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The Alternative Investment Fund Managers Directive
Case Studies and Reference Manual



Contents

Introduction

A practical approach	3
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Key message	3
-------------	---

Case Studies

Case Study 1: UK Manager (managing UK funds)	4
--	---

Case Study 2: US Manager (managing non-EU funds)	9
--	---

Case Study 3: UK Manager (managing both EU and non-EU funds)	14
--	----

Case Study 4: US Manager (managing both EU and non-EU funds)	18
--	----

Case Study 5: Managers of private equity funds	22
--	----

Reference manual

1. Scope and exemptions	26
-------------------------	----

2. Marketing	27
--------------	----

3. Liquidity	33
--------------	----

4. Leverage	33
-------------	----

5. Depositaries	34
-----------------	----

6. Delegation	36
---------------	----

7. Disclosure and transparency	37
--------------------------------	----

8. Valuation	41
--------------	----

9. Capital adequacy	42
---------------------	----

10. Asset stripping	43
---------------------	----

11. Remuneration	44
------------------	----



Introduction

On 11 November 2010 the directive on Alternative Investment Fund Managers (the “AIFMD” or the “Directive”) was finally adopted. This comes two years after the first draft arrived, without consultation, to the surprise and concern of not only the investment fund industry it purported to regulate but also the professional investors that it purported to protect

The original draft of the AIFMD laid down the markers for what turned out to be a long, difficult but ultimately largely successful battle to remedy the Directive’s most worrying shortcomings. The original and early subsequent drafts, not unreasonably characterised as a political, rather than rational, reaction to the collapse of Lehman, would have left foreign fund managers without access to European investors; left European investors without access to foreign funds; created fixed leverage ceilings; banned short selling; left prime brokers in the wilderness; and forced expert non-EU investment advisers out of fund management structures. Its thrust was protectionist, its timing out of sync with the rest of the world.

It is a testament to the lobbying of interested parties that it is now possible to say that the AIFMD, as adopted, is a much improved text. Will existing fund arrangements need to be fundamentally restructured? It seems not, for now. Will large tracts of the industry be prevented from raising finance in Europe? Again, it seems not, for now. Has the AIFMD cleared the path for a single do-it-all vehicle? None obviously jumps out. Do managers need to pay attention to the detail? Without a doubt. Investment management agreements (“IMAs”) will need to be amended, new rules on capital will need to be adhered to, and the relationship between managers and the boards of directors of funds (where applicable) is set to become more intimate. These represent but a few of the consequences of the AIFMD coming into force.

This manual is intended to be, so far as possible, a practical guide to the provisions of the AIFMD, always asking the question of what you need to be doing, and when. It is, however, to be remembered that this is framework legislation and that various implementing measures will, over time, add detail and eliminate some ambiguity. The AIFMD purports to regulate managers of alternative investment funds (“AIFMs”) but all the key participants in fund structures need to be familiar with it as its reach goes far beyond AIFMs.

A practical approach

The AIFMD is but one factor feeding into the strategic decision making of funds and fund managers, alongside, for example, the quality of regulator, service providers and marketing/investor considerations. Given the high profile negotiations that mark out the history of the AIFMD, it is easy to overstate its impact. The discipline to be imposed on understanding the impact of the AIFMD on a business or fund should be to ask what strategic decisions would have been made had the AIFMD not been introduced and then to ask if the AIFMD prevents it, affects it or facilitates it (a question, admittedly not always answerable given the volume of secondary legislation which is anticipated).

Timing highlights:

Adopted: 11 November 2010

In force: Q1 2011 (expected)

Long stop date for national transposition (inclusive of passport for EU fund managers managing EU funds): Q1 2013

Long stop date for compliance by AIFMs: Q1 2014*

Passport extension to third country managers and funds: 2015 (expected but subject to delegated legislation)

End of private placement: 2018 (expected but subject to delegated legislation)

*The AIFMD contains no significant grandfathering provisions.

Key message

You will see that in each of the following case studies we have drawn up it is clear that nothing need be changed for the next two years. For certain fund managers changes will need to start to be made through 2013, but these are not dramatic changes. Looking further into the future, between 2015 and 2018, it is possible some larger scale structural changes may need to be made. Our key message therefore is to take a measured approach and not to make drastic and costly decisions in haste.

What needs to happen right now? Map out your structure. Map out your strategy in the short, medium and long term. Where do you want to sell? Do you want to continue to market only into the traditional EU territories? Is European finance something you can live without or is it a key source of funding? Answer these questions and when the full legal picture arrives you will be well positioned to make appropriate structural changes.

Case Studies

Case Study 1: UK Manager (managing UK funds)

Key features

	Fund 1	Fund 2	Fund 3 (to be launched in February 2014)
Fund domicile	UK	UK	UK
Fund type	Closed ended investment trust	Closed ended investment trust	Closed ended investment trust
Investment advisers / sub-delegated portfolio managers (in addition to UK manager)	UK portfolio manager	Chinese sub-delegate manager; UK adviser	None
Asset class	Commodities and commodities companies	Shares in Chinese companies	Equities in UK start ups
Listing/trading	Main market of LSE	Main market of LSE	Main market of LSE
Selling strategy	UK and Ireland only	UK, France, Spain, Italy	UK only
Custodian/prime broker arrangements	Single UK custodian, used sub-depositaries in Australia and Indonesia; no prime broker	UK custodian and Chinese sub-custodians	UK custodian
Borrowing	Yes, for working capital only	Yes, for working capital only	Yes, for working capital and for bridging
Use of derivatives	No	No	No
NAV production	UK Administrator with manager input	UK Administrator with manager input	UK Administrator with manager input
Assets under management	€150m	€140m	Maximum €150m

Who is the AIFM?

In this case there is an external manager who has been legally appointed to be the portfolio manager of the assets of the Funds on a discretionary basis. It is thus likely that this external manager would be considered the AIFM (although note the discussion in **Section 1 of the Reference Manual** on other possible interpretations). In respect of Funds 1 and 2, the sub-delegate portfolio managers would not be the AIFM as they have not been legally appointed by the Fund (but by the manager). The investment advisers would also not be, given that they are not managing the portfolio.

Does this affect me today - should I apply for authorisation under the AIFMD today?

No. The AIFMD has been adopted and is expected to come into force in Q1 2011, but it is only when it becomes national law that it will take effect. The longstop date for national transposition of the AIFMD will be two years after the date of the Directive coming into force ("**National Transposition Date**"). The process for obtaining authorisation will be developed and ultimately published by the Financial Services Authority ("FSA").

When will this affect me - should I apply for authorisation soon after Q1 2013?

As a UK manager that is managing non-UCITS funds, you will eventually need to obtain authorisation in order to manage or market the funds you manage (the "Funds"), unless you fall within the de minimis exemption described in **Section 1 of the Reference Manual**.

In this case the de minimis exemption currently applies, so you would not need to obtain authorisation and comply with the full scope of the AIFMD. None of the launched Funds offer redemption rights nor do they use borrowing for the purpose of acquiring assets. €500 million assets under management ("AUM") is the threshold above which the AIFMD applies to a manager if none of the funds it manages have redemption rights or use leverage for the purpose of asset acquisition. The current total AUM in this case is €290 million. Thus, immediately after the National Transposition Deadline, there would be no need to comply with the provisions of the AIFMD. Instead you would need to seek registration (and provide the FSA with information on the instruments traded by the Funds). If you had more funds and your AUM was over €500 million, you would have until Q1 2014 to submit an application to the FSA for authorisation (the AIFMD offers a 1 year grace period in which to submit your application from the National Transposition Deadline, during which it appears that management can continue).

Fund 3, when launched, will potentially bring the AUM of the manager to €440 million, still below the €500 million threshold. Fund 3, however, intends to use borrowing for working capital and bridging purposes (ie, to acquire one asset while disposing of another). €100 million is the total AUM threshold above which the AIFMD applies to a manager if even one of the non-UCITS funds it manages uses leverage for the purpose of asset acquisition. It should be noted that it is unclear whether bridging loans constitute 'leverage', and we expect to see this clarified in subsequent secondary legislation. Following the launch of Fund 3 in February 2014, and once the borrowing is actually used for the purpose of acquiring an asset, then within 30 calendar days you may need to seek authorisation.

Had none of Funds 1, 2 or 3 used borrowing or only used them for working capital purposes or for share buy backs, we would anticipate that the de minimis exemption would have applied.

What will the authorisation process be?

It is unclear at this stage, but most UK managers are already authorised under the Financial Services and Markets Act 2000 ("FSMA") and we expect the FSA to issue guidance or a consultation on the process. We would expect this to be relatively straightforward for managers who are already authorised under FSMA. Investment managers authorised in the UK, who do not currently have to submit details of remuneration policies, would, however, likely need to do so.

Does anyone else in the structure need to apply for authorisation (eg, the funds, portfolio managers or investment advisers)?

Only the legal persons appointed by the Funds (or on behalf of the Funds) and who are responsible for managing the Funds, need to seek authorisation. This would exclude investment advisers, administrators, depositaries and other service providers.

All sub-delegate portfolio managers, however, have to be authorised or registered for the purpose of asset management and subject to supervision. If not, the FSA would need to consent to their appointment.

Typically Chinese investment managers (as used by Fund 2) need to obtain the approval of the China Securities Regulatory Commission in China. If the existing Chinese portfolio manager to Fund 2 is so authorised or registered, the consent of the FSA will likely not be required in order to continue using it (unless the view is taken that they are not subject to appropriate supervision). The UK portfolio manager will need to be authorised or registered for asset management in the UK.

The AIFMD does not attempt to regulate, directly, funds themselves.

If there is no intention to market any of the Funds anymore, do I still need to be authorised?

A UK manager will need authorisation irrespective of whether or not it intends to market shares in the funds it manages.

Do the existing fund arrangements need to be restructured in any way in order to market within Europe?

Possibly. As stated above, in order to continue to use the Chinese manager for Fund 2, it will either need to be authorised or registered for the purpose of asset management and subject to supervision or the FSA will need to consent to its use. If the FSA does not approve the Chinese manager (in a case where it is not authorised or registered for asset management), then the use of the Chinese manager will be prohibited. Secondly, in order to use the Chinese manager, cooperation between the FSA and the supervisory authority of the Chinese manager "shall be ensured". It is not yet clear exactly what this will entail. Thirdly, the delegation to the UK and Chinese investment managers cannot be so extensive that the manager legally appointed directly by the Fund, can no longer be considered to be the manager and becomes a 'letter box entity' (a term which has no specific meaning in EU law as yet; although secondary legislation on the point is promised).

As to re-structuring the depositary arrangements, please see below.

If the marketing of our Funds is done by third parties and intermediaries do we need to obtain authorisation and comply with the AIFMD?

As a UK manager you will need authorisation irrespective of whether or not you intend to market shares in the funds you manage (directly or through a third party).

I have authorisation and comply with the AIFMD, so can I market Fund 3 once I comply with the relevant marketing application process obligations under the AIFMD?

No. Even though the AIFMD states that Member States are to ensure that an authorised manager may market the shares in an EU fund that it manages to professional investors as soon as certain conditions are met, the reality is that for any investment trust that wishes to list on the Official List and trade on the main market of the London Stock Exchange, a fully Prospectus Directive compliant prospectus will need to be stamped by the FSA before marketing can commence. In practice it is likely that the obligations imposed on the manager by the AIFMD, which are misleadingly expressed to be necessary and sufficient to market a Fund, will be rolled into the prospectus. We expect the FSA to release guidance on the interaction between the Prospectus Directive and AIFMD.

Will my time to market be affected by the AIFMD?

Fund 3 IPO

The FSA will have 20 business days from the date of submission of a suite of documents to them (including the articles of association or 'AIF Rules' and information on Funds (including among other things, descriptions of investment strategy and objectives, descriptions of delegation, descriptions of the valuation process, descriptions of all fees, charges and expenses, the historical performance of the fund, terms of the issue and a description of the liquidity risk management function)) to decide if Fund 3 can be marketed within the UK. Typically in the launch of an investment trust, these documents and this information will be finalised only shortly prior to stamp off by the FSA. Much will depend on how the FSA dovetail the Prospectus Directive with the AIFMD (as a prospectus would also be required for the launch of Fund 3). We would expect the FSA to publish guidance on how the AIFMD marketing application process fits with the prospectus stamp off process and we are hopeful that they will dovetail the two.

Fund 2

(Secondary offering, into Italy and France)

The strategic selling goal of Fund 2 is to sell into the non-traditional jurisdictions of France and Italy as well as the UK. The marketing passport will not be available until 2015, at the earliest. When it does come into force it appears that the time to market will be the same as described immediately above (ie, the time it takes to get permission to market through the EU would be no longer than the time it takes to get permission to market into the UK). The FSA (or its successor body) will still have a 20 day period and it shall notify the Italian and French competent authorities within

this period, at which point, once the manager has become aware of the notification, Fund 2 can be marketed.

Can the existing custodian relationships remain in place?

Yes. Each fund will need to have one primary depositary, which needs to be appointed pursuant to a written contract. The depositary used by each Fund will need to have its registered office or a branch in the UK. It is unclear whether the contract needs to be with the UK branch, or whether simply the existence of a UK branch is sufficient.

What changes should be made to custodian/prime brokerage agreements?

There will be secondary legislation stating what needs to be contained in the depositary agreement. Certain changes that will need to be made to existing contracts can, however, be deduced now.

Central to the depositaries role will be the holding of all financial instruments that can be registered in an account in its books and that it can have physically delivered to it. Liability for this function cannot be limited (terms in existing contracts which provide that the depositary would only be held liable for the loss of financial instruments to the extent that such loss was due to the negligence, fraud or wilful default of the depositary will not have effect as liability can only be avoided if the loss occurred as a result of an event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary) although the depositary can discharge itself of liability (rather than limit it) in certain circumstances.

If either of Funds 1 and 2 want to pass on liability to their respective sub-depositaries, the existing depositary contract with the relevant Fund must be amended to expressly allow for such a discharge of liability and must state that the discharge shall only be effective if the depositary has entered into a written contract with the sub-depositary which explicitly transfers liability to the sub-depositary and which "makes it possible" for the relevant Fund or the manager to sue the sub-depositary directly (ie, at the very minimum, the contract cannot carve out rights of third parties, but in all likelihood the relevant Fund will need to be party to the sub-delegation agreements). In respect of Fund 1 it is likely that such a discharge of liability to the Australian sub-custodian is possible (as the delegation will be able to accord with the conditions described in **Section 5 of the Reference Manual**) and so the depositary agreement should be amended to discharge liability to the Australian sub-custodian and the Australian sub-custodian agreement should make Fund 1 a party.

In relation to the Indonesian custodian, the same amendments would need to be made to the depositary's contract with Fund 1. In addition, the articles of association of Fund 1 would need to be amended to explicitly permit the discharge of liability to the Indonesian entity. Moreover, it appears that investors would have had to have been informed of the discharge of liability prior to their investment. If correct, this potentially means that unless the prospectus made clear that there was such a discharge of liability, then no discharge of liability that

exists or any amendments to the contract to provide for the discharge would be effective.

Besides the holding of financial instruments, the depository must 'ensure' that the sale, issue, re-purchase, redemption and cancellation of shares in the Funds, the calculation of net asset values, and the application of any income of the Funds accords with law and their respective articles of association. These functions cannot be delegated to a different entity. Thus contracts with custodians will likely need to be amended to give the depository some oversight power in relation to net asset value calculations and publication, perhaps through an 'approval' mechanism. On the launch of Fund 3 the contract with the custodian may need to provide that its legal expenses, should it choose to seek advice as to the legality of the issue, can be recovered from the Company. Contracts would also need to provide for ongoing reimbursement as depositaries seek to recharge to the Fund the costs of ensuring repurchases, redemptions and the declaration of dividends are carried out in accordance with the law.

Do I need to keep more capital?

This is likely to require further consideration. Although the requirement to maintain minimum own funds of one quarter of fixed annual overheads remains, there will be new restrictions on the use of funds held to meet that requirement, and also a need to obtain professional indemnity insurance. There are also changes to the calculation of the variable element of a firm's regulatory capital requirement. However, the AIFMD does not impose a group capital requirement, unlike the Capital Requirements Directive.

Do I need to make changes to my existing remuneration arrangements?

The Directive requires managers 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 funds they manage. Managers will therefore need to review the prescriptive requirements to see whether any changes are required to their existing compensation scheme as many widely used practices will be curtailed, eg, guaranteed bonuses are restricted. Significantly sized managers will also be required to have a remuneration committee consisting of non-executive members of the management body.

The Directive does, however, allow AIFMs 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. A number of the remuneration principles, and the concept of proportionate application, substantially mirrors the provisions contained in the revised remuneration code issued by the FSA which reflects the requirements of the amended Capital Requirements Directive and the provisions of the UK Financial Services Act 2010. The remuneration provisions of the AIFMD are detailed in **Section 11 of the Reference Manual**.

Do I need to disclose my remuneration?

Yes. You will be required to prepare an annual report in respect of each Fund which discloses the total amount of remuneration (salary and bonus elements), broken down by key individuals, paid by the manager to its staff for the financial year. The annual report will be made to competent authorities and (upon request) to investors. This requirement would be effective from the National Transposition Date. Presumably the financial year is a reference to the financial year of the fund in respect of which the annual report is being produced. It would appear that the requirement is to disclose the total remuneration at the fund manager level (and not just that part of it attributable to the particular fund in respect of which the report is being produced). If so, besides the obvious sensitivity of making available such information, it would make the determination of the total amount of remuneration in a financial year cumbersome as it would need to be recalculated for each fund managed by the manager (assuming they have different year end dates).

Does my IMA need to change?

In order to comply with its obligations under the AIFMD the manager needs, among other things: to "ensure" that appropriate and consistent valuation procedures are in place and that such procedures include at least an annual valuation of the assets; to ensure that only a single depository is appointed and that it is appointed on the terms as set out in the AIFMD, described in **Section 5 of the Reference Manual**; to demonstrate that it complies at all times with the leverage limits set for the AIF; and to "ensure" that the risk profile of a Fund matches its investment strategy and policy.

From a manager's perspective, the ideal approach would be amend IMAs so as to give managers the necessary powers and information to enable them to comply with their obligations under the AIFMD. Such an approach, however, raises some interesting questions in relation to investment companies around directors' duties and obligations. Where a board and a manager disagree on the provisions to be inserted it cannot be correct that a manager can override the board.

