this restriction applies only to balance sheet assets held to cover the level of own funds required by the Directive. This type of requirement does not apply to UCITS managers or to MiFID investment managers subject to existing EU capital adequacy legislation. The only type of manager to whom this requirement will be applied by EU directives is an AIFM.

Remuneration

The Directive will require AIFM to have remuneration policies and practices for certain staff. The Directive anticipates that these will include senior management, "risk takers" (such as traders and investment committee members), "control functions" (which might include legal, compliance, human resources and risk management staff) and employees whose remuneration takes them into the same bracket as senior management or risk takers.

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 overarching requirement is for the AIFM to have a remuneration policy that is consistent with and promotes sound and effective risk management. There are requirements for fixed remuneration (e.g. salary) and variable remuneration (e.g. bonus) to be appropriately balanced, restrictions on the amount of bonus that can be paid without deferral, requirements for a portion of variable remuneration to be paid in units or shares in the relevant AIF (or similar instruments), restrictions on 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).

There is some 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". ESMA must produce guidelines which may clarify the scope for AIFM to comply on a proportionate basis.

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

AIFM must also prepare an annual report for investors and regulators and this must contain certain information in relation to remuneration.

Depositary requirements

EU AIF

An AIFM must ensure that a depositary is appointed for each EU AIF it manages. An AIFM cannot be the depositary.

A depositary for an EU AIF must be:

(a) an EU credit institution;

(b) a MiFID investment firm meeting certain criteria (probably investment banks but not most asset managers and agency brokers); or

(c) a prudentially regulated and supervised institution of a type that is eligible to be a UCITS depositary.

In effect, the principal provider of depositary services to EU AIF will have to be an EU bank or investment bank. An EU branch of a non-EU bank will not qualify. A prime broker cannot be depositary to an AIF that is its counterparty unless certain conditions are met. This restriction does not prevent a depositary delegating custody tasks to a prime broker. Firms which use prime brokers are likely to need to review and restructure their arrangements.

Non-EU AIF

The depositary requirements do not apply in respect of a non-EU AIF unless:

- it is managed by an EU AIFM which markets the non-EU AIF in the EU via national private placement regimes. In such a case a depositary must be appointed, but detailed Directive provisions on depositary liability, delegation and who can be a depositary do not apply. However, after the passporting provisions for non-EU funds come into effect (2015) the depositary requirement will apply in full whether or not the passport is actually used for marketing.
- it is marketed by a non-EU AIFM under a passport (which cannot happen until after 2015). This means that a non-EU AIFM can market a non-EU AIF under national private placement for so long as it is available (i.e. until 2018) without the AIF having to comply with the depositary requirement.

Depositary duties

The depositary has a range of duties some of which go beyond traditional custodian duties. For example, it must ensure that AIF shares or units are valued in accordance with applicable national law, the AIF rules and Directive valuation requirements. There are limits on its ability to delegate. The Directive provides the basis for depositary liability, which is wider than might arise under typical current custody contracts.

Where financial instruments held in custody are lost, the depositary is obliged to return identical financial instruments or the corresponding amount. This is subject to a limited exception which provides that, where financial instruments held by a sub-custodian are lost and the sub-custodian has accepted direct liability to the underlying clients, the depositary can transfer its liability for the return of financial instruments to the sub-custodian. It is doubtful whether this will be commercially feasible. 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. 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.

Valuation

AIFM are required to have procedures for proper and independent valuation of the AIF's assets and to ensure that the net asset value of the AIF shares or units is calculated and disclosed to investors.

Valuations may be performed by the AIFM or a professional external valuer and must be performed at least once a year. AIFM that carry out their own valuations must ensure independence between the valuation and portfolio management functions. 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.

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.

Delegation

The Directive imposes requirements on an AIFM when delegating any of the AIFM functions (being portfolio and risk management, AIF administration, 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. 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.

Annual report

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 provided to investors on request and to the relevant EU competent authorities.

The annual report must include (amongst other things):

- the balance sheet or statement of assets and liabilities and a report on activities;
- 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 fund.

Acquisition of substantial stakes in EU companies

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 Directive also makes provision to restrict "asset stripping" in relation to such companies.

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. There are limited exemptions for special purpose vehicles established to buy, hold or administer real estate and where the investee is a small or medium-sized enterprise.

