EUROPEAN PRIVATE EQUITY AND
VENTURE CAPITAL ASSOCIATION

AIFMD Essentials

A guide to the
Alternative Investment
Fund Managers Directive

EVCA PUBLIC AFFAIRS

What's inside?

Foreword:

Essentials is your comprehensive guide to the Alternative Investment Fund Managers Directive

By Dörte Höppner,
Secretary-General, EVCA

Find out more

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Foreword

From Dörte Höppner, EVCA

Essentials is **your comprehensive guide** to the Alternative Investment Fund Managers Directive (AIFMD), **covering both the original Directive and recent implementing regulations and guidelines**. It addresses when and how to seek authorisation; how to ensure your compliance; and how the AIFMD will affect and apply to non-EU fund managers.

The AIFMD marks us out as an established asset class. While we are pleased that the Directive is more proportionate and tailored than that originally proposed five years ago, the EVCA's work does not end with the implementation deadline of 22 July 2013. We will work closely with regulators to monitor transposition in member states and address any challenges to a level playing field across Europe. We will also make the case for an appropriate third country regime.

Importantly, the EVCA will continue to promote the benefits of European private equity before 2017's scheduled review of the Directive, known as AIFMD II. It is vital that we, with our fellow associations, keep up our engagement in advance of 2017 to ensure this regulation remains proportionate, while engaging on the many other items of legislation that have the potential to affect our industry.

I predict Essentials will fast become an indispensable companion for practitioners as we move into a new era of pan-European regulation. I would like to thank all of the EVCA members who gave their valuable time to help to produce this guide.

Dörte Höppner
EVCA Secretary-General

Chapter one: **Scope**

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In this section

Primary contributors: James Bermingham (top) and Anne Holm Rannaleet (below)

The AIFMD regulates the management and marketing of alternative investment funds (AIFs) in the European Economic Area[1].

AIFs are a particular type of collective investment undertaking (referred to as funds) that raise capital from a number of investors with a view to investing that capital in accordance with a defined investment policy and which are not otherwise caught by the UCITS Directive. These are expected to include most types of private equity fund. This is because all investment vehicles, irrespective of legal form, are likely to be seen by national authorities as raising capital from investors for the purpose of collective investment. Whether or not specific vehicles, such as co-investment vehicles, are categorised as AIFs may differ between member states based on national interpretations.

Fund management includes taking investment and divestment decisions and/or controlling investment-related risks, and may also include a number of ancillary activities such as marketing, administration and the provision of services to fund assets. Marketing is best understood as making fund-related securities available for purchase within the EEA by locally-based investors (so typically in private equity, offering participations in a fund). This includes both direct offerings and, for example, those made available indirectly through a placement agent.

Managers operating closed-end, unleveraged funds in the EEA with assets worth EUR 500 million or less (calculated on a rolling basis in accordance with the AIFMD Regulations), need only comply with national registration and reporting requirements. If these managers want the benefit of a passport to make an offering in different EEA member states, then they must either opt-in to the scope of the Directive or make use of any other passport rights that may be available (e.g. under the EuVECA[2] or EuSEF[3] Regulations) or continue to rely, on a case-by-case basis, on applicable national placement rules.

1 The European Economic Area (EEA) unites the 28 EU member states and the three EEA EFTA States (Iceland, Liechtenstein, and Norway).

2 Regulation (345/2013) of the European Parliament and of the Council of 17 April 2013 on European venture capital funds (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:115:0001:0017:EN:PDF)

3 Regulation (346/2013) of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:115:0018:0038:EN:PDF)

General

The AIFMD is intended to establish a harmonised regulatory framework for the management and marketing of AIFs in the EEA.

The Directive regulates the manager (AIFM) rather than the AIF itself. An AIF may be additionally regulated and supervised at national level, for example if it is a Qualified Investor Fund or similar. The Directive applies to AIFMs established in any member state of the EEA which manage one or more AIFs irrespective of where the AIF is established. In addition, the Directive applies to AIFMs that are established outside the EEA to the extent that they offer or place interests in non-EEA AIFs to EEA-based investors within the EEA. From 2015, it will apply to non-EEA managers managing AIFs established in the EEA. The AIFMD does not apply to managers that neither manage nor market AIFs in the EEA.

The scope of the AIFMD is particularly important because it will also be relevant for other regulatory and fiscal initiatives within the EEA. This is because private equity and venture capital managers as "regulated entities", together with the AIF, are now defined participants in the EEA financial markets legal infrastructure.

"A **harmonised regulatory framework** for the management and marketing of AIFs in the EEA."

Alternative investment funds

Collective investment undertakings (referred to as funds) can take any legal form. Funds are best understood as undertakings that pool capital raised from a number of passive investors for the purpose of collective investment.

Pooling occurs between investors participating in a legal arrangement (e.g. a company, limited partnership, contractual scheme or a trust) which results in the sharing of investment risks. A private equity fund comprising multiple partnerships will normally comprise multiple AIFs (unless perhaps, the different pools are identical).

Funds (other than UCITS) constitute AIFs if they:

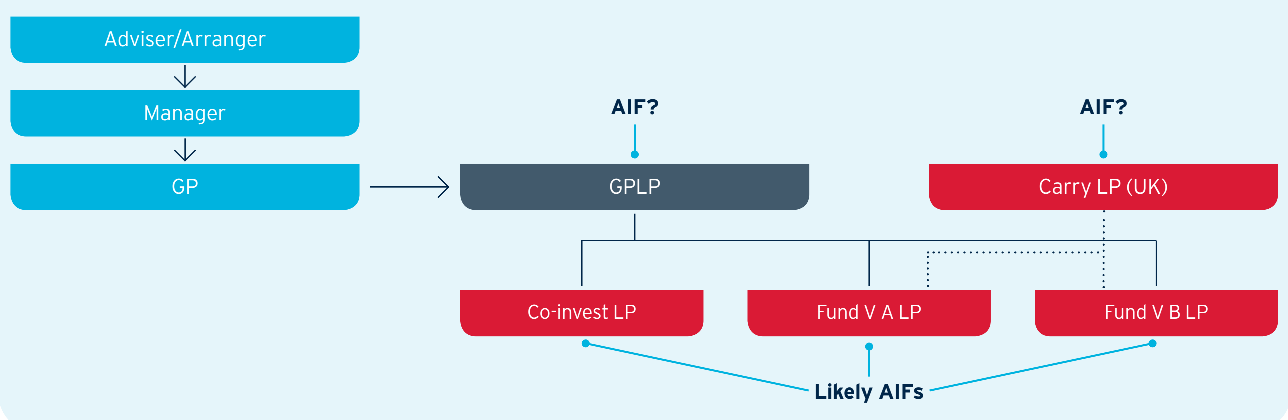
- raise capital
- from a number of investors
- with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

Capital-raising is best understood as the process of facilitating subscriptions. An investment policy must be set out with a requisite level of definition in an offering or other document. A defined investment policy is a fixed ongoing obligation that restricts the AIFM from carrying on general business (although the fact that it is not technically binding should not be used to facilitate circumvention). The investment policy must be defined in relation to investors and, therefore, commercial investment undertakings acting in the ordinary course of trade would not have a defined investment policy for the purposes of the Directive.

Generally, an entity should not be considered as an AIF unless all the elements of the definition are present.

Each AIFM will need to identify which entities will constitute an AIF (see Figure 1 below).

Figure 1: Identifying AIFs



> ESMA has published **technical guidance** on these concepts in order to ensure common, **uniform and consistent interpretation** across the EEA.

ESMA has published technical guidance on these concepts in order to ensure common, uniform and consistent interpretation across the EEA; however, it remains to be seen whether this will be effective. This is because the term 'AIF' is not specifically defined by it and the concept has different established use across the EEA.

EEA AIF

An AIF should be defined in accordance with the law of its domicile. An AIF is an EEA AIF if it is authorised or registered as an AIF in a member state or otherwise has a registered office in a member state.

Out of scope

The following AIFs do not qualify as in-scope AIFs under the AIFMD:

- vehicles that fall outside the definition of an AIF in different jurisdictions;

  These could include on a case-by-case basis:

a) single investor funds, unless the single investor is simply a nominee for multiple investors or part of another arrangement achieving the same result;

b) vehicles established for non-business related purposes;

c) undertakings carried on for a general commercial or industrial purpose and not collective investment;

d) commercial joint ventures between active participants where, for example, (i) no single party is in de facto control and/or (ii) capital is not raised from external parties;

e) private equity acquisition vehicles (including those where management participates);

f) arrangements that do not pool capital, such as separate accounts or co-ownership arrangements (provided that they are not seen as a fund in the relevant state);

g) vehicles that do not raise external capital, such as family offices and carried interest vehicles;

h) employee participation schemes, which could include staff carried interest and co-investment schemes (but probably not if participation is offered more widely to "friends" of the manager); and

i) funds which are not naturally intended to have a binding investment policy, such as some pledge or club arrangements.

If a vehicle is not structured as a fund, then it is likely to be out-of-scope. The AIFMD is targeted at funds.

- funds managed by AIFMs falling below the applicable threshold tests (see below on page 10);

  Other exempted vehicles including:

a) AIFs whose only investors are other group companies of the manager, provided that none of those investors is an AIF;

b) holding companies, which are defined as companies carrying out a business strategy or strategies through their affiliates in order to contribute to their long-term value. Such companies should be operating for their own account if listed on a regulated market in Europe although the mere fact of being listed is not in itself enough to warrant exemption, or not established for the purpose of generating returns for investors by the sale of its subsidiaries or affiliates. The term 'company' is intended here in a broad sense; and

c) certain securitisation special purpose vehicles (as described by ECB Regulation 24/2009) including most Collateralised Loan Obligation vehicles,

- any additional vehicles excluded at a national level (such as, possibly, real estate investment trusts in certain member states).

Management

Each AIF based within the EEA must appoint an external management company as an AIFM unless its legal form permits internal management. It is this external AIFM, or the AIF itself where internally managed, which is subject to authorisation and regulation (including restrictions on its activities).

Internally or externally managed?

Internal and external management is not precisely defined by the AIFMD. An internally managed fund would logically include a corporate AIF managed by its board of directors, but the position of a general partner of a limited partnership is less clear and, where the general partner is the AIFM, the limited partnership could be viewed as internally or externally managed depending on the jurisdiction. This distinction is likely to be important as it will determine what minimum capital requirements will apply.

"Managing" the AIF means providing by way of regular business at least the following:

- portfolio management (taking investment and divestment decisions on behalf of the fund); or
- risk management (establishing and implementing risk management procedures and policies for identifying risks, e.g. ensuring a fund does not over commit, makes timely drawdowns and distributions, respects diversification rules, handles foreign exchange risks etc.).

This is a binary test that may result in an AIF having more than one manager. Where an AIF does have more than one manager, the managers must decide between themselves which is the AIFM that will be primarily responsible for ensuring compliance with the Directive (see Figure 2 below). The second manager who is not responsible for ensuring compliance with the Directive will be treated as a delegate of the AIFM.

Dual managers

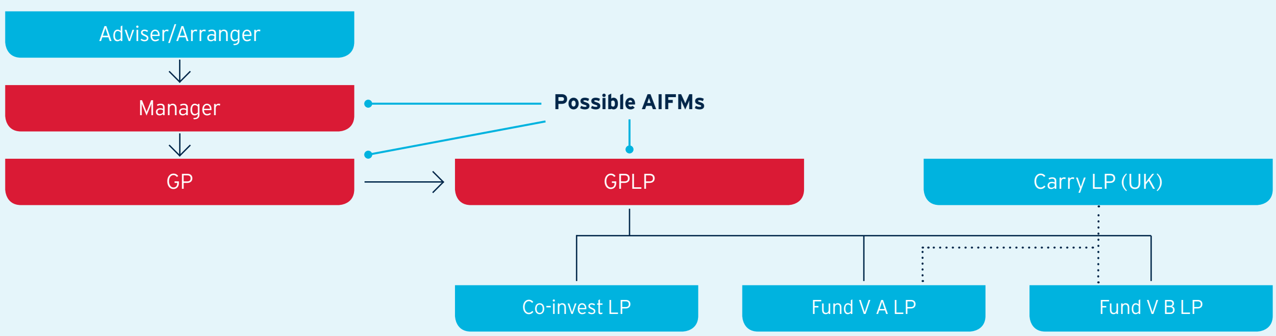
The need for dual managers could arise in a private equity context where, for example, a non-EEA manager managing an EEA AIF wanted to make immediate use of the marketing passport. This could be achieved by an advisor assuming responsibility for risk management.

Whichever entity is an AIFM, the term "managing" will essentially consist of a limited number of activities where investment management or controlling risk is performed in a classic private equity context.

The manager may also perform ancillary activities such as administration or marketing of the AIF or other services related to fund assets; however, none of these ancillary activities on their own constitute managing.

Management should not be confused with other activities related to the assets of the AIF, and does not include stand-alone investment advice. Investment advice is identified as a non-core service.

Figure 2: Identifying AIFMs



Marketing

The term 'marketing' has a specific meaning under the AIFMD that is similar to UCITS. It is defined as the offering, or placement within the EEA of fund-related securities to investors which are domiciled, or have a registered office, within the EEA where the offering or placement is by, at the initiative of or on behalf of the AIFM. It does not ordinarily include broader promotional activities carried out by related parties (i.e. the key question is whether units or shares of an AIF are being made available by the AIFM for purchase by potential investors). It should be clear in most circumstances from the documents themselves when a contractual offering or placing is being made as opposed to a general promotion. In order to be "marketing" within the scope of the Directive, therefore an offer, or placing, must be at the initiative of the manager, and may be made directly by it, or indirectly by an agent acting on its behalf (such as a placement agent).

Some member state regulators (including those in Germany and the UK) have expressed that in their view "marketing" is something which happens late in a fund-raising process, when the investor has all of the information they need to make a decision about whether or not to invest. On that basis, the definition of marketing does not include pre-closing discussions or broader promotional activities including the provision of draft or generic documents to potential investors. On the other hand, such activities could be subject to local laws and rules, such as the financial promotion regime in the UK.

Generally, secondary market activity in fund interests does not involve "marketing" because it is not at the initiative of the AIFM or on behalf of the AIFM. This may be particularly relevant in relation to existing listed vehicles.

Some member state regulators (including those in Germany and the UK) have expressed that in their view **"marketing" is something which happens late in a fund-raising process.**

In addition, marketing does not occur where an EEA-based investor invests in an AIF at its own initiative. This is called 'reverse solicitation'. It is already a concept recognised in some regions where complex marketing restrictions apply. There is at the time of writing no consensus between regulators as to what constitutes "reverse solicitation".

Interpretations are likely to differ between member states.

For example, it must in theory be possible for an existing investor in a fund raised before the Directive came into force to approach the manager entirely of its own initiative with a view to investment in a successor fund managed by the same manager (which had not been marketed to that investor owing to restrictions imposed by the Directive or local private placement regimes). Everything will turn on the facts in the particular case. However, it is possible that regulators and courts in some member states might not agree.

It is therefore very important to create a clear audit trail if an investor proposes investment of its own initiative.

The terms 'unit' and 'share' are intended to be generic and may be interpreted as encompassing all forms of AIF-related interests (including some debt interests).

Managers whose AIF assets under management fall below certain thresholds

EEA-based AIFMs that manage:

- AIF portfolios whose assets, including any assets acquired through the use of leverage, in total do not exceed EUR 100 million; or
- portfolios of AIFs whose assets under management in total do not exceed EUR 500 million where the portfolio consists of AIFs that are not leveraged and have no redemption rights exercisable during the first five years following the initial closing of such AIF (i.e. a typical private equity fund arrangement),

are subject to a simplified registration and reporting regime in the relevant jurisdiction and are exempted from the requirements of the AIFMD.

For these purposes a manager must include assets under management (AUM) of AIFs which are managed by it directly, or indirectly through a company with which the manager is linked by common management or control, or by a substantive direct or indirect holding. This is an anti-avoidance provision and the mere fact that two managers of clearly separate funds are under common control should not require their assets to be aggregated for the purposes of applying the *de minimis* size thresholds to either of them.

For the purposes of applying the small funds' exemption, 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 otherwise.

> If an AIF borrows monies on a short-term basis to pre-fund capital calls backed by investor commitments, then **this should not constitute leverage.**

The Regulations also make clear that borrowing undertaken by private equity acquisition companies should not be considered to be leverage of the fund, where its limited recourse nature does not increase the exposure of the AIF, for example, the AIF does not guarantee portfolio company borrowing. There is scope for interpretation however, and national variations may exist.

If an AIF borrows monies on a short-term basis to pre-fund capital calls backed by investor commitments (i.e. a typical investor bridge facility), then this should not constitute leverage (as long as the borrowing is not expressed to have a permanent nature).

For these purposes, assets under management means gross asset value calculated in accordance with the valuation rules set out in the fund's own constitutional documents. This is likely to be lower than committed capital.

Impact: On Investors

No EEA investor (professional or not) is subject to the AIFMD in its capacity as an investor. The AIFMD only deals with the authorisation of AIFMs, i.e. managers, and the compliance burden falls squarely on them. Nonetheless, the impact of the cost of compliance is something that will impact investors insofar as any costs of compliance are borne by the fund.

Professional investors established in the EEA will be able to continue to invest in AIFs at their own initiative. Investors should note, however, the possibility that regulators in different member states may take different views of what constitutes reverse solicitation and what is regarded as marketing by the AIFM.

Impact: On Fund-of-Funds (FoF)

Authorisation is required under the AIFMD if a FoF manager intends either to manage or market an AIF within the EEA. The authorisation is applied to the FoF manager, as the AIFM of the FoF. Investments made by that FoF in underlying AIFs are made as an investor only, and the AIFM of the FoF has no obligations in relation to the management of the underlying AIF(s). A FoF is not restricted from investing in non-qualifying AIFs (such as funds managed by AIFMs whose AUM fall below the threshold or third country funds).

Please also note the specific marketing rules applicable to EEA feeder AIFs in Chapter 4.

Below threshold managers

EEA managers that are exempted from the AIFMD on the basis of the *de minimis* exemption (i.e. on the basis that their AUM are below the threshold) must nonetheless register with the relevant national authorities. On registration, the manager must provide the authorities with details of the AIF that it manages and their investment strategies and, once registered, the manager must regularly provide information to the national regulator on the main instruments in which it trades, its principal exposures and the most important concentrations of the AIF that it manages (which in a private equity context is likely to involve disclosing the largest portfolio company investments), to facilitate the ongoing monitoring of systemic risks. The precise nature of this registration regime is likely to vary in different jurisdictions.