Under the AIFMD if a manager cannot "ensure" all that it should, then the manager is ultimately obliged to resign. It is thus important that the manager has the ability to terminate its mandate immediately, without penalty, if it reasonably considers that one of the Funds it manages persists in non-compliance despite its efforts.

Equally, however, it is important that IMAs are amended to prevent the abuse, by either the manager or the fund, of the manager's obligation to resign by using it as a back-door route to prematurely terminating the relationship. If a fund's board wants to terminate the manager for poor performance it must not be able to persist in non-compliance with the AIFMD as a method of forcing the manager to resign, without having to compensate the manager. A manager must also be dis-incentivised from walking away, by unreasonably proclaiming persistent non-compliance, simply because it no longer wants to manage a fund.

It is also the responsibility of the manager (and not a fund or any other service provider) to comply with increased disclosure and transparency obligations. IMAs should thus be amended to, amongst other things, give the manager such access to information as is necessary to comply with applicable law; permit the manager to make such disclosures as required by law; deal with the production of prescribed information; give the manager the power to instruct the fund's service providers directly in respect of such disclosures; allocate the costs of production and distribution of such information; allocate liability in respect of incorrect disclosures; and provide appropriate indemnity cover in respect of such disclosures.

Is my existing risk management function going to be sufficient going forward?

For many managers the AIFMD will require an internal reorganisation and require that certain operational protocols be reconfigured. In particular it will be important to ensure that your risk monitoring capability and function is segregated from your portfolio management function. You will need to ensure that the risks attached to each investment position can be identified, managed, monitored and also measured on an ongoing basis through stress testing. Prescriptive sounding secondary legislation will, among other things, specify what risk management systems are to be employed by the manager, the frequency of review of the risk management system and 'how' the risk management function is to be separated from portfolio management.

Can our preferred administrator continue to carry out the valuations with our input?

Yes, if, among other things, the delegation can be justified with objective reasons; the administrator is subject to mandatory professional registration or to regulatory provisions or rules of conduct (as, for example, the main service providers in the UK are); and the administrator is able furnish sufficient professional guarantees (secondary legislation will clarify what this means).

It will, however, remain the manager's responsibility to "ensure" that there are appropriate and consistent procedures established so that a "proper" and independent valuation of the Funds' assets can be performed in accordance with both the AIFMD and the articles of association of the relevant Fund (including at least an annual net asset value calculation and calculations of net asset value every time shares are redeemed or bought back (and subsequently cancelled)). Importantly, liability to the Funds and their investors for the calculation and publishing of valuations cannot be divested to the administrator, although, in turn, the administrator will be liable to the manager for any losses suffered by the manager as a result of the administrator's negligence or wilful default.

The administrator can calculate the net asset value, although in order for the manager to fulfil its obligations and in order to enable the manager to recover from

the administrator on a 'back to back' basis in the event of error, it will effectively need to be party to the administration agreement. Additionally, the contract will need to allow for the effective supervision and ongoing review of this function by the manager.

Should I re-domicile?

Immediately following the natural transposition of the AIFMD there will be a period where national private placement regimes are available to managers that are not authorised. While on one analysis, it could be said, because of this, that there are attractions to re-domiciling, our advice at this stage would be that obtaining authorisation within the EU is likely to be the better long-term approach.

Case Studies

Case Study 2: US Manager (managing non-EU funds)

Key features

	Fund 1	Fund 2	Fund 3
Fund domicile	Guernsey	Cayman Islands	Cayman Islands
Fund type	Closed ended feeder investment company	Hedge fund investment company	Hedge fund limited partnership
Investment advisers / sub-delegate portfolio managers (in addition to US manager)	None	UK adviser, US adviser	UK adviser, HK sub-delegate portfolio manager
Asset class	Hedge fund	Equities	Debt and derivatives
Listing/trading	Main market of LSE	Irish listing	Unlisted
Selling strategy	Seeking new jurisdictions: UK but also France, Italy and the US	UK and non-EU	UK and non-EU
Custodian/prime broker arrangements	None	Multiple prime brokers, sub-prime brokers and banks	Multiple prime brokers, sub-prime brokers and banks
Borrowing	Yes, for working capital only	Yes, for working capital only	Yes, for working capital and for bridging
Use of derivatives	No	Yes, with embedded leverage	Yes, with embedded leverage
NAV production	Guernsey Administrator with manager input	Cayman Administrator with manager input	Cayman Administrator with manager input
Assets under management	£100m	£80m	£60m

Who is the AIFM?

In this case there is an external manager who has been legally appointed to be the portfolio manager of the assets of the Funds on a discretionary basis. It is thus likely that this external manager would be considered the AIFM. The sub-delegate portfolio manager would not be the AIFM as it has not been legally appointed directly by the Fund 3 (but by the Manager). The investment advisers would also not be, given that they are not managing the portfolio.

Does this affect me today - should I apply for authorisation under the AIFMD today?

No. The AIFMD has been adopted and is expected to come into force in Q1 2011, but it is only when it becomes national law that it will take effect. The longstop date for national transposition of the AIFMD will be two years after the Directive comes into force.

When will this affect me - should I apply for authorisation soon after Q1 2013?

No. Subject to the discussion below on accessing European investors after 2015, as a non-EU manager of non-EU funds you do not need to obtain authorisation and therefore do not need to comply with the AIFMD.

As a manager, however, seeking wider EU distribution for Fund 1, the AIFMD presents an opportunity to passport Fund 1 into hitherto inaccessible jurisdictions such as Italy and France from 2015 (when an EU wide passport for non-EU managers may be introduced), and thus facilitates the execution of this strategy. The passport will only be available to those managers who obtain authorisation. If, however, this proves too onerous or not cost-effective, no authorisation will be needed as non-EU fund managers can (if certain conditions are satisfied) market shares in non-EU funds, without authorisation, to European investors, if selling is restricted to using national private placement rules (as harmonised by the AIFMD) although it may be that this route will only be available until 2018 when the private placement regime should be removed. This approach would, however, mean that say France and Italy for example, would remain relatively inaccessible.

Similarly, Funds 2 and 3 (Cayman hedge funds only intending to raise capital in the UK and outside the EU), would not trigger a need to obtain authorisation (to use a passport) as private placement regimes would likely be sufficient to meet their strategic marketing objectives until 2018.

Does anyone at all in the structure need to apply for authorisation (eg, the funds or investment advisers)?

No. No entity needs to be authorised until such time as it is decided that the passport is to be utilised.

The AIFMD does not attempt to regulate funds themselves.

If the passport was to be utilised by any of the Funds, only the legal person appointed by the Fund (or on behalf of the Fund) and who is responsible for managing the Fund, would need to seek authorisation. Sub-delegate portfolio managers, investment advisers, administrators, depositaries and other service providers would not need to obtain authorisation.

If I am not authorised, can I still raise money from investors in the EU?

Fund 1

From now until national transposition

Member States will transpose the AIFMD into national law at different times between 2011 and 2013. You would be able to continue to market to EU investors in Member States, on the currently available basis, until the date of national transposition of the AIFMD in that Member State.

From the date of national transposition

It appears that the restrictions on marketing are effective immediately from the date of national transposition. Therefore any marketing that takes place to EU investors after that date will need to be in accordance with the AIFMD.

In this case, the strategic push behind Fund 1 is to market across the EU. The AIFMD therefore may provide an opportunity from 2015 to market on the basis of the EU passport.

Until this time the only way to market a Guernsey fund managed by a US manager to investors in the EU would be pursuant to national private placement regimes (which is currently how such funds are typically marketed to EU investors today) but as harmonised pursuant to the AIFMD. This harmonisation means that in order to take advantage of this permitted private placement regime you would need to comply with certain of the disclosure and transparency provisions of the AIFMD in respect of those Funds that you market to EU investors and those companies which any of your funds control and also comply with the restrictions on 'asset stripping' which are of concern to private equity managers (these provisions are set out in **Section 10 of the Reference Manual**). In addition there must be cooperation arrangements in place as between the competent authorities of each of the Member States in which you intend to market, the supervisory authority of the manager (in this case, the Securities and Exchange Commission ("SEC")) and the supervisory authority of the relevant Fund to be marketed (in this case, the Guernsey Financial Services Commission). Finally, neither Guernsey nor the US should, at the time of marketing, be listed as a 'Non-Cooperative Country and Territory' by the Financial Action Task Force on anti-money laundering and terrorist financing.

If these conditions are met (which some consider unlikely, in the case of the US) then from the National Transposition Date you can continue to raise finance from investors in the EU, until the private placement regime is ultimately removed.

From 2015

In 2015, if the European Securities and Markets Authority ("ESMA") report favourably on the functioning of the existing passport for EU fund managers (which comes into force with the AIFMD), it may be extended to allow non-EU fund managers to passport their funds throughout Europe. Fund 1's long term strategy is to expand by raising capital from hitherto untapped sources, such as France and Italy.

It remains to be seen how effective a tool it is, as previous passports (such as that provided under the Prospectus Directive) have not been taken up widely. If you wish to utilise the passport on behalf of Fund 1 then you will need to seek authorisation under the AIFMD, despite being a non-EU manager. You will need to comply with all of the provisions of the AIFMD, in the same way as an EU AIFM. This means that you will need to comply with, amongst other requirements, added disclosure and transparency obligations, more onerous capital adequacy requirements, remuneration rules (for which see **Section 11 of the Reference Manual**) and self-imposed limits on leverage. Your existing custodian and prime broker relationships would also likely need to be restructured. If the compliance

changes are such that the strategy no longer becomes worthwhile, the private placement regime described above can continue to be used where existing local rules allow.

Even if you were willing to satisfy all of these conditions and become authorised it is not a given that you would be able to use the passport. In order for the passport to be available to you there must be information exchange cooperation arrangements in place between the competent authority of the Member State of Reference (which, in this case, would likely be the FSA – see Figure 3 in Section 2 of the Reference Manual for how to work out who your Member State of Reference is) and the supervisory authority of the country in which the manager is established (in this case, the SEC). In addition the fund home county (in this case, Guernsey) must not be listed as a ‘Non-Cooperative Country and Territory’ by the Financial Action Task Force on anti-money laundering and terrorist financing. Finally agreements on exchange of information relating to tax matters which “fully” comply with article 26 of the OECD Model Tax Convention and which ‘ensure’ an effective exchange of information in tax matters needs to be in place between Guernsey (the home state of Fund 1) and each Member State in which it is proposed that the Fund 1 be marketed (in this case: Italy, France and the UK). As Section 2 of the Reference Manual shows, it appears that such agreements are not currently in force. If these conditions are not satisfied then the harmonised private placement regime would remain the only way to access European investor capital.

From 2018

In 2018 ESMA will opine on whether the harmonised private placement regime should remain a route to accessing European investor capital. Assuming this route had been available to Fund 1, if it was abolished in 2018 then the passport would be the only means of accessing Europe. If, however, the tax exchange agreements described above were not in place or if it was decided that the cost of authorisation was prohibitive, then there would appear to be no way to market into Europe, save for reverse solicitation (which is not prohibited under the AIFMD).

Funds 2 and 3

In this case, there is no strategic imperative to market Funds 2 and 3 widely to EU investors, so continuing to use the private placement regime in relation to these Funds (and ignoring the passport) makes sense. If however the passport is taken up for Fund 1, the manager will anyway have to be authorised and comply with the AIFMD. The fact that Funds 2 and 3 would not market under a passport would not reduce the compliance burden of the manager. In fact, if the passport is taken up but only with the intention of benefitting Fund 1, certain burdens increase unnecessarily by keeping Funds 2 and 3 under the management of the same legal entity as Fund 1. For example it is likely that the capital burden will become greater (it will be calculated in relation to all three Funds). In addition a leverage limit will need to be set for each of Funds 2 and 3. However, if in 2018 the private placement is abolished, the new manager of Funds 2 and 3 would in any event need to be authorised if marketing into Europe is intended. On balance, therefore, it seems that such a restructuring may not offer the best outcome over the long term. One might, however, argue

in favour of establishing a new non-authorised manager to manage funds 2 and 3 if it is not intended that they be marketed to EU investors in the future.

If I want to effect a secondary raising for Fund 1 on the main market of the London Stock Exchange, does the marketing permission regime under the AIFMD mean that I no longer have to comply with the Prospectus Directive?

No, compliance with the Prospectus Directive will continue to be necessary. Following the implementation of the AIFMD in 2013, you would still need to prepare a Prospectus Directive compliant prospectus in order to admit a fund to trade on a regulated market or to raise capital in a secondary public offering. At this point however the fund will not be free, as before, to market the shares in the EU using the prospectus. Instead it will need to be determined whether the intention is to market under the AIFMD’s harmonised national private placement regime or use the passport. If private placement is chosen then the manager will first need to comply with the relevant transparency rules set out in the AIFMD (see Section 7 of the Reference Manual) and the relevant cooperation agreement would need to be in place (see above and also Section 2 of the Reference Manual). If the passport route is chosen the relevant tax exchange agreement would need to be in place (see Section 2 of the Reference Manual) and the manager would need to be in compliance with the entire AIFMD and be authorised by the Member State of Reference, before marketing can commence using the prospectus.

If the marketing of our funds is done by third parties and intermediaries do we still need to obtain authorisation and comply with the AIFMD?

Yes. It appears that the AIFMD effectively looks through intermediaries such that it considers marketing of funds by placing agents, intermediaries or on platforms as marketing by or on behalf of a manager.

Thus, to say that a manager does not need to comply with the AIFMD because it will not itself market shares in a fund, is not a credible way to avoid the obligations and duties imposed by the AIFMD.

Can my hedge funds, Funds 2 and 3, continue to use multiple prime brokers?

Yes, unless the passport is sought, in which case the use of prime brokers becomes problematic.

If ongoing marketing through the harmonised private placement regime is sought, then although some provisions of the AIFMD will apply, the provisions governing the use of depositaries and prime brokers will not apply (see Section 2 of the Reference Manual).

If the passport is required then compliance with the prime broker and depositary rules will be required. Thus, while the use of prime brokers is not prohibited, the obligations imposed on the manager are much greater in respect of them. As detailed in **Section 5 of the Reference Manual**, there can only be one depositary per fund. Prime brokers may provide prime brokerage services but would have to be delegated the custody function. This may prove difficult to achieve in practice as the primary depositary may find it difficult to divest its liability for the loss of financial instruments in certain circumstances, and for this reason may be more reluctant to delegate this function. See **Section 5 of the Reference Manual** for more detail on the liability regime that will apply to the primary depositary.

What changes should be made to custodian/prime brokerage agreements?

None, unless a passport is sought, in which case the answer will be the same as set out in Case Study 1, for an authorised fund manager. The multiple prime broker model will have to be reconfigured so that there is one custodian who then delegates custody to prime brokers.

Does my IMA need to change?

This will depend on whether or not further marketing of shares into the EU by any of the Funds is anticipated.

If private placement is anticipated then, as stated above, certain transparency and disclosure obligations are imposed. It will be the responsibility of the manager (and not the fund or any other service provider) to comply with increased disclosure and transparency obligations. IMAs should thus be amended to, amongst other things, give the manager such access to information as is necessary to comply with applicable law; permit the manager to make such disclosures as is required by law; deal with the production of prescribed information; give the manager the power to instruct the fund's service providers directly in respect of such disclosures; allocate the costs of production and distribution of such information; allocate liability in respect of incorrect disclosures; and provide appropriate indemnity cover in respect of such disclosures.

If the passport is sought then full compliance with the AIFMD would be required. In order to comply with its obligations under the AIFMD the manager needs, among other things: to "ensure" that appropriate and consistent valuation procedures are in place and that such procedures include at least an annual valuation of the assets; to ensure that only a single depositary is appointed and that it is appointed on the terms as set out in the AIFMD, described in **Section 5 of the Reference Manual**; to demonstrate that it complies at all times with the leverage limits set for the AIF; and to "ensure" that the risk profile of a Fund matches its investment strategy and policy.

From a manager's perspective, the ideal approach would be to amend IMAs so as to give managers the necessary powers and information to enable them to comply with their obligations under the AIFMD. Such an approach, however, may create a conflict with the exercise by the directors of the fund of their directors' duties and

obligations. Where a board and a manager disagree as to the terms of an IMA it cannot be correct that a manager can override the board.

Under the AIFMD if a manager cannot "ensure" all that it should, then the manager is ultimately obliged to resign. It is thus important, that the manager has the ability to terminate its mandate immediately, without penalty, if it reasonably considers that the fund persists in non-compliance despite the efforts of the manager.

Equally, however, it is important that IMAs are amended to prevent the abuse, by either the manager or the fund, of the manager's obligation to resign by using it as a back-door route to prematurely terminating the relationship. If a fund's board wants to terminate the manager for poor performance it must not be able to persist in non-compliance with the AIFMD as a method of forcing the manager to resign, without having to compensate the manager. A manager must also be dis-incentivised from walking away, by unreasonably proclaiming persistent non-compliance, simply because it no longer wants to manage a fund.

In addition, as would be the case if private placement were pursued, the IMA needs to provide for the managers increased disclosure obligations.

What do I need to tell the boards of directors of our funds?

That not much will change until 2013 at which point it is possible (though perhaps not likely) that marketing could be restricted for reasons beyond their control (for example, the relevant third countries do not meet the standards set down in the AIFMD). On the assumption that private placement could be used, however, you can tell the boards that not much will change until 2018, when private placement may be removed. If it is intended that a passport is sought, and therefore that you need to seek authorisation, it will be important to explain that it may be available in 2015 (and may be necessary by 2018) and that it entails authorisation. The board of directors should be made to understand what your new regulatory obligations would be. It is of importance that the directors understand that you could be compelled to resign if the fund persists in non-compliance.

Do I need to make changes to my existing remuneration arrangements?

The Directive requires managers 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 funds they manage. Managers will therefore need to review the prescriptive requirements to see whether any changes are required to their existing compensation scheme as many widely used practices will be curtailed, eg, guaranteed bonuses are restricted. Significantly sized managers will also be required to have a remuneration committee consisting of non-executive members of the management body.

The Directive does, however, allow managers to take a proportionate approach, by complying with the principles in a way and to the extent that is appropriate to the manager's size, internal organisation and the nature, scope and complexity of the manager's activities. A number of the remuneration principles, and the concept of proportionate application, substantially mirrors the provisions contained in the revised remuneration code issued by the FSA which reflects the requirements of the amended Capital Requirements Directive and the provisions of the UK Financial Services Act 2010. The remuneration provisions of the AIFMD are detailed in **Section 11 of the Reference Manual**.

