

The Impact of the Alternative Investment Fund Managers Directive on Non-E.U. Managers of Non-E.U. Funds

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Background

The Alternative Investment Fund Managers Directive¹ (the Directive) entered into force on July 21, 2011 with E.U. Member States (Member States) having until July 22, 2013 to implement it. The Directive broadly aims to create a single harmonized pan-European regulatory framework for E.U.-established managers (Managers) of alternative investment funds (AIFs). It also sets out a regime for the marketing in the E.U. of both E.U. and non-E.U. AIFs by non-E.U. Managers. This memorandum focuses on the specific provisions of the Directive and the U.K.'s implementing regulations² (Draft Regulations) applicable to non-E.U. Managers seeking to market non-E.U. AIFs to E.U. investors.

Executive summary

The key points for non-E.U. Managers seeking to market non-E.U. AIFs to E.U. investors are that:

- from July 22, 2013, non-E.U. Managers may continue to make use of Member States' existing private placement regimes provided that (i) they comply with certain disclosure and transparency requirements, (ii) appropriate information sharing agreements are in place between the relevant Member State and the jurisdictions of establishment of both the non-E.U. AIF and the non-E.U. Manager, and (iii) the jurisdictions of establishment of both the non-E.U. AIF and the non-E.U. Manager are not on the Financial Action Task Force's (FATF) Non-Cooperative Country and Territory list (the Three Conditions). The Three Conditions are set out in greater detail below;
- in the U.K., non-E.U. Managers will be required to notify the U.K.'s Financial Conduct Authority (FCA) before they can commence marketing the AIFs that they manage to U.K. based investors. The Draft Regulations provide a one year transitional period under which non-E.U. Managers that immediately prior to July 22, 2013 are managing and marketing (in an E.E.A. state) AIFs (whether E.U. based or not), need not comply with the Draft Regulations (in other words, will not need to meet the Three Conditions or the requirement to first notify the FCA) until July 22, 2014;
- from July 22, 2013, restrictions on "asset stripping" will apply during the first 24 month period following acquisition of control of a non-listed company;
- from the second half of 2015, non-E.U. Managers may, subject to advice from the European Securities Markets Authority (ESMA) on the extension of the regime to non-E.U. Managers, use the pan-E.U. passport regime to market their AIFs provided that the relevant non-E.U. Manager first becomes authorized in a Member State and complies with the various regulatory requirements that authorization implies, including, in relation to disclosure and transparency, limits on leverage, the appointment of a depositary and remuneration;

¹ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers. The text of the Directive can be found [here](#).

² Draft Statutory Instrument 2013 No. 0000, Financial Services and Markets, The Alternative Investment Fund Managers Regulation 2013. The text of the Draft Regulations can be found [here](#).

- from the end of 2018, and subject to ESMA's advice, the existing Member States' private placement regimes may be withdrawn; and
- reverse solicitation or passive marketing should, depending on local Member State law and regulation, remain available to non-E.U. Managers up until and after 2018. The concept of reverse solicitation is enshrined in the Draft Regulations.

Some definitions

Manager

A Manager is a legal person whose regular business is managing one or more AIFs. A Manager can be considered to be managing an AIF where, in the course of managing the AIF, it is performing at least portfolio management and/or risk management functions.

AIF

AIFs are defined as collective investment undertakings (including any related investment compartments) which “*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.*”³ E.U. AIFs are AIFs which are either (i) authorized or registered in a Member State or (ii) have their registered office and/or head office in a Member State. Any AIF that is not an E.U. AIF is a non-E.U. AIF. Family office vehicles would fall outside of the definition of an AIF. There is also a specific carve out for UCITS (Undertakings for Collective Investment in Transferable Securities).⁴

Marketing

Marketing is defined as the “*direct or indirect offering or placement at the initiative of the [Manager] or on behalf of the [Manager] of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the [European] Union.*”⁵ This suggests that reverse solicitation or passive marketing, as discussed in further detail below, is not prohibited by the Directive.

A brief overview of the Directive

The Directive applies to (i) E.U. Managers which manage one or more AIFs (regardless of whether the AIFs are E.U. based or not); (ii) non-E.U. Managers who manage one or more E.U. AIFs; and (iii) non-E.U. Managers seeking to market AIFs (regardless of whether the AIFs are E.U. based or not) to investors in the E.U. The Directive does not directly apply to the AIFs themselves, although it is worth bearing in mind that the AIF would remain subject to applicable Member State law and regulation, if any. As such, the Directive would apply to, say, a U.S. Manager of an AIF established in the Cayman Islands to the extent that the U.S. Manager seeks to market the fund to E.U. based investors. There are, however, a limited number of exemptions, the key ones of which are set out below.