The AIFMD does not otherwise apply to managers with AUM below the threshold unless a member state chooses to apply it in this way to AIFMs established in its jurisdiction. In particular, the Directive's rules concerning delegation of portfolio or risk management (one of which concerns "letter-box entities" – see below on page 49) will not apply to them.

While managers below the thresholds do not benefit from the marketing passport granted by the Directive (i.e. to manage and market funds freely across the EEA), they may be allowed to continue cross-border marketing in the EEA but this will depend upon the national placement regimes of each member state. If a marketing passport is desired or required, small fund managers may opt-in to the Directive or look to make use of any other passport rights under the Regulations for European Venture Capital Funds (EuVECA), or European Social Entrepreneurship Funds (EuSEF).

Impact: On Investors

Investors should arrange their affairs to ensure that regulatory changes do not impact their ability to invest in all AIFs.

Investors will want to be able to access AIFs and so it will be important for investors to check that AIFMs of below threshold AIFs are able to market their AIFs under the appropriate regime (opting-in to use the AIFMD passport or using the relevant national placement regime) or to make sure that other arrangements are made ensuring they continue to have access to different investment opportunities, irrespective of where the fund or manager may be domiciled. This may require greater proactivity on the part of investors.

Some investors may have a preference for investing only in regulated and/or authorised funds and for those investors they ought to consider the impact of the AIFMD on their investment policy for AIFMs of sub-threshold AIFs.

Impact: On Fund-of-Funds (FoF)

The FoF manager is the authorised AIFM and not the underlying managers. It should be of no consequence, therefore, whether or not an underlying manager is operating under a threshold exemption. That underlying manager does, of course, need to inform its own investors, including a FoF, of any changed status.

An underlying manager deciding to forego the threshold exemption and opt-in to the entire AIFMD may incur additional costs altering the investment case on which a FoF may have made its original investment decision, so full consultation is advisable before any such decisions are taken.

Transposition and grandfathering

The AIFMD should be transposed by EEA member states into national law by 22 July 2013. As a general position, an EEA-based AIFM will need to submit an application for authorisation as soon as is practicable and no later than one year after the transposition date (i.e. by 22 July 2014). On 22 July 2014 it must comply in all other respects with the Directive's requirements. The European Commission has indicated that, in the interim, it expects AIFMs to use best efforts to comply with all relevant provisions of the Directive, insofar as this is reasonable. At the time of writing, it appears that some member state regulators are taking a different position, and treating the grandfathering provision as absolute. Everything depends on the specific implementing legislation in each member state.

Some member state authorities intend to go even further and provide that, if a non-EEA manager is marketing an AIF in their jurisdiction (or, in some cases, anywhere in the EEA) before 22 July 2013, that manager may continue to market that AIF (and possibly other AIFs) until 22 July 2014 on the basis of domestic placement laws alone, and without otherwise complying with Directive requirements. The position in this respect is very likely to differ between member states.

"The European Commission has indicated that, **in the interim, it expects AIFMs to use best efforts to comply with all relevant provisions of the Directive**, insofar as this is reasonable."

There are specific grandfathering rules for:

- Public AIFs

  The marketing provisions of the AIFMD do not apply to the marketing of AIF-related securities that are subject to a current offer to the public under a prospectus that has been drawn up, and published, in accordance with the Prospectus Directive before the transposition deadline. This is, however, only the case provided that the prospectus is valid.

- Closed-end AIFs that are fully invested

  AIFMs which manage existing closed-end AIFs that do not make any additional investments after 22 July 2013 can continue to manage such AIF(s) without authorisation under the AIFMD. If they also manage other AIFs which are within the scope of the Directive, then they need not conform to Directive requirements in respect of the grandfathered AIF(s) (although the position in this respect may differ between member states).

  Follow-on investments should not be considered as additional investments for the purposes of these rules where these are modest by reference to the value of the fund and aimed at maintaining the value of existing investments (i.e. they are not new investments in nature).

  Crudely, this may mean that modest equity cure follow-ons would not be considered as "additional investments", whereas this may not be the case for fund financing buy-and-build strategies. However, it is also possible that EEA member states will interpret this in different ways.

  As most private equity funds have an investment period of five years, this would imply that most private equity funds raised five years before the transposition deadline (i.e. before early 2008) should be exempt from authorisation.

- Closed-end AIFs with a fixed life-span

  AIFMs which manage closed-end AIFs whose subscription period for investors closed before 22 July 2011 (i.e. held a final closing before this date) and that must be liquidated before 22 July 2016 (i.e. which are constituted for a period of time that expires before that date), may continue to manage such AIF(s) without needing to submit an application for authorisation, or needing to comply with the AIFMD in respect of that AIF. AIFMs with such funds must, however, comply with the annual report requirements and, where relevant, the transparency and anti-asset stripping provisions in relation to EU portfolio companies.

As most private equity funds have an investment period of five years, this would imply that **most private equity funds raised five years before** the transposition deadline **should be exempt from authorisation.**

Grandfathered AIFMs that are exempt from authorisation and compliance with the AIFMD are also exempt from registration (unless otherwise required by local laws, so check with the relevant regulator).

Impact:
On Investors

It is still unclear in some jurisdictions exactly how the grandfathering provisions will be applied (in practice) and whether some existing AIFs will need restructuring or migrating. The extent to which a closed-end fully invested, but as yet not fully liquidated, AIF can be fully grandfathered will be particularly important in this regard.

Impact:
On Fund-of-Funds (FoF)

FoF managers will need to consider whether the status of any of their existing funds will require the manager to seek authorisation, and at what stage. For closed-end fully subscribed FoFs, "invested" should relate to the making of the FoF's commitment to a portfolio fund and not the contributions subsequently drawn down as no new contract is being entered into.

Marketing of third country funds

Third country private equity funds with a non-EEA AIFM, identified in accordance with the definitions used in the AIFMD, will fall outside the scope of the Directive in its entirety if final closing has taken place by transposition (i.e. 22 July 2013). This will be the case even if a third country AIFM continues to rely on investment advice supplied by an EEA-based advisory business.

Where final closing of a qualifying AIF is not achieved by the final implementation date in the relevant state, and in relation to any future funds, the AIFMD will only apply where an actual offering or placement is made to professional investors in the EEA, and subject, as described above, to any transitional relief permitted by particular member states. If such an offering is made, then the AIFM must comply with either the updated rules attaching to private placement until 2018, or from 2015 the AIFMD third country passport regime (if the anticipated timetable is followed). The updated national placement rules may require additional registrations in the relevant third country. The ability to use the national placement regimes within the EEA will also be dependent on the relevant cooperation agreements being put in place between the home regulatory authority of the AIFM and the AIF (if different) and each EEA member state into which the fund is marketed (see Chapter 6).

Where a third country fund does not constitute an AIF in an EEA member state, existing marketing rules will continue to apply. This would include the right to publish a prospectus in the EEA.

Impact:
On Investors

To enable continued access to third country funds, investors will need to ensure that the AIFMs of such AIFs have understood the arrangements which will apply to be able to continue to market under the various national placement regimes after July 2013. In jurisdictions where national placement regimes are impossible to comply with in a commercial way, investors may need to rely on reverse solicitation.

Chapter two:
Authorisation and Registration Process

2

In this section

Primary contributors: Stephanie Biggs (top) and Lisa Cawley (below)

Authorisation under AIFMD or registration with national regulator?

EEA firms whose aggregate AUM exceed the AIFMD threshold[4] must apply for authorisation under the AIFMD. An authorised AIFM:

- must comply with the AIFMD in full; and
- (upon notifying its intention to do so to its own regulator) is entitled to provide fund management services and/or market fund interests to professional investors across the EEA (known as "passporting").

Sub-threshold EEA firms whose aggregate AUM do not exceed the AIFMD threshold:

- must register with their local financial services regulator and comply with basic regulatory reporting obligations; or
- may apply for authorisation under the AIFMD on a voluntary basis in order to benefit from passporting rights.

Registered sub-threshold firms that do not opt-in to the AIFMD may, if eligible, register under the European Venture Capital Fund (EuVECA) or European Social Fund (EuSEF) regulations in order to benefit from passporting rights under those respective regimes (these are outside the scope of this briefing).

When must firms apply?

The authorisation regime for EEA AIFMs takes effect when the AIFMD comes into force on 22 July 2013.

- New firms – those which begin acting as an AIFM on or after 22 July 2013 – must be authorised under the AIFMD before providing those services.
- Existing firms – those already acting as an AIFM prior to 22 July 2013 – benefit from a one-year transitional period, and so have until 21 July 2014 to apply for authorisation.

Sub-threshold EEA AIFMs will be subject to registration from 22 July 2013 in accordance with national law applicable in their home jurisdiction.

In the longer term, non-EEA AIFMs will also be able to apply for authorisation under the AIFMD in order to benefit from passporting rights (see Chapter 6 and Annex I below). However, this will not be possible until at least 2015, so this Chapter sets out the process as it applies to EEA firms only. Until 2015 the position of non-EEA firms managing an AIF incorporated in an EEA member state, depends on the local law of the AIF's member state.

"EEA firms whose aggregate AUM exceed the AIFMD threshold **must apply for authorisation** under the AIFMD. In the longer term, **non-EEA AIFMs will also be able to apply for authorisation** under the AIFMD in order to benefit from passporting rights."

4 EUR 500 million for AIFMs which manage unleveraged funds with no redemption rights in the first five years and EUR 100 million for other AIFMs. See Chapter 1 for more information.

Applying for registration (sub-threshold firms)

The practical aspects of the registration process will be determined by individual regulators. However, the information to be provided on registration is prescribed by the AIFMD. On registration, sub-threshold firms must provide the following information:

- total AUM;
- a description of the investment strategy for each fund managed (e.g. a copy of, or extract from, the offering memorandum) specifying at least:
  - the main categories of assets in which the fund may invest;
  - any industrial, geographic or other market sectors or specific classes of assets which are the focus of the investment strategy; and
  - a description of the fund's borrowing or leverage policy.

This information must be updated annually, or more frequently if required by the regulator.

> The practical aspects of **the registration and the application process** will be determined by individual regulators.

Applying for authorisation under the AIFMD

The practical aspects of the application process will be determined by individual regulators. However, the content of the application form is prescribed by the AIFMD. The application must include:

- information about the persons who effectively conduct the business of the AIFM (*core*);
- information on the direct or indirect 10%+ shareholders (or members) of the AIFM (*core*);
- details of the firm's organisational structure, including how it intends to comply with its obligations under the AIFMD (*core*);
- information on the firm's remuneration policies and practices (*core*);
- information on any delegation of functions (*non-core*); and
- information on the fund(s) to be managed, including:
  - country of establishment (including where the master fund is established, if the fund is a feeder fund) (*core*);
  - investment strategy (*core*);
  - policy on use of leverage (*core*);
  - risk profile (*core*);
  - depositary information (*non-core*);
  - the fund agreement or other constitutional document (*non-core*);
  - the information required to be provided to investors before investment, as prescribed by the AIFMD (*non-core*).

The regulator must inform the AIFM **within three months of submission** of a complete application whether or not authorisation has been granted.

However, it is not necessary for a UCITS management company to duplicate information already provided under the UCITS Directive.

The regulator is obliged to determine the application for authorisation once the information identified above as "core" information has been provided. If, however, any "non-core" information is provided subsequently to the main application, the AIFM must not undertake fund management activities until at least one month after all required information (core and non-core) has been submitted. This applies even if authorisation has already been granted on the basis of the core information provided in the main application.

Once authorised, the firm must notify the regulator in advance of any material changes to this information. There is then a one-month waiting period (which may be extended by a further month) in which the regulator may reject the changes or impose restrictions.

How does the regulator determine whether authorisation should be granted?

To grant authorisation, the regulator must be satisfied that:[5]

- the AIFM will be able to comply with the AIFMD;
- the AIFM has sufficient regulatory capital, as prescribed by the AIFMD;
- the persons who effectively conduct the business of the AIFM are sufficiently experienced and of sufficiently good repute (and there must be at least two such persons);
- the substantial (10%+) shareholders of the AIFM are suitable;
- the head office and the registered office of the AIFM are in the same EU member state.

The regulator may not grant authorisation if effective exercise of its regulatory function is prevented by the AIFM's close links with other persons or the laws governing such persons. The regulator will consult with other relevant EU regulators if the AIFM is in the same corporate group as, or under common control with, an existing EU-regulated firm.

The regulator must inform the AIFM within three months of submission of a complete application whether or not authorisation has been granted. The regulator may extend this period for up to three additional months if necessary.

If authorisation is granted, the regulator may restrict the scope of the authorisation; in particular, it may limit the AIFM to certain investment strategies.

5 Authorised firms must meet these conditions at all times, and must notify the regulator in advance of any material changes.

Fund management activities under the AIFMD include **portfolio management and risk management.**

Limitations on other business activities

An authorised AIFM may carry on the following business activities only:

- fund management activities under the AIFMD; and
- acting as a UCITS management company, if authorised under the UCITS Directive.

Fund management activities under the AIFMD include portfolio management and risk management. As part of its AIFM functions, an AIFM may (see page 8) also undertake:

- fund administration activities;[6]
- marketing activities; and
- ancillary activities connected with the management of the fund or its portfolio, such as providing corporate finance advisory services or real estate administration services to portfolio companies and running carried interest and staff co-investment schemes to the extent that these are not AIFs.

Firms may not be authorised under the AIFMD:

- to undertake portfolio management without also being authorised to undertake risk management, or vice versa; or
- to undertake only the ancillary activities of fund administration, marketing and/or providing corporate finance and real estate services to portfolio companies without also being authorised to undertake portfolio management and risk management for AIFs.

These restrictions on the other activities that an AIFM may carry on are extremely important and must be considered very carefully. In some cases, they may force business reorganisations.

At the discretion of individual EU member states, external AIFMs may additionally be permitted to manage investment portfolios for individual clients (in effect, may offer separate managed accounts) and provide limited non-core services comprising investment advice, custody of fund interests and reception and transmission of orders pursuant to their AIFMD authorisation, but firms may not be authorised under the AIFMD:

- to perform only these additional services (as that would be a MiFID firm, not an AIFM); or
- to provide the limited non-core services without also being authorised to manage investment portfolios for individual clients.

Where an AIFM provides these additional services, certain MiFID provisions apply in relation to those activities.

6 Legal and fund management accounting services; customer inquiries; valuation and pricing, including tax returns; regulatory compliance monitoring; maintenance of the unit/shareholder register; distribution of income; unit/shares issues and redemptions; contract settlements, including certificate dispatch; and record keeping.

Withdrawal of authorisation

The regulator may withdraw a firm's authorisation where the firm:

- does not make use of the authorisation within 12 months;
- has ceased acting as an AIFM for six months;
- renounces the authorisation;
- obtained authorisation by making false statements or other irregular means;
- no longer meets the conditions for authorisation;
- has seriously or systematically infringed the AIFMD;

or where national law provides for withdrawal of authorisation by reason of matters falling outside the scope of the AIFMD.

"The **regulator may withdraw a firm's authorisation** where the firm has ceased acting as an AIFM for six months or no longer meets the conditions for authorisation."

Register of authorised AIFMs

ESMA will keep a central public register of all authorised AIFMs, as notified by EU regulators on a quarterly basis.

Impact:
On Investors

Being able to identify if an AIFM is authorised under the AIFMD will be helpful to investors when conducting due diligence (and also when carrying out anti-money laundering compliance checks), as investors can be confident that a regulator has vetted an authorised AIFM as part of the authorisation process. It should be straightforward to check the register of the competent authority to determine an AIFM's status and will bring a degree of standardization to the process when assessing AIFMs operating in different EU member states.

Investors will need to be notified if an AIFM's authorisation is materially altered or withdrawn. Before committing to an AIF, investors may want to think about how they would respond to AIFMs who are authorised at the start of the life of the AIF, but who subsequently have their authorisation withdrawn. Investors may wish to ensure this is addressed in the AIF's governing documentation.

Investors may wish to consider how, if at all, their investment criteria are impacted by AIFMs who are subthreshold and choose not to opt-in to the AIFMD (nor to the EuVECA or EuSEF). Likewise investors may wish to consider how the AIFMD will affect the cost structures of the AIFs managed by AIFMs impacted by the AIFMD.

Chapter three:

Ongoing Compliance Requirements

3

In this section

Primary contributors: Phil Bartram (top), Margaret Chamberlain (middle) and Tim Lewis (bottom)

The Directive covers the management of a very diverse range of AIFs, and makes only limited distinction between AIFs belonging to different alternative asset classes.

The requirements laid out in the Directive, such as disclosure, use of depositaries, and capital adequacy, with limited exception are the same irrespective of the nature of the AIFs under management.

This means that some of the requirements are not specifically tailored to the business model of private equity and venture capital. Existing AIFMs will have to carry out an analysis of the extent to which they have to adapt their business for it to comply with the requirements of the Directive and what the true costs of this will be.

General principles

The Directive introduces certain general principles that AIFMs must comply with on an on-going basis. These are relatively abstract. The general principles are essentially a codification of principles that are consistently applied within the private equity and venture capital industry and routinely reflected in fund documentation. Compliance by AIFMs with these general requirements will in future be supervised not only by investors but also by regulators.

In the implementing Regulation, the European Commission has elaborated on the general principles in significant ways – specifying criteria to be used by the relevant regulator to assess compliance by an AIFM with its high-level obligations. In practice, in many cases, the Regulation requires the AIFM to establish (and periodically review) detailed and granular policies and procedures. Most managers will already have processes in place which they might argue would be sufficient to allow them to achieve the high-level principles, but their processes are unlikely to be sufficiently formalised. They will need to be enshrined in formal policies and procedures. It would be prudent to conduct a formal gap analysis against each requirement of the implementing Regulation. Below, we summarise only the more significant requirements.

> The general principles are essentially **a codification of principles that are consistently applied within the private equity and venture capital industry** and routinely reflected in fund documentation.