Do I need to disclose my remuneration?

Yes. You will be required to prepare an annual report in respect of each Fund (as each is marketed to EU investors) which discloses the total amount of remuneration (salary and bonus elements), broken down by key individuals, paid by the manager to its staff for the financial year. The annual report will be made available to competent authorities and (upon request) to investors. This requirement would be effective from the National Transposition Date. It would appear that the requirement is to disclose the total remuneration at the fund manager level (and not just that part of it which is attributable to the particular fund in respect of which the report is being produced). If so, besides the obvious sensitivity of making available such information, it would make the determination of the total amount of remuneration in a financial year cumbersome as it would need to be recalculated for each fund managed by the manager (assuming they have different year end dates).

Should I re-domicile?

There is no advantage in re-domiciling the manager entity into Europe. Unless the benefit of the passport or private placement is sought and your home country cannot meet the necessary criteria, as set out in **Section 2 of the Reference Manual**, there is no reason to re-domicile if you were not going to do so anyway. If, however, it is the case that the US (or the SEC) will not enter into the cooperation agreements necessary in order for the Funds to be marketed to European investors under private placement or the passport, then (if raising finance in Europe is essential) it would make sense to either onshore the manager into the EU or into another offshore jurisdiction that is more likely to comply with the necessary conditions.

In any event, to take advantage of the passport you will need to establish a legal representative in your Member State of Reference (see **Section 2 of the Reference Manual** as to how to determine which Member State this will be).

Should you market by way of private placement only for each of the Funds, then there would be no major structural consequences.

Case Studies

Case Study 3: UK Manager (managing both EU and non-EU finds)

Key features

	Fund 1	Fund 2	Fund 3 (to be launched in February 2014)
Fund domicile	Guernsey	Ireland	UK
Fund type	Closed ended investment company	UCITS	NURS
Sub-delegate portfolio managers (in addition to UK manager)	None	None	UK sub-delegate manager
Asset class	Asia pacific and emerging market securities	Equities	Equities
Listing/trading	Main market of LSE	Irish listing	None
Selling strategy	Seeking new jurisdictions: UK but also France, Italy and the US	UK and throughout Europe	UK only (retail)
Custodian/prime broker arrangements	Guernsey custodian and Australian sub custodian, various South American custodians. No prime brokers.	Irish custodian. No prime brokers.	UK Custodian. No prime brokers.
Borrowing	Yes, for working capital only	Yes, for working capital only	Yes for working capital only
Use of derivatives	No	No	No
NAV production	Guernsey Administrator with manager input	Irish Administrator with manager input	UK administrator with manager input
Assets under management	€150m	€200m	€50m

Who is the AIFM?

In this case there is an external manager who has been legally appointed to be the portfolio manager of the assets of the Funds on a discretionary basis. It is thus likely that this external manager would be considered the AIFM. The sub-delegate manager would not be considered the AIFM as it is not appointed directly by Fund 3.

Does this affect me today - should I apply for authorisation under the AIFMD today?

No. The AIFMD has been adopted and is expected to come into force in Q1, but it is only when it becomes national law that it will take effect. The longstop date for national transposition of the AIFMD will be two years after the date the Directive comes into force.

When will this affect me - should I apply for authorisation soon after Q1 2013?

Yes. As you are an EU manager managing an EU fund, the NURS, you will need to be authorised in order to continue to manage it. You would also need authorisation in order for shares in it to be marketed to EU investors. Even if you did not manage the NURS you would need authorisation, as an authorisation is required by an EU AIFM to manage funds (such as Fund 1) even if they are not domiciled in the EU or marketed to EU investors.

You would not have needed to obtain authorisation if you had fallen within the de minimis exemption described in **Section 1 of the Reference Manual**. In this case, however, the de minimis exemption does not apply.

Thus, following the National Transposition Date, an application for authorisation will need to be submitted in order to be able to continue to manage either of Funds 1 and 3 (Fund 2, a UCITS, can be managed regardless of whether such an application is lodged). The AIFMD offers a 1 year grace period during which an application for authorisation must be submitted. Pending the outcome of such application it appears that management activities can continue.

If, before the National Transposition Date, it is decided that Fund 1 should not make anymore investments (eg, if the Fund is to wind up), then you would not need to be authorised to manage that Fund (as such closed ended funds benefit from one of the few transitional exemptions). This would only be of real value to the manager, however, if the remaining non-UCITS Funds had an AUM under €100m (the de minimis threshold), otherwise authorisation would be required in any event. In this case the NURS is only €50m and so authorisation would not be required if Fund 1 was to cease making investments.

Do the existing fund arrangements need to be restructured in any way in order to market within Europe?

In a case where the UK sub-delegate portfolio manager of Fund 3 is not authorised or registered for asset management, then it cannot be used unless the FSA consents to its use. As to re-structuring the depositary arrangements, please see below.

On the assumption that the delegated portfolio manager is authorised or regulated, you need to be careful that you have not delegated portfolio management to such an extent that you can no longer be considered the manager and have become a 'letter-box entity' (see **Section 6 of the Reference Manual** for more detail). Such delegations are not permitted.

If the marketing of our funds is done by third parties and intermediaries do we need to obtain authorisation and comply with the AIFMD?

A UK manager will need authorisation irrespective of whether or not it intends, directly or indirectly, to market shares in the funds it manages.

Can I market the funds once I comply with the relevant application process obligations under the AIFMD?

Fund 1

From now until national transposition

Member States will transpose the AIFMD into national law at different times between 2011 and 2013. You would be able to continue to market to EU investors in Member States, on the currently available basis, until the date of national transposition of the AIFMD in that Member State.

From the date of national transposition

It appears that the restrictions on marketing are effective immediately from the date of national transposition. Therefore any marketing that takes place to EU investors after that date will need to be in accordance with the AIFMD.

Unlike in Case Study 1 where both the manager and funds were onshore, the existence of an offshore element means there are more restrictions to overcome than in Case Study 1, even though the UK manager is authorised in both cases.

In this case, the strategic push behind Fund 1 is to market widely across the EU. The AIFMD therefore may provide an opportunity to market, from 2015, on the basis of a passport. Until this time, however, the only way to market a Guernsey fund managed by a UK manager to EU investors would be pursuant to national private placement regimes (which is currently how such funds are typically marketed into Europe today) but as harmonised pursuant to the AIFMD.

This harmonisation means that in order to take advantage of this permitted private placement regime there must be cooperation arrangements in place as between the competent authorities of each of the Member States in which you intend to market and the supervisory authority of the relevant Fund to be marketed (in this case, the Guernsey Financial Services Commission ("GFSC")). Finally, Guernsey must not, at the time of marketing, be listed as a 'Non-Cooperative Country and Territory' by the Financial Action Task Force on anti-money laundering and terrorist financing.

If these conditions are met then from the National Transposition Date you can continue to raise finance from European investors, until the private placement regime is ultimately removed.

From 2015

In 2015, if ESMA reports favourably on the functioning of the existing passport for EU fund managers managing EU Funds, it may be extended to allow EU fund managers to passport their non-EU funds to EU investors. As stated, Fund 1's long term strategy is to expand by raising capital from hitherto untapped sources, such as France and Italy.

It remains to be seen how effective a tool the passport is, as previous passports (such as that provided under the Prospectus Directive) have not been taken up widely. If you wish to utilise the passport on behalf of Fund 1 then there must be information exchange cooperation arrangements in place between the competent authority of the Member State of the manager (the FSA) and, the supervisory authority of the country in which the Fund is established (in this case, the GFSC). In addition the fund home country (in this case Guernsey) must not be listed as a 'Non-Cooperative Country

and Territory’ by the Financial Action Task Force on anti-money laundering and terrorist financing. Finally agreements on exchange of information relating to tax matters which “fully” comply with article 26 of the OECD Model Tax Convention and which ‘ensure’ an effective exchange of information in tax matters need to be in place between Guernsey (the home state of Fund 1) and each Member State in which it is proposed that the Fund 1 be marketed (in this case: Italy, France and the UK). As **Section 2 of the Reference Manual** shows, it appears that such agreements are not currently in force. If these conditions are not satisfied then the harmonised private placement regime would remain the only way to access European investor capital.

From 2018

In 2018 ESMA will opine on whether the harmonised private placement regime should remain a route to accessing European investor capital. Assuming this route had been available to Fund 1, if it was abolished in 2018 then the passport would be the only means of accessing Europe. If the tax exchange agreements described above were not in place or if it was decided the cost of authorisation was prohibitive, then there would appear to be no way to market into Europe, save for reverse solicitation (which is not prohibited under the AIFMD).

Fund 2

As this is a UCITS vehicle the AIFMD has no application and it can continue to be marketed on the current basis.

Fund 3

Marketing of the NURS, a UK fund, will be as is the case for the investment trusts described in Case Study 1.

Will my time to market be affected by the AIFMD?

Fund 1

If Fund 1 is marketed using private placement, then there should be no discernable impact on time to market (on the assumption that the manager is already appropriately authorised).

If Fund 1 is marketed pursuant to the passport, then there may be an impact on time to market as the FSA will have 20 business days from the date of submission of a suite of documents to them including the articles of association or ‘AIF Rules’ and information on the fund (including among other things, descriptions of investment strategy and objectives, descriptions of delegation, descriptions of the valuation process, descriptions of all fees, charges and expenses, the historical performance of the fund, terms of the issue and a description of the liquidity risk management function) to decide if a fund can be marketed within the UK. Typically in the launch of a listed closed ended investment company, these documents and this information will be finalised only shortly prior to the anticipated date of launch. Much will depend on how the FSA dovetail the Prospectus Directive review process with the AIFMD process. We would expect the FSA to publish guidance on how the AIFMD marketing application process fits with the prospectus approval process. It is to be noted that there appears to be set no additional timing consequence of Fund 1 deciding to market into Italy and France (rather than just the UK) as the FSA simply need to notify the French and Italian competent authorities within the 20 business day period.

Fund 2

There will be no impact on Fund 2, the UCITS fund.

Fund 3

As Fund 3 is marketed to retail investors, regardless of the time to market under the AIFMD, it appears that it will also have to comply with the existing process under COLL (the FSA handbook requirements for collective investment schemes). In practice, therefore, it is unlikely that time to market for a NURS will be extended owing to the manager having now also to comply with the AIFMD.

Can existing custodian relationships remain in place?

Fund 1

Yes. If marketing is to be by way of private placement then, as described above and in more detail in **Section 2 of the Reference Manual**, as a UK manager managing an offshore fund, the manager does not need to comply with the depositary provisions of the AIFMD in respect of Fund 1 (being an offshore fund), save that it must have one or more depositaries to perform the functions of a depositary (as such functions are set out in the AIFMD).

If, however, marketing is sought through the use of the passport in 2015 or 2018 then the depositary rules would apply and the custodian arrangements would need to be re-structured so that there is only one depositary (with sub-depositaries as needed). This primary depositary would need to have its registered office or a branch in Guernsey or the UK and would be liable for most of the functions of any sub-depositary (see **Section 5 of the Reference Manual** for further detail).

Fund 2

Yes. This is a UCITS fund to which the AIFMD does not apply. There has, however, been speculation that the UCITS depositary regime, which is more flexible than that which applies to EU managers of EU funds, will move closer to that of the AIFMD (the European Commission intends to begin work on UCITS V in 2011).

Fund 3

Yes. This is a simple single custodian depositary arrangement, and the AIFMD would not require it to be restructured.

What changes should be made to custodian/prime brokerage agreements?

The depositary provisions, in respect of Fund 1, will only apply if the passport is utilised. Therefore the earliest these provisions will apply in respect of Fund 1 is 2015. In such a case, the changes to be made will be as for Case Study 1.

Do I need to keep more capital?

This is likely to require further consideration. Although the requirement to maintain minimum own funds of one quarter of fixed annual overheads remains, there will be new restrictions on the use of funds held to meet that requirement, and also a need to obtain professional indemnity insurance. There are also changes to the calculation of the variable element of a firm’s regulatory capital requirement. However, the AIFMD does not impose a group capital requirement, unlike the Capital Requirements Directive.

Do I need to make changes to my existing remuneration arrangements?

The Directive requires managers 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 funds they manage. Managers will therefore need to review the prescriptive requirements to see whether any changes are required to their existing compensation scheme as many widely used practices will be curtailed, eg, guaranteed bonuses are restricted. Significantly sized managers will also be required to have a remuneration committee consisting of non-executive members of the management body.

The Directive does, however, allow managers to take a proportionate approach, by complying with the principles in a way and to the extent that is appropriate to the manager's size, internal organisation and the nature, scope and complexity of the manager's activities. A number of the remuneration principles, and the concept of proportionate application, substantially mirrors the provisions contained in the revised remuneration code issued by the FSA which reflects the requirements of the amended Capital Requirements Directive and the provisions of the UK Financial Services Act 2010. The remuneration provisions of the AIFMD are detailed in Section 11 of the Reference Manual.

Do I need to disclose my remuneration?

Yes. You will be required to prepare an annual report in respect of each Fund (except for Fund 2) which discloses the total amount of remuneration (salary and bonus elements), broken down by key individuals, paid by the manager to its staff for the financial year. The annual report will be made available to competent authorities and (upon request) to investors. This requirement would be effective from the National Transposition Date. Presumably the financial year is a reference to the financial year of the fund in respect of which the annual report is being produced. It would appear that the requirement is to disclose the total remuneration at the manager level (and not just that part of it attributable to the particular fund in respect of which the report is being produced). If so, besides the obvious sensitivity around making available such information, it would make the determination of the total amount of remuneration in a financial year cumbersome as it would need to be recalculated for each fund managed by the manager (assuming they have different year end dates).

Moreover, the remuneration earned by portfolio managers in respect of Fund 2, a UCITS not within the scope of the AIFMD, would, it seems, need to be disclosed in the annual report of the other Funds (although couched in an aggregate sum disclosure). For a manager with several UCITS funds and only one alternative investment fund, this disclosure could be disproportionate and misleading.

Does my IMA need to change?

In order to comply with its obligations under the AIFMD the manager needs, among other things: to "ensure" that appropriate and consistent valuation procedures are in place and that such procedures include at least an annual valuation

of the assets; to ensure that only a single depositary is appointed (in cases where the passport is sought) and that it is appointed on the terms as set out in the AIFMD, described in Section 5 of the Reference Manual; to demonstrate that it complies at all times with the leverage limits set for the AIF; and to "ensure" that the risk profile of each Fund matches its investment strategy and policy.

From a manager's perspective, the ideal approach would be amend investment management agreements so as to give managers the necessary powers and information to enable them to comply with their obligations under the AIFMD. Such an approach, however, would raise some interesting questions around directors' duties and obligations in the context of investment companies. Where a board and a manager disagree on the provisions to be inserted it cannot be correct that a manager can override the board.

Under the AIFMD if a manager cannot "ensure" all that it should, then the manager is ultimately obliged to resign. It is thus important, that the manager has the ability to terminate its mandate immediately, without penalty, if it reasonably considers that one of the Funds it manages persists in non-compliance despite its efforts.

Equally, however, it is important that IMAs are amended to prevent the abuse, by either the manager or the Fund, of the manager's obligation to resign by using it as a back-door route to prematurely terminating the relationship. If a fund's board wants to terminate the manager for poor performance it must not be able to persist in non-compliance with the AIFMD as a method of forcing the manager to resign, without having to compensate the manager. A manager must also be dis-incentivised from walking away, by unreasonably proclaiming persistent non-compliance, simply because it no longer wants to manage a fund.

It is also the responsibility of the manager (and not a fund or any other service provider) to comply with increased disclosure and transparency obligations. IMAs should thus be amended to, amongst other things, give the manager such access to information as is necessary to comply with applicable law; permit the manager to make such disclosures as required by law; deal with the production of prescribed information; give the manager the power to instruct the fund's service providers directly in respect of such disclosures; allocate the costs of production and distribution of such information; allocate liability in respect of incorrect disclosures; and provide appropriate indemnity cover in respect of such disclosures.

Is my existing risk management function going to be sufficient going forward?

From the date of authorisation of the manager in 2013 or early 2014, the AIFMD will require that there be internal reorganisation and require that certain operational protocols be reconfigured. In particular it will be important to ensure that your risk monitoring capability and function is segregated from your portfolio management function. You will need to ensure that the risks attached to each investment position can be identified, managed, monitored and also measured on an ongoing basis through stress testing. Prescriptive sounding secondary legislation will, among other things, specify what risk management systems are to be employed by the manager, the

frequency of review of the risk management system, and 'how' the risk management function is to be separated from portfolio management.

Can our preferred administrators continue to carry out the valuations with our input?

Yes (if the delegation can be justified with objective reasons), although it is the manager's responsibility to "ensure" that there are appropriate and consistent procedures established so that a "proper" and independent valuation of the relevant Fund's assets can be performed in accordance with both the AIFMD and the Fund's articles of association (including at least an annual net asset value calculation and calculations of net asset value every time shares are redeemed or bought back (and subsequently cancelled)).

Importantly, liability to the Funds and their investors for the calculation and publishing of valuations cannot be divested to the administrator although, in turn, the administrator will be liable to the manager for any losses suffered by the manager as a result of the administrator's negligence or wilful default.

The administrator can calculate the net asset value, although in order for the manager to fulfil its obligations and in order to enable the manager to recover from the administrator on a 'back to back' basis in the event of error, the manager should be party to the administration agreement. Additionally, the contract will need to allow for the effective supervision and ongoing review of this function by the manager.

The chosen administrator must be subject to mandatory professional registration or to regulatory provisions or rules of conduct (as, for example, the main service providers in Guernsey are (each is registered with the GFSC)). The administrator must also be able furnish sufficient professional guarantees (secondary legislation will clarify what this means).



Case studies

Case study 4: US Manager (managing both EU and non-EU finds)

Key features

	Fund 1	Fund 2
Fund Domicile	UK	US
Fund type	Limited Partnership	Limited Liability Corporation
Investment advisers/ sub-delegate portfolio managers (in addition to US manager)	UK sub-delegate portfolio manager and UK investment adviser	None
Asset class	Equities	Equities
Listing/trading	None	None
Selling strategy	UK only	US only
Custodian/ prime broker arrangements	UK custodian. UK sub-delegate custodian. No prime brokers.	US custodian
Borrowing	Yes, for asset acquisition	Yes, for asset acquisition
Use of derivatives	No	Yes
NAV production	UK administrator with manager input	Performed by manager
Lock ups	No	No
Assets under management	€150m	US\$200m

Who is the AIFM?