E.U. based Managers will be required to be authorized under the Directive. As a consequence of being authorized, a Manager will be able to market units or shares in the AIF that it manages across the Member States under the pan-E.U. passport regime. Authorized Managers will however, be subject to a number of obligations including in relation to governance and conduct of business standards, capital

³ Article 4(1)(a), Directive.

⁴ As defined in Directive 2009/65/EC (Recast UCITS Directive).

⁵ Article 4(1)(x), Directive.

requirements, enhanced disclosure and transparency requirements and remuneration policies. In addition, authorized Managers are required to appoint a depositary on behalf of each AIF that they manage.⁶ Authorized Managers will also be subject to limitations on leverage and will face restrictions in relation to asset stripping (as set out in greater detail below). Finally, both ESMA and Member States' regulators have increased inspection and intervention powers.

Please refer to the December 17, 2010 Investment Management Regulatory Update for a detailed discussion on the Directive (which is available [here](#)) and the February 27, 2013 Investment Management Regulatory Update for an overview of the European Commission's Level 2 AIFMD Regulations (which is available [here](#)).

The marketing of non-E.U. AIFs by non-E.U. Managers

From the implementation of the Directive until at least 2018 (see below regarding the possible end of the availability of the private placement regime), Member States may allow non-E.U. Managers to market units or shares in the non-E.U. AIFs that they manage to professional investors (as opposed to retail investors) provided that each of the Three Conditions, set out in greater detail below, is fulfilled.⁷ It is worth noting that these are the minimum requirements set out under the Directive, which specifically provides that Member States may "gold plate" these requirements by imposing stricter rules on non-E.U. Managers in relation to the marketing of non-E.U. AIFs to investors in their jurisdiction.

First Condition: Disclosure and transparency

Non-E.U. Managers must comply with the following four disclosure and transparency provisions of the Directive:

- **annual report:** non-E.U. Managers are obliged, in respect of each non-E.U. AIF that they market to investors in the E.U., to make available to investors and the relevant competent authorities an annual report for each financial year. The annual report must contain, amongst other things, a statement of assets and liabilities, the aggregate remuneration for the financial year paid by the non-E.U. Manager to its staff, (including carried interest paid by the AIF) and (i) the aggregate remuneration for senior management and (ii) the aggregate remuneration of staff whose actions have a material impact on the risk profile of the AIF;
- **disclosure to investors:** in respect of each AIF that it markets to investors in the E.U., non-E.U. Managers must make available certain information to potential investors including details of the investment strategy, a description of all fees, charges and expenses (and the maximum amounts borne directly or indirectly by investors) and a description of any preferential treatment afforded to an investor. Investors must be notified of any material changes to the information provided;
- **reporting obligations to competent authorities:** non-E.U. Managers are required (in relation to each non-E.U. AIF that they market into the E.U.) to make a number of disclosures to the relevant Member State's competent authority, including disclosure of the percentage of the fund's assets which are subject to special arrangements arising from their illiquid nature and disclosure of the main categories of assets in which the fund is invested. Non-E.U. Managers are also required, where they employ substantial leverage, to make available to the relevant competent authorities information about the overall level of leverage used by the relevant AIF, including a break-down

⁶ Please refer to Richard Small (co-author), *Depositaries, Custodians and Client Money*, *The Hedge Fund Journal*, February 2011 for further information on the role of a depositary.

⁷ Article 42(1), Directive.

between leverage arising from borrowing cash or securities and leverage embedded in financial instruments and the extent to which the fund's assets have been reused under leveraging arrangements; and

- **notification of acquisition of control:** where a non-E.U. AIF acquires more than 10% of the voting rights in a non-listed company established in the E.U., the non-E.U. Manager must make a notification to the relevant competent authority. The non-E.U. Manager will need to make further notifications where the non-E.U. AIF's proportion of the voting rights reaches, exceeds or falls below the thresholds of 10%, 20%, 30%, 50% and 75%. Separately, where a non-E.U. AIF either individually or jointly acquires control of a non-listed company or an issuer established in the E.U. whose shares are admitted to trading on a regulated market, it must disclose such fact to the company concerned, the shareholders of that company and the relevant competent authority. There is an exemption to this requirement in place for special purpose vehicles established for the purpose of purchasing, holding or administering real estate.

Second Condition: International cooperation

Appropriate cooperation agreements must be in place between the competent authorities of the Member State into which the non-E.U. Manager is seeking to market and the competent authorities of the jurisdictions in which both the non-E.U. Manager and the non-E.U. AIF are established (Cooperation Agreements). The relevant Cooperation Agreements should be in line with international standards and should ensure an efficient exchange of information to allow the competent authorities of the relevant Member State to carry out their duties under the Directive. ESMA is in the process of negotiating Cooperation Agreements in the form of a standard memorandum of understanding (based on a template produced by IOSCO) and expects to have these in place with key non-E.U. jurisdictions by July 22, 2013.