The AIFM is required to:

- act honestly, fairly and with due skill, care and diligence in conducting its activities;
- ensure that members of its governing body have the appropriate knowledge, skills and experience, commit sufficient time to their role, and act with integrity and "independence of mind"; act in the best interests of the AIF(s) or the investors of the AIF(s) and the integrity of the market;
- establish policies and procedures for preventing malpractice, such as market abuse or improper charging of fees;
- adopt due diligence policies and procedures which refer to the fund's investment objectives and restrictions; apply a high standard of due diligence consistent with that policy, and generate records of due diligence which must be kept for at least five years; have and employ effectively the resources and procedures that are necessary for the proper performance of its business activities;
- put in place policies and procedures relating to the handling and execution of "orders" and decisions to deal on behalf of the AIF; the drafting contemplated dealings in liquid instruments through intermediaries and on formal venues (e.g. a public stock exchange), which private equity AIFMs will transact on relatively rarely, nevertheless such policies and procedures will need to be developed;
- take all reasonable steps to avoid conflicts of interests and, when they cannot be avoided, to identify, prevent, manage, monitor and where relevant, disclose those conflicts in order to: (a) prevent them from adversely affecting the interests of the AIF it manages and the AIF's investors; and (b) ensure that the AIF(s) it manages are fairly treated (there are extensive and detailed requirements concerning the conflicts policy, conflicts map and supporting procedures which should be put in place);
- comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of the AIF or the investors of the AIF and the integrity of the market (i.e. not only those deriving from the Directive);
- treat all AIF investors fairly.

No investor in an AIF may obtain a **preferential treatment unless this is disclosed in the AIF rules** or instruments of incorporation.

The AIFM must ensure that any preferential treatment accorded to one or more investors does not result in "an overall material disadvantage to other investors". No investor in an AIF may obtain a preferential treatment unless this is disclosed in the AIF rules or instruments of incorporation. Specifically, pre-investment disclosures to prospective investors must include a description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains a preferential treatment or the right to preferential treatment, a description of that preferential treatment and the type of investors who obtain it. This may prompt changes to the way that fund side letters are described in offering documents, and (unless there is a strong most-favoured-nation provision in the fund documents) may require changes to the fund closing process so that investors have an opportunity to consider side letters granted to other investors before they are bound.

Inducements

The implementing Regulation applies an "inducements rule" to AIFMs, which is expressed in similar terms to that which already applies to MiFID firms. The name of the rule is misleading because there need not be any "inducement" to improper behaviour for the rule to be relevant.

In summary, the inducements rule concerns any fee, commission or non-monetary benefit which is paid or provided to or by the AIFM in relation to its AIFM functions. AIFMs may wish to work systematically through accounting ledgers to identify relevant fees or commissions, before considering what non-monetary benefits might exist. Any such arrangement must be placed into one of three categories.

1. Fees, commissions or non-monetary benefits paid or provided to or by the AIF or a person on behalf of the AIF.
2. Fees, commissions or non-monetary benefits which are "proper fees", such as legal fees or fees paid to regulators, which by their nature do not give rise to conflicts of interest. It is thought that the requirement that a fee must be "proper" may also mean that it must not be excessive.
3. All other fees, commissions or non-monetary benefits. These are only permitted to exist if three conditions are satisfied:
   a) they do not conflict with the AIFM's duty to act in the best interest of the AIF or investors;
   b) the arrangement is "designed to enhance the quality of the... service" provided by the AIFM to the AIF; and
   c) the existence, nature and amount of the fee, commission or benefit is clearly disclosed to investors in a manner that is comprehensive, accurate and understandable, prior to the provision by the AIFM of the relevant service to the AIF. If that is not possible, then the method of calculating it must be disclosed instead. Disclosure of some details may be deferred but the AIFM will be under a continuing obligation to provide further details to investors on request.

In a private equity and venture capital context, this rule is likely to be particularly relevant to fees paid to the AIFM by portfolio companies, such as transaction arrangement fees, monitoring fees or fees for the provision of directors. An AIFM should be prepared to justify why such fees meet the three conditions listed above. It may be part of the justification that such fees are offset against the management fee, or that the manager bears the costs of aborted deals as a quid pro quo.

Disclosure to investors

An AIFM must, for each EEA AIF it manages and for each AIF it markets in the EEA, make available to investors the following information before they invest in the AIF and on any subsequent change thereof, including, but not limited to, a description of:

- the investment strategy and objectives of the AIF;
- the types of assets which the AIF may invest in, and techniques it may employ;
- associated risks (including an outline of risk management systems, the way the manger will assess the sensitivity of the portfolio to such risks and, if risk limits have been or are likely to be exceeded, a description of the circumstances and the remedial measures taken);
- any investment restrictions, types and sources of leverage permitted and associated risks, the maximum level of leverage which the AIFM may employ on behalf of the AIF; the implementing Regulation elaborates on the disclosures which must be made concerning leverage, if relevant;
- the main legal implications of the contractual relationship entered into by the investor;
- the identity of the AIFM, the AIF's depositary, auditor and any other service providers;
- a description of any delegated management function and any safekeeping function delegated by the depositary, and any conflicts of interest that may arise from the delegation;
- the AIF's valuation procedure and pricing methodology;
- all fees, charges and expenses and the maximum amounts thereof which are directly and indirectly borne by the investors;
- the latest net asset value of the AIF and historic performance information (where available); and
- any preferential treatment for individual investors, the type of investors that are granted preferential treatment, and their links (if any) to the AIF and the AIFM (see above on page 22 as to the impact on side letter arrangements and the fund closing process).

“An AIFM must, for each EEA AIF it manages and for each AIF it markets in the EEA, **make information available to investors** before they invest in the AIF.”

Impact:
On Investors

A standardised approach to the presentation of this information would make it easier for investors to check that they have received the required information. There is a timing challenge here as any preferential terms are generally negotiated during the marketing of an AIF, so it is possible that one investor has committed to investment prior to preferential terms being negotiated with another investor. A full most-favoured-nation provision in the fund constitutional documents may help to mitigate this timing risk.

Impact:
On Fund-of-Funds (FoF)

A key point FoF managers should be aware of is that this requirement to disclose information to investors also applies to investors in their funds.

Annual reports

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

There should be no need to prepare an annual report for accounting periods ending before the AIFM becomes subject to the Directive. The AIFM should still be entitled to obtain authorisation, a management or marketing passport and/or to market on a private placement basis before it has prepared, and had audited, its first Directive-compliant annual report, provided all other conditions are met.

The annual report must be provided to:

- investors, on request; and
- the home member state competent authority of the AIFM and, where applicable, of the AIF.

A non-EEA manager must also provide the annual report to the competent authority in each jurisdiction in which it has marketed. (It is to be hoped that such AIFMs will not be required to continue providing annual reports to regulators in jurisdictions in which they marketed unsuccessfully and have no investors.)

Public disclosure is not required.

"The AIFM must **prepare an annual report** in respect **of each EEA AIF it manages** and each AIF it markets in the EEA."

Content of the annual report

The annual report must include:

- an audited balance sheet or statement of assets and liabilities; the implementing Regulation specifies in some detail the items which must be included and the way the information must be presented;
- an audited income and expenditure account;
- a report on the fund's activities over the year (again, the implementing Regulation elaborates);
- any material changes during the financial year covered in respect of the information required to be disclosed to investors pre-investment (see above on page 24); such changes are deemed material if there is a substantial likelihood that a reasonable investor becoming aware of the information would reconsider its investment in the AIF;
- certain disclosures about remuneration of certain staff of the AIFM (see below on page 41).

Disclosures in the annual report about remuneration

The following items must be disclosed:

- the total amount of remuneration paid by the AIFM to its staff for the financial year, including (a) the split between fixed and variable remuneration; (b) the number of beneficiaries; and (c) carried interest where relevant; and
- the aggregate amount of remuneration for senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

Such disclosures concerning the AIFM must be broken down by AIF (insofar as this information exists or is readily available), with a description of how the allocation has been arrived at.

(There is some choice as to how to present the first item: (i) as a simple total relating to the entire staff of the AIFM, and the number of them; (ii) as the total remuneration of those staff of the AIFM who are fully or partly involved in the activities of the AIF, including the number of them; and/or (iii) as the proportion of the total remuneration of the staff of the AIFM attributable to the relevant AIF, and the number of them.)

The annual report must also include general information on remuneration policies and practices – enough to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interest.

AIFs subject to the Transparency Directive

AIFs subject to the Transparency Directive[7] (e.g. a listed private equity investment trust to the extent it falls to be categorised as an AIF) 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 on request, 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 fund rules and in accordance with accounting standards applicable to the fund or (for non-EEA AIFs) the country where the AIF has its registered office (although there remains some uncertainty, it is thought that this means whatever accounting policy is provided for in the fund's constitutional documents unless mandatory local law specifies some other accounting standards applicable to the vehicle – the Directive itself does not specify any); and
- audited by an EEA auditor or (for non-EEA AIFs 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 AIFs without a registered office.

Impact:
On Investors

In practical terms investors will continue to receive annual reports much as they have in the past. Under the Directive, however, the main difference will be that the reports will contain more information regarding remuneration than in the past.

Impact:
On Fund-of-Funds (FoF)

The main challenge for FoF managers will be the practical one of meeting the reporting timetable. The FoF manager's ability to report will be driven by how promptly the underlying managers report to the FoF. If those underlying managers take the full six-month window to report (or are managers outside the scope of the Directive and who may therefore plan to take longer to report), then it is challenging to expect the FoF manager to report within the same timeframe. Some flexibility may be necessary to ensure that the FoF manager is able to meet its mandated deadline in the event of late reporting from its underlying managers.

FoF managers should be aware that any of their existing AIFs, which will not make any further investments after transposition in 2013, do not need to produce an annual report.

Those FoF managers who are managing listed or public investment companies should note that the four-month annual report publication timeframe specified by the Transparency Directive still applies.

"AIFs subject to the Transparency Directive may fulfil their obligation to disclose details by **including them within the public annual report.**"

7 Directive 2004/109 of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0038:EN:PDF)

Regulatory reporting

The AIFMD, together with the AIFMD Regulations, introduce new regulatory reporting requirements for AIFMs including all AIFMs based in the EEA as well as non-EEA AIFMs which either manage an EEA AIF or market within the EEA. Reporting is made to relevant national regulators.

The reporting template breaks down into four broad parts:

- the first part covers information on the main instruments traded by the AIFM and individual exposures, including information about investment strategy, geographical focus, individual exposures and portfolio turnover;
- the second part covers information on an AIF's strategies, its main instruments which it trades, its principal exposures at the reporting date, most important portfolio concentrations, principal markets and investor concentration;
- the third part covers information on individual exposures, value of turnover, dominant influence (for private equity funds), market risk profile, counterparty risk profile, liquidity profile (including investor redemptions and side letters), borrowing risk, exposure risk and historical risk profile; and
- the fourth part covers information on AIFs employing leverage on a substantial basis.

Only the first two parts of the proposed template need to be completed by AIFMs falling below the threshold tests. All "full scope" EEA and non-EEA AIFMs must report more extensively by completing the third part of the template. AIFMs which manage AIFs employing leverage on a substantial basis (i.e. three times its net asset value) must further complete part 4.

Frequency of reporting

a) For AIFMs managing portfolios of AIFs with total AUM above the threshold exemptions but not more than EUR 1 billion, reporting is half-yearly.

b) For AIFMs managing portfolios of AIFs with total AUM in excess of EUR 1 billion, reporting is quarterly.

c) For AIFMs falling within paragraph a) above, for each AIF with total AUM in excess of EUR 500 million, reporting must be quarterly for that particular AIF.

d) For all AIFMs managing AIFs which are unleveraged and invest in non-listed companies to acquire control (private equity), reporting is annual.

Reporting periods are likely to be based on calendar years and must be made within one month of the end of each reporting period. If the AIF is a fund-of-funds, this period may be extended by 15 days.

National regulators can require additional reporting under the AIFMD where necessary for the effective monitoring of systemic risk.

ESMA took the view that there was need to supplement the AIFMD Regulation with further guidelines on reporting obligations to ensure the greater standardisation of information sent to national competent authorities to facilitate the easy exchange of information. The consultation closed on 1 July and, therefore, the final position is not yet known. More details can be found in the EVCA's response to the ESMA consultation (available on the EVCA website).

"**Reporting periods are likely to be based on calendar years** and must be made within one month of the end of each reporting period."

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Annex I

Capital requirements

AIFMs will be required:

(i) to have a minimum amount of "initial capital" plus a minimum amount of "own funds";

(ii) to maintain qualifying professional indemnity insurance (PII) 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".

There are two important qualifications to these standard requirements:

- An AIFM which is also authorised as a UCITS management company will only be subject to the requirements in (ii) and (iii) (as the UCITS Directive sets the initial capital and own funds requirements for this type of investment manager); and
- An AIFM which obtains a "top-up permission" to conduct certain MiFID activities (to the extent that option is made available in its member state), such as segregated investment management, will be subject to both the AIFMD capital requirements and the capital requirements deriving from the Banking Consolidation Directive and Capital Adequacy Directive, collectively known as the Capital Requirements Directive ("CRD") (although those are themselves subject to change under the Capital Requirements Regulation and fourth Capital Requirements Directive ("CRR/CRDIV").

"Initial capital and own funds are **two ways of measuring** what are essentially shareholder funds."

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

These definitions are derived from the CRD. "Initial capital" and "own funds" are two ways of measuring what are essentially "shareholder funds" (after deducting adjustments, e.g. for accrued losses). Certain types of preference shares and subordinated debt can be counted towards "own funds".

Member states may permit AIFMs to meet up to 50% of their own funds requirement through a guarantee from certain banks or insurers. Not all member states permit this option.

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. As at 22 July 2013 it is not known whether these changes will materially impact AIFMs. CRR/CRDIV contain changes to the calculation of own funds. CRR/CRDIV will come into effect on 1 January 2014.

Initial capital requirement

An internally managed AIF will be required to maintain initial capital of EUR 300,000 at the time of authorisation.

An AIFM managing external AIFs will have to maintain initial capital of at least EUR 125,000 at the time of authorisation.

Own funds requirement

An AIFM (whether it is an external AIFM or an internally managed AIF) will have to maintain own funds equal to:

a) the higher of:

   i) its initial capital requirement + 0.02% of fund assets under management in excess of EUR 250 million (up to EUR 10 million); and

   ii) 1/4 of the AIFM's annual fixed overheads; plus

b) one of the following, selected by the AIFM (and in practice therefore the lower), to cover professional liability risks:

   i) 0.01% of assets under management (the "additional own funds requirement") which the applicable regulator has discretion to reduce to 0.008% case-by-case; or

   ii) if the AIFM is relying on professional indemnity insurance cover to meet the Directive requirements, then a further amount equal to the PII policy excess plus (at least in the UK) the value of any exclusions.

The own funds requirement applies **only at solo level** and not on a consolidation basis.

Fixed overheads are as defined for the purposes of the CRD. The precise test may differ between member states. They typically include (amongst other things) fixed salary costs. They typically do not include, for example, staff bonuses which are not guaranteed.

When calculating funds under management for these purposes it may be necessary to include the AUM of grandfathered AIFs (see Chapter 1 above). This may differ between member states.

The own funds requirement applies only at solo level (i.e. the level of the AIFM's unconsolidated balance sheet) and not on a consolidation basis.

The table below sets out an example of how an external AIFM with EUR 1 billion AUM would calculate its own funds requirements. The arrows indicate the likely outcome and total amount of own funds required.

Own funds ≥	Amount (EUR)	
a) Higher of		
i) EUR 125k + 0.02% AUM > EUR 250m; and	275,000	←
ii) 1/4 of fixed overheads; plus	225,000	
b) Choice of		
i) 0.01% of AUM (or 0.008%); or	100,000	←
ii) PII excess + exclusions cover	200,000	
Total own funds requirement	**375,000**	

Professional indemnity insurance

Covering Professional Liability risk by way of professional indemnity insurance

AIFMs which elect to use professional indemnity insurance to cover professional liability risk must check that the policy meets certain requirements. These include the risks which must be covered by the insurance policy, together with minimum requirements for the policy, including that:

- the policy shall have an initial term of no less than one year;
- it shall have a notice period for cancellation of at least 90 days;
- the cover for each individual claim must be at least equal to 0.7% of the value of the portfolios of the AIFs managed by the AIFM;
- the cover for claims in aggregate per year must be at least equal to 0.9% of the value of the portfolios of the AIFs managed by the AIFM.

In addition, any defined excess (and in the UK, any exclusions in the policy) must be fully covered by additional own funds. It is currently expected that for many AIFMs, these additional requirements will make professional indemnity insurance a more expensive option than the additional own funds option referred to above.

Liquid assets

The liquid assets requirement is to hold own funds (including any additional own funds) in "liquid assets or assets readily convertible into cash" equal to:

a) the higher of:

   i) 0.02% of fund assets under management in excess of EUR 250 million (up to EUR 10 million);

   ii) 1/4 of fixed annual overheads; plus

b) one of the following, selected by the AIFM (and in practice the lower):

   i) 0.01% of assets under management, which the relevant regulator may reduce to 0.008% case-by-case; or

   ii) if the AIFM is relying on professional indemnity insurance cover to meet the Directive requirements, then a further amount equal to the professional indemnity insurance excess plus any exclusions.

The following table sets out an example of how an external AIFM with EUR 1 billion AUM would calculate its liquid assets requirement. The arrows indicate the likely outcome and total amount of liquid assets required.

The UK regulator has given examples of liquid assets including:

- cash;
- readily realisable investments (not held for short term resale);
- debtors, readily convertible to cash within one month.

Liquid assets ≥	Amount (EUR)	
a) Higher of		
i) 0.02% AUM > EUR 250m; and	150,000	
ii) 1/4 of fixed overheads; plus	225,000	←
b) Choice of		
i) 0.01% of AUM (or 0.008%); or	100,000	←
ii) PII excess + exclusions cover	200,000	
Total liquid assets requirement	**325,000**	

This liquid assets requirement is an entirely new requirement in EEA financial services law. It means AIFMs are restricted in their ability to use own funds as working capital, and is a significant difference from the current requirements for MiFID investment firms.

Other requirements

Apart from the capital rules summarised above, an AIFM is also required to maintain financial resources adequate to its assessed risk profile.

AIFMs must also maintain an historical loss database to record all operational failures, loss and damage. AIFMs are required to use this as part of their risk management framework. The AIFM must use this database when formulating its risk management framework and make internal reports on operational risk exposures and losses. AIFMs are additionally required to maintain an operational risk management policy and procedure.