Member States may also apply stricter rules on a national basis in respect of investment in companies.

The Directive provisions apply in relation to one or more AIFM where control is acquired by:

(a) a single AIF;

(b) multiple AIF under an agreement aimed at acquiring control; or

(c) multiple AIFM co-operating on the basis of an agreement under which their AIF jointly acquire control.

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

Further disclosures are required if a controlling stake is acquired. "Control" of a non-listed EU company refers to more than 50% of its voting rights. Control of an entity whose securities are traded on an EU regulated market ("an issuer") refers to the threshold for a mandatory bid under the Takeovers Directive. This will vary between Member States. In the UK, it is currently set at 30% of voting rights.

When control of a non-listed company is reached, the AIFM must notify its regulator, the company and shareholders whose details are accessible to the AIFM, of certain details including:

- the voting rights situation and the chain of undertakings through which voting rights are effectively held;
- the identity of the different shareholders involved and persons entitled to exercise voting rights on their behalf;
- the policy for preventing and managing conflicts of interest, in particular between the AIFM, the AIF and the non-listed company/issuer; and
- the policy for external and internal communication relating to the non-listed company/issuer, in particular as regards employees.

When control of an issuer is reached, the AIFM must disclose the last two items listed above.

The AIFM must also make available to the non-listed company and the shareholders whose details are accessible to the AIFM its intentions as to the company's future business and the likely repercussions on employment. The AIFM must use best efforts to ensure the board of a non-listed company (and, in some cases, an issuer) passes the information on to employee representatives or (if there are none) the employees themselves. AIFM will not be required to ensure that the company's board passes information to employee representatives or employees if, objectively, this would seriously harm or be prejudicial to the company.

The Directive also requires further ongoing disclosures in the annual report for each AIF or the annual report of the non-listed company.

The AIFM must also provide its regulator and the AIF investors with information on the financing of the acquisition.

"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 when structuring transactions.

Leverage

Leverage is: "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". It includes "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 (including any chain of newcos through which the operating company is held).

AIFM are required to set leverage limits in respect of each AIF they manage.

AIFM must be able to demonstrate that the leverage limits it has set are reasonable and are complied with at all times. AIFM are required to disclose to AIF investors, pre-investment (and whenever there is a material change) the circumstances in which the AIF may use leverage, any restrictions on the use of leverage, and the types, sources and maximum level of leverage permitted.

AIFM which manage AIF that employ leverage "on a substantial basis" are subject to leverage reporting requirements in respect of all its AIF. 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 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.

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.

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.

Conduct of business requirements

Certain general conduct of business principles are applicable to the AIFM. They may seem relatively innocuous, but similar provisions in MiFID have provided the basis for detailed regulation in Level 2 legislation. The principles include requirements to:

- act in the best interests of the AIF, or the investors in the AIF, and the integrity of the market;
- act honestly, fairly and with due skill, care and diligence;
- treat all AIF investors fairly;
- identify, manage, monitor and disclose conflicts of interest.

Risk management

The AIFM is required (amongst other things) to:

- "functionally and hierarchically" separate risk management from portfolio management; Member States may disapply this requirement if there are adequate safeguards against conflicts of interest and the risk management process is both compliant and effective;
- implement adequate risk management systems to identify, measure, manage and monitor the risks associated with each AIF's investment strategy; and
- follow a documented and regularly updated due diligence process for investment.

Liquidity management

The AIFM must (except in relation to unleveraged closed-ended funds):

- adopt appropriate liquidity management procedures to ensure that the liquidity profile of investments complies with the AIF's "underlying obligations", e.g. in relation to redemptions;
- regularly conduct stress tests and monitor the AIF's liquidity risk; and
- ensure that each AIF's investment strategy, redemption policy and liquidity profile are consistent with each other.

Investing in securitised investments

There will be restrictions on investment in securitisations by AIFM. The Commission will be obliged to lay down requirements which must be met by originators, sponsors or original lenders before the AIFM can invest an AIF in a securitisation. This will include a requirement that the originator, sponsor or original lender retain at least a 5% net economic interest. The Directive will also amend the UCITS IV Directive to provide for equivalent restrictions on UCITS.

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.

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Appendix: Indicative Timeline