In this case there is an external manager who has been legally appointed to be the portfolio manager of the assets of the Funds on a discretionary basis. It is thus likely that this external manager would be considered the AIFM. The sub-delegate portfolio manager would not be the AIFM as it has not been legally appointed directly by Fund 1. The investment adviser would also not be, given that it is not managing the portfolio.

Does this affect me today - should I apply for authorisation under the AIFMD today?

No. The AIFMD has been adopted and is expected to come into force in Q1 2011, but it is only when it becomes national law that it will take effect. The longstop date for national transposition of the AIFMD will be two years after the Directive comes into effect.

When will this affect me – do I need to apply for authorisation?

Yes. In 2015. From 2015 as a non-EU manager managing a fund established in the EU (Fund 1), you would need to obtain authorisation under the AIFMD, irrespective of your marketing activities, and therefore would need to comply with the AIFMD. In order to obtain authorisation you will need to comply with all of the provisions of the AIFMD, in the same way as an EU AIFM. This means, that you will need to comply with, amongst other requirements, added disclosure and transparency obligations, more onerous capital adequacy requirements, remuneration rules and self-imposed limits on leverage. For many managers their existing custodian and prime broker relationships would also likely need to be restructured.

In 2015 you would therefore need to consider whether it is worthwhile remaining the manager of Fund 1 (or if it should be wound up). Alternatively it may be worthwhile considering restructuring options.

The authorisation requirement is not triggered by Fund 2, which is a non-EU fund managed by a non-EU AIFM that is not marketed within the EU.

Does anyone else in the structure need to apply for authorisation?

No. The AIFMD does not attempt to regulate funds themselves.

Only the legal person appointed by the fund (or on behalf of the fund) and who is responsible for managing the fund, needs to seek authorisation. This would exclude sub-delegate portfolio managers, investment advisers, administrators, depositaries and other service providers.

All sub-delegate portfolio managers, however, have to be authorised or registered for the purpose of asset management and subject to supervision. If not, the FSA would need to consent to their appointment.

While I am not authorised can I still raise money from investors in the EU?

From now until national transposition

Member States will transpose the AIFMD into national law at different times between 2011 and 2013. You would be able to market to EU investors in any given Member State, subject to existing Member State level national laws, until the date of national transposition of the AIFMD in that Member State.

From the date of national transposition

It appears that the restrictions on marketing are effective immediately from the date of national transposition. Therefore any marketing that takes place to EU investors will need to be in accordance with the AIFMD.

The only way to market a fund (even a fund domiciled in the UK such as the UK limited partnership) managed by a US manager into the UK (as is the intention for Fund 1) would be pursuant to the UK's national private placement regime (which is currently how such funds are typically marketed today) but as harmonised pursuant to the AIFMD. This harmonisation means that in order to take advantage of this permitted private placement regime you would need to comply with certain of the disclosure and transparency provisions of the AIFMD in respect of the funds that you market to EU investors and those companies which any of your funds control and also comply with the restrictions on 'asset stripping' which are of concern to private equity managers (these provisions are set out in Section 10 of the Reference Manual). In addition there must be cooperation arrangements in place as between the competent authorities of each of the Member States in which you intend to market, the supervisory authority of the manager (in this case, the Securities and Exchange Commission) and the competent authority of the relevant Fund to be marketed (in this case, the FSA).

If these conditions are met (which some consider unlikely in the case of the US) then even from the National Transposition Date you can still raise finance from EU investors, until the private placement regime is removed.

From the date of my authorisation in (or around) 2015 in what ways can I raise capital from EU investors?

From 2015

In 2015, if ESMSA report favourably on the functioning of the existing passport for EU fund managers, it may be extended to allow non-EU fund managers to passport their funds throughout Europe. Fund 1's strategy does not involve marketing anywhere besides the UK. To this end the potential introduction of the passport in 2015 will be of little benefit to the manager (although the manager would be required to be authorised).

From 2018

In 2018 ESMA will opine on whether the harmonised private placement regime should remain a route to accessing European investor capital. Assuming this route had been available to Fund 1 (because the necessary international cooperation agreements were in place), if it was abolished in 2018 then the passport would be the only means of accessing EU investors (save for reverse solicitation).

If you wish to utilise the passport on behalf of Fund 1 you would be able to do so as you would already have been authorised as a manager of an EU fund. Note, however that the home country of the manager (in this case the US) would not need to comply with conditions such as putting in place a cooperation agreement with the FSA or having a tax exchange agreement in place, in order for the manager to benefit from the passport in respect of Fund 1 (full details are set out in Section 2 of the Reference Manual).

If the marketing of Fund 1 is done by third parties and intermediaries would we need to comply with the AIFMD?

Yes. It appears that the AIFMD effectively looks through intermediaries such that it considers marketing of funds by placing agents, intermediaries or on platforms as marketing by or on behalf of a manager.

If there is no intention to market Fund 1 anymore, do I need to obtain authorisation?

Yes, in 2015. See above.

Will my time to market be affected by the AIFMD?

If Fund 1 is marketed using private placement, then there should be no discernable impact on time to market (on the assumption that the manager is already appropriately authorised).

If Fund 1 is marketed pursuant to the passport (as may have to be the case from 2018), then there will likely be an impact on time to market as the FSA will have 20 business days from the date of submission of a suite of documents to them including the articles of association or 'AIF Rules' (likely to be the partnership agreement) and information on the fund (including among other things, descriptions of investment strategy and objectives, descriptions of delegation, descriptions of the valuation process, descriptions of all fees, charges and expenses, the historical performance of the fund, terms of the issue and a description of the liquidity risk management function) to decide if a fund can be marketed within the UK. Much will depend on how the FSA approach the application process as, in theory at least, they could take as little as 24 hours to approve an application to market. We would expect the FSA to publish guidance on how the AIFMD marketing application process will work. It is to be noted that there appears to be no additional timing consequence of deciding to market outside the UK as the FSA simply need to notify the relevant competent authorities within the 20 business day period.

Can existing custodianship relationships remain in place?

Yes. If marketing is to be by way of private placement then, as described above and in more detail in Section 5 of the Reference Manual, as a US manager managing an onshore fund, the manager does not need to comply with the depositary provisions of the AIFMD.

From 2015, however, (the date of authorisation) the depositary rules would apply and the custodian arrangements would need to be in compliance with the AIFMD such that that there is only one depositary (with sub-depositaries as needed). This primary depositary would need to have its registered office or a branch in the UK (see Section 5 of the Reference Manual for further detail). In this case, Fund 1 is currently in compliance and so the existing custodian relationships can remain in place even after 2015.

Fund 2's custody arrangements will not be impacted by the authorisation of the manager.

Do I need to make changes to my existing remuneration arrangements?

The Directive requires managers 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 funds they manage. Managers will therefore need to review the prescriptive requirements to see whether any changes are required to their existing compensation scheme as many widely used practices will be curtailed, eg, guaranteed bonuses are restricted. Significantly sized managers will also be required to have a remuneration committee consisting of non-executive members of the management body.

The Directive does, however, allow managers to take a proportionate approach, by complying with the principles in a way and to the extent that is appropriate to the manager's size, internal organisation and the nature, scope and complexity of the manager's activities. A number of the remuneration principles, and the concept of proportionate application, substantially mirrors the provisions contained in the revised remuneration code issued by the FSA which reflects the requirements of the amended Capital Requirements Directive and the provisions of the UK Financial Services Act 2010. The remuneration provisions of the AIFMD are detailed in Section 11 of the Reference Manual.

Do I need to disclose my remuneration?

Yes. You will be required to prepare an annual report in respect of Fund 1 (because it is marketed into the EU) which discloses the total amount of remuneration (salary and bonus elements), broken down by key individuals, paid by the manager to its staff for the financial year. The annual report will be made available to competent authorities and (upon request) to investors. This requirement would be effective from the National Transposition Date, when the reliance on the harmonised national private placement regime begins). Presumably the financial year is a reference to the financial year of the fund in respect of which the annual report is being produced. It would appear that the requirement is to disclose the total remuneration at the manager level (and not just that part of it attributable to the particular fund in respect of which the report is being produced). There will clearly be sensitivity about making available such information.

Moreover, it appears that remuneration attributable to Fund 2, which is neither managed nor marketed within the EU, would need to be disclosed (although couched in an aggregate sum). If this turns out to be correct, the sensitivity of such disclosures may be such that the manager may consider moving Fund 2 under the management of a legally separate manager.

Does my IMA need to change?

After 2015, in order to comply with its obligations under the AIFMD the manager needs, among other things: to "ensure" that appropriate and consistent valuation procedures are in place and that such procedures include at least an annual valuation of the assets; to ensure that only a single depositary is appointed and that is appointed on the terms as set out in the AIFMD, described in Section 5 of the Reference Manual.; to demonstrate that it complies at all times with the

leverage limits set for the AIF; and to “ensure” that the risk profile of the Fund matches its investment strategy and policy.

From a manager's perspective, the ideal approach would be amend investment management agreements so as to give managers the necessary powers and information to enable them to comply with their obligations under the AIFMD. Such an approach, however, would cut across the role traditionally undertaken by the general partner in a UK limited partnership such as Fund 1 and will therefore require further thought.

Under the AIFMD if a manager cannot “ensure” all that it should, then the manager is ultimately obliged to resign. It is thus important that the manager has the ability to terminate its mandate immediately, without penalty, if it reasonably considers that the fund persists in non-compliance despite the efforts of the manager.

Equally, however, it is important that the IMA is amended to prevent the abuse, by either the manager or the Fund, of the manager's obligation to resign by using it as a back-door route to prematurely terminating the relationship. If the Fund wants to terminate the manager for poor performance it must not be able to persist in non-compliance with the AIFMD as a method of forcing the manager to resign, without having to compensate the manager. A manager must also be dis-incentivised from walking away, by unreasonably proclaiming persistent non-compliance, simply because it no longer wants to manage a fund.

It is also the responsibility of the manager (and not the fund or any other service provider) to comply with increased disclosure and transparency obligations. IMAs should thus be amended to, amongst other things give the manager such access to information as is necessary to comply with applicable law; permit the manager to make such disclosures as required by law; deal with the production of prescribed information; give the manager the power to instruct the fund's service providers directly in respect of such disclosures; allocate the costs of production and distribution of such information; allocate liability in respect of incorrect disclosures; and provide appropriate indemnity cover in respect of such disclosures.

Is my existing risk management function going to be sufficient going forward?

From the date of authorisation of the manager in 2015, the AIFMD will require that there be internal reorganisation and require that certain operational protocols be reconfigured. In particular it will be important to ensure that your risk monitoring capability and function is segregated from your portfolio management function. You will need to ensure that the risks attached to each investment position can be identified, managed, monitored and also measured on an ongoing basis through stress testing. Prescriptive secondary legislation will, among other things, specify what risk management systems are to be employed by the manager, the frequency of review of the risk management system, and ‘how’ the risk management function is to be separated from portfolio management.

Can our preferred administrator continue to carry out the valuations with our input?

Yes (if the delegation can be justified with objective reasons), although it is the manager's responsibility to “ensure” that there are appropriate and consistent procedures established so that a ‘proper’ and independent valuation of the fund's assets can be performed in accordance with both the AIFMD and the fund's articles of association (including at least an annual net asset value calculation and calculations of net asset value every time shares are redeemed or bought back (and subsequently cancelled)).

Importantly liability, to the Fund and its investors, for the calculation and publishing of valuations cannot be divested to the administrator, although, in turn, the administrator will be liable to the manager for any losses suffered by the manager as a result of the administrator's negligence or wilful default.

The administrator can calculate the net asset value, although in order for the manager to fulfil its obligation to ‘ensure’ and in order to enable the manager to recover from the administrator on a ‘back to back’ basis from the administrator (an indemnity from the administrator), the manager should be party to the administration agreement. Additionally the contract will need to allow for the effective supervision and ongoing review of this function by the manager

The chosen administrator must be subject to mandatory professional registration or to regulatory provisions or rules of conduct (as, for example, the main service providers in the UK are). The administrator must also be able furnish sufficient professional guarantees (secondary legislation will clarify what this means).

Should I re-domicile?

The only way for the manager to avoid having to comply with the AIFMD is to re-domicile the Fund itself outside of the EU. At this point Case Study 2 would be relevant. The issues following this restructuring would be in relation to marketing to European investors going forward. These marketing restrictions could be approached in the same way as they are in Case Study 2 ie, through the use of the AIFMD's harmonised private placement regime (at least until 2018, assuming all the relevant international cooperation agreements are in place). See Case Study 2 for more detail in relation to raising finance from EU investors using a non-EU manager, non-EU fund structure.

Alternatively, it may be that the better long term option where the EU continues to be a significant market is to establish an EU domiciled management company to act as the AIFM for EU marketed funds.

Case Studies

Case Study 5: Managers of private equity funds

Key features

	Fund 1	Fund 2	Fund 3
Manager	UK manager appointed in place of GP	UK GP	US GP
Fund domicile	UK	Cayman Islands	Cayman Islands
Fund type	Private equity limited partnership	Private equity limited partnership	Private equity limited partnership
Investment advisers (in addition to manager)	None	None	None
Stage of commitments/ investments	Currently in Subscription period. Expected to be fully invested in 2012	Subscription period ended in 2010. Investments currently being made.	To be launched
Selling strategy	Global	Global	Undetermined
Listing/trading	None	None	None
Borrowing	Yes, for bridging only	Yes, for bridging only	Yes, for bridging only
Assets under management	€200m	€300m	€100m

Managers of private equity funds will have certain questions and concerns particular to the industry and strategy. Case study 5 looks at some of these questions.

Who is the AIFM?

The provisions in the AIFMD relating to the 'determination of the AIFM' do not properly contemplate partnerships. The AIFM is defined as the legal person whose regular business is managing one or more AIF (which is to say that it undertakes portfolio management and/or risk management). UK limited partnerships would typically see a general partner ("GP") responsible for operation of the fund, with limited partners simply accruing an economic benefit. In UK limited partnerships, an external manager may be appointed to operate and manage the fund in place of the GP. We consider it likely that in such instances, the external manager would be the AIFM, and not the GP. Thus in the case of Fund 1, which has an external manager, it is this external manager that would be the AIFM.

In other private equity structures, such as those constituted in the Cayman Islands, the GP is often the entity which undertakes the portfolio management with advice from other entities. It is unclear whether in such models the fund will be considered to be self managed or whether the GP would be considered an external AIFM. This question is important as it will have ramifications as to whether or not the entity which is GP or the partnership itself needs to seek authorisation (with all attendant consequences that brings).

Does this affect me today - should I apply for authorisation under the AIFMD today?

No. The AIFMD has been adopted and is expected to come into force in Q1 2011, but it is only when it becomes national law that it will take effect. The longstop date for national transposition of the AIFMD will be two years after the Directive comes into force (the "National Transposition Date").

When will this affect me – do I need to apply for authorisation?

Funds 1 and 2 (Funds with UK Managers)

As a UK manager, the managers of Funds 1 and 2 would, prima facie, need to obtain authorisation in 2013 in order to manage or market the funds, regardless of where the funds are domiciled. In these cases, however, the managers may be able to rely upon the limited grandfathering provisions for closed-ended funds contained in the AIFMD.

Fund 1 is expected to be fully invested in 2012. Provided that no additional investments are made after the National Transposition Date the manager should be allowed to continue to manage (but not market) Fund 1 without the need for further authorisation.

The manager of Fund 2 may also be able to benefit from a lighter level of requirements. Provided that the subscription period for investors closed prior to the AIFMD coming into force and the Fund 2 has a termination date which expires at the latest three years after the National Transposition Date, the Fund 2 manager will only have to comply with the requirement to publish an annual report and, where relevant, the provisions relating to a manager which acquires control of non-listed companies (both of these requirements are discussed in detail in **Section 7 of the Reference Manual**). It is unclear whether a provision for the life of a fund being extendable for a further one year period subject to investor consent (as is often the case for partnership vehicles) will impact on the ability to rely upon this provision.

Obviously, if it is decided that further capital is needed and marketing to EU investors becomes necessary, then the relevant manager can opt-in to be authorised. In the case of Fund 1, which is a UK fund, this would allow for marketing to UK investors immediately and to investors in the rest of the EU once the passporting application process has been satisfied. In the case of Fund 2, marketing, even with authorisation, could only take place under the private placement regime until at least 2015 when the passport would be made available to non-EU funds too.

These grandfathering provisions are to be welcomed by the private equity and real estate industry as many existing funds will fall within the scope of such provisions. We expect further details on the provisions to be contained in the secondary legislation.

Fund 3 (non-EU manager)

No. Subject to the discussion below on accessing EU investors after 2015, as a non-EU manager of non-EU funds the Fund 3 manager does not need to apply for authorisation and therefore does not need to comply with the AIFMD.

If Fund 3 manager, however, decides to market broadly to EU domiciled investors, the AIFMD presents an opportunity to passport Fund 3 from 2015 and thus facilitates the execution of this strategy. The passport will only be available to those managers who opt-in to be authorised under the Directive. An authorised manager will be subject to the provisions of the entire Directive. If, however, this proves too onerous or not cost-effective, no authorisation will be needed as non-EU managers can (if certain conditions are satisfied) market shares in non-EU funds without authorisation, to European investors, if selling is restricted to using national private placement rules (as harmonised by the AIFMD) although

this route may only be available until 2018 when the private placement regime may be removed.

The position of the Fund 3 manager highlights the dilemma many non-EU private equity firms will face in the future. Given that the AIFMD effectively makes private equity a regulated industry at EU level, non-EU managers will have to determine whether they want to incur the potentially significant costs (both for manager and, ultimately, investor) and additional requirements on private equity managers arising from opting to be authorised so as to access European capital. As many private equity managers comprise small teams, the relative impact of these additional requirements should not be underestimated. Private equity managers will need to balance these considerations with the fact that they will continue to compete for such investor capital from other non-EU fund vehicles which may fall outside the scope of the Directive and from the EU funds industry which will no doubt evolve following the introduction of the Directive.