The historical loss database requirement and operational riskprocedures are drawn from the CRD.

Impact:
On Investors

AIFMs may have less available capital to invest alongside their investors as a consequence of the initial capital requirements. The alignment of interest between investors and managers, which is a core characteristic of the private equity and venture capital model, may be adversely impacted as a consequence of this.

Impact:
On Fund-of-Funds (FoF)

There are no specific implications for FoF managers that are any different than for other AIFMs. A FoF manager must put aside the required amount of initial capital and ensure that such sums are kept on short-term availability, at all times.

The Directive requires the AIFM to ensure that **a single depositary is appointed** for each AIF it manages, even where the AIF was established before the Directive entered into force.

Depositary

General

The Directive requires the AIFM to ensure that a single depositary is appointed for each AIF it manages, even where the AIF was established before the Directive entered into force.

For AIFMs and AIF investors, the key questions are the availability of service providers, their capacity, expertise and understanding in relation to private equity investment and the cost of their service.

What is the depositary for?

The depositary concept is borrowed from the EU's retail fund (UCITS) legislation. The European Parliament's glossary for the Directive 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 goes on to explain that a depositary typically has three core functions:

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

The need to have a single depositary for each AIF performing these roles will represent a significant, and potentially costly, change for private equity management in many EEA jurisdictions.

Some of the tasks carried out by the depositary in relation to private equity and venture capital investment will be duplicated between the AIFM and depositary because a PE/VC AIFM already performs these tasks as part of the investment and valuation process. There may also be duplication with the functions of an external auditor of the fund, if one is appointed.

Does the Directive regulate depositaries?

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 that a depositary is appointed in accordance with the requirements of the Directive for each fund it manages.

Is the requirement to have a depositary ever disapplied?

A depositary is not required in relation to non-EEA AIFs that are:

- managed by a non-EEA AIFM and marketed in the EEA via national regimes; or
- managed by an EEA AIFM but not marketed in the EEA.

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

Appointment

There must be a written contract of appointment. The implementing Regulation specifies in some detail the mandatory content of that contract, including a description of the service to be provided, statements concerning the depositary's liability, termination rights, information exchange arrangements, and operational information concerning the accounts concerned. 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 legislative 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 EEA fund must be:

- an EEA credit institution;
- a MiFID investment firm subject to the same CRD capital requirements as credit institutions; or
- a prudentially regulated and supervised institution of a type that (at the date the AIFMD enters into force) is eligible to be a UCITS depositary under the UCITS IV Directive.

For non-EEA AIFs, the depositary may also be an 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 EEA law. Additional flexibility is provided for (primarily) private equity and real estate funds whose investors have no redemption rights for five years from the date of their initial investment.

The depositary to these funds may be an entity (e.g. a fund administrator or auditor) 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. In the UK, the capital requirement will be EUR 125,000.

"Additional **flexibility is provided for (primarily) private equity and real estate funds** whose investors have no redemption rights for five years from the date of their initial investment."

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 they fulfil the requisite requirements) – whether this is possible is likely to differ between member states.

Additional restrictions apply to prime brokers which wish to act as depositary.

Where may the depositary be established?

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

- EEA AIFs
  For EEA AIFs, the depositary must be established in the AIF's home member state.

  The AIF's (or, for unregulated funds, the AIFM's) home member state competent authorities will have discretion, until four years from implementation of the Directive, to allow a depositary to be established in another member state but only if it is an EEA credit institution.
- Non-EEA AIFs
  The depositary of a non-EEA AIF must be established in the AIFM's home member state (or member state of reference, in the case of a third-country AIFM). Alternatively, the depositary may be established in the third country in which the AIF is established if the following conditions are met:
  - cooperation and information exchange arrangements must be in place between the depositary's regulator, the AIFM's home member state competent authority and the competent authority in each member state where the fund 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 fund 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 EEA law. The Commission must adopt criteria to determine this;
  - the depositary's jurisdiction must not be listed by the Financial Action Task Force (FATF) as a Non-Cooperative Country and Territory; and
  - the depositary must have agreed to:
    - accept liability to the fund or fund investors on the basis provided by the Directive (see below on page 35); and
    - comply with the Directive requirements relating to delegation by depositaries.

These 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 depositary must:

a) ensure that fund cash flows are properly monitored; the implementing Regulation requires the depositary to implement effective and proper procedures to reconcile cash flow movements and perform **daily** reconciliations – less frequent reconciliations are permitted in the case of "infrequent cash movements", which may be relevant to some private equity funds. To be clear, cash is not a custody asset and cash monitoring should not be confused with safekeeping obligations and the duty is limited to the fund itself, no look-through obligation applies;

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

- a central bank;
- an EEA credit institution;
- a bank authorised in a third 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 EEA law;

c) hold in custody the financial instruments belonging to the fund that:

- can be physically delivered (e.g. bearer instruments); or
- can be registered in a financial instruments account opened in the depositary's books

  the above are called "custody assets", and the Regulation provides more detail as to what falls within this concept;

d) for all other assets of the fund (so called "non-custody assets" – see further below), verify whether the fund (or the AIFM on its behalf) has ownership of the asset and, if so, maintain a record evidencing ownership; this obligation will apply on a "look-through" basis to the underlying assets held by entities controlled directly or indirectly by the AIF or AIFM;

Looking-through by the FoF

The look-through obligation in relation to controlled assets does not apply to fund-of-funds and master-feeder structures where the underlying funds have some form of depositary (not necessarily a depositary conforming to Directive standards) which provides ownership verification and record-keeping functions for the underlying fund or vehicle's assets. Also, it does not apply in relation to a fund-of-fund where its AIFM has no direct or indirect control over the underlying fund or vehicle.

e) ensure transactions in fund units/shares are carried out in accordance with applicable national law and the fund rules;

f) ensure fund shares/units are valued in accordance with applicable national law, the fund rules and Directive valuation requirements (see the section on Valuation as of page 42);

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

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

i) ensure fund income is applied in accordance with applicable national law and the fund rules (as set out in the AIF's governing documentation); and

j) act independently, honestly, fairly and professionally and in the interest of the fund and fund investors. It seems likely that these requirements will necessarily lead to the depositary being involved to some extent in or in the run up to both fund closings and transaction closings, which may have both cost and timetable implications.

The drafting of the legislation which defines "custody assets" is complex, the underlying legislative intention was (we understand) that investments in private companies which are registered in the name of the fund on the issuer's register should not be treated as "custody assets". This is also reflected in the implementing Regulation, which provides that "non-custody assets" are defined to include "financial instruments which (...) are only directly registered in the name of the AIF with the issuer itself or its agent, such as a registrar or transfer agent". It is unclear if the AIF can use a nominee to be registered for it, this may depend on the view of local member state regulators.

Limits on delegation

A depositary may delegate only the tasks referred to in (c) and (d) above.

Delegation of these tasks 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 fund assets without informing the depositary in advance and obtaining the prior consent of the fund (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.

The impact of these requirements on the ability of a professional services firm depositary to delegate to another such firm is unclear. For instance, it is unclear what "effective prudential requirements" requires in these circumstances. Where the law of a non-EEA 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 fund investors are informed prior to their investment; and
- the fund (or the AIFM on its behalf) instructs the depositary to delegate to that sub-custodian.

Sub-delegation is permitted, provided that the criteria for delegation are also met in relation to the sub-delegation.

What are 'financial instruments that can be held in custody'?

Financial instruments

Pursuant to the terms of the AIFMD, 'financial instruments' are defined to include those instruments specified in Annex I, section C of the MiFID Directive. In broad terms, this includes:

1. transferable securities;
2. money-market instruments;
3. units in collective investment undertakings; and
4. various derivative contracts.

Held in custody

Financial instruments will be considered to be capable of being 'held in custody' in the following circumstances:

1. **Bearer securities:** financial instruments that can be physically delivered to the depositary will always be considered to be 'held in custody'.
2. **Electronically settled securities:** the following financial instruments will be considered to be 'held in custody' when they are registered or held in an account directly or indirectly in the name of the depositary:
   a) transferable securities (including those that embed derivatives[8]);
   b) money market instruments; and
   c) units in collective investment undertakings.
3. **Optional:** financial instruments capable of being held in custody at the request of the relevant parties.

It was not the legislator's intention to include all private securities with in the custody obligation as this would have a dramatic impact on other costs and risks under the AIFMD.

8 As set out in Article 51(3) of Directive 2009/65/EC and Article 10 of Directive 2007/16/EC

The depositary will be **liable to the AIF or its investors** for certain losses.

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 this should be fault based liability. The final version of the Directive imposes each type of liability on the depositary, depending on the type of loss.

- Strict/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 fund (or the AIFM on its behalf) without undue delay. There is also near strict liability for loss by sub-custodians (whether or not affiliated with the depositary). The exact meaning of "loss" is not clear; it is defined very broadly and could include cases where the AIF/AIFM did not have good title to the instruments in the first place.

  However, there are two exceptions to this liability.

1. 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 depositary would have to show that despite rigorous and comprehensive due diligence, it could not have prevented the loss. This requirement will be deemed to be fulfilled if the loss arises due to certain "force majeure" type events (e.g. wars, laws and regulations) but the exception as a whole is very narrow.
2. 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;
     - it has a written contract with the sub-custodian which effects the transfer of liability to the subcustodian 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.

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

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

Liability and indemnification

Strict liability only attaches to loss of financial instruments held in custody. Otherwise, a depositary is only liable for its negligent or intentional failure to comply with its obligations under the AIFMD. This liability is also likely to be mirrored under its terms of engagement.

Where financial instruments are not held in custody, there is nothing in the AIFMD restricting depositaries from seeking to limit liability or benefit from indemnification provisions. Any benefit from reduced liability should be reflected in the fee model adopted by the depositary.

Restrictions on the depositary

The Directive prohibits a depositary from:

- re-using fund assets without the prior consent of the AIF (or the AIFM acting on its behalf);
- conducting activities in relation to the fund 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 fund investors.

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Alignment with UCITS IV

The Directive expressly acknowledges the differing investment strategies and investor bases of AIFs and UCITS. It does not therefore contemplate future alignment of the roles and responsibilities of AIF and UCITS depositaries. That said, AIFMD negotiations have been influenced by member states anticipating the debate around the UCITS review and willing to use the AIFMD as "minimal benchmark". Therefore, future interaction between both texts cannot be excluded.

Disclosures to investors and competent authorities

AIFMs applying for authorisation must disclose details of their AIFs' depositary arrangements to their home member state competent authority, including any delegation by the depositary (see also section headed "Limits on delegation" on page 34). This information must also be made available to investors in the AIF before they invest, and must be updated to reflect any material changes.

The depositary must make available on request to its own competent authority and to the competent authorities of the AIF and/or AIFM information which it obtains when undertaking its duties which may be necessary for those authorities.

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

AIFMs applying for authorisation **must disclose details of their AIFs' depositary arrangements** to their home member state competent authority, as well as to investors in the AIF before they invest.

Impact:
On Investors

It is inevitable that the requirement to appoint a depositary, even where that depositary is fulfilling principally a record keeping function, will introduce additional costs for managers and for investors. Investors ought to ensure that they understand the Depositary arrangements the manager has put in place. Throughout the life of the fund, investors ought to monitor how the arrangements are operating in practice, paying particular attention to any areas of duplication of existing checks and controls. Investors may also wish to satisfy themselves that the AIF's depositary requirements in respect of the investment process do not inhibit the AIFM's ability to implement the investment strategy.

Impact:
On Fund-of-Funds (FoF)

Where a FoF invests in an AIF for which a depositary must be appointed, there are likely to be additional costs that will feed up to the FoF level. These will be in addition to the cost that a FoF will incur for appointing its own depositary.

Some of the responsibilities carried out by the depositary in relation to private equity and venture capital investment will be duplicated between the AIFM and depositary because an AIFM needs to perform these tasks as part of the investment process. One example will be record keeping, where this is a function already undertaken by a FoF manager, yet a depositary will still be required to undertake the same activity on behalf of the FoF.

Remuneration

The remuneration provisions in the Directive are based on those included within the CRD, which member states are required to implement from 1 January 2011. The CRD provisions apply to banks and investment firms. The stated intention behind those provisions is to ensure that pay for senior staff – in particular bonuses and other "variable remuneration" – aligns the interests of those staff with the bank's interests. Many of the principles have been transposed into the Directive with little or no change, even though they are designed for banks. This means that while it may not as such be easy for private equity (or other) funds or managers to apply the rules in a way which is letter by letter consistent with the stated underlying aim of the provisions, namely sound and effective risk management, the industry as such is well placed to meet this underlying objective, given the well established use of co-investment and carried interest arrangements designed to align the interests of senior private equity manager staff and investors in the fund.

The Directive requires EEA AIFMs 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 the AIF.

The main question for most PE and VC AIFMs will be whether the prescriptive requirements in the Directive for aligning risk with remuneration require changes to the AIFM's compensation arrangements where bonuses or similar types of variable remuneration are paid to individuals as compensation for services rendered. That said, the way carried interest is covered offers some margin of manoeuvre that has to be assessed carefully and individually.

In July 2013, the European Securities and Markets Authority (ESMA) published its final guidelines on sound remuneration principles under the Directive translated into the official languages of the EU. The guidelines will apply to national regulators on a comply or explain basis, and directly to AIFMs. In the final guidelines ESMA has reflected some, but by no means all, of the comments made by respondents to its consultation in summer 2012. The guidelines are open to a wide range of interpretations in several respects.

Considerable work therefore still remains to be done by national regulators when they implement the law and the guidelines into their national rule books. Firms should take time and care in considering the implications of the rules in a changing environment. It is possible that the views expressed in this section of this document could be subject to change after publication.

Non-EEA AIFMs of non-EEA AIFs will not be **forced** to become subject to the Directive's pay regulation rules until the end of 2018 at the earliest. For them, the ESMA guidelines will not be directly relevant. Rather, they must consider disclosures about aggregation remuneration to be made in the Annual Report concerning the fund (see above on page 25). The guidelines may nevertheless help to inform their approach to disclosure.

What is "remuneration" for these purposes?

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

- remuneration of any type paid by the AIFM;
- any amount paid directly by the fund, including "carried interest" (as poorly defined); and
- any transfer of shares or units of the fund.

ESMA takes the view that carried interest is to be treated for these narrow regulatory purposes as if it were remuneration. Of course, carried interest is not remuneration. ESMA expressly recognises that the Directive's provisions concerning remuneration are extended to carried interest for regulatory purposes only.

ESMA provides that co-investment is not remuneration provided it is "pro rata" to investors. It is not clear what this means. As a general proposition, returns on investment (other than carried interest) are not to be treated as remuneration.

ESMA provides that returns on co-investment funded by loan from the AIFM should be considered to be remuneration for the purposes of the rules and guidelines "if the loan has not been reimbursed by the time the return is paid".

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Each AIFM must assess the **application of the principles** to its overall variable remuneration arrangements on a **case-by-case basis** by reference to those policy objectives.

ESMA gave guidance on payments made by the AIF to the AIFM. For example, some firms route a portion of co-investment or carried interest through the AIFM, as opposed to it being distributed directly to individuals or through separate co-investment or carried interest vehicles. The guidance provides that such payments should be treated as remuneration "whenever payments (...) are made directly by the AIF to the AIFM for the benefit of relevant categories of staff of the AIFM for professional services rendered, which may otherwise result in a circumvention of the relevant remuneration rules". Reimbursement of costs and expenses is disregarded. It is not clear what this means.

More helpfully, ESMA clarified that distributions received by partners of an AIFM should not be treated as remuneration for the purposes of the rules and guidance unless "the material outcome of [such payments is] a circumvention of the relevant remuneration rules, any intention to circumvent such rules being irrelevant...".

The same principle should apply to dividends paid to ownermanagers of AIFMs not structured as partnerships but having similar characteristics.

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 the AIFM's activities".

In its guidelines, ESMA expressly recognises that certain remuneration principles (including those requiring deferral of a proportion of variable pay, payment in units and ex-post risk adjustment) may be satisfied if an AIFM puts in place a carried interest model which aligns the interests of the AIFM with those of its investors. This is extremely welcome and important to the industry. Although the ESMA guidelines only illustrate one example of a carried interest structure it is generally similar to the model employed by many EVCA members.

Carried interest models other than the example given by ESMA may also satisfy the policy objectives of alignment of interest with investors and avoiding incentives for inappropriate risk taking. Each AIFM must assess the application of the principles to its overall variable remuneration arrangements on a case-by-case basis by reference to those policy objectives. It is to be hoped that regulators in each member state confirm this approach.

ESMA also recognises that certain (though not all) other remuneration principles may be disapplied on grounds of proportionality. Relevant principles include those which require deferral of a proportion of variable pay, payment in units and ex-post risk adjustment. This must be justified by each firm on a case-by-case basis. ESMA says that proportionality may operate on a firm-by-firm and/or individual-by-individual basis.

AIFMs will need to assess and take advice on the grounds upon which AIFMs may justify disapplication of the principles on grounds of proportionality. There may be a range of outcomes depending on the precise details of the arrangements and how the regulator in a particular member state may regard these.

However, some private equity and venture capital AIFMs may conclude that the fact that they have in place a carried interest model (meeting the policy objectives described above on page 37) gives good grounds for disapplication of the relevant principles on its payment of variable remuneration. When making this assessment, the AIFM should consider whether, in the particular case, the most important element of variable incentive is carried interest. If it is not, the alignment effect may break down. It is also likely to be critical that the carried interest model is expressly agreed by investors, for example in the AIF's constitutional documents. There may be other grounds on which private equity and venture capital firms may reach the same conclusion.

> Where justified, **the principles can be disapplied** in relation to the carried interest arrangement itself, but they can also be disapplied in relation to other forms of variable remuneration including annual bonuses.

Where justified, the principles can be disapplied in relation to the carried interest arrangement itself, but they can also be disapplied in relation to other forms of variable remuneration including annual bonuses.

Some AIFMs may not be able to demonstrate that their carried interest models satisfy the appropriate alignment requirements of the Directive. In some cases, a particular member of Identified Staff may not participate in the carried interest. For these or other reasons, such AIFM may be obliged to defer a proportion of variable pay (such as any annual bonus) and to apply ex-post risk adjustment to that deferred element. However, to the extent that a private equity or venture capital firm operates only closed-end funds, that alone should be good grounds to disapply the principle requiring payment in units, since it is practically impossible to pay in units. Some firms may exceptionally be able to pay instead in other instruments, such as shares in the AIFM or its parent, if the management group is listed.