As of June 3, 2013, Cooperation Agreements were in place with regulators in a number of jurisdictions, including the British Virgin Islands, the Cayman Islands, Guernsey and Jersey. A Cooperation Agreement has been signed with the Securities and Exchange Commission (SEC) but not with the Commodity Futures Trading Commission (CFTC). If a Cooperation Agreement is not reached with the CFTC by July 22, 2013 fund managers registered as commodity trading advisors or commodity pool operators with the CFTC will not be able to meet the Three Conditions. The position of dual SEC/CFTC registrants is not currently entirely clear and as such dual registrants should consult with counsel if a Cooperation Agreement has not been reached with the CFTC by such date.

Third Condition: FATF compliance

The jurisdictions of establishment of the non-E.U. Manager and any non-E.U. AIFs that it manages should not be listed as a Non-Cooperative Country and Territory by the FATF.

The impact of the U.K.'s Draft Regulation

The Directive requires that Member States implement the Directive into local law by July 22, 2013. The Directive further provides for a one year transitional period. Non-E.U. Managers must therefore fully comply with the requirements of the Directive that are relevant to them by July 21, 2014. The Draft Regulations are the U.K.'s transposition of the Directive. The key elements that are of relevance to non-E.U. Managers seeking to market non-E.U. AIFs to investors in the U.K. are set out below.

Transitional provisions

The U.K. has put in place transitional provisions for Managers managing AIFs immediately before July 22, 2013. Until July 22, 2014, Managers (including non-E.U. Managers) that immediately prior to July 22, 2013 are managing and marketing (in a Member State) AIFs (whether E.U. based or not), need not comply with the Draft Regulations when marketing AIFs to U.K. based investors (in other words, will not need to meet the Three Conditions).⁸ A non-E.U. Manager operating under the transitional arrangements could launch and market a new AIF after July 22, 2013 but would not need to comply with the Three Conditions until the earlier of becoming authorized or July 22, 2014. From July 22, 2014, however, such non-E.U. Manager would either need to obtain FCA authorization or comply with the Three Conditions to continue to market to U.K. investors.

Notification requirement

Notwithstanding the U.K.'s HM Treasury statement that it did not intend to impose additional requirements on non-E.U. Managers or non-E.U. AIFs over and above the Directive's minimum requirements, the Draft Regulations require non-E.U. Managers wishing to market AIFs that they manage into the U.K. to first notify the FCA of that fact.⁹ The notification must be in writing and must contain a statement confirming that:

- the non-E.U. Manager is the person responsible for ensuring compliance with the Draft Regulations relating the marketing of the AIF; and
- each of the Three Conditions has been complied with.

Note that, unlike earlier versions of the Draft Regulations, the non-E.U. Manager does not need to receive approval from the FCA once notification has been made. There is an ongoing obligation to inform the FCA where there is a material change to the information provided in the notification.

Reverse solicitation

The Draft Regulations enshrine the concept of reverse solicitation or passive marketing in the U.K.¹⁰ The Draft Regulations provide that the conditions attached to the marketing of AIFs (i.e., notification to the FCA and the Three Conditions) "*do not apply to an offering or placement of units or shares of an AIF to an investor made at the initiative of that investor.*"¹¹ The FCA expects to publish guidance on reverse solicitation and passive marketing shortly. Non-E.U. Managers will therefore, if the Draft Regulations are ultimately adopted in their current form, be able to sell in the U.K. units or shares in their AIFs without having to comply with the various requirements imposed on them under the Directive and the Draft Regulations to the extent that it is the investor who takes the initiative. As set out in greater detail below, reverse solicitation or passive marketing may, depending on local Member State law and regulation, be available to non-E.U. Managers in other Member States as well.

⁸ Regulation 73(2), Draft Regulations.

⁹ Regulation 59, Draft Regulations.

¹⁰ "Reverse solicitation" or "passive marketing" refers to the situation where an investor contacts a Manager at the investor's own initiative (rather than at the Manager's direct or indirect initiative) with a view to making an investment in one or more of the funds being managed by that Manager.

¹¹ Regulation 47, Draft Regulations.

The use of the pan-E.U. passport regime by non-E.U. Managers

The pan-E.U. passport regime should, subject to positive advice from ESMA on the extension of the regime, become available to non-E.U. Managers from the second half of 2015.¹² Non-E.U. Managers that wish to make use of the pan-E.U. passporting regime will first need to obtain authorization in a Member State. Authorized non-E.U. Managers will be obliged to comply with all of the requirements of the Directive, including in relation to the appointment of depositaries, the limits on leverage, the minimum capital requirements and remuneration practices and policies. In practice therefore, non-E.U. Managers seeking authorization would need to examine their existing prime brokerage and custodian arrangements to ensure that they comply with the Directive's requirements, amending them where necessary.