All Funds

Had none of the Funds been in a position to be able to rely upon the grandfathering provisions, the de minimis exemption could have been applicable. €500 million AUM is the threshold above which the AIFMD applies to a manager if none of the funds it manages have redemption rights or use leverage for the purpose of asset acquisition. As private equity vehicles typically do not have a redemption facility or employ leverage at the fund level (and leverage at the portfolio level is disregarded for this purpose), the de minimis provision should be useful for managers of smaller funds. The assets under management for each of Funds 1 to 3 fall below the €500m threshold and so it would appear that each of the managers could rely upon the de minimis exemption (although each manager would need to aggregate the AUM of all of the funds it manages directly or indirectly). An important caveat to the above analysis is that the Directive does not specify whether bridging loans will be construed as leverage 'for the purpose of asset acquisition' and we hope to see this clarified in subsequent secondary legislation. Moreover, it is unclear whether investor commitments structured as loans would be construed as 'leverage', in which case the de minimis threshold drops to €100 million. For those managers that can rely upon the de minimis exemption, there will be no requirement to obtain authorisation; instead such managers will need to seek registration from the competent authority in its Member State.

Will my time to market be affected by the AIFMD?

Fund 1

Yes. Had Fund 1 not been in a position to rely upon the grandfathering or de minimis provisions, authorisation under the Directive would be required. In this situation, as an EU manager of an EU fund wishing to market to EU investors, there will be an impact on time to market as the FSA will have 20 business days from the date of submission of a suite of documents (the 'notification pack', details of which are contained in **Section 2 of the Reference Manual**) to decide if a fund can be marketed in the UK. The time to market to other Member States the Fund 1 manager wishes to market to should not be much different from that required to market to UK investors. The FSA will notify the regulators in each of those Member States. Marketing of the fund can commence in those Member States once the FSA has notified the manager that the relevant Member States have been notified.

During the private equity fundraising process, the key documentation are heavily negotiated and amended. Material changes to the information contained in the notification pack will need to be notified one month in advance (or immediately after the change, in the event of unplanned change). It is unclear whether this requirement to notify of changes will be triggered by changes of a regulatory nature or by all material changes including changes to the commercial terms contained in the documentation.

Funds 2 and 3

As an EU AIFM of a non-EU AIF (Fund 2) and a non-EU AIFM of a non-EU AIF (Fund 3), the managers of Funds 2 and 3 may market (subject to certain conditions being met) using the private placement regime (until its potential removal in 2018) or, by opting-in to authorisation, the passport regime (which may be introduced for such funds in 2015).

If the Funds are marketed using private placement, there should be no material impact on the time to market (on the assumption that the manager is already appropriately authorised). If Funds 2 and 3 are marketed pursuant to the passport, the potential impact on time to market described in respect of Fund 1 above will apply.

The requirement to obtain authorisation to market (under the passport regime) will require private equity managers to interact with regulators in this regard for what may be, in many cases, the first time and it is therefore critical for such managers to allow sufficient time to prepare for the authorisation process.

What impact will the AIFMD have on carried interest paid?

The detailed remuneration principles annexed to the AIFMD is explicitly stated to apply to carried interests paid by a fund. Typical carried interest structures will already comply with many of the key principles central to the annex. For example, payment is deferred and it is “in line with the business strategy, objectives, values and interests” of the fund. Much of the detail however does not sit comfortably with carried interest structures and, in particular, the fact that it is not typically paid to the manager but to a special limited partner. ESMA is to issue guidance on sound remuneration policies which comply with the remuneration principles annexed to the AIFMD and it is to be hoped that when this guidance is issued it deals with how the principles are to be read in the private equity context. In particular it is to be hoped that existing structures that involve payment to a special limited partner are not viewed as means of avoiding compliance as the AIFMD explicitly states that variable remuneration is not to be “paid through vehicles that facilitate the avoidance of the requirements of the Directive”.

Funds 1 and 2

In this case study Funds 1 and 2 are managed by a UK manager. The UK manager would need to be authorised and would therefore need to comply with the AIFMD's provisions on remuneration (unless, as discussed above, they fall within one of the limited transitional exemptions described above or fall under the de minimis threshold).

Fund 3

Fund 3 (which is a non-EU fund managed by a non-EU manager) would not need to comply with the remuneration principles, unless it decided that marketing to investors in a wide range of Member States was necessary (in which case it would need to seek authorisation to use the passport). If however it completes its marketing before the AIFMD is nationally transposed or if it only needs to rely on private placement, then it would not need to comply with the provisions on remuneration.

Do I need to make public the carried interest paid?

You will be required to make available to investors and competent authorities (of the AIFM and fund) an annual report in respect of the fund which discloses the total amount of remuneration (salary and bonus elements), broken down by key individuals, paid by the manager to its staff for the financial year. Depending on how you have structured cash flows it may be that the carry is not however paid to the manager, but to a special limited partner. The AIFMD is, however, drafted widely enough such that carried interests paid by the fund to a special investment partner may also need to be disclosed in the annual report (i.e. even if not paid to the designated AIFM). This requirement would be effective from the date of national transposition (i.e. in 2013) for Funds 1 and 2 but will not apply to Fund 3 unless and until it seeks the marketing passport.

Do I need to make public my valuation of the fund's assets and, if so, how frequently?

Each of the managers who would need to seek authorisation (being in this case study Funds 1 and 2 at a minimum, on the assumption that exemptions and transitional provisions do not apply, for which, see above) will likely have to make changes to their valuation processes. The changes will not, however, likely be dramatic changes as the provisions on valuation have been tempered since the earlier drafts of the AIFMD were issued.

A manager must ensure that the net asset value per share or unit of its funds are disclosed to investors at least once a year. It is not clear how this is to apply to interests in partnerships. Furthermore it appears that Member States may impose different requirements in relation to the calculation and disclosure to investors of valuations.

Before an investor invests in the fund you would need to describe the valuation procedure and pricing methodology of the fund. This applies also to any assets considered hard to value. It remains to be seen what disclosure would be required in cases where a fund has not yet identified a target entity in which to invest and thus has not yet determined a pricing methodology or valuation procedure. It may be that stating that the fund intends to follow BVCA/ EVCA guidelines would be sufficient.

Do I need an independent external valuer?

AIFMs can, however, take some comfort from the fact that the use of an external valuer is not mandatory (which, if it had been, would have been a marked departure from current practice within the private equity industry). If the AIFM decides to carry out its own valuations, however, it must ensure independence between the valuation and the portfolio management functions. The AIFM must put in place measures to mitigate conflicts of interest arising in connection with in-house valuation (eg, 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.

For smaller private equity managers wishing to carry out its valuations internally, this requirement for functional independence is likely to be challenging. There will also no doubt be cost implications of carrying out valuations, internally or externally, in accordance with the Directive's provisions. Further details on the valuation provisions are contained in Section 8 of the Reference Manual)

Do I need to disclose the research and development activities and other such sensitive information of portfolio companies?

Earlier drafts of the AIFMD contained onerous requirements pursuant to which information such as the research and development activities of portfolio companies and revenues and earnings broken down by business segment of portfolio companies needed to be disclosed in annual reports, simply because they were controlled by private equity. This may have led to certain portfolio companies, when faced with a choice of funding sources, to shy away from private equity or venture capital. It may also have put certain of these portfolio companies at a competitive disadvantage to their peers who were not so funded. There are still additional disclosures to be made about companies that are controlled by private equity, but they are less onerous. "Important events" that have occurred since the end of the financial year (presumably of the portfolio company and not the fund) need to be disclosed. There is also a broadly drafted requirement to disclose the portfolio company's "likely future development". Unhelpfully, it appears that no further legislation will be issued at the European level to elaborate on what this means. It is, however, to be hoped that disclosure of information harmful to competitive advantages will not be required.

These disclosure provisions would apply to funds such as Fund 1 and 2 (managed by a UK manager) but they would also apply to funds with structures similar to Fund 3 (a non-EU manager managing a non-EU fund) if such Fund is to be marketed to investors in the EU (even if they are not authorised rely simply on the private placement facility). Please see Section 7 of the Reference Manual for further details on the disclosure provisions.

Do I need to have a depositary?

A single, independent depositary will need to be appointed for each AIF managed (including existing AIFs), which will represent new practice for many private equity and real estate fund managers. We hope that secondary legislation will take into account the fact that the depositary services required by a private fund manager are very different from those required by a listed fund or hedge fund. Full details on depositaries are contained in Section 5 of the Reference Manual.

Does the AIFMD impact on how quickly I can extract value from a portfolio company?

When an AIF acquires control of a non-listed company/ issuer (as defined in Section 10 of the Reference Manual), the AIFM may not facilitate, support, instruct any distribution, capital reduction, share redemption and/or acquisition of shares by the company/issuer for 24 months. Full details on asset stripping are contained in Section 10 of the Reference Manual).

Reference manual

1. Scope and exemptions

Scope

The AIFMD applies to AIFMs established in the EU which manage one or more alternative investment funds (“AIFs”) irrespective of where the AIFs are located or what legal form the AIF takes.

The AIFMD also applies to AIFMs established outside the EU which manage one or more AIF established in the EU or which market in the EU one or more AIF established in the EU or elsewhere.

Who is the AIFM?

The AIFMD provides that an AIFM is any legal person whose regular business is managing one or more AIFs (“managing” an AIF for these purposes means providing at least portfolio management or risk management functions in respect of an AIF) and can either be:

- (i) an external manager appointed by or on behalf of the AIF; or
- (ii) in the case of an AIF that “permits an internal management” and chooses not to appoint an external AIFM, the AIF itself.

On its face, therefore, if an AIF appoints an external investment manager, that manager will be the AIFM for the purposes of the AIFMD. By contrast, in the case of, for example, a self-managed UK investment trust, the investment trust itself will be both the AIF and the AIFM and will therefore require authorisation under the AIFMD. Similarly, it seems that a fund which is structured such that it receives investment advice from third party investment advisers but whose board retains responsibility for investment decisions and risk management would itself qualify as both the AIF and AIFM for the purposes of the AIFMD.

An alternative reading of the AIFMD, however, may be that because the board of directors of an investment company or the general partner of a fund structured as a partnership is typically “responsible” for portfolio and risk management, the board or general partner will itself be the AIFM, notwithstanding that an external investment manager may have been appointed. Under this interpretation, the external investment manager would be a delegate of the board or directors or general partner. We expect the FSA to clarify its position with respect to this alternative interpretation prior to 2013.

As a general point it is to be noted that it is as yet unclear how a general partner responsible for portfolio or risk management would be treated. In particular, it is unclear if the general partner would, if deemed to be an AIFM, be considered an ‘external’ manager or whether the partnership itself would be deemed to be the AIFM.

What is an AIF?

The AIFMD provides that an AIF is any collective investment undertaking which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy. It is to be noted that there is no risk spreading criteria internal to the definition of an AIF, thereby bringing single asset funds into scope. In essence all arrangements typically thought of as ‘funds’ would be caught save for UCITS funds, which are specifically exempted, and some other limited exemptions as described below. Certain arrangements not typically thought of as “funds”, such as certain acquisition vehicles, may also be caught by the definition (although the recitals to the AIFMD specifically exclude joint ventures (undefined)).

Exemptions

The AIFMD contains fewer exemptions than were contained in previous drafts and in particular the concept of partial exemptions for real estate funds and private equity funds which were previously contained in the Parliament Draft have largely been removed, save for some limited concessions (notably in relation to the use of depositaries).

The Directive does not apply to AIFMs if they manage one or more AIF whose only investors are the AIFM or the parent or subsidiaries of the AIFM provided none of those investors are an AIF.

The Directive also specially excludes from its scope the management of holding companies; certain pension funds; employee participation or savings schemes; supranational institutions; national central banks; national, regional and local governments and bodies or institutions which manage funds supporting social security and pensions systems; securitisation special purpose vehicles and insurance contracts.

The De Minimis Exemption

If an AIFM falls under the de minimis threshold then only limited provisions of the AIFMD will apply. Such AIFM will be required to register with (but not seek authorisation from) the competent authorities in its Member State and must provide information on the investment strategies, exposures and concentrations of the AIF(s) it manages. AIFMs that fall within this exemption are unable to benefit from the marketing passport granted by the AIFMD unless they elect to opt-in to the full provisions of the AIFMD.

The de minimis thresholds are (a) where leverage is employed to any extent within the portfolios of the AIF(s) managed by the AIFM, aggregate AUM of €100 million; and (b) where no leverage is employed and the AIF(s) managed by the AIFM do not provide investors with redemption rights during the first five years from investment, €500 million AUM.

We would expect the related secondary legislation to place the onus on the AIFM to confirm the identity of the portfolios of the AIF under its management and to calculate the value of AIF assets under management. This is particularly important for the private equity industry where there is no single accepted method for determining the value of AUM by private equity firms.

Grandfathering provisions for existing closed-ended funds
(particularly relevant to private equity and real estate funds)

Condition(s)	Authorisation	Applicable AIFMD requirements
(i) AIF in question managed before the final national transposition date* (ii) No additional investments made after the final national transposition date*	AIFM can continue to manage (but not market) AIF without authorisation	No requirements
(i) Subscription period closed prior to the AIFMD coming into force (ii) Termination date which expires at the latest three years after the final national transposition date*	AIFM can continue to manage (but not market) AIF without authorisation	(i) publication of an annual report (ii) (where relevant) notification and disclosure obligations where an AIF acquires control of a non-listed company or issuer (iii) (where relevant) asset stripping

* the final national transposition date is the deadline by which Member States must pass national legislation to implement the AIFMD, being the second anniversary of the AIFMD coming into force

EU AIFM	Non- EU AIFM	EU AIF	Non- EU AIF
An AIFM which has its registered office in a Member State of the EU	An AIFM which is not an EU AIFM	An AIF which is authorised or registered in the EU, or, if not applicable, which has registered or head office in the EU	Any AIF which is not an EU AIF

2. Marketing

General

The provisions of the AIFMD concerning the marketing of AIF have been of general concern and significant public debate throughout the drafting stages of the AIFMD, particularly with regard to the application of the AIFMD to marketing activity by non-EU AIFMs and to the marketing of non-EU AIFs and the ability of professional investors within the EU to continue to access those funds. The position taken on marketing provides a more balanced approach than had previously been proposed, particularly by the Parliament, but nonetheless will require changes to the way that AIF are currently marketed, the detail of which will only become clear once secondary legislation is introduced. One fundamental change is that while efforts have been made to provide a workable regime for marketing to professional investors (using the MiFID definition of an investor which is or may be treated as a professional client), marketing to retail investors will be subject to an additional layer of regulation at the level of individual Member States. This is a key change for, for example, closed ended AIFs, which may currently take advantage of the passporting regime for public offers of securities under the Prospectus Directive.

Timeline for implementation

The passport regime allowing the marketing of EU AIFs by EU AIFMs on a cross-border basis within the EU will enter into force from the date of national transposition of the AIFMD by Member States in 2013. In 2015 the European Securities and Markets Authority (“ESMA”) will report on the functioning of the regime and give recommendations as to whether or not it should be extended to the marketing of non-EU AIFs and marketing by non-EU AIFMs. Any extension to the passport regime would take effect shortly after such ESMA report. In the meantime, AIFs may be marketed in Member States subject to partially harmonised national private placement exemptions provided that the AIFM and the relevant third countries themselves comply with the relevant parts of the Directive as discussed below. The continuation of the national private placement regimes would be considered by ESMA concurrently with its evaluation of the workings and possible extension of the passport regime. Depending on the outcome or ESMA’s work in this area, the partially harmonised national private placement regime may be extinguished (to be replaced by a more comprehensive passport regime) in 2018.

Marketing

Under the AIFMD, “marketing” means “any direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled in the EU”.

The scope of the definition is broad but is focused on the issue of units or shares in an AIF, rather than the more general activities of an AIF following an issue of units or shares. It is therefore to be hoped that AIF/AIFM activities such as the publication of regular fact sheets and “investor updates” would not be considered to constitute “marketing” for these purposes and that the position will be clarified prior to the AIFMD being implemented in Member States.

Reverse solicitation

A significant improvement on earlier drafts is that the recitals to the Directive now specifically state that the AIFMD “should not affect the current situation, whereby a professional investor established in the Union may invest in AIF at its own initiative, irrespective of where the AIFM and/or the AIF is established”. “Reverse enquiry” investment in AIFs by EU investors will, therefore, continue to be available.

EU AIFM marketing EU AIF

An EU AIFM wishing to market an AIF to professional investors in its home Member State must first submit to its home Member State regulator a suite of documentation concerning the AIF it wishes to market (an Annex III notification, [see Figure 1 below](#)). That notification pack comprises, in summary, the constitutional documents of the AIF, its marketing materials and information on the arrangements established to prevent the marketing of the AIF to retail investors. We would expect that practice will develop such that the prospectuses or other offering documents of relevant AIFs will include items to cover the disclosure requirements of the AIFMD, to the extent that they do not already do so, such that in practice this process can become relatively standardised.

The home Member State regulator must inform the AIFM whether or not it may start marketing the AIF in that Member State within 20 working days of receiving the notification pack from the AIFM and may only withhold its consent to such marketing in the case of non-compliance with the AIFMD. In the case of closed-ended listed funds, we would hope that where the home Member State regulator is also reviewing a prospectus of the relevant fund for the purposes of the Prospectus Directive, the 20 working day period could in practice run concurrently with that review process. However, it seems likely that some additional time may have to be factored into the timetable for the launch of most new AIFs once the AIFMD is in force. More clarity will need to be sought from regulators as to how they intend to dovetail existing regulatory review processes with those set out in the AIFMD. This will be of particular importance to managers of funds which currently have a short ‘time to market’ (such as Irish “Qualified Investor Funds” which are often authorised within 24 hours) as it appears that the commencement of marketing will now be dependent on the approval of the AIFM’s competent authority rather than on the authorisation of the fund itself.

The process for marketing EU AIFs to professional investors in other Member States (under the passport regime) is similar in that the application is made to the AIFM’s home Member State regulator (an Annex IV notification, [see Figure 2 below](#)), which then must (within 20 working days of receipt of the required documentation) notify the regulators in each of the other Member States in which the AIFM intends to market the AIF; in practice we would expect the applications to market in the home Member State of the AIFM and elsewhere to be considered concurrently.

It should also be noted that any material changes to the information provided to the home Member State regulator for the purposes of the marketing approval are required to be notified to the regulator at least a month before taking effect. While it can be hoped that accepted market practice will develop to provide a sensible materiality threshold for these purposes, this provision potentially represents an unwelcome constraint on the ability of AIFs and their managers to adopt quickly changes to the way that AIFs operate.