Paying staff in control functions (e.g. compliance, risk management, legal)

It is consistent with the ESMA guidelines to incentivise staff in control functions substantially through their participation in a carried interest arrangement having the features described above. The ESMA guidelines provide that such variable pay should not be determined "**solely** by AIFM-wide performance".

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 funds it manages (known as "Identified Staff"). Depending on their impact on risk, these might include:

- senior management;
- "risk takers" (likely to include senior investment executives who are not also senior management);
- employees whose remuneration takes them into the same bracket as senior management and risk takers; and
- "control functions" (including the firm's compliance officer, for example).

Certain rules apply to all staff of the AIFM, for example restrictions on guaranteed variable remuneration. The table in Annex II to the ESMA guidelines gives guidance about which of the remuneration principles apply to all staff and which apply only to Identified Staff[9].

What are the requirements?

When establishing and applying their remuneration policies and practices AIFMs must comply with a number of principles, which are listed in Annex II to the Directive. The overarching requirement is for the AIFM to have a remuneration policy that is consistent with and promote 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 AIFs/investors.

9 Please see: http://www.esma.europa.eu/system/files/2013-232_aifmd_guidelines_on_remuneration_-_en.pdf

The policy and its implementation must be periodically reviewed.

Key additional requirements (or "principles") 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;
- 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;
- at least 50% of variable remuneration must be paid in units or shares in the relevant fund (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 also manages significant amounts in separately managed accounts);
- 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 fund; and
  - is based on a combination of individual performance and performance of the business unit, fund and the AIFM as a whole;
- 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).

Payment in units

For these purposes, "units" is a generic term meaning interests in the fund. This could include, for example, limited partnership interests.

The ESMA Guidelines recommend that, where a proportion of variable remuneration must be paid in units, the units should relate "mainly" to the AIF managed by the individual. There is an odd caveat, though, that this should not lead to excessive concentration "facilitating an excessive risk-taking" by the individual. It is not clear what this means. It may be grounds for staff to participate more widely in the funds managed by the AIFM and not exclusively in funds managed by the individual being part of a particular investment committee.

Where an AIFM manages closed-end funds or otherwise cannot award or transfer units in AIF to Identified Staff, it may award "equivalent ownership interests". There is not much guidance as to what this means. It could encompass "phantom" fund interests or shares in the AIFM or its parent undertaking, particularly where the AIFM or its parent has shares admitted to trading on a public market.

Remuneration committee

AIFMs that are significant in terms of their size or the size of the funds they manage will also be required to have a remuneration committee which consists of (including its chair) non-executive members of the management body.

ESMA acknowledges that, for some firms, it may be disproportionate to establish a remuneration committee. It gives a non-exhaustive list of factors to be taken into account, including:

- whether or not the AIFM is listed;
- the legal structure of the AIFM;
- the number of employees of the AIFM;
- the AIFM's assets under management;
- whether the AIFM is also a UCITS manager; and
- whether or not the AIFM has obtained "top-up" permission to provide certain MiFID investment services.

ESMA acknowledges that, for some firms, it **may be disproportionate** to establish a remuneration committee.

In elaborating on the factor of size, ESMA gives examples of firms which may not need to establish a remuneration committee. They include AIFMs with AUM not greater than EUR 1.25 billion and not more than 50 employees. However, even a firm which is larger than this may conclude that it would be disproportionate to establish a remuneration committee taking into account other factors. ESMA acknowledges that AIFMs which are part of banking, insurance or investment groups may look to a group remuneration committee external to the AIFM, provided that the rules governing its composition, role and functions are equivalent to those required by the guidelines.

Application of the remuneration principles to delegates of the AIFM

The ESMA guidelines require AIFMs to ensure that, to the extent that portfolio management or risk management activities are delegated by the AIFM, the delegate is either: (a) itself subject to pay regulation of equivalent effect; or (b) is made subject to contractual obligations which are to similar effect in order to prevent "circumvention".

In applying the new requirements concerning delegates, it will be important for firms to establish to whom the AIFM delegates "portfolio management or risk management". For example, in some structures, an AIFM may procure investment advice from an advisory affiliate. This may not involve the delegation of either portfolio management or risk management activities. Where delegation happens, if the delegate is an investment firm subject to the Capital Requirements Directive, it is likely already to be subject to EU pay regulation. Other delegates may soon be made subject to separate ESMA guidelines on remuneration practices. Final guidelines are due to be published in 2013. If those rules and guidelines are deemed to be ESMA's final guidelines on remuneration equivalent to the ESMA guidelines under the AIFMD, this may mitigate any concerns.

Otherwise, the guidelines require contractual arrangements to cover any payments made to the delegates' "Identified Staff". That term is defined to include staff of the delegate "whose professional activities have a material impact on the risk profiles of the AIF that the AIFM manages". In some delegation arrangements, the role of the delegate will not be sufficiently important for any of the delegate's staff to fall into this category.

Disclosure requirements

AIFMs applying for authorisation will be required to disclose details of their remuneration policies and practices to their home member state competent authority.

The AIFM must also prepare an annual report in respect of each EEA fund it manages and each fund it markets in the EEA, and this must contain certain information in relation to remuneration (see page 25).

Valuation

Overview

For each of their funds, AIFMs are required:

- to have procedures for proper and independent valuation of the AIF's assets; and
- to ensure that the net asset value ("NAV") of the AIF's assets 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. There is no mandatory external valuer as initially foreseen by the Commission.

Valuation rules and procedures

The implementing Regulation includes detailed rules about the valuation function.

For example, AIFMs must establish, maintain, implement and review formal valuation policies and procedures. The policies and procedures must address, for example, the competence and independence of those engaged in the valuation function, and controls over the selection of valuation inputs, sources and methodologies. The policies and procedures must be subject to review at least annually.

The AIFM must be able at all times to demonstrate that the portfolio of the AIFs it manages are properly valued. The AIFM must not invest in a particular type of asset for the first time unless an appropriate valuation methodology has been identified for that type of asset.

> Valuations may be performed by the AIFM or a professional external valuer. **There is no mandatory external valuer** as initially foreseen by the Commission.

The accounting standards 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 in the AIF rules and/or instruments of incorporation" (e.g. the limited partnership agreement). Although the matter is not free from doubt, the better view is that this permits the use of whatever accounting standard is specified in the fund documents unless mandatory local law requires the use of a different standard in relation to the AIF vehicle concerned. The Directive is not itself prescriptive.

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

It is not clear how the "share or unit" concept is to be applied to funds which issue neither shares nor units, such as private equity funds structured as limited partnerships (probably the most common EEA structure by amount of total capital invested).

Details of the valuation procedures for a fund (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 the AIFM's home member state competent authority when the AIFM applies for authorisation.

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

Valuation frequency

Valuations must be performed at least once a year. For closed-end funds, valuations must also be carried out whenever there is an increase or decrease in the AIF's capital. "Capital" is not defined for these purposes.

More frequent valuation requirements apply to open-end funds.

Who can perform valuations?

The AIFM may perform valuations itself, or arrange for an independent external valuer to perform this function.

AIFMs that carry out their own valuations must ensure independence between the valuation and portfolio management functions. The AIFM must put in place measures to mitigate conflicts of interest arising in connection with in-house valuation (e.g. arising from the AIFM's 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

It is thought unlikely that many private equity or venture capital firms will seek to appoint an external valuer. A number of conditions must be met where an external valuer is appointed. Sub-delegation by external valuers is not permitted.

- 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 home member state regulator, which (in certain circumstances) can require a different external valuer to be appointed.
- The AIFM must also be able to demonstrate that:

a) the appointment:

- is objectively justifiable;
- 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;

b) the external valuer:

- is subject to mandatory professional registration/rules of professional conduct;
- can furnish sufficient professional guarantees
- is capable of performing, and is qualified to and has sufficient resources to perform, the valuations;
- was selected with all due care; and
- can be effectively monitored and instructed by the AIFM; and

c) the external valuer's relevant staff are sufficiently experienced and of good repute.

A fund's depositary may act as the AIF's external valuer, provided that:

- it "functionally and hierarchically" separates its depositary and valuation functions; and
- the potential conflicts of interest are properly identified, managed, monitored and disclosed to investors.

Liability issues

The AIFM will be responsible for valuations, 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.

Impact:

Impact on Investors

The requirement for functional independence of valuation could result in changes to current policies and procedures for existing funds. This may require changes to be made to the fund documentation and may result in higher costs being borne by funds. It may also have implications for the current role of LP Advisory Committees in respect of the valuation process. Investors ought to check the provisions in their current fund documents and discuss the impact of the new requirements with their managers as appropriate.

Impact:

Impact on Fund-of-Funds (FoF)

There are no different implications which are specific to FoF managers. Like any AIFM, FoF managers may elect to conduct valuation internally or to appoint an external valuer.

For smaller FoF managers, there is a practical requirement for 'functional independence' from portfolio management and the remuneration policy. This is likely to be challenging for smaller FoF managers who may not currently employ sufficient people to be able to separate these activities.

Chapter four: **Fundraising and Structuring**

4

In this section

Primary contributors:
Patricia Volhard

Fund structuring is likely to increase in complexity in the AIFMD world.

The principle will be that an EEA AIFM managing EEA AIFs will be subject to the EU passport regime triggering notification/approval and disclosure requirements as set out below (regarding disclosure requirements, see also Chapter 3). For all non-EEA AIFMs and those which fall below the size threshold (see Chapter 1), it will be up to the national legislators to decide whether or not to retain their current national placement regimes subject to the minimum requirements foreseen under the AIFMD (see Chapter 6 on Third countries) or whether to impose additional requirements, as some have already done.

Fundraising

What is "marketing"?

The AIFMD defines marketing as the direct and indirect offering or placement at the initiative of the AIFM, or on behalf of the AIFM, of units or shares of an AIF it manages to, or with, investors in the EEA.

This definition does, however, leave space for a broad range of different interpretations by national legislators. The interpretation of marketing is, however, key as only a fundraising activity which is deemed to be "marketing" will trigger the AIFMD requirements (i.e. notification etc. as set out below). For example, in the UK "marketing" is to be understood to involve making a fund interest available for investment, for example by circulating a substantially final PPM, LPA and subscription document (even if those documents may be further negotiated with the investor before final closing). In Germany, however, "marketing" begins when a PPM is submitted to the investor enabling the investor to subscribe to the fund.

In the private equity and venture capital context, the raise of capital usually starts with general negotiations about possible investment opportunities, the presentation of key persons and the provision of teaser documents only. Such non-binding meetings should not be seen as "marketing" and should therefore not trigger notification requirements. However, as soon as the prospective investors have been enabled to make final investment decisions or documents have been submitted which are not subject to any (significant) further changes, marketing should be assumed.

> The AIFMD defines marketing as the **direct and indirect offering or placement at the initiative of the AIFM**, or on behalf of the AIFM, of units or shares of an AIF it manages to, or with, investors in the EEA.

The sales of secondary positions in an AIF will not generally constitute "marketing". The AIFMD provides:

"an investment firm shall, directly or indirectly, offer units or shares of AIFs to, or place such units or shares with, investors in the Union, only to the extent the units or shares can be marketed in accordance with the Directive".

This can only be interpreted as a clarification that even if marketing is being assumed by a placement agent and not the AIFM itself the marketing requirements under the AIFMD must be respected. It does not imply that secondary sales are meant to be covered. This view is also consistent with a statement of the German regulator (BaFin) pursuant to which the sale of shares in an AIF by an investor is not marketing.

Notification requirements/sign-off by competent authority

EEA AIFM with EEA AIF

Before an EEA AIFM (and also a non-EEA AIFM benefiting from the passport) starts marketing, it must comply with certain notification requirements and submit certain information in respect of the AIF it intends to market in the EEA.

The AIFM is required to submit a notification to the competent authorities of its home member state in respect of each AIF that it intends to market. The notification must include, among other things, a program of operations identifying the AIF and information on where the AIF is established, the AIF rules or instruments of incorporation, the identity of the depositary of the AIF and any information on the AIF available to investors. It must also include all information required to be disclosed to investors prior to investment (see Chapter 3).

No later than 20 working days after receipt of the complete notification file, the competent authority will inform the AIFM whether it may start marketing the AIF identified in the notification.

If the AIFM intends to market the AIF in a member state other than its home member state, then the competent authority of the home member state/member state of reference of the AIFM will transmit the complete notification file to the competent authorities of each member state in which the AIF is proposed to be marketed. This will be done within 20 working days of issuing approval and the AIFM will be informed without delay that this has taken place. The AIFM may start marketing the AIF in the host member state(s) as of date of that notification. A regulator may refuse permission to market only if the management of the AIF will not be in accordance with the Directive, or the AIFM is generally not in compliance with its obligations under the Directive.

EEA feeder AIFs ("Feeder AIFs"), broadly defined as AIFs which invest 85% of their assets in another AIF (the "Master AIF"), may only be marketed under the above regime if they are investing into a Master AIF that is also an EEA AIF managed by an authorised EEA AIFM. Other EEA Feeder AIFs may be marketed on the same basis as third country AIFs.

Special requirements apply with respect to the marketing of non-EEA AIFs managed by non-EEA AIFMs or EEA AIFMs (see Chapter 6).

Impact on existing funds being marketed at transposition date (22 July 2013)

The AIFMD marketing requirements described above will have some impact on existing AIFs including those which have already started their fundraising process before 22 July 2013.

With effect from that date, the new AIFMD rules apply. The AIFMD foresees that the AIFM has one year to apply for authorisation and in the meantime can continue to manage the AIF without authorisation. However, it is unclear whether an AIFM may also continue to market funds during such one year period. Certainly it does not have any passport right to market until it is authorised. This again could mean that no marketing is possible for an AIFM which is subject to authorisation requirements until such AIFM has obtained its authorisation. Certain member states (e.g. the UK, Germany and the Netherlands) have introduced special marketing grandfathering rules which foresee that an AIFM which already manages an AIF can market that and other AIFs after such date under the current placement regimes. However, AIFMs would need to check for each target country whether they can continue marketing after 22 July 2013.

EEA AIFMs which have finished marketing prior to 22 July 2013 become subject to the AIFMD in any event. However, in such case the AIFMD grandfathering rule applies and they have one year to apply for the authorisation. Note, however, that the Commission seems to be taking the view that as of 22 July 2013 the Manager must apply best efforts to comply otherwise with the rules under the Directive (including the reporting requirements) but member states do not appear to agree with this view.

Impact on fundraising process in future

In order to admit investors, the AIFM will need to inform its regulatory authorities and submit the relevant documentation before any marketing activity takes place (see pages 46 et seqq.).

The requirement to present the competent authorities with documentation prior to the start of the marketing process stems from a belief that private equity and venture capital funds are 'sold' when in fact they are partnership negotiations that take place over a period of time, usually many months. However, throughout the PE/VC fundraising process the terms are often negotiated and hence the documentation submitted will be subject to numerous amendments. However, only "material" changes to the information provided will have to be submitted to the competent authorities at least one month in advance (or, immediately after the change takes place, in the event of an unplanned change). It is unclear whether the marketing programme has to stop while this review takes place.

Material from a regulatory perspective should, for example, be an amendment to the investment policy, replacement of the AIFM or depositary in the structure, taking on leverage for the first time. It is also likely that changing key man terms would be material.

Summary: marketing for EEA AIFMs with EEA AIFs

Passport

The AIFM must comply with the AIFMD in full.

Notification to the competent authorities of the EEA AIFM's home member state is required in case of marketing of EEA AIF interests in other member states.

National placement regime

Small AIFMs below the threshold are expected to be able to continue to rely on a case-by-case basis on applicable national placement rules, subject to additional conditions set by the Directive.

If these AIFMs want the benefit of a passport to make an offering in different EEA member states, then they must either opt-in to the scope of the AIFMD or make use of any other passport rights that may be available (e.g. under the EuVECA or EuSEF Regulations).

Impact:
On Investors

An investor ought to confirm with the AIFM of any fund to which it is already committed, whether or not that fund is grandfathered or exempt. Investors should note that there is potential for additional costs being incurred retrospectively by any AIF to the extent the AIFM does not qualify for grandfathering or another exemption. These costs may not have been taken into account when the costs of the fund were originally calculated.

On new funds being raised, investors ought to establish, as part of their due diligence, whether or not the AIFM is required to comply with the AIFMD. If the AIFM is subject to the Directive but is not authorised, then the reasons for this ought to be established.

Investors are permitted to invest at their own initiative including in AIFs managed by non-AIFMD compliant AIFMs. What exactly is to be understood by "at its own initiative", however, remains subject to the interpretation of the national legislators (see Chapter 1 above).

It remains to be seen what practical impact the marketing requirements will have on the process of the negotiation of the fund documents before final closing.

Impact:
On Fund-of-Funds (FoF)

It is possible that FoF AIFMs may need to consider several different investment structures to feed into a single AIF to accommodate the particular and diverse criteria of their investors. Each investment structure could potentially qualify as an AIF and should be examined carefully.

FoF will have to consider the additional costs which arise at the FoF but possibly also at the target fund level.

Impact:
On Placement Agents

Where a placement agent is being used such placement agent and the AIFM must ensure that the AIFMD marketing requirements are met. As stated above, the better view is that secondary sales should not be 'marketing' by the GP (as also supported by the UK). In case investors themselves decide to sell their shares in an AIF and engage an intermediary to act on their behalf no marketing within the meaning of the Directive should be assumed because the offering or placement of such shares is not at the initiative of the AIFM, or on behalf of the AIFM.

Structuring aspects

The new marketing requirements should also have an impact on structuring considerations. An AIFM based outside the EEA which is marketing to investors in the EEA must check whether the target countries in which it intends to market retain their placement regimes and whether any additional requirements will apply in future. An EEA-based AIFM which exceeds the threshold will have to apply for an AIFM authorisation. Once such authorisation is received, and the passport right exercised, it would no longer have to worry about local marketing restrictions. However, until the authorisation is obtained – even if the AIFM has submitted its application within time and even if it benefits in its home country from a transition period of one year to submit such application – no passport can be relied upon and the AIFM must verify if and under what circumstances it can market in the respective target country. The same issue arises if the AIFM is below the threshold and as such only registered as a small AIFM in its home country: in such case the local marketing restrictions must be respected unless the AIFM qualifies for the EuVECA or EuSEF.