As well as becoming authorized, non-E.U. Managers would need to ensure that the appropriate Cooperation Agreements are in place and that the jurisdiction in which the non-E.U. Manager or the non-E.U. AIFs that it manages are established is not listed as a Non-Cooperative Country and Territory by the FATF. In addition to these requirements, a tax information exchange agreement (which complies with Article 26 of the OECD Model Tax Convention) must be in place between the jurisdiction in which the non-E.U. AIF is established and the Member State in which the non-E.U. Manager is authorized and any other Member States in which the non-E.U. AIF will be marketed.

The end of the E.U. Member States' private placement regime

It is expected that the private placement regime set out above will remain in place until at least the end of 2018. At that point, depending on ESMA's advice, the private placement regime would either remain in place or be terminated, leaving the pan-E.U. passport regime as the only route available to non-E.U. Managers wishing to market their funds to E.U. based investors. As discussed in greater detail above, to make use of the pan-E.U. passport regime, non-E.U. Managers would need to obtain authorization from the relevant competent authority. Non-E.U. Managers that choose not to become authorized may still be able to sell units or shares in the non-E.U. AIFs that they manage on a reverse solicitation or passive marketing basis (as set out below).

Some frequently asked questions

Marketing by non-E.U. Managers prior to July 22, 2013

Prior to transposition of the Directive by Member States, the Directive will not be applicable to non-E.U. Managers and as such non-E.U. Managers will be able to continue to use Member States' existing private placement regimes. As noted above, the long-stop date for transposition is July 22, 2013.

Key exemptions

There are a number of exemptions to the Directive, the key ones being for:

- Managers to the extent that they manage only AIFs whose only investors are the Manager or any related group company that is not itself an AIF;
- Managers who manage portfolios of "small" AIFs whose total assets (across all the AIFs that they manage) do not exceed €100 million or €500 million where the portfolio is unleveraged and no redemption rights are exercisable for the first five years from the initial investment in the AIF; and
- securitization special purpose vehicles.

¹² ESMA is due to deliver to the Commission its advice in relation to the extension of the pan-E.U. passporting regime to non-E.U. Managers by July 22, 2015.

Reverse solicitation or passive marketing

The Directive does not specifically prohibit reverse solicitation or passive marketing. As such, there are no restrictions at the level of the Directive on E.U. based investors contacting a non-E.U. Manager with a view to making an investment in a non-E.U. AIF managed by that non-E.U. Manager. To the extent therefore that a non-E.U. Manager cannot satisfy either the relevant private placement regime or the Directive's pan-E.U. passporting regime and on the assumption that there are no other restrictions imposed by the Member State in question, reverse solicitation will be the only way that an E.U. based investor can invest in a non-E.U. AIF managed by a non-E.U. Manager.

As noted above, reverse solicitation is specifically permitted in the U.K. by the Draft Regulations. When relying on reverse solicitation, non-E.U. Managers should ensure that:

- there are no restrictions on reverse solicitation or passive marketing under the local law and regulation of the relevant Member State; and
- they have appropriate policies and procedures in place to capture and maintain an audit trail for each reverse solicitation investor.

Asset stripping

Managers (including non-E.U. Managers) will face restrictions on "asset stripping" during the first 24 month period following acquisition (by an AIF marketed to E.U. investors) of control of a non-listed company established in the E.U. Broadly, Managers will be prohibited from facilitating, supporting or instructing any distributions, capital reductions, share redemptions and/or acquisitions by the non-listed company of its own shares. Managers will also not be allowed, to the extent that they can vote on behalf of the non-E.U. AIF they manage, to vote in favor of such action and should use their best efforts to prevent such action.

The consequences of non-compliance with the Directive

The Directive does not provide for a specific sanctions regime for non-E.U. Managers who fail to comply with the Directive. Member States are, however, obliged under the Directive to ensure that in addition to any criminal sanctions that could apply under that Member State's national law for non-compliance with the Directive, they have the power to impose "*effective, proportionate and dissuasive*" administrative measures and/or penalties for failure to comply with the Member State's implementation of the Directive.¹³

In the U.K., the Draft Regulations broadly provide that non-E.U. Managers marketing non-E.U. AIFs into the U.K. in contravention of the Draft Regulations could face imprisonment of a term not exceeding three months. In addition, agreements entered into in contravention of the Draft Regulations may, in certain circumstances, be unenforceable by the non-E.U. Manager.

¹³ Article 48, Directive.

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