EU AIFM marketing non-EU AIF

Partially Harmonised National Private Placement Regime (2013 to 2018)

As noted above, the AIFMD envisages that for a transitional period until the passport regime is extended to cover non-EU AIFs and be available to non-EU AIFMs, and existing private placement regimes in each Member State are terminated, (which, if it happens, is currently envisaged to take place in 2018 or soon after), EU AIFMs may market non-EU AIFs to professional investors in EU Member States in accordance with the private placement regime (if any) currently available in each Member State provided that:

- a) the AIFM complies with the AIFMD (other than the provisions relating to depositaries, provided that the AIFM ensures with respect to the relevant non-EU AIF that cash management, safekeeping of assets, the processing of redemptions and subscriptions and the valuation of assets are undertaken by a third party);
- b) cooperation agreements are in place for the purposes of systemic risk oversight between the supervisory authorities of the third country where the non-EU AIF is authorised or registered (or if neither apply, where it has its registered office) and the competent authority of the home state of the AIFM; and
- c) the third country where the AIF is authorised or registered (or if neither apply, where it has its registered office) is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

The Commission has been tasked with putting in place measures to allow for a common framework to be adopted facilitating the establishment of cooperation agreements with third countries. It is to be hoped that sensible arrangements can be put in place with the key offshore fund jurisdictions and the EU Member States by the time the marketing restrictions come into effect following national transposition in 2013, although it might

be expected that these offshore jurisdictions will prioritise putting such arrangements in place with those Member States which are home to the greater number of traditional AIF investors.

Passport (2015 onwards)

If and when the passport regime is extended to apply to non-EU AIFs (anticipated to be in 2015 or soon after), EU AIFMs authorised under the AIFMD may market non-EU AIFs to professional investors within the EU, provided that they comply with the AIFMD and:

- a) cooperation agreements are in place between the competent authority of the home state of the AIFM and the supervisory authorities of the third country where the non-EU AIF is authorised or registered (or if neither apply, where it has its registered office) to allow for an efficient exchange of information such that the home Member State regulator of the AIFM may conduct its supervisory functions properly;
- b) the third country is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing; and
- c) the third country has signed an agreement with the home Member State of the AIFM and any other Member State in which marketing is proposed which complies fully with the OECD model tax convention and ensures an effective exchange of tax information.

Again, it is to be hoped that sensible arrangements can be put in place to allow these conditions to be satisfied in respect of key offshore jurisdictions by the time that the passporting regime takes effect. One concern, however, is whether the requirement for an agreement between the third country in which the relevant AIF is domiciled and each of the AIFM's home Member State and each Member State in which the AIF will be marketed which is fully compliant with the OECD model tax convention is feasible. It is questionable whether the agreements that the UK currently has in place with typical offshore domiciles would be regarded as fully compliant. The agreements in place with the US, Ireland, Guernsey, Jersey, BVI, Isle of Man and the pending agreement with Cayman Islands are not in the form of the most recent version of the Convention (for example, because they cover only specified taxes and/or "necessary" as opposed to "foreseeably relevant" information). Notably, however, Luxembourg have approved a fully compliant amendment to its agreement with the UK which will come into force next year. If this condition is read and applied strictly, it is to be hoped that fully compliant amendments are agreed in respect of the other offshore jurisdictions.

Non-EU AIFM marketing Non-EU AIFs

Partially Harmonised Private Placement Regime (2013 to 2018)

Until the passport regime is extended so as to be available to non-EU AIFMs and the existing private placement regimes in each Member State are terminated, the AIFMD provides that Member States may allow non-EU AIFM (who would not be authorised under the AIFMD) to market non-EU AIFs to professional investors in that Member State, provided that:

a) they comply with the provisions of the Directive dealing with annual reports, disclosure to investors and reporting obligations (see Section 7 of the Reference Manual for further details);

b) if relevant, they comply also with the provisions of the AIFMD restricting asset stripping (see Section 10 of the Reference Manual for further details);

c) cooperation agreements for the purposes of systemic risk oversight are in place between the competent authorities of the Member States in which the AIFs are marketed, the supervisory authorities of the third country where the non-EU AIFM has its registered office and the supervisory authorities of the third country where the non-EU AIF is authorised or registered (or if neither apply, where it has its registered office); and

d) neither the third country where the AIF is authorised or registered (or if neither apply, where it has its registered office) nor the third country where the non-EU AIFM has its registered office is listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

The discretion as to whether to allow marketing on this basis lies with the individual Member States and the AIFMD expressly provides for them to impose stricter requirements should they wish.

Passport (2015 onwards)

If and when the passporting regime is extended so as to be available to non-EU AIFMs (anticipated to be 2015), non-EU AIFM will be able to market non-EU AIFs in their Member State of Reference (see Figure 3 as to how to determine the Member State of Reference) if they are authorised under the AIFMD (see "Authorisation of a non-EU AIFM" below) and submit an Annex III notification which is approved by the competent authority of the Member State of Reference. The competent authority must inform the AIFM within 20 working days of receipt of the notification if it may start marketing.

If the non-EU AIFM wants to market the non-EU AIF elsewhere in the EU it would need to be authorised under the AIFMD, submit an Annex IV notification which would need to be approved by the competent authorities of the Member State of Reference which it would then transmit to the competent authorities of the Member States in which the EU AIFs are to be marketed. The competent authority of the Member State of Reference must transmit the Annex IV notification within 20 working days of receipt of the notification and inform the AIFM of this fact. Marketing may commence in the relevant Member States upon notification of the transmission.

In addition, in order to market non-EU AIFs to professional investors within the EU pursuant to the passport the following conditions must be satisfied:

a) cooperation agreements must be in place between the competent authority of the Member State of Reference of the AIFM and the supervisory authorities of the third country where the non-EU AIF is authorised or registered (or if neither apply, where it has its registered office);

b) the third country where the non-EU AIFM has its registered office is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing; and

c) the third country where the non-EU AIFM has its registered office must have signed an agreement with the home Member State of the AIFM of and any other Member State in which marketing is proposed which complies fully with the OECD model tax convention and ensures an effective exchange of tax information (see above for a discussion as to existing tax information exchange agreements).

Non-EU AIFM marketing EU AIFs

Partially Harmonised Private Placement (2013 to 2018)

Until the passport regime is extended so as to be available to non-EU AIFMs and the existing private placement regimes in each Member State are terminated, Member States may allow non-EU AIFM (who would not be authorised under the AIFMD) to market EU AIFs to professional investors, provided that:

a) they comply with the provisions of the AIFMD dealing with annual reports, disclosure to investors and reporting obligations (see Section 7 of the Reference Manual for further details);

b) if relevant, they comply also with the provisions of the Directive restricting asset stripping (see Section 10 of the Reference Manual for further details);

c) cooperation agreements for the purposes of systemic risk oversight are in place between the competent authorities of the Member States in which the AIF are marketed, the supervisory authorities of the third country where the non-EU AIFM has its registered office and the competent authority of the Member State in which the EU AIF is established ; and

d) the third country where the non-EU AIFM has its registered office is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

The discretion as to whether to allow marketing on this basis lies with the individual Member States and the AIFMD expressly provides for them to impose stricter requirements should they wish.

Passport (2015 onwards)

If and when the passport regime is extended so as to be available to non-EU AIFM, non-EU AIFM may market EU AIFs in their Member State of Reference if they are authorised under the AIFMD (see “Authorisation of a non-EU AIFM” below) and submit an Annex III notification which is approved by the competent authority of the Member State of Reference. The competent authority must inform the AIFM within 20 working days of receipt of the notification if it may start marketing.

If the non-EU AIFM wishes to market the EU AIF elsewhere in the EU it will need to be authorised under the AIFMD, submit an Annex IV notification which would need to be

approved by the competent authorities of the Member State of Reference and then transmitted to the competent authorities of the Member States in which the EU AIFs are to be marketed. The competent authority of the Member State of Reference must transmit the Annex IV notification within 20 working days of receipt of the notification and inform the AIFM of this fact. Marketing may commence in the relevant Member States upon notification of the transmission.

There are, however, no additional third country conditions to comply with (as there are with Non-EU AIFMs marketing non-EU AIFs) as the AIF is based in a Member State.

Figure 1

Annex III notifications include:

- A notification letter (identifying the AIF) and including a “programme of operations”
- The AIF Rules or instruments of incorporation
- The identity of the depositary of the AIF
- A description of, or any information on, the AIF that is available to investors
- If a feeder fund, information on the master fund
- The items listed in Section 7 under the heading “disclosure to investors/disclosure before investment”
- Information on arrangements established to prevent units or shares in the AIF from being marketed to retail investors

Figure 2

Annex IV notifications include:

- A notification letter (identifying the AIF) and including a “programme of operations”
- The AIF Rules or instruments of incorporation
- The identity of the depositary of the AIF
- A description of, or any information on, the AIF that is available to investors
- If a feeder fund, information on the master fund
- The items listed in Section 7 under the heading “disclosure to investors/disclosure before investment”
- The Member States in which the AIFs are to be marketed
- Information on arrangements established to prevent units or shares in the AIF from being marketed to retail investors

As described above, non-EU AIFM will need to become authorised under the AIFMD in order to use the passport when available. From 2018, the passport may be the only viable method of raising substantial finance from EU investors (save for reverse solicitation). Once authorised under the AIFMD, the provisions of the AIFMD will apply to non-EU AIFMs in the same way as they apply to EU AIFMs. All references to the competent authority of an EU AIFM are, however, to be read as references to the competent authority of the non-EU AIFM's ‘Member State of Reference’. See Figure 3 as to how to determine which Member State is the Member State of Reference.

A non-EU AIFM will not need to comply with a provision of the AIFMD upon authorisation if: (i) it is “impossible” to both comply with the provision in the AIFMD and a “mandatory” provision in the law to which the non-EU AIFM (or non-EU AIF) is subject; (ii) the law to which they are subject contains an “equivalent” rule having the “same” regulatory purpose and offering the “same” level of protection to the investors of the AIF in question; and (iii) the non-EU AIFM (and non-EU AIF, if relevant) complies with such equivalent provision.

Applications for authorisation are to be made to the relevant non-EU AIFM's Member State of Reference.

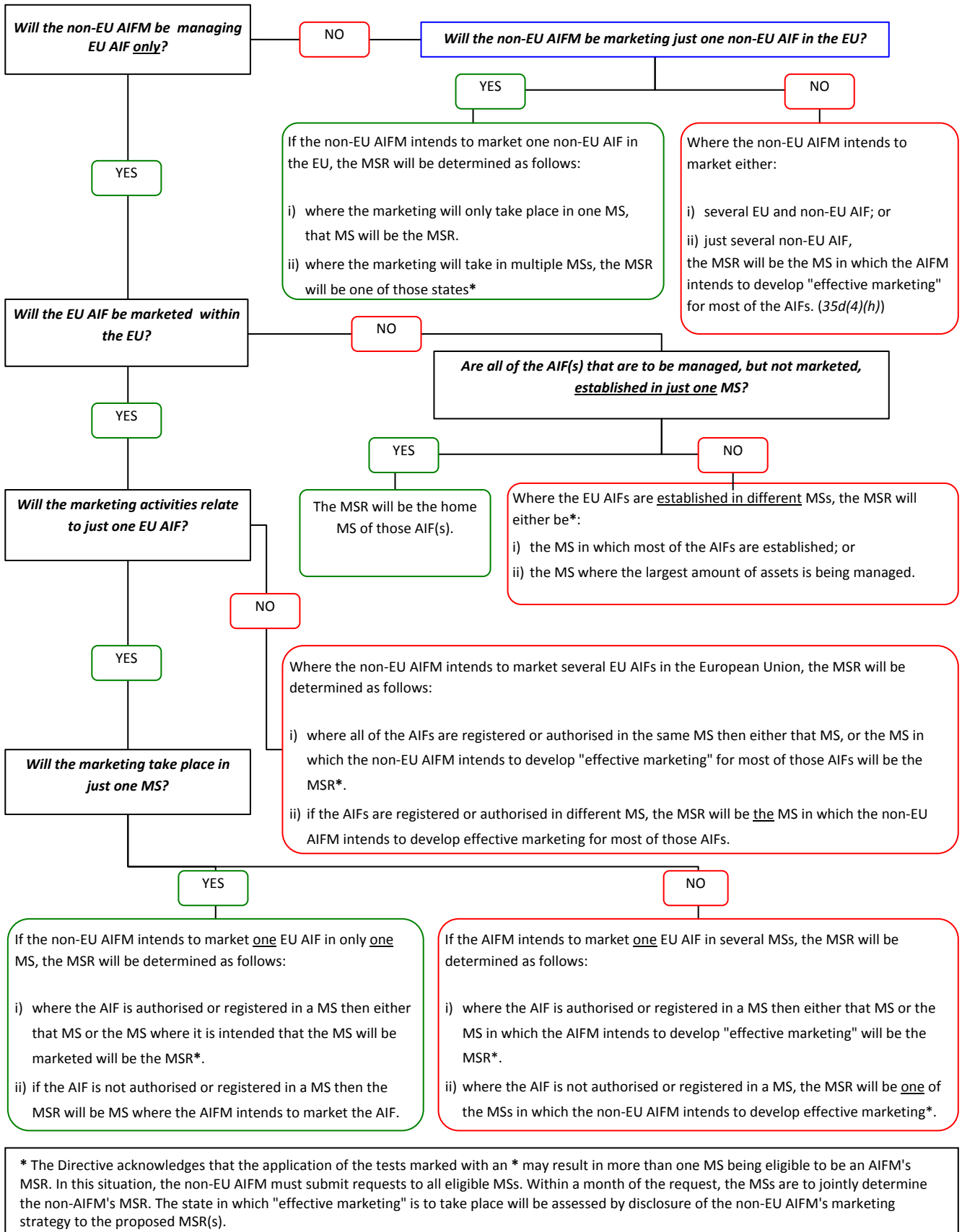
Conditions for obtaining authorisation are as follow:

- a) the non-EU AIFM must have a registered office or branch in the Member State of Reference;
- b) the Member State of Reference has been correctly selected (see Figure 3 below);
- c) cooperation agreements are in place between the competent authority of the non-EU AIFM's Member State of Reference and the competent authority of the EU AIF concerned and the supervisory authorities of the third country where the non-EU AIFM is established;
- d) the third country where the non-EU AIFM has its registered office is listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing;
- e) the third country where the non-EU AIFM has its registered office must have signed an agreement with the home Member State of Reference of the AIFM and any other Member State in which marketing is proposed which complies fully with the OECD model tax convention and ensures an effective exchange of tax information (see above for a discussion as to existing tax information exchange agreements);
- f) the effective exercise by the competent authority of the Member State of Reference of its supervisory functions under the AIFMD is not prevented by the laws, regulations or administrative provisions of a third country governing the AIFM, nor by limitations in the supervisory and investigatory powers of the supervisory authorities of the third country in which the AIFM is established.

Marketing to retail investors

The ability to market AIFs to retail investors is left to the discretion of individual Member States, which may impose stricter requirements than those applicable to marketing to professional investors as long as they do not discriminate between (a) AIFs established in another Member State and marketed on a cross-border basis and (b) those established domestically (thereby rendering the provision of the AIFMD as a minimum standard in respect of retail investors)

Figure 3: Determination of the Member State of Reference ("MSR") for Non-EU AIFMs



3. Liquidity

For each AIF it manages the AIFM is to:

- a) employ “an appropriate liquidity management system”;
- b) have procedures which enable the AIFM to monitor the “liquidity risk” of the AIF; and
- c) ensure the liquidity profile of the investments of the AIF complies with its underlying obligations (for example, assets need to be liquid enough to satisfy the redemption rights of shareholders or unitholders).

The AIFMD also now requires the AIFM to conduct stress tests (under both “normal” and “exceptional” liquidity conditions) such that it can assess and monitor the “liquidity risk” of the AIF.

Underpinning these provisions is the requirement for the AIFM to ensure that for each AIF it manages, the investment strategy, liquidity profile and redemption policy are aligned. Essentially this will mean that for open-ended funds promising frequent and easy exits, the assets of the AIF will need to be highly liquid. For closed-ended funds, illiquid asset classes will presumably continue to be acceptable.

The provisions of the Directive relating to liquidity described above do not apply to closed-ended funds that are “unleveraged”. Although closed-ended funds which employ borrowings for investment purposes or derivatives with embedded leverage would presumably qualify as “leveraged” for these purposes, it is unclear whether a closed-ended fund which has a borrowing facility in place solely for working capital purposes would be treated as “unleveraged”. Similarly, it is unclear whether any temporary leverage incurred by AIFs to facilitate an investment (often used by private equity and real estate funds, amongst others) would be treated as ‘unleveraged’.

4. Leverage

The AIFMD defines “leverage” as “any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means”. The AIFMD does not elaborate upon this definition (although it should be noted by private equity and real estate participants that the recitals state that leverage that exists at the level of a portfolio company is not to be caught).

It is, however, a key definition as “leverage” is used in several of the Directive’s provisions including the de minimis exemption (see Section 1 of the Reference Manual), disclosure provisions and, importantly, the provisions on leverage limits.

If guidance on the definition is included in secondary legislation, it will need to take into account the various business models and approaches to leverage in the industry. For example, in the case of private equity funds, investor commitments structured as loans could inadvertently fall within the definition.

Disclosure to investors

As part of an ongoing obligation of disclosure under the AIFMD, authorised AIFMs are required to make the following information, specifically relating to leverage, available to investors before they invest in an AIF:

- the circumstances in which the AIF may use leverage;
- the types and sources of leverage permitted and the associated risks;
- any restrictions to the use of leverage and of any collateral and asset “re-use” arrangements; and
- information on the maximum level of leverage which the AIFM may employ on behalf of the AIF.

Additionally, for each EU AIF it manages which employs leverage, and each AIF it markets within the EU which employs leverage, an AIFM must disclose on a regular basis:

- a) any changes to the maximum level of leverage which the AIFM may employ on behalf of that AIF, as well as any right to re-use collateral or any guarantee granted under the leveraging arrangement; and
- b) the total amount of leverage employed by that AIF.

The AIFMD provides that the Commission will adopt measures specifying the disclosure obligations, including the frequency of disclosure.