It is up to the AIFM to notify the regulatory authority prior to marketing and to ensure that all AIFMD requirements are met.

However, it is not always easy to determine the AIFM in a fund structure.

In many current limited partnership structures, the (managing) general partner would be deemed to be the AIFM under the Directive. However, it is also possible that the managing general partner appoints an external manager as the AIFM; this scenario has to be distinguished from scenarios where the general partner merely delegates certain management functions but remains the AIFM of the AIF. In the case where the AIFM functions are delegated (e.g. portfolio management or risk management) the AIFM will remain liable to the AIF and to the investors and it must be able to control the services performed by the delegate on an ongoing basis. The delegation will only be possible to a regulated entity (unless the competent authority has waived such requirement) and be subject to meeting the delegation requirements set out in the section below. The qualification as an internally or externally managed partnership is therefore crucial from a structuring perspective and it may vary from one country to another what the best structure and the legal analysis would be. The UK considers the general partner of a limited partnership, if is the AIFM, to be an external and not an internal manager.

An advisor providing non-discretionary investment advice to the AIFM should not be considered an AIFM if such advisor will not take final investment decisions. However, if such advisor is assuming risk management functions it could potentially be considered an AIFM, any risk management carried out by an adviser needs to be clearly as a delegate of the AIFM to avoid this construction. In addition many advisers do not carry out risk management, they provide information and assistance to the AIFM who carries out the actual risk management.

Delegation

Overview

The Directive imposes requirements on an AIFM when delegating any of the functions set out in Annex I of the Directive (i.e. portfolio management, risk management, administrator functions, marketing and activities related to the assets of AIFs). In particular, the engagement of a mere advisor (providing deal sourcing, monitoring the portfolio, rendering the due diligence processes prior to an investment etc.) does not qualify as delegation. Specific additional restrictions apply when delegating portfolio management or risk management functions. Such requirements and restrictions do not apply where purely administrative or technical functions are delegated (so called non-core services delegation).

As only a single AIFM may be authorised to manage an AIF, a global manager with international offices will need to ensure that it has the correct delegations in place in regard to portfolio management or risk management. These delegations should be identified in the AIFM's authorisation submission.

Disclosures to investors and competent authorities

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 home member state competent authority, and must then give its competent authority advance notice of any new delegation.

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

Liability

Delegation does not affect the liability of the AIFM for the matters delegated. Hence, the obligations of the AIFM to the AIF and its investors are not altered as a result of the delegation. However, the AIFM and the delegate may agree on an indemnification for the benefit of the AIFM.

General requirements relating to delegation

The general conditions to be met with respect to a delegation (other than a delegation of pure administrative functions) are as follows:

- any delegation must be justifiable with "objective reasons"; for such objective reasons, the following criteria, in particular, shall be considered:
  - optimising of business functions and processes;
  - cost saving;
  - expertise of the delegate in administration or in specific markets or investments;
- 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 portfolio and risk management functions to the extent that, in essence, it is no longer the manager of the relevant AIF (i.e. it becomes a "letter-box entity").

Even if an AIFM has delegated more functions than it retains, it may still be **admissible** if the **importance of the functions retained by the AIFM** justifies that it is not considered a letter-box entity.

An AIFM is deemed a letter-box entity and shall no longer be considered to be the AIFM of the AIF, at least in any of the following situations:

- the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the implementation of the general investment policy and investment strategies;
- the AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice;
- the AIFM delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself. When assessing the extent of delegation, competent authorities shall assess the entire delegation structure taking into account not only the assets managed under delegation but also the following qualitative criteria:
  - the types of assets the AIF or the AIFM acting on behalf of the AIF is invested in, and the importance of the assets managed under delegation for the risk and return profile of the AIF;
  - the importance of the assets under delegation for the achievement of the investment goals of the AIF;
  - the geographical and sectoral spread of the AIF's investments,
  - the risk profile of the AIF;
  - the type of investment strategies pursued by the AIF or the AIFM acting on behalf of the AIF;
  - the types of tasks delegated in relation to those retained; and
  - the configuration of delegates and their sub-delegates, their geographical sphere of operation and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM.

Regarding this latter point it is totally unclear how the qualitative criteria shall be read and what impact they shall have. It will have to be seen how national regulators will interpret these rules. We understand that the qualitative criteria are meant to soften the quantitative rule of the preceding sentence. Hence, even if an AIFM has delegated more functions than it retains, it may still be admissible if the importance of the functions retained by the AIFM justifies that it is not considered a letter-box entity. Much legal uncertainty remains with regard to this requirement.

The UK regulator has indicated that, when assessing whether a UK AIFM is a letter-box, it will undertake a proportionate supervisory assessment, which will be more qualitative than quantitative; the AIFM will be expected to exercise effective oversight and control over risk and portfolio management in an active way and on a continuous basis; the governing body of the AIFM must not abdicate their responsibility.

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 home member state competent authority; and
- the requirements applicable to a delegation of the function are also met in relation to the sub-delegation.

The notification to the home Member Sate competent authority must contain details of the delegate, the name of the competent authority where the sub-delegate is authorised or registered, the delegated functions, the AIFs affected by the sub-delegation, a copy of the written consent by the AIFM and the intended effective date of the sub-delegation. The delegate must review the services provided by its subdelegates on an ongoing basis. Additional restrictions apply on sub-delegation of portfolio or risk management.

Restrictions on 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;
- a non-EU undertaking, unless cooperation between that undertaking's regulator and the AIFM's home member state competent authority is "ensured";
- any entity that is not authorised/registered and supervised for asset management, unless the AIFM's home member state competent authority has given its prior consent; or
- any other entity whose interests may conflict with the AIFM or the fund 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 fund investors.

The following entities are deemed to be authorised/registered for the purpose of asset management and subject to supervision:

- management companies authorised under Directive 2009/65/EC;
- investment firms authorised under Directive 2004/39/EC to perform portfolio management;
- credit institutions authorised under Directive 2006/48/EC having the authorisation to perform portfolio management under Directive 2004/39/EC;
- external AIFMs authorised under Directive 2011/61/EU;
- third country entities authorised or registered for the purpose of asset management and effectively supervised by a competent authority in those countries.

An AIFM must review the services provided by its delegates on an ongoing basis and must particularly ensure that the delegate carries out the delegated functions effectively and in compliance with applicable law and regulatory requirements.

Impact:
On Investors

There is no significant impact on investors beyond checking that the requisite information has been received and that the necessary authorisations are in place. The primary responsibility for this lies with the competent authorities, which will maintain a register of authorised AIFMs. Investors will have access to this register.

Impact:
On Fund-of-Funds (FoF)

There are no additional implications which are specific to FoF managers beyond those for any other AIFM. The principle consideration will be to ensure that the correct delegations are in place where the FoF manager is an international manager with international branches or subsidiaries which may be undertaking either or both of the core functions of portfolio management and risk management. A FoF manager must identify any planned delegations in its submission for authorisation.

Depending on the domicile of the AIF and the domicile of the potential investors it intends to target fund structuring may well change in the AIFMD world. The principle will be that an EEA AIFM managing EEA AIFs will be subject to the EEA passport regime triggering notification/approval and disclosure requirements as set out below (regarding disclosure requirements, see also Chapter 3). For all non-EEA AIFMs and those which fall below the size threshold (see Chapter 1), it will be up to the national legislators to retain or not their placement regime subject to the minimum requirements foreseen under the AIFMD (see Chapter 6).

Chapter five:
Fund Management and Portfolio Company Provisions

5

In this section

Primary contributors: Karen Butler (top) and Simon Witney (below)

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Annex I

Fund management

PE and VC funds do not typically undertake day to day management of portfolio companies themselves. These companies will be managed by the management teams appointed by investors/owners. That said, the investors in each portfolio company will have agreed a strategy with each other and management in advance and exercise shareholder rights within a defined framework to implement and refine that strategy. The relevant provisions of the AIFMD relating to portfolio companies therefore should be understood and applied in this context.

AIFMs will need to review the contractual documentation entered into with portfolio companies as well as general company law provisions applicable in the relevant jurisdiction, to ensure that they are able to comply with the disclosure and notification requirements outlined in this chapter. They should also be aware that the Directive may result in a certain unlevel playing field whereby other forms of owners will not be subject to the same obligations and restrictions. It will be important to consider deal structures in light of these notification requirements and so-called "asset stripping" provisions. The portfolio company provisions will apply to non-EEA AIFMs who market actively in the EEA, as well as to EEA AIFMs.

Although in this section most attention has been focused on the portfolio company provisions, the Directive, and more particularly the Level 2 Regulation, also contains a number of other provisions which will directly affect EEA AIFMs' investment management processes and policies. So although most fund managers currently have robust due diligence procedures in place which consider whether the investment is in line with the fund's objectives, it will be important to ensure that the investment process is documented in the way, and covers the matters, required by the Directive and the Level 2 Regulation as outlined in this chapter. Voting strategies will also have to be formulated and recorded, to the extent this is not already done.

The Level 2 Regulation contains detailed rules on best execution, order handling, aggregation and allocation and the choice of counterparties for some types of transactions. Frequently some of these requirements will not apply to private equity transactions or will not have significant impact on the way firms operate. In the private equity context such requirements are most likely to become relevant when an AIF invests by way of a public to private deal or exits an investment by way of an Initial Public Offering. Firms need to consider the extent to which they will apply to their business and implement the relevant policies and procedures to ensure compliance or to demonstrate why they do not apply.

"AIFMs will need to **review the contractual documentation** entered into with portfolio companies as well as general company law provisions applicable in the relevant jurisdiction."

Finally, although delegation and depositary provisions are not covered in this chapter, it should be noted that:

- sometimes an investment process may require delegation of an aspect of the task to a third party and when this is the case it will be necessary to check whether the Directive delegation rules apply (and comply if necessary). However in each case there needs to be a careful assessment of whether there is delegation of a function within the meaning of the Directive, as opposed to using a third party to provide information or assistance; and
- the depositary's monitoring obligations are likely to mean that many depositaries may require significant involvement in the investment process and allowance will need to be made for this in order to ensure smooth completion of transactions.

Portfolio company provisions

The notification, disclosure and asset stripping provisions below only apply to portfolio companies whose registered office is in the EEA.

Notification of an interest in a company

When an AIF acquires or disposes of shares in an unlisted portfolio company which has its registered office in the EEA, the relevant AIFM is obliged to notify its competent authority (within 10 working days) if the proportion of shares held reaches, exceeds or falls below the thresholds of 10%, 20%, 30%, 50% and 75%. This applies even if there is no control position, and so applies also to funds acquiring minority stakes.

> The notification, disclosure and asset stripping provisions only apply to **portfolio companies whose registered office is in the EEA.**

Initial disclosures when a company is "controlled" by an AIF

The Directive also includes additional disclosure and notification requirements for AIFMs which manage funds that acquire "control" of portfolio companies (either alone, or in combination with other AIFs on the basis of an agreement between them or their AIFMs). The provisions only apply in relation to portfolio companies (other than SMEs and certain real estate SPVs – see further below on page 57) with their registered office in the EEA.

Meaning of "control"

In the case of an unlisted company, an AIF (or combination of AIFs) will have "control" if they have more than 50% of the voting rights of the company (subject to various anti-abuse provisions which aggregate shares held by related entities). For "issuers", which (broadly) means companies that are listed on a stock market, "control" is defined by reference to the way in which member states define it for the purposes of the Takeover Directive[10] (which in many countries is at or around 30%, but which varies across the EU and ranges from 25% to 66%[11]).

Notification on acquisition of control of an unlisted company

When there is an acquisition of control of an unlisted company, the AIFM(s) managing the relevant AIF(s) will be obliged to notify that fact to:

- the company;
- the shareholders of which the identities and addresses are available to the AIFM or can be made available by the company, or through a register to which the AIFM has or can get access; and
- the competent authority of the home member state of the AIFM.

This notification will also have to include details of the voting rights held (although it is not entirely clear if this applies only to those shares held by the AIF), the "conditions under which control has been reached" (including the identity of the different shareholders involved, any person entitled to exercise voting rights on their behalf and, if applicable, the chain of undertakings through which voting rights are effectively held), and the date on which the AIF(s) acquired control.

10 Article 5(3) of Directive 2004/25/EC
11 See Report on the Implementation of the Directive on Takeover Bids, 2007 (21.02.2007 SEC (2007) 268)

> Where control is acquired in a **public company** there are **other provisions under existing European law**, including the Takeover Directive, which need to be applied.

Disclosures on acquisition of control

As well as the notification referred to above, there are further disclosure requirements on an acquisition of control. These apply in relation to "issuers", as well as unlisted companies.

These disclosure provisions will require the AIFMs to notify the company, shareholders and competent authority of:

- the identity of the AIFMs which either individually or in agreement with another AIFM manage the AIF(s) that have acquired control;
- the policy for "preventing and managing conflicts of interest, in particular between the AIFM, the AIF and the company" and including "the specific safeguards established" to ensure that any agreement between the AIFM and/or the AIF and the company is at arms-length; and
- the policy for external and internal communication relating to the company, in particular as regards employees.

In relation to unlisted companies the regulator in the AIFM's home state may also require the information to be disclosed to the regulator in the member state of the unlisted company if the company is in a different member state.

Notification of future intentions

Where control is acquired of an unlisted company the AIF must disclose "its intentions with regard to the future business" of the company and the "likely repercussions on employment, including any material change in the conditions of employment".

This information must be made available to the company and its shareholders, and the AIFM must use its best efforts to ensure that the board passes the information on to employee representatives (or, if there are none, to the employees themselves).

This wording is taken from the Takeover Directive and has been subject to interpretation by case law in that context, which confirms that this obligation can be fulfilled by fair but general information. This could mean including a general statement in the offer document that the existing employment rights of the target company's employees will be safeguarded (or fully safeguarded).

Where control is acquired in a public company there are other provisions under existing European law, including the Takeover Directive, which need to be applied. For example, the offer document must include information on a broad range of issues including restrictions on transfers of shares or limitations on voting rights as well as details on rules governing board appointments and the board members' powers.

Notification and disclosure to employees

The AIFM will be obliged to request the board of directors of the company to pass all of the above information on to the representatives of employees (or, if there are none, the employees themselves). The AIFM has to use its "best efforts" to make sure that the employee representatives (or employees) are informed.

Provisions in the Directive seek to protect confidential information, which could damage the company, from disclosure to employees.

Information concerning financing

Finally, there are obligations (which only seem to apply in the case of acquisition of control of an unlisted company[12]) to provide competent authorities and investors in the AIF with "information on the financing of the acquisition". This is likely to include disclosure of the principal "sources and uses" of funds and their principal terms.

12 Although Recital 56 says they should also apply in relation to issuers.

Additional information about controlled companies in annual reports

When an unlisted company (other than an SME or real estate holding company) is controlled by an AIF (either individually or jointly) each AIF or the controlling AIFs (as the case may be) has to ensure that additional information is disclosed on an annual basis. It can do this in one of two ways:

- it can either "request and use its best efforts to make sure" that the company's own annual report includes the additional disclosures, or
- it can include the additional information in the AIF's annual report to investors (prepared in accordance with Article 22 and discussed in Chapter 3).

In both cases, there are provisions to make sure that employee representatives (through the company's board) and investors in the AIF receive the information disclosed.

The information which must be disclosed includes:

- a fair review of the development of the company's business representing the situation at the end of the period covered by the annual report;
- an indication of any important events that have occurred since the end of the financial year;
- an indication of the company's likely future development; and
- certain information concerning any acquisitions of own shares by the company.

When an unlisted company is controlled by an AIF each AIF or the controlling AIFs has to **ensure that additional information is disclosed on an annual basis.**

Asset stripping provisions

Rules to prevent asset stripping by private equity owners could, depending on jurisdiction, impose additional restrictions on distributions, capital reductions, share redemptions or purchases of own shares by "controlled" portfolio companies (listed and unlisted) during the first two years of an AIF's ownership. Although drawn from European company law, these restrictions will apply to all types of company owned by private equity funds, and therefore (depending on how the Second Company Law Directive has been implemented in a member state) may go further than is the case in many member states at the moment.

The way the rules are framed means that they apply obligations to the AIFM rather than the company itself. The AIFM is not allowed to "facilitate, support or instruct" any of the prohibited actions, nor can it vote in favour of them, and must use "best efforts" to prevent them.

The restrictions imposed do not prevent **all** payments to shareholders during the two year period, but broadly they only allow "distributable profits" to be paid out, and only then when the company's net assets would remain at or above the level of the subscribed capital plus undistributable reserves. Distributions which are prohibited include "dividends and interest relating to shares", and there are additional exceptions for certain share re-purchases or capital reductions.

Existing company law rules on distributions and other payments to shareholders by private companies vary across EU member states, and so the impact of these changes will be different in different countries. However, these prohibitions may prevent, for example, special dividends being paid following a recapitalisation of the company, and certain other forms of partial exit. They may therefore have an impact on exit strategies and deal structuring.

Exclusion for SMEs and real estate holding companies

The Directive does not impose the additional notification and disclosure requirements in relation to portfolio companies which are SMEs. SMEs are defined as companies which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million. There is also an exception for special purpose vehicles which purchase, hold or administer real estate.

There are also exclusions from the asset stripping provisions for SMEs and real estate special purpose vehicles.

Impact:
On Investors

The requirements in relation to additional information on controlled companies may result in a greater consistency of information supplied in annual reports across different AIFs in which they are invested. There may also be slightly more clarity and consistency on reporting across AIFs on how acquired companies are financed.

Impact:
On Fund-of-Funds (FoF)

A FoF which does not co-invest directly in portfolio companies is unlikely to be subject to these notification and asset stripping provisions as they apply to the respective owner AIF in which the FoF is invested. An AIFM which is authorised principally as a FoF AIFM, however, but which also manages direct investment portfolios, would be subject to these provisions.

Other provisions affecting the investment process

(many of which will not be relevant for a 'non-trading'[13] PE/VC fund)

Due Diligence and record keeping

The Level 2 Regulation requires AIFMs to establish formal written due diligence procedures which must be regularly reviewed and updated to ensure compliance with the AIF's objectives, strategy and risk limits. Where the AIFM plans to acquire less liquid assets after negotiations, which will be the case for almost all private equity investments, it will be obliged to:

- produce and regularly update a business plan;
- select transactions consistent with the business plan;
- assess each selected transaction against other opportunities and related risks (e.g. legal, fiscal and financial, human and material resources, management and exit strategies);
- perform the due diligence exercise prior to execution;
- monitor performance against the business plan; and
- retain records of the transactions considered and due diligence exercise conducted for at least five years.

In addition to the new record keeping obligations relating to due diligence, the AIFM must keep records of transactions actually made. Most private equity and venture capital transactions only need the usual records to be kept (e.g. name of AIF, legal transaction documents and price). Where the relevant transaction is entered into on an execution venue (i.e. regulated exchanges or certain regulated trading platforms) as is the case in a Public to Private transaction, considerable detail is required. This is unlikely to be relevant in the private equity context since any interests acquired are unlikely to be executed on a regulated trading platform.

13 For example, where fund interests are acquired outside of a regulated exchange or trading platform.

Exercising voting rights

The Level 2 Regulation also contains rules on the exercise of voting rights by AIFMs. AIFMs will be obliged to develop and implement strategies for determining when and how any voting rights held in the AIF's portfolio(s) are to be exercised for the exclusive benefit of the relevant AIF and its investors.

The AIFM's voting strategy must include procedures to: (a) monitor relevant corporate actions; (b) ensure voting is in line with the AIF's investment objectives; and (c) prevent or manage conflicts. AIFMs should provide investors with a summary description of its voting strategy and details of the actions taken on the basis of the strategy, upon request.

Best execution

Best execution obligations will apply to transactions that are transmitted or executed on certain regulated markets and trading venues, or where a choice of execution venue is available. In the PE context this will likely only arise in public-to-private deals, PIPEs, gilts or money market instruments held pending investment in private equity, or hedging or other derivatives.

Broadly, this will require AIFMs to have a best execution policy in place which is designed to ensure that AIFMs take all reasonable steps to (a) obtain the best possible result for the AIF or the investors; or (b) confirm that the firms to which the AIFM passes the order provides best execution.

The best execution factors include: the price, costs, speed, likelihood of execution and settlement, size, nature of the order and any other consideration relevant to the execution of an order. The AIFM has some discretion in assessing the relative importance of these factors in the light of the AIF's objectives, investment policy and risks, the order and assets concerned and the execution venues potentially available.

Where the AIFM places an order with other firms for execution, the best execution policy should identify, in respect to each class of financial instrument, the firms with which the orders may be placed; and AIFMs are required to provide investors with 'appropriate information' regarding the policy and any material changes to it.

Monitoring and reviewing the best execution policy

AIFMs will be required to monitor the effectiveness of their best execution policy, including the quality of execution by firms to which orders are passed, and identify and correct any deficiencies found. The policy should be reviewed at least annually and must be reviewed whenever a material change occurs which affects the AIFM's ability to provide best execution.

An AIFM must be able to demonstrate that they have executed orders or placed orders with other firms on behalf of the AIF in accordance with its best execution policy.

Impact:
On Managers

Investments in real estate and partnership interests and certain other negotiated arrangements are not subject to the detailed best execution requirements in the Level 2 Regulation.

Most private equity AIFMs already have detailed due diligence and investment decision taking procedures and rarely need to deal in the type of investment or for investors where orders are time sensitive and need detailed handling and aggregation processes or where there is a relevant choice of counterparty. These factors mean that it is unlikely that the order execution and handling and due diligence requirements will materially impact the day-to-day operations of AIFMs in the private equity or venture capital sector.

However, it will be necessary to review and amend existing investment processes to ensure compliance, including recording voting strategies. The very fact that transactions subject to the best execution, choice of counterparty and securitisation provisions are likely to be relatively rare will mean that additional care will need to be taken to identify relevant transactions in order to ensure that they are carried out correctly.

Order handling, aggregation and allocation

In practice, although the order handling, aggregation and allocation rules will apply to private equity and venture capital AIFMs in full, it will rarely be the case that the nature of the transactions undertaken, and the parties for whom they are undertaken, require very detailed processes and procedures to handle orders.

AIFMs must establish procedures and arrangements which facilitate the prompt, fair and expeditious execution of an AIF's orders (including decisions the AIFM takes to deal for the AIFM), including ensuring that:

- orders are promptly and accurately recorded and allocated; and
- comparable AIF orders are executed sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable, or the interests of the AIF or the investors require otherwise.

Financial instruments, sums of money or other assets received in settlement of the executed orders must be promptly and correctly delivered or registered in the account of the relevant AIF. The AIFM must have arrangements in place to prevent the misuse of information regarding AIF orders.

In a normal private equity transaction the timing of the transaction and its completion is negotiated contractually and applies to all co-investing parties in accordance with any co-investment agreement, rather than the AIFM deciding timing of execution and whether or not to aggregate orders. Nevertheless, the allocation of transactions between funds and other investors is important. Policies on allocation will need to comply with the Regulation requirements as well as order handling and order aggregation policies being formulated in case they are ever relevant.

Broadly, AIFMs are allowed to aggregate an AIF order with an order of another AIF, a UCITS, or a client, or with an order made by the AIFM when investing its own funds where:

- it is reasonably likely that aggregation will not work to the disadvantage of any other AIF, UCITS, or client; and
- the AIFM has an order allocation policy in place. The policy must contain 'sufficient' precise terms for the fair allocation of orders that are aggregated, including how the volume and price of orders determines allocations and the treatment of partial executions.

Choice of counterparties

If an AIFM plans to enter into an OTC derivatives transaction (even if just for hedging purposes), securities lending or repo transaction then it will be subject to new due diligence obligations requiring the AIFM to ensure that the counterparty is (a) subject to ongoing supervision by a public authority (b) financially sound (in relation to which the AIFM can take account of whether the counterparty is subject to prudential regulation including capital requirements and effective supervision); and (c) has the necessary organisational structure and resources to perform the relevant services.

Securitisation transactions

In the rare case that a private equity AIFM considers investing in a securitisation position, including where such a situation might arise in a refinancing or exit, extensive new restrictions will apply. AIFMs will not be allowed to assume exposure to a securitisation unless the originator, sponsor or original lender has explicitly disclosed to the AIFM that it retains a material net economic interest (as described in the Level 2 Regulation) of at least 5%. Even when it does so the AIFM is responsible for carrying out extensive qualitative tests and having appropriate policies and procedures for that purpose.

Reporting essential information on execution of subscription and redemption orders

The Level 2 Regulation requires AIFMs to provide investors with "essential information" regarding the execution or acceptance of a subscription or redemption order from investors unless another firm is required to provide investors with a confirmation, which includes the essential information.

AIFMs will also be obliged to provide investors with information about the status of the order or acceptance of the subscription offer or both, upon request.

AIFMs will also be required to provide investors with essential information when an investor invests in (or commits to) the AIF; however in traditional closed-end private equity AIFs these requirements would only apply to the initial acceptance of the commitment and not to the subsequent draw downs and distributions.

The term "essential information" means the:

- identification of the AIFM;
- identification of the investor;
- date and time of receipt of the order;
- date of execution;
- identification of the AIF; and
- gross value of the order including charges for subscription or the net amount after charges for redemptions.

Chapter six:
Third Country Funds and Fund Managers

6

In this section

Primary contributors:
Jay Modrall (top) and Catherine Taddei (below)

Although the AIFMD is a European Union Directive (with EEA relevance), the AIFMD could still have relevance for a GP that does not have its registered office in the EEA, depending on its activities.

Under the Directive, such a GP will be treated as a 'non-EEA AIFM'.

The AIFMD applies to non-EEA AIFMs if, and to the extent that, they manage EEA AIFs, or market fund interests (in EEA or non-EEA AIFs) to EEA investors. Unlike EEA AIFMs, however, non-EEA AIFMs are not initially eligible to apply for authorisation under the AIFMD or to benefit from the AIFMD "marketing passport". Rather, the AIFMD provides for a series of transitional periods leading to full application of the AIFMD to non-EEA AIFMs no earlier than Q4 2018.

Timeline

The phasing in of the AIFMD with respect to non-EEA AIFs and AIFMs can be broken down into four periods.

1. 22 July 2013 until 21 July 2014

The AIFMD provides a one-year grace period for AIFMs already engaged in AIFMD activities as at the implementation date. These AIFMs may continue to conduct certain activities under the pre-AIFMD rules until 21 July 2014. The grace period was originally understood to apply only to EEA AIFMs, but a number of jurisdictions are now expected to permit non-EEA AIFMs who were in the market before 22 July 2013 to benefit from transitional relief. Thus it may be possible for non-EEA AIFMs to continue fundraising under the existing rules without becoming subject to all of the AIFMD's requirements.

However, the detailed requirements a non-EEA AIFM must satisfy to be able to benefit from the grace period (including what activities must have been conducted before 22 July 2013) and the extent to which some AIFMD requirements may nonetheless apply even if the grace period applies), are likely to vary from member state to member state, so local advice should be taken.

2. 22 July 2013 until late 2015

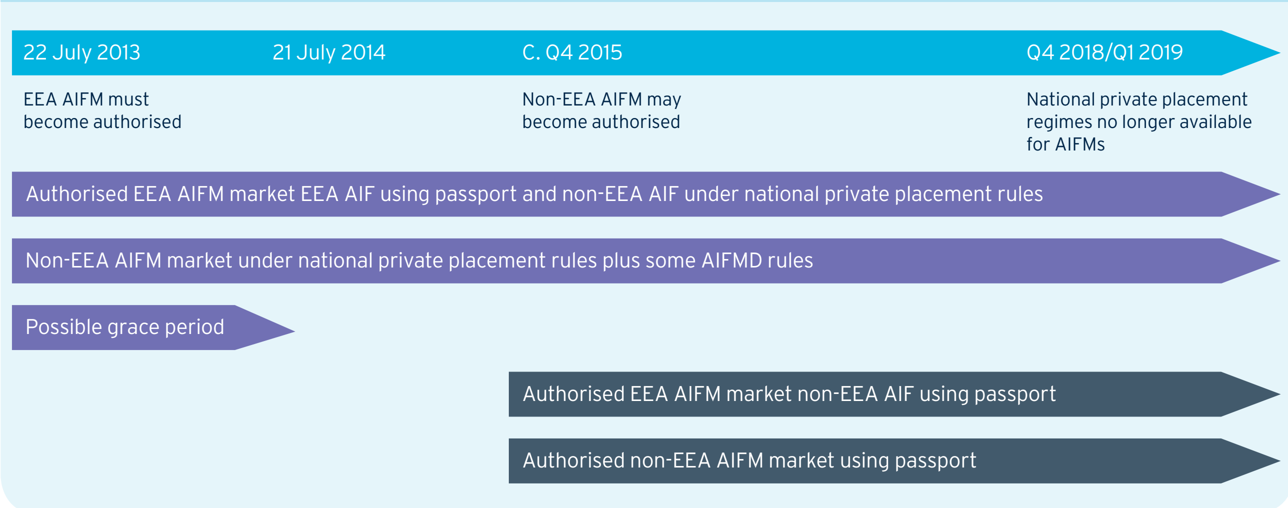
Non-EEA AIFMs that cannot rely on the grace period and, from 22 July 2014, all non-EEA AIFMs may market AIF interests to EEA professional investors only pursuant to member state placement regimes. National placement regimes must include minimum requirements as set out in the AIFMD, and may include other conditions imposed under member state law. Member states are not required to offer placement regimes, and it is expected that some will elect not to do so. If member states do elect to offer such placement regimes, the regimes must comply with the requirements set out below on pages 67 et seqq.

Non-EEA AIFMs may manage EEA AIFs during this period if permitted by national law in the relevant member state.

Non-EEA AIFs may continue to make investments throughout Europe. If the AIF has been marketed to EEA investors after 22 July 2013 (and subject to any transitional rules), however, the AIFM must comply with the AIFMD portfolio company provisions (see Chapter 5) in addition to the requirements applicable to its marketing activities.

EEA AIFMs marketing non-EEA AIF interests to EEA investors will have to comply with all obligations under the AIFMD (other than certain depositary obligations), but will not benefit from the passport when marketing interests in those non-EEA AIFs.

Figure 3: Timeline



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3. Late 2015 to late 2018/early 2019

Non-EEA AIFMs from qualifying jurisdictions will be eligible to apply for full authorisation under the AIFMD (enabling them to market funds to EEA professional investors and/or manage EEA funds on the same basis as EEA AIFMs) following a positive opinion from ESMA, and a decision by the European Commission on the operation of the passport regime. The earliest this can happen, however, is Q4 2015.

Non-EEA AIFMs may also continue to use national placement regimes for marketing to EEA investors as described above if, and to the extent, such regimes remain in place. To benefit from the passport, a non-EEA AIFM must become authorised by an EEA regulator under the AIFMD and comply with the AIFMD in full.

Authorised EEA AIFMs marketing non-EEA AIF interests to EEA investors will benefit from the EU passport from this time (as they will already be AIFMD-compliant in relation to those AIFs).

4. Late 2018/early 2019 onwards

Subject to a positive opinion from ESMA and a decision by the European Commission, national placement regimes will no longer be available for non-EEA AIFMs. Non-EEA AIFMs will be able to market AIF interests to EEA investors only if the non-EEA AIFM is from a qualifying jurisdiction and is authorised by an EEA regulator under the AIFMD.

Non-EEA AIFMs

The treatment of non-EEA AIFMs was one of the most controversial issues in the drafting of the AIFMD. The final text is intended to create a level playing field between EEA and non-EEA AIFMs, but the regime permitting non-EEA AIFMs to become authorised under the AIFMD and enjoy the same market access as EEA AIFMs will not become available until at least Q4 2015.

In July 2015, ESMA is required to deliver to the European Commission an opinion on the functioning of the management and/or marketing of AIFs by non-EEA AIFMs in the member states and advice on whether the passport should apply to the management and/or marketing of AIFs by non-EEA AIFMs. Subject to positive advice from ESMA and a subsequent decision by the Commission, non-EEA AIFMs from qualifying jurisdictions will be able to apply for authorisation under the AIFMD on the same basis as EEA AIFMs.

To qualify, a non-EEA jurisdiction must:

- have appropriate regulatory cooperation arrangements in place with relevant member state regulators;
- have OECD tax information exchange agreements in place with relevant member states; and
- not be designated as a Non-Cooperative Country and Territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

ESMA has negotiated memoranda of understanding ("MOUs") with the regulatory authorities in many third countries, including Bermuda, the Cayman Islands, the Channel Islands and the United States. MOUs need to be entered into on a bilateral basis by each relevant member state regulator. In addition, local law in the AIFM's home jurisdiction must not prevent effective supervision of the AIFM by its EEA regulator. Basic requirements for authorisation (once available).

A non-EEA AIFM wishing to manage an EEA AIF or market any AIF in the EEA in reliance on the marketing passport must apply for authorisation to the regulator in its "member state of reference" (see further below), which will be treated as the non-EEA AIFM's home member state regulator for purposes of the AIFMD.

Non-EEA AIFMs becoming authorised under the AIFMD will be required to comply with the AIFMD in full, unless a legal requirement in the non-EEA AIFM's home jurisdiction directly conflicts with an obligation under the AIFMD and the AIFM can demonstrate that it is subject to an equivalent domestic rule having the same regulatory purpose and offering the same level of protection to investors. ESMA is required to give advice on the appropriateness of an exemption in case of incompatibility with an equivalent rule, and the availability of such waivers is expected to be extremely limited.

The authorisation process is largely the same as for EEA AIFMs (see Chapter 2), except that a member state of reference must be identified to act in place of the home member state regulator.

Member state of reference

Broadly speaking, a non-EEA AIFM's member state of reference will be the predominant EEA jurisdiction in which the non-EEA AIFM manages or markets AIFs, although the detailed rules are relatively complex.

In situations where there are several possible member states of reference (e.g. where the non-EEA AIFM markets AIFs in different EEA jurisdictions), the non-EEA AIFM must submit a request[14] to the regulators of all member states that could potentially be the member state of reference, who then jointly determine where the non-EEA AIFM should become authorised.

The regulators in all possible member states of reference will jointly decide which of them will be the member state of reference within a month of receipt of the non-EEA AIFM's request to determine its Member State of reference. This period may be extended if further information and documents are requested by the regulators. ESMA will advise on the appropriateness of the choice of member state of reference.

Where a non-EEA AIFM intends to market more than one non-EEA AIF to EEA investors, the member state of reference will be the one where the non-EEA AIFM intends to develop effective marketing for most of those non-EEA AIFs.

> Broadly speaking, a non-EEA AIFM's member state of reference **will be the predominant EEA jurisdiction** in which the non-EEA AIFM manages or markets AIFs.

Unfortunately, neither the AIFMD nor the Commission's Regulation on member state of Reference indicate whether other relevant factors may be taken into account in deciding upon the member state of reference. Factors to be considered may include the non-EEA AIFM's preference, whether affiliates of the non-EEA AIFM are already regulated by a member state regulator, or the member state regulator's working language.

If the AIFM changes its marketing strategy within two years after its initial authorisation and this change would have affected the determination of the member state of reference, the AIFM must notify the competent authorities of the initial member state of reference and indicate its new member state of reference based on the new strategy. The AIFM will justify its assessment by disclosing its new marketing strategy to its initial member state of reference. At the same time, the AIFM will provide information on the entity that would be its new legal representative after the change, including at least the identity and the location of the new legal representative.

Legal representative

Non-EEA AIFMs registering under the AIFMD will be required to appoint a "legal representative" in their member state of reference. The legal representative will, together with the AIFM itself, be the contact point for investors, ESMA and EEA regulators as regards the activities for which the AIFM is authorised in the EEA. The legal representative must at least be sufficiently equipped to perform the AIFMD compliance function.

Marketing of interests in non-EEA AIFs

Non-EEA AIFMs

Member states may, but are not obliged to, retain national placement regimes for non-EEA AIFMs from qualifying jurisdictions until at least Q4 2018. Such non-EEA AIFMs will be able to market interests in non-EEA AIFs without a passport subject to compliance with the AIFMD's transparency and disclosure requirements (see Chapter 3) and portfolio company provisions (see Chapter 5), plus any additional conditions imposed by member state law.

To be a qualifying jurisdiction for this purpose, the jurisdiction must:

- have in place cooperation arrangements with the competent/supervisory authorities in the relevant EEA jurisdictions; and
- not be designated by FATF as a Non-Cooperative Country and Territory.