Reporting obligations to competent authorities

Authorised AIFMs will have regular reporting obligations to its home competent authority. Where an AIFM manages one or more AIF which employs leverage on a “substantial” basis, it must make available to its competent authority information about:

- the “overall” level of leverage employed by each AIF it manages;
- a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives; and
- the extent to which their assets have been re-used under leveraging arrangements.

Such information will include the identity of the five largest sources of borrowed cash or securities for each AIF, and the amounts of leverage received from each of those sources for each of the AIF managed by the AIFM.

The AIFMD provides competent authorities with the power to require further information than is outlined in the Directive, periodically as well as on an ad-hoc basis, where it is deemed to be necessary for the effective monitoring of systemic risk. Additionally, in exceptional circumstances and where required in order to ensure stability and integrity of the financial system, the AIFMD provides ESMA with

the power to request competent authorities to impose additional reporting requirements.

Competent authorities are required to use information gathered under the AIFMD for the purposes of identifying the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system, risks of disorderly markets, or risks to the long term growth of the economy.

All the information that a competent authority gathers must be made available to other competent authorities, ESMA and the European Systemic Risk Board (“ESRB”). A competent authority is also required to provide information to another competent authority if an AIFM under its responsibility, or an AIF managed by it, could potentially constitute an important source of counterparty risk to credit institutions based in other Member States.

The Commission will adopt measures which will specify when leverage is considered to be employed on a substantial basis, as well as the nature of the obligations to report and provide information as described above.

Leverage limits

The AIFM is required to set a maximum level of leverage that the AIFM may employ in relation to each AIF it manages.

When setting this level, the AIFM should take into account factors such as the type of AIF concerned, its strategy, the sources of its leverage, any need to limit the exposure to any one counterparty, the “assets liability ratio”, the relationships which the AIFM has with other financial services institutions which could pose systemic risk and the extent to which the leverage is collateralised. Clearly this is a broad spectrum of factors to be considered by the AIFM. Unfortunately it does not appear that there is further secondary legislation forthcoming setting out further detail on these factors. It is to be hoped that the FSA and other competent authorities will issue further guidance on the setting of leverage limits.

An authorised AIFM must demonstrate that the leverage limit which it sets for each AIF it manages is reasonable and complied with at all times. Competent authorities will assess the risks that the use of leverage by an AIFM on the AIFs it manages creates, and they will have the power to impose limits on the level of leverage an AIFM may employ or other restrictions on the management of the AIFs to limit the extent to which the use of leverage contributes to the build-up of systemic risk in the financial system or risks of disorderly markets. The European Commission is required to adopt measures setting out principles specifying the circumstances in which competent authorities may take such steps.

In normal circumstances, a competent authority proposing to impose such restrictions is required under the AIFMD to notify ESMA, the ESRB and, as the case may be, the competent authority of the AIF, at least 10 working days before the proposed restrictions are intended to take effect or be renewed. Exceptionally, however, a competent authority may act on more quickly.

Where ESMA determines that the leverage employed by an AIFM or a group of AIFMs poses a substantial risk to the stability and integrity of the financial system (on the basis of information received from the competent authorities), it will be able to issue advice to competent authorities specifying remedial actions to be taken. This may include limits to the level of leverage which an AIFM, or a group of AIFMs, may employ.

5. Depositaries

These provisions apply to all EU-AIFMs save in respect of non-EU AIFs managed by such AIFM (unless they elect to use, when available, the marketing passport described in Section 2 of the Reference Manual to market such non-EU AIFs). Non-EU AIFMs do not have to comply with these provisions (unless they elect to use, when available, the marketing passport to market AIFs managed by them) or unless they are required to become authorised as a consequence of managing an EU AIF.

Requirement for a depositary

For each AIF it manages, the AIFM must ensure that a single depositary is appointed (by a contract in writing) in accordance with the provisions of the AIFMD. This, unfortunately, runs contrary to common practice, particularly in the hedge fund space, post-Lehman.

Who can be a depositary?

The depositary needs to be a credit institution, an investment firm or another entity permitted under the UCITS Directive that has its registered office in the EU. The AIFM is not allowed to act as depositary. The depositary should have its registered office or a branch in the same country as the AIF.

Third country depositaries

For non-EU AIFs only, the depositary can also be a (non-EU) credit institution or any other entity of the same nature as the entities described above provided that the entity is subject to effective prudential regulation and supervision to the same effect as the provisions laid down in EU law (the AIFMD is not more specific than this) and which are effectively enforced. The European Commission shall adopt secondary legislation as to the criteria for assessing whether this is the case with respect to any non-EU jurisdiction.

For a non-EU AIF, the depositary may be an entity having its registered office or branch in the home country of the AIF, the home Member State of the AIFM (if applicable) or the Member State of Reference of the AIFM (if applicable). See Figure 3 in Section 2 of the Reference Manual as to the determination of the Member State of Reference.

The appointment of a depositary with a non-EU registered office or branch is subject to: (a) there being cooperation agreements in place between the competent authority of the depositary and the competent authorities of the home Member State of the AIFM and the Member States into which share in the AIF are to be marketed; (b) the depositary being subject to effective prudential regulation and supervision to the same effect as the provisions laid down in EU law (the Directive is not more specific than this) and which is effectively enforced; (c) the third country where the depositary is located

is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and terrorist financing; and (d) the third country where the depositary is established must have signed an agreement with the home Member State of the AIFM and of any other Member State in which marketing is proposed which complies fully with the OECD model tax convention and ensures an effective exchange of tax information.

Can a prime broker be the depositary?

A prime broker acting as counterparty to an AIF is not allowed to act as a depositary unless it has “functionally and hierarchically” separated the performance of its depositary functions from its tasks as prime broker and any potential conflicts of interest are properly identified, managed, monitored and disclosed to the investors of the AIF.

Depositaries of private equity funds, venture capital funds and real estate funds

Certain AIFs may appoint depositaries that are not subject to the restrictions described above. If an AIF (a) does not allow investors to redeem their investments within the first 5 years from the date of initial investment or (b) does not invest in financial instruments or generally invests in the securities of unlisted companies with a view to potentially acquiring control over them; then the depositary may be an entity “which carries out depositary functions” as part of its own professional or business activities (provided it is subject to professional registration, regulatory provisions or rules of professional conduct) and which can “furnish sufficient financial and professional guarantees to be able to effectively perform the relevant depositary functions and meet commitments inherent to those functions”. It is unclear what this last condition means.

This appears to be an exemption of sorts aimed at private equity funds, venture capital funds and real estate funds. The open question where this exemption applies, however, is to what extent the prescribed functions of a depositary still need to be adhered to. Moreover it remains to be seen if any entities such as lawyers or registrars would be willing to offer these services at a price acceptable to private equity or real estate funds.

Expanded functions of the depositary

The depositary must act honestly, fairly, professionally, independently and in the interest of the AIF and the investors in the AIF.

The depositary is generally responsible for ensuring that the AIF's cash flows are properly monitored. In addition the depositary (i) is responsible for the safe-keeping of the assets of the AIF; (ii) must ensure that the sale, issue, re-purchase, redemption and cancellation of shares or units of the AIF are carried out in accordance with the applicable national law and the AIF rules or instruments of incorporation; (iii) must ensure that the value of the shares or units of the AIF is calculated in accordance with the applicable national law and the AIF rules or instruments of incorporation and the procedure provided by the AIFMD; (iv) must carry out the instructions of the AIFM, unless they conflict with the applicable national law or the AIF rules or instruments of incorporation; (v) must ensure that in transactions involving the AIF's assets any consideration is remitted to the AIF within the usual time limits; and (vi) must ensure that an AIF's income is applied in accordance with the applicable national law and the AIF rules.

Delegation of its functions

The safe-keeping of assets can be delegated to a third party, who in turn can delegate this function. However, the following conditions must be satisfied (unless the law of a third country requires that certain financial instruments are held in custody by a local entity and there are no local entities which satisfy these conditions):

- a) the depositary's tasks cannot be delegated with the intention of avoiding the requirements of the AIFMD;
- b) the depositary must be able to demonstrate that there is an objective reason for the delegation;
- c) the depositary must exercise due skill and diligence in the selection of the sub-depositary (and shall periodically review and undertake ongoing monitoring of such sub-depositary);
- d) the depositary must ensure (and continue to ensure on an ongoing basis) that the sub-depositary:
 - a. has adequate structures and expertise to keep safe the particular assets of the AIF;
 - b. insofar as the assets held by the sub-delegate are financial instruments, is subject to prudential regulation (including minimum capital requirements) and supervision;
 - c. insofar as the assets held by the sub-delegate are financial instruments, is subject to periodic audit (to ensure the financial instruments are in its possession);
 - d. keeps the assets segregated from its own assets (such that they can, at any time, be clearly identified as belonging to the AIF);
 - e. may not make use of the assets without the prior consent of the AIF or AIFM; and
 - f. shall act honestly, fairly, professionally, independently and in the interest of the AIF and investors of the AIF.

None of the depositary's other functions (ie, those set out in (ii) to (vi) in the sub paragraph “Expanded functions of the depositary” above) may be delegated to a third party.

Delegates may further sub-delegate, provided that the above conditions are met.

Use of prime brokers

The AIFMD permits an AIF to continue to use one or more prime brokers. Unless it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker and any potential conflicts of interest are properly identified, managed and disclosed to the investors of the AIF, however, no prime broker should be appointed as a depositary.

Liability

The AIFMD imposes liability for the losses suffered by the AIFM, the AIF and the investors in the AIF on the depositary.

The AIFMD distinguishes between (i) the loss of financial instruments held in custody and (ii) any other losses.

a) In the case of the loss of financial instruments, the depositary will be liable, unless it can prove that the loss is the result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary.

b) In the case of other losses, the depositary will be liable for losses suffered by the AIF as a result of the depositary's negligent or intentional failure to perform its obligations pursuant to the AIFMD.

Discharge of liability

The depositary's liability will generally not be affected by any delegation to a third party. The depositary can, however, discharge itself of liability with respect to the loss of financial instruments where it has delegated its safe-keeping role provided:

a) the contract between the depositary and the AIF explicitly allows for such a discharge of liability; and

b) the delegation contract between the depositary and the third party explicitly transfers the liability of the depositary to the third party and makes it possible for the AIF to bring a claim against that third party.

The depositary will only be able to benefit from any such discharge of liability if it can prove that it has duly performed its due diligence duties with respect to the delegate and that the specific requirements for delegation are met.

There will be situations where a delegation of custody functions to a local custodian is necessitated by local law in the jurisdiction in which the financial instrument is located or registered. The AIFMD caters for such situations and allows for such delegation. The AIFMD states that where the law of a third country provides that certain financial instruments must be held in custody by a local entity (and there are none which satisfy the delegation criteria described above), the depositary can discharge itself of liability if the following conditions are met:

a) the "fund rules" or articles of association of the AIF expressly allow for such a discharge (this may require the articles of existing AIFs to be amended and/or for future iterations of offering memoranda to make such an allowance);

b) investors in the AIF are informed of this discharge of liability (and the circumstances justifying it) prior to their investment (this may prevent existing AIFs from being able to discharge liability where such a message was not articulated prior to the investment of existing shareholders or unitholders);

c) the depositary must have been instructed by the AIF or AIFM to make such delegation to the local custodian;

d) the contract between the depositary and the AIF (or AIFM as agent for the AIF) must expressly provide for such a discharge of liability; and

e) the delegation contract between the depositary and the local custodian explicitly transfers the liability of the

depositary to the local custodian and makes it possible for the AIF to bring a claim against the local custodian or for the depositary to make such a claim on behalf of the AIF.

6. Delegation

What are the functions of an AIFM?

Annex 1 sets out the "investment management functions which an AIFM must at least perform when managing an AIF" (being portfolio management or risk management). It also sets out "other functions an AIFM may additionally provide in the course of collective investment management of an AIF" (emphasis added) (being legal and fund management accounting services; customer inquiries; valuation and pricing (including tax returns); regulatory compliance monitoring; maintenance of unit/shareholder registers; distribution of income; unit/share issues and redemptions; contract settlements; record keeping; marketing; and activities related to the assets of AIF). It appears, therefore, that whether or not the "other functions" set out in Annex 1 are subject to the delegation provisions in the AIFMD (and, in particular, the inability to disclaim liability for delegated functions) depends on whether the AIFM or a third party (possibly a group company of the AIFM) is appointed by the AIF to perform those functions.

Notification and disclosure

The AIFMD deals with delegation by an AIFM of the functions it carries out for AIFs. Any delegation must be notified to the competent authority of the AIFM before the delegation takes effect. It remains unclear whether the relevant competent authority will conduct any due diligence on the delegate or if the notification will need to contain diligence information on the delegate.

Disclosure of any delegated function is also required (no definition of 'function' is included in the AIFMD). Please see the **Section 7 of the Reference Manual** on disclosure for further detail.

Liability

An AIFM's liability to an AIF and its investors will not be affected by any delegation, or indeed, any sub-delegation.

Conditions for delegating (general)

The costs of delegation can be expected to increase because of the requirement to satisfy the conditions described below and the associated due diligence this will involve. In particular, the AIFMD has the potential to increase significantly the costs of delegating portfolio and risk management functions, especially for larger asset managers that have affiliates carrying out management activities both within and outside the EU. For other functions, such as administrative matters, an AIFM will be subject to a greater degree of scrutiny in outsourcing than was previously the case.

The AIFMD sets out a number of conditions that must be complied with by an AIFM when delegating any of its functions. These conditions represent a significant regulatory burden for an AIFM wishing to delegate and will necessitate an assessment of existing delegation arrangements. The introduction of policies and procedures to be followed by the AIFM when considering delegation is advisable (although many AIFMs will already have such policies and procedures in place). Ongoing monitoring of delegation arrangements will also be necessary.

The conditions include:

a) the AIFM must be able to justify its entire delegation structure with objective reasons.

While there is no guidance on what this means or to whom the AIFM would need to justify its delegation, a holistic analysis of the delegation arrangements an AIFM has in place will be prudent. It appears that the rationale for any delegation will need to be robust enough to meet an objective standard, rather than merely a subjective standard (that is, of the particular AIFM). We would expect FSA guidance to shed light on what should be considered to be 'objective reasons', particularly if secondary legislation adopted by the Commission does not. We would hope that any list of criteria used by the FSA to access whether the delegation is justified will be non-exhaustive so as to allow business models to evolve to accommodate investor needs.

b) the delegate must possess sufficient resources to carry out the delegated functions and the persons who conduct the business of the delegate must be of sufficiently good repute and be sufficiently experienced.

Although it is not clear what 'good repute' means in this context, it is to be hoped that this condition should be comparatively easy for an AIFM to meet.

c) delegation must not prevent the effectiveness of supervision of the AIFM and must not prevent the AIFM from acting or the AIF from being managed in the best interests of investors.

It appears from this that the AIFM should not delegate to such an extent that the supervision of the AIFM itself by the relevant competent authority is hindered. An alternative reading would be that the AIFM must retain sufficient controls with respect to the delegation such that the supervision by the AIFM of the delegate is not hindered.

d) the AIFM must also be able to demonstrate a number of things with respect to any delegate: (i) that the delegate is qualified and capable of undertaking the delegated functions, (ii) that the delegate was selected with all due care, (iii) that the AIFM is able to monitor effectively at any time the delegated function, (iv) that the AIFM is able to give at any time further instructions to the delegate and (v) that the AIFM is able to withdraw the delegation with immediate effect when this is in the interests of investors.

Items (i) and (ii) will in many cases be relatively straightforward to demonstrate and will likely be of little concern to most managers. Items (iii) to (v) can be 'demonstrated', one would hope, by including suitable provisions in the relevant delegation agreement (or amendments thereto in the case of existing arrangements).

How much can be delegated?

AIFMs are prevented from delegating functions to the extent that the AIFM might be regarded as no longer being the manager of an AIF, but rather would be considered a 'letter box entity'. Unfortunately, however, no definition of 'letter box entity' is included in the AIFMD or in any other European legislation where the term is used, presumably because the

circumstances where a manager is merely a 'letter box entity' will vary from case to case. It is specifically noted, however, in the Directive that secondary legislation will be issued specifically on this point. The large variety of structures and models used by AIFMs means that the secondary legislation should not be overly prescriptive and we hope that a common sense approach is therefore adopted.

Additional conditions for delegating portfolio or risk management

In addition to satisfying the conditions set out above, the delegation of portfolio management or risk management may only be effected where the delegate is authorised or registered for the purpose of asset management and subject to supervision. If this condition cannot be met, delegation is possible with the prior approval of the AIFM's competent authority. In the case of a delegate established outside of the EU, there must be "co-operation" between the regulator in the home Member State of the AIFM and the supervising regulator of the delegate.

The delegation of portfolio and risk management is not permitted to a depositary (or its delegate). Delegation to any entity whose interests may conflict with those of the AIFM and investors is also restricted, although there are exemptions to this restriction where there is separation of these functions from conflicting functions and potential conflicts are identified, managed, monitored and disclosed.

Where AIFMs currently delegate these functions to unauthorised, unregistered or unsupervised entities, this requirement will compel AIFMs to either bring these functions in house, delegate them to regulated entities or to seek the approval of the relevant competent authority.

Delegation by depositaries

Specific rules also apply to delegation by depositaries. Please see **Section 5 of the Reference Manual** for further detail.

Further sub-delegation by delegates

Delegates will be able to sub-delegate provided that the AIFM has consented to such sub-delegation, the AIFM gives prior notice to its competent authority and the above stated conditions are also met as between the AIFM and the sub-delegate. This could mean, in practice, that the AIFM would need also to be party to the contracts effecting such sub-delegation arrangements (in particular in relation to condition (d)).

Grandfathering

Existing and historic arrangements are not exempted from compliance and any application for authorisation by an AIFM in 2013 will need to include information on how the AIFM intends to comply with the delegation provisions.

7. Disclosure and transparency

The AIFMD imposes a range of disclosure obligations on AIFMs in respect of the AIFs that they manage, requiring disclosure by various means and to various parties. Most of the disclosure and transparency provisions in the Directive apply both to EU and to non-EU AIFMs, and in respect of both EU AIFs and non-EU AIFs marketed into the EU.

For some AIFs, particularly AIFs that are subject to the Listing, Disclosure and Transparency Rules, the Directive's disclosure requirements will act as an overlay to their current obligations. The AIFMD seeks to avoid duplication of other disclosure requirements imposed by European legislation. For other AIFs, such as private offshore funds marketed into the EU, many of the disclosure obligations may be entirely new.