14 Such a request must contain the information set out in the Commission's Implementing Regulation establishing a procedure for determining the member state of Reference of a non-EU AIFM.

EEA AIFMs

National placement regimes for EEA AIFMs marketing interests in non-EEA AIFs established in qualifying jurisdictions may also be retained until at least Q4 2018, although it is anticipated that most will utilise the third country passport once available (which will be no earlier than Q4 2015).

All AIFMs after Q4 2015

As from Q4 2015, again subject to positive advice from ESMA and a decision by the Commission, all AIFMs authorised under the AIFMD will be entitled to market interests in non-EEA AIFs they manage to EEA professional investors using a passport, provided that:

- the jurisdiction of the AIF or the AIFM meets the eligibility requirements summarised above;
- OECD tax information exchange agreements apply between the relevant jurisdictions; and
- the local law in the non-EEA jurisdiction does not prevent effective supervision by the relevant EEA regulator.

Role of ESMA

ESMA will have an important role in the application of the AIFMD to non-EEA AIFMs and AIFs.

In particular, in July 2015, ESMA must issue an opinion on the functioning of the passport for EEA AIFMs managing and marketing EEA AIF interests and the managing or marketing of AIF interests without a passport by EEA AIFMs and non-EEA AIFMs, and advise the European Commission on whether the passport should be extended to non-EEA AIFMs and non-EEA AIFs. ESMA will base its opinion and advice on, among other things, the use made of the passport for EEA AIFs and any problems encountered during its use; the effectiveness of the collection and sharing of information by national regulators, ESMA and ESRB (European Systemic Risk Board); compliance with the rules on marketing and managing AIFs during the transitional period; and potential market disruptions and distortions.

If ESMA's opinion and advice is positive (i.e. favourable), the Commission must adopt a delegated act within three months specifying the date when the regime enabling non-EEA AIFMs to become authorised under the AIFMD, and non-EEA AIF interests to be marketed with the passport, will enter into force. ESMA is required to issue a positive advice if it considers that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk. If ESMA does not issue its advice by the deadline, the Commission will set a new time limit. The consequences if ESMA's advice is negative are not clear.

Similarly, three years after the entry into force of the passport regime for non-EEA AIFMs and non-EEA AIFs, ESMA will issue an opinion and advice on the functioning of the passport. If the advice is positive, the Commission will adopt another delegated act setting out the date on which national placement regimes must be terminated.

Impact:
On Investors

All authorised AIFMs will be entered on a central register maintained by competent authorities and held centrally by ESMA. Investors will, therefore, be able to identify which AIFMs are authorised under the Directive.

Investors should be aware, however, that AIFMs may be authorised to manage, but not market, an AIF.

Investors wanting to invest in a third country fund (or a fund managed by a non-EEA manager) ought to confirm with the manager of that fund that the manager has taken steps to understand the implications of the Directive, including its ability to fund raise. As noted in Chapter 1 above, the Directive does allow for investors to commit to funds at their own initiative (reverse solicitation) but that it is unclear just how much investors can rely on this provision to gain access to funds.

The restrictions on marketing interests in non-EEA AIFs may, in practice, mean that it becomes more difficult for EEA investors to access non-EEA funds, as some non-EEA sponsors may decide not to market future funds under the AIFMD regime. However, the AIFMD does not preclude a non-EEA AIFM from selling interests in non-EEA AIFs to EEA investors so long as the AIFM does not engage in marketing to EEA investors. Thus, investors should be able to continue to invest if they proactively contact non-EEA sponsors to request information about future funds.

The AIFMD marketing restrictions may, however, mean that, in future, third country fund sponsors are less willing, or able, to take an active role in secondary transfers of fund interests, as it may be important to demonstrate that any such transfer is undertaken at the initiative of the investor.

Annex I: **Guide to marketing in the EEA for Third Country AIFs and AIFMs**

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Annex I

In this section

The table on the following pages, summarises how non-EEA AIFMs marketing any type of AIF to EEA investors and how EEA AIFMs marketing non-EEA AIFs to EEA investors are affected by the Directive.

Scenario 1: Non-EEA AIFM – EEA AIF

Passport[15]: not available for third-country AIFs and AIFMs until late 2015

A non-EEA AIFM managing an EEA fund will be required to obtain authorisation under the AIFMD as soon as the regime for non-EEA AIFMs becomes available in 2015.[16] Once authorised, the AIFM must comply with the AIFMD in full.[17]

In addition, the following conditions must be fulfilled:

- Appropriate cooperation arrangements are in place between the regulator in the country where the AIFM is established and the regulator in the EEA member state in which the AIFM has obtained authorisation (i.e. the AIFM's member state of reference) (and, if different, the regulator in the EEA member state in which the AIF is established).
- The jurisdiction where the AIFM is established must not be listed as a non-cooperative country or territory by the FATF on anti-money laundering and terrorist financing.
- A tax information sharing agreement which fully complies with standards of the OECD Model Tax Convention is in place between the country where the AIFM is established and the EEA member state in which the GP has obtained authorisation (the AIFM's member state of reference).
- Domestic law and regulation applicable to the AIFM must not prevent the relevant EEA regulator from supervising the AIFM effectively.
- The non-EEA AIFM must appoint a legal representative in the member state in which it has obtained authorisation.

Notification to the non-EEA AIFM's member state of reference is required if marketing of EEA AIF interests is intended in the non-EEA AIFM's member state of reference or any other member states.

Note also that any AIFM authorised under the AIFMD will be entitled to passport its fund management services (i.e. will not need to be separately licensed in each EEA jurisdiction in which it manages funds), and will also benefit from the marketing passport.

National placement regimes[18]: continue to be available for third-country AIFs and AIFMs until at least three years after the third country passport becomes available

Until the introduction of the passport (expected in 2015/2016), a non-EEA AIFM may manage an EEA fund if permitted by national law in the relevant EEA jurisdiction.

Until the introduction of the passport, the fund may be marketed to EEA investors under national placement regimes on the same basis as a non-EEA fund provided however that the EEA AIF must have appointed one or several persons assuming depositary functions. The passport will not be available until later 2015 at the earliest.

More specifically:

At a minimum, national placement regimes must require non-EEA AIFMs to comply with the following provisions of the AIFMD:

Chapter IV: Transparency requirements

- The AIFM will need to **disclose** to its **investors**, among other things, information about the fund's investment policy and performance, investor protection measures, leverage, liquidity and service providers (like the depositary). The disclosures must be made prior to investment and updated on any material change.
- The AIFM will need to produce an **annual report** for each fund containing audited financials, a narrative report on the fund's activities over the year, aggregated remuneration disclosures and details of any material changes to the investor disclosures.
- The AIFM will be subject to **regulatory reporting obligations** in each member state in which funds are actively marketed according to a pro-forma reporting template. Frequency of reporting will depend on a number of factors, such as the value of assets under management.

15 The passport only entitles AIFMs to market fund interests to professional investors. EU jurisdictions may impose additional restrictions on marketing to retail investors (Article 43 AIFMD).

16 There are detailed rules that determine the EU jurisdiction in which the AIFM should seek authorisation.

17 There is a very limited power to derogate if the GP can demonstrate that AIFMD compliance is incompatible with a mandatory legal requirement to which it is subject and that other requirement has the same regulatory purpose and offers the same level of investor protection as the AIFMD provision.

18 In most countries the use of the passport will be voluntary, in the sense that until late 2018/early 2019, non-EEA AIFMs should have a choice between becoming authorised and benefitting from the passport, on the one hand, and continuing to market under national placement regimes, on the other hand. In some countries, however, national regimes will be abolished and marketing will only be permitted by authorised AIFMs. If national placement regimes are terminated in 2018/19, authorisation will be the legal regime applicable for all firms that want to actively solicit EEA investors.

National placement regimes: continue to be available for third-country AIFs and AIFMs until at least three years after the third country passport becomes available

Chapter V: Portfolio Company requirements[19]

- Notification of acquisitions. The AIFM must make a basic regulatory filing when the voting percentage held by the fund in an EU company exceeds or falls below 10%, 20%, 30%, 50% or 75%.
- Disclosures on acquisition of control:[20] Additional disclosures to regulators, other shareholders and the portfolio company's board of directors and employees of information including the identity of the managers of the fund that has taken control, intentions with regard to the future business of the company and likely impact on employment and changes to conditions to employment.
- Where the fund has control, additional **annual report** information reviewing the last financial year, important post-year end events and likely future development.
- Anti-asset stripping: For the first two years after control has been acquired, the AIFM must not facilitate, support, instruct or vote in favour of any distribution to shareholders, capital reduction, share redemption or acquisition of own shares by the portfolio company that would (broadly speaking) result in a reduction in the company's net assets or be made otherwise than out of distributable profits.

National placement regimes will only be available in relation to those non-EEA jurisdictions where:

- Appropriate cooperation arrangements for systemic risk oversight are in place between the regulator in each member state where the AIF is marketed and the supervisory authorities of the jurisdiction(s) where the AIFM and the AIF are established.
- The jurisdictions where the AIFM and the AIF are established must not be listed as a non-cooperative country or territory by the FATF on anti-money laundering and terrorist financing.

From late 2015 (triggered by the requirement to get authorisation for management of EEA AIFs), the AIFM will need to comply with the full AIFMD. At that point, the following conditions will also need to be fulfilled:

- Cooperation agreements are 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.
- Cooperation agreements for systemic risk oversight need to be in place between the competent authorities of 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 country where the AIFM is established must not be listed as a non-cooperative country and territory by the FATF on anti-money laundering and terrorist financing.
- A tax information sharing agreement which fully complies with standards of the OECD Model Tax Convention is in place between the country where the AIFM is established and its member state of reference.
- The local law in the AIFM's jurisdiction must not prevent effective supervision.

19 SME portfolio companies are excluded.
20 Additional obligations are set in case of EU portfolio companies where AIFM takes control (50% of voting rights for unlisted companies, 30%-33% on a take-private).

Scenario 2: Non-EEA AIFM – Non-EEA AIF

Passport[21]: not available for third-country AIFs and AIFMs until late 2015

To benefit from the passport, the AIFM must become authorised by an EEA regulator on the same basis as an EEA firm, and must comply with the AIFMD in full.[22]

In addition, the following conditions must be fulfilled:

- Appropriate cooperation arrangements are in place between the regulator(s) in the jurisdiction(s) where the AIFM and the AIF are established and the regulator in the EEA member state in which the AIFM has obtained authorisation (i.e. the AIFM's member state of reference).
- The jurisdiction(s) where the AIFM and the AIF are established must not be listed as a non-cooperative country and territory by the FATF on anti-money laundering and terrorist financing.
- A tax information sharing agreement which fully complies with standards of the OECD Model Tax Convention is in place between the countries where the AIF and the AIFM are established and the EEA member state in which the AIFM has obtained authorisation (i.e. AIFM's member state of reference), and between the country where the AIF is established and all EEA member states into which it is to be marketed.
- Domestic law and regulation applicable to the AIFM must not prevent the relevant EEA regulator from supervising the AIFM effectively.
- The non-EEA AIFM must appoint a legal representative in the member state in which it has obtained authorisation.

Notification to the non-EEA AIFM's member state of reference is required if marketing of non-EEA AIF interests is intended in the non-EEA AIFM's member state of reference or any other member states.

National placement regimes[23]: continue to be available for third-country AIFs and AIFMs until at least three years after the third country passport becomes available

Until 2018, EEA member states may – but are not required to – permit non-EEA AIFMs to market fund interests to investors domiciled or with their registered office in that jurisdiction.

Those jurisdictions that offer national placement regimes may impose specific requirements for that jurisdiction. These may be procedural (e.g. a requirement to register with the regulator before marketing) or other substantive requirements.

At a minimum, national placement regimes must require non-EEA AIFMs to comply with the following provisions of the AIFMD:

Chapter IV: Transparency requirements

- The AIFM will need to **disclose** to its **investors**, among other things, information about the fund's investment policy and performance, investor protection measures, leverage, liquidity and service providers (like the depositary). The disclosures must be made prior to investment and updated on any material change.
- The AIFM will need to produce an **annual report** for each fund containing audited financials, a narrative report on the fund's activities over the year, aggregated remuneration disclosures and details of any material changes to the investor disclosures.
- The AIFM will be subject to **regulatory reporting obligations** in each member state in which funds are actively marketed according to a pro-forma reporting template. Frequency of reporting will depend on a number of factors, such as the value of assets under management.

21 The passport only entitles AIFMs to market fund interests to professional investors. EU jurisdictions may impose additional restrictions on marketing to retail investors (Article 43 AIFMD).

22 There is a very limited power to derogate if the GP can demonstrate that AIFMD compliance is incompatible with a mandatory legal requirement to which it is subject and that other requirement has the same regulatory purpose and offers the same level of investor protection as the AIFMD provision.

23 In most countries the use of the passport will be voluntary, in the sense that until late 2018/early 2019, non-EEA AIFMs should have a choice between becoming authorised and benefitting from the passport, on the one hand, and continuing to market under national placement regimes, on the other hand. In some countries, however, national regimes will be abolished and marketing will only be permitted by authorised AIFMs. If national placement regimes are terminated in 2018/19, authorisation will be the legal regime applicable for all firms that want to actively solicit EEA investors.

National placement regimes: continue to be available for third-country AIFs and AIFMs until at least three years after the third country passport becomes available

Chapter V: Portfolio Company requirements[24]

- Notification of acquisitions. The AIFM must make a basic regulatory filing when the voting percentage held by the fund in an EU company exceeds or falls below 10%, 20%, 30%, 50% or 75%.
- Disclosures on acquisition of control:[25] Additional disclosures to regulators, other shareholders and the portfolio company's board of directors and employees of information including the identity of the manager of the fund that has taken control, its intentions with regard to the future business of the company and the likely impact on employment and changes to conditions to employment.
- Where the fund has control, additional **annual report** information reviewing the last financial year, important post-year end events and likely future development.
- Anti-asset stripping: For the first two years after control has been acquired, the AIFM must not facilitate, support, instruct or vote in favour of any distribution to shareholders, capital reduction, share redemption or acquisition of own shares by the portfolio company that would (broadly speaking) result in a reduction in the company's net assets or be made otherwise than out of distributable profits.

National placement regimes will only be available in relation to those non-EEA jurisdictions where:

- Appropriate cooperation arrangements for systemic risk oversight are in place between the regulator in each member state where the AIF is marketed and the supervisory authorities of the jurisdiction(s) where the AIFM and the AIF are established.
- The jurisdiction(s) where the AIFM and the AIF are established must not be listed as a non-cooperative country or territory by the FATF on anti-money laundering and terrorist financing.

24 SME portfolio companies are excluded.
25 Additional obligations are set in case of EU portfolio companies where AIFM takes control (50% of voting rights for unlisted companies, 30%-33% on a take-private).

Scenario 3: EEA AIFM – Non-EEA AIF

Passport[26]: not available for third-country AIFs and AIFMs until late 2015

Marketing

As an EEA AIFM, authorisation under the AIFMD will be required. This means compliance with the full AIFMD (except for Chapter VI).

In addition, the following requirements need to be met:

- Cooperation arrangements are in place between the competent authorities of the AIFM's home member state and the supervisory authorities of the third country where the non-EEA AIF is established.
- The third country where the AIF is established must not be listed as a non-cooperative country and territory by the FATF on anti-money laundering and terrorist financing.
- A tax information sharing agreement which fully complies with standards of the OECD Model Tax Convention is in place between the third country where the AIF is established and the AIFM's home member state and each other member state in which the AIF is (intended to be) marketed.

Notification to the competent authorities of the EEA AIFM's home member state is required in case of marketing of non-EEA AIF interests in the AIFM's member state or any other member states.

Managing

If an EEA AIFM wants to manage a non-EEA AIF, BUT NOT market it in the EEA:

- The AIFM will need to comply with all AIFMD requirements, except for the depositary (Article 21) and annual report (Article 22) requirements in respect of those AIFs, and
- Appropriate cooperation arrangements must be in place between the competent authorities of the AIFM's home member state and the supervisory authorities of the third country where the non-EEA AIF is established.

National placement regimes[27]: continue to be available for third-country AIFs and AIFMs until at least three years after the third country passport becomes available

In the transitional period to 2018, member states may – but are not required to – permit EEA AIFMs to market non-EEA AIFs to professional investors, provided that:

- The AIFM complies with the full AIFMD in relation to those AIFs, excluding aspects of Article 21 on Depositary requirements.[28]

In addition, the following conditions need to be complied with:

- Cooperation arrangements for systemic risk oversight need to be in place between the competent authorities of the AIFM's home member state and the supervisory authorities of the third country where the AIF is established.
- The third country where the AIF is established must not be listed as a non-cooperative country and territory by the FATF on anti-money laundering and terrorist financing.

26 The passport only entitles AIFMs to market fund interests to professional investors. EU jurisdictions may impose additional restrictions on marketing to retail investors (Article 43 AIFMD).

27 In most countries the use of the passport will be voluntary, in the sense that until late 2018/early 2019, non-EEA AIFMs should have a choice between becoming authorised and benefitting from the passport, on the one hand, and continuing to market under national placement regimes, on the other hand. In some countries, however, national regimes will be abolished and marketing will only be permitted by authorised AIFMs. If national placement regimes are terminated in 2018/19, authorisation will be the legal regime applicable for all firms that want to actively solicit EEA investors.

28 Note that the AIFM must ensure that one or more entities are appointed to carry out certain depositary functions.

Glossary – List of Abbreviations

AIFMD	Alternative Investment Fund Managers Directive (Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010)
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AUM	Assets under Management
CRD	Commonly used to refer to the Banking Consolidation Directive and Capital Adequacy Directive
CRR/CRD IV	Capital Requirements Regulation and fourth Capital Requirements Directive
EEA	European Economic Area
ECB	European Central Bank
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EuVECA	European Venture Capital Fund Regulation (Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds)
EuSEF	European Social Entrepreneurship Fund Regulation (Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds)
FATF	Financial Action Task Force
FoF	Fund-of-funds
MiFID	Markets in Financial Instruments Directive (Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC)
MOU	Memorandum of Understanding
OECD	Organisation for Economic Cooperation and Development
OTC	Over-the-counter
PII	Professional Indemnity Insurance
UCITS IV	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

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The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.

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