Disclosure in the annual report

AIFMs must make available, to the competent authorities of its home Member State and (where applicable) the home Member State of the AIF, a financial report for each EU AIF (and for each non-EU AIF it markets into the EU) no later than six months from the end of the financial year, and provide it to investors on request.

Where the AIF is required to make public an annual financial report in accordance with the Transparency Directive, the AIFM may combine that annual financial report with the annual report required by the AIFMD. Where the AIFM does so, the combined report is required to be made public no later than four months from the end of the financial year (ie, in the manner required by the Transparency Directive, not by the AIFMD).

The information required to be disclosed in the annual report includes:

- a balance sheet, or statement of assets and liabilities;
- an income and expenditure account for the financial year;
- the full auditor's report, including any qualifications;
- a report on the activities of the financial year;
- any material changes to the information required by the Directive to be disclosed to investors before they invest (please see the paragraph on "Disclosure to investors" below);
- the total amount of remuneration for the financial year, split into fixed and variable remuneration paid by the AIFM to its staff members, and the number of beneficiaries, and, where relevant, carried interests paid by the AIF; and
- the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

The AIFMD states that secondary legislation will specify the content and format of the annual report required.

The accounting information contained in the annual report must be prepared in accordance with the accounting standards of the AIF's home Member State or, for non-EU AIFs, in accordance with the accounting standards of the country in which the AIF has its registered office and the accounting rules laid down in the AIFs fund rules or instrument of incorporation. The accounts must be audited to EU standards or, for AIFM marketing non-EU AIFs, to the standards of the country where the AIF has its registered office.

The requirement to include detailed disclosure of remuneration paid by AIFMs to their principals and employees is broadly drafted, and it remains to be seen whether it will only catch remuneration paid out in cash or whether more sophisticated forms of remuneration (for example, performance shares or stock options) will also be subject to disclosure. **Please see Section 11 of the Reference Manual** for further details on remuneration under the Directive.

Disclosure to investors

The Directive requires AIFMs to disclose certain information to investors in their EU AIFs (and non-EU AIFs that they market in the EU) before the investment is made. The AIFM must also disclose any material changes to the information provided before investment, and must make other periodic disclosures of information concerning liquidity management and leverage.

Disclosure before investment

The requirement for disclosure before the investors invest in the AIF may cause difficulties. For open-ended AIFs, the AIFM will need to ensure that the "live" offering document is up to date so that, at the time when any investor invests in the AIF, the disclosure requirements in the Directive are satisfied. As for closed-ended AIFs, it is to be hoped that, but is not entirely clear whether, the "before they invest" requirement will not apply to investors who acquire their interest in the secondary market as well as those acquiring shares in a placing or other offer of new shares by the fund.

The information required to be disclosed before investment includes the following:

- a description of the investment strategy and objectives of the AIF, and information on its overall structure (including details of any master-feeder arrangement);
- the types of assets in which the AIF may invest and the techniques it may employ, as well as all associated risks;
- the circumstances in which the AIF may use leverage, the types and sources of leverage permitted and the associated risks, and the maximum level of leverage which the AIFM may employ on behalf of the AIF;
- details of the AIF's management, depositary, audit and other service arrangements, including details of the valuation and pricing methodology, of the AIFM's professional indemnity insurance, and of all fees and expenses;
- details of any arrangement made by the AIF with its depositary to contractually discharge the depositary of liability, and any changes made to the liability of the AIF's depositary;
- details of how the AIFM ensures fair treatment of investors in the AIF and, if any investor obtains a preferential treatment (or the right to do so) a description of that preferential treatment, the types of investors who receive such treatment and, where relevant, their legal or economic links to the AIFM or the AIF; and
- the identity of the prime broker and a description of any material arrangement of the AIF with its prime broker.

Where an AIF is required to publish a Prospectus Directive compliant prospectus, the Directive only requires the publication of information that is in addition to that contained in the prospectus. The additional information may either be published separately or contained in the prospectus.

It should be noted, in particular, that there is no materiality qualification to the requirement to disclose “all associated risks” in connection with the investment strategy and techniques. Nor is there any qualification to the requirement to disclose “the associated risks” in connection with the AIF’s leverage policy. This may require more extensive risk disclosure than is currently common for AIFs.

The obligation to disclose preferential treatment is likely to require disclosure of confidential side letters and other collateral agreements. This will be of concern to certain hedge funds and may reduce the attractiveness of such arrangements to AIFMs and to AIF investors.

Periodic disclosures: illiquid assets and risk profile

AIFMs are also required to disclose, for each of the EU AIFs they manage and for each non-EU AIF that they market in the EU, the following information periodically:

- the percentage of the AIF’s assets which are the subject of special arrangements arising from their illiquid nature, and any new arrangements for managing the liquidity of the AIF; and
- the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks.

Regular disclosures: leverage

AIFMs must also disclose, for any of their EU AIFs (or non-EU AIF marketed in the EU) that employ leverage, the following information on a regular basis:

- any change to the maximum level of leverage that the AIFM may employ on behalf of the AIF, along with any right of the re-use of collateral or any guarantee granted under the leveraging arrangement; and
- the total amount of leverage employed by the AIF.

The requirement to disclose total leverage on a regular basis may be particularly onerous in relation to certain AIFs that use derivatives for investment purposes: the definition of “leverage” in the AIFMD is broad and covers “any method by which the AIFM increases the exposure of an AIF it manages”, including leverage embedded in derivative positions. Moreover it is not always clear what exactly is required to be disclosed: for example, what is meant by “total” leverage employed (this could, for example, mean either net or gross leverage) or by “the re-use of collateral”.

It is not yet clear how frequent either the “periodic” disclosures of liquidity management and risk profile or the “regular” disclosures of leverage must be. Secondary legislation should provide further detail.

Reporting obligations to competent authorities

General

The AIFM must report regularly to its home Member State regulator on the principal markets and instruments on and in which it is trading on behalf of the AIF, as well as the principal exposures and concentrations in the AIF’s portfolio. It must also provide details, for each EU AIF it manages and each EU AIF it markets in the EU, of:

- its liquidity management of the AIF, including the percentage of the AIF’s assets that are subject to special arrangements arising from their illiquid nature (for example, assets held in “side pockets”);
- the AIF’s “actual risk profile”, and the risk management tools employed by the AIFM to manage market risk, liquidity risk, counterparty risk, operational risk and other risks;
- the main categories of assets in which the AIF is invested; and
- the results of the stress-tests required by the AIFMD in relation to the impact of investment positions on the AIF’s portfolio.

An AIFM must also provide to the competent authority of its home Member State, on request, the annual report for each of its EU AIFs and non-EU AIFs marketed into the EU and a detailed list of all AIFs which the AIFM manages as at the end of each financial quarter.

Leverage

AIFMs that manage one or more AIFs that employ leverage on a “substantial” basis must make available to the competent authorities of the AIFM’s home Member State information on:

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

It is not yet clear how much leverage must be employed for the leverage to be “substantial”; or how frequently these disclosures must be made to the competent authorities of the home Member State; the AIFMD states that these details (among others) will be specified in future secondary legislation, that will take into account the need to avoid excessive administrative burden on the competent authorities.

The Directive provides that, for non-EU AIFMs, the requirement to disclose details of leverage is limited to the EU AIFs managed by the non-EU AIFM and the non-EU AIFs that it markets into the European Union. The disclosure should be made to the competent authorities of the Member States in which the AIF are to be marketed.

Emergency powers

The Directive also contains a power for Member State regulators to require additional disclosures (on a periodic or an ad-hoc basis) where necessary for the effective monitoring of systemic risk. Additionally, in exceptional circumstances (in order to ensure the stability and integrity of the financial system), ESMA may require Member State regulators to impose additional reporting requirements.

Notifications in respect of portfolio companies

The AIFMD imposes a number of obligations on AIFMs in respect of AIFs that build up significant stakes in, or take control of, portfolio companies (both listed and private). A variety of disclosures are required, including to the regulators, to the portfolio company's shareholders, and to the portfolio company's employees. These provisions are particularly focussed on private equity funds.

The disclosure obligations will act as an overlay to the existing disclosure requirements imposed on AIFs when they are seeking to build a stake in, or take control of, portfolio companies. Accordingly, the requirements of the Directive should be considered alongside the Listing Rules, the Disclosure and Transparency Rules, and the Takeover Code.

These provisions of the AIFMD do appear to discriminate against and disadvantage portfolio companies on the basis of ownership interests. A company in which a controlling influence is taken by a non-AIF entity would not be required to make the same disclosures (although disclosures might be required pursuant to other legislation). The recitals to the Directive recognise this and invite the European Commission to consider the need for creating a regime so that disclosure is required regardless of the type of investor (a concession that may offer little solace to the private equity industry in the interim).

The obligations are notable particularly for the requirement to engage with the portfolio company's board and its employees, including (in some circumstances) providing details of the AIFM's future intentions for the company.

Notification of the acquisition of major holdings and control of non-listed companies

In the Directive, "non-listed company" means any company that has its registered office in the European Union and whose shares are not admitted to trading on a regulated market (such as the main market of the London Stock Exchange). Accordingly, holdings in EU companies that are traded on AIM will be subject to the requirements of these provisions. Holdings in non-EU companies will not trigger a disclosure under the Directive whether or not their shares are admitted to trading on a regulated market.

An AIFM must notify the voting rights held by AIFs managed by it in a non-listed company when that holding reaches, exceeds, or falls below 10%, 20%, 30%, 50% or 75%.

An AIFM must also notify the non-listed company, its shareholders (where traceable) and the AIFM's home Member State regulator when an AIF that it manages acquires control individually or jointly of a non-listed company. Control for these purposes means more than 50 per cent. of the voting rights held by the AIF in the non-listed company, including any undertaking controlled by that AIF and any voting rights of any natural or legal person acting on behalf of the AIF (or an undertaking controlled by the AIF). Shares in respect of which the voting rights have been suspended shall also be included.

The latter disclosure must include details of how the control was obtained, including the identities of the various shareholders involved, the date on which control was reached, and the chain of entities through which voting rights are effectively held. The AIFM must ask the board of the non-listed company to inform the company's employees or employee representatives of the acquisition of control, and to inform them of the above details.

These notifications must be made as soon as possible, and no later than ten working days after the relevant threshold is reached or passed, or after control is acquired.

Disclosure in the case of acquisition of control of a non-listed company or an issuer

When an AIF acquires control, individually or jointly, of a non-listed company or issuer, the AIFM must inform the company, its shareholders (where traceable) and the competent authorities of the AIFM's home Member State of the details set out below.

For non-listed companies, "control" means, as described above, more than 50 per cent. of the voting rights in the non-listed company. For issuers "control" means as defined in Article 5(3) of the Takeover Directive, which requires reference to the rules of the Member State in which the issuer has its registered office. For UK issuers, "control" (as defined in the Takeover Code) means an interest or interests in shares carrying in aggregate 30 per cent. or more of the voting rights of a company, irrespective of whether such interest or interests gain de facto control.

The required information is:

- the identity of the AIFM;
- the AIFM's policy for preventing and managing conflicts of interest, in particular between the AIFM, the AIF and the company; and
- the policy for external and internal communication relating to the company, in particular as regards employees.

"Issuer" for these purposes means a company that has its registered office in the European Union and which is admitted to trading on a regulated market. Accordingly, issuers

incorporated outside the EU will not be caught by these provisions whether they are listed or not. As above, the AIFM must also ask the board of the company to inform employees or their employee representatives of the information above.

This is an area of particular focus for private equity funds.

Aside from the additional compliance burden represented by these requirements, it should be noted that it is unusual for a shareholder to be required to manage conflicts of interest in respect of a company it controls.

Where the acquisition of control is of a non-listed company, the AIFM must also provide its home Member State regulator and the investors in the AIF with information on the financing of the acquisition, and must make available to the company and to its shareholders (where traceable):

- its intentions regarding the future business of the non-listed company; and
- the likely repercussions on employment as a result of the acquisition of control, including any material change to the conditions of employment.

It is not clear when this information must be provided, although the drafting suggests that it is not required until after the acquisition of control, ie, post completion. While this would be preferable, because the disclosure requirement would not arise during the takeover process itself, this remains an onerous requirement. Furthermore it is unclear what disclosure on the AIFM's intentions regarding the future business would be required (although in the context of the Takeover Directive this test has been satisfied on fairly general terms). It will need to be carefully managed by AIFMs in operational terms when taking over non-listed companies.

The AIFM must also ask the board of the non-listed company to provide this information to the company's employees or their employee representatives.

The annual report of an AIF exercising control of non-listed companies

When an AIF acquires control of a non-listed company, individually or jointly, the AIFM must ensure that the non-listed company's annual report, and the annual report of the AIF, includes the following information:

- at least a fair review of the development of the non-listed company's business, representing the situation at the end of the period covered by the annual report;
- any important events that have occurred since the end of the financial year;
- the company's likely future development; and
- information concerning share buybacks effected during the financial year (including volumes, consideration, and reasons).

The AIFMs must use its best efforts to ensure that the board of the non-listed company makes the annual report available to the company's employees or their employee representatives.

8. Valuation

Obligation of the AIFM

The AIFM is to ensure that, for each AIF it manages, that "appropriate" and consistent procedures are established so that a proper and independent valuation of the assets of the AIF can be performed.

Valuation method and frequency

The rules for valuation of assets and calculation of net asset values per share or unit of an AIF are to be laid down in the law of the country where the AIF has its registered office or in the AIF's rules (eg, its prospectus or offering memorandum) or its instruments of incorporation, such as its articles of association.

We would hope that any such national legislation reflects the diverse characteristics of the assets in which the AIF invests. The use of established standards, such as the International Private Equity and Venture Capital Valuation Guidelines, (for private equity funds) and the International Valuation Standards Council, (for real estate funds) would be welcomed.

The AIF's assets, shares and units are to be valued and calculated at least once a year, although open-ended funds are required to carry out valuations at a frequency which is appropriate to the assets held by the fund and its issuance and redemption frequency (secondary legislation has been promised on this point). Closed-ended funds are required to carry out valuations in case of increase or decrease of capital. In the private equity context, this may correspond to changes in commitment levels

Valuation by the AIFM

An AIFM can perform the valuation function provided that the task of valuing is functionally independent of portfolio management and that remuneration policies (and other measures) "ensure" that any conflict of interest that may arise out of the manager performing the valuation function is mitigated and that undue influence on employees is prevented.

If the valuation function is not performed by an independent external valuer, the AIFM may be required to have its valuation procedures and/or valuations verified by an external valuer or an auditor.

Valuation by an external person

Alternatively, the valuation function can be performed by an external person independent of the AIFM, the AIF and any persons "with close links to" the AIFM or the AIF.

The depositary appointed for an AIF cannot be the external valuer of that AIF unless there is functional and hierarchical separation between its depositary functions and its tasks as an external valuer.

Where an external valuer is used, the AIFM must be able to demonstrate that (i) the external valuer is subject to mandatory professional registration or to legal or regulatory provisions or rules of professional conduct (ii) the external valuer can furnish sufficient professional guarantees to be able to perform its functions (it is not clear what this means but secondary legislation on the point is promised) and (iii) the appointment is in accordance with the conditions of delegation as set out in Section 6 of the Reference Manual.

If the external valuer does not meet the conditions above, the AIFM will be required to appoint another external valuer.

The external valuer is not permitted to further sub-delegate the valuation function.

Liability

The Directive provides that the AIFM is responsible for the proper valuation of the AIF's assets and the AIFM's liability towards the AIF and its investors shall not be affected by the fact that the AIFM has appointed an external valuer.

In return, however, the AIFMD provides that even if contractual arrangements provide otherwise, the external valuer shall be liable to the AIFM for any loss suffered by the AIFM due to the external valuer's negligence or intentional failure to perform its tasks.

9. Capital adequacy

A key obligation under the AIFMD is that AIFMs will be required to have a minimum amount of "initial capital" and, where relevant, "own funds".

"Initial capital" and "own funds" are terms defined in the Directive by reference to the re-cast Banking Consolidation Directive. "Initial capital" is defined to include share capital, share premium accounts and other capital resources such as reserves. "Own funds" is defined to include capital items eligible as "initial capital", amongst others, but less certain deductions, including for losses and intangible assets such as goodwill.

Whether an AIFM is required to hold initial capital and own funds or simply initial capital will depend on whether the AIFM is an external AIFM or an internal AIFM (i.e., where the AIFM is the AIF). External AIFMs will be required to maintain initial capital and own funds, whereas an internal AIFM will be required only to maintain initial capital.

External AIFMs which are also authorised to provide the investment service of discretionary portfolio management will also need to ensure that they comply with the re-cast Capital Adequacy Directive 2006/49/EC.

External AIFMs

An external AIFM will need to maintain initial capital of €125,000 and a minimum level of own funds. As set out above, amounts which are eligible as initial capital will also count towards own funds.

The requirement is that own funds must be the higher of:

(a) one-quarter of the preceding year's fixed annual overheads (although the text adopted refers to a different Article of the re-cast CAD, we expect that this is the provision which will be applied under the version to be published in the EU's Official Journal); and

(b) €125,000 plus 0.02% of the amount by which the total value of portfolios under management exceeds €250 million.

It is possible for the second of these two requirements to be relaxed, in that the amount required may be reduced by up to 50% if an EEA bank or insurer (or third country bank or insurer subject to equivalent prudential supervision) has guaranteed the balance. Further, these amounts are subject to an overall cap of €10 million.

The percentage calculation under b) above excludes funds where management of the funds has been delegated to the AIFM, and includes funds where management has been delegated to a third party by the AIFM.

While the wording of the adopted text implies that an AIFM which has been separately authorised to provide discretionary investment management services will also need to comply with the requirements of the Capital Adequacy Directive, as re-cast by the Capital Requirements Directive, the exact extent of this obligation is not clear. It seems unlikely that this will involve the imposition of different initial capital requirements, and it seems more likely that it will in practice impose an additional own funds requirement in respect of investments managed under that authorisation.

Internal AIFMs

The manager of an internally-managed AIF must maintain initial capital of €300,000, but has no own funds requirement.

There is no regulatory capital requirement for an externally-managed AIF.

Capital resources

The AIFMD requires that own funds are invested in liquid assets, or assets readily convertible to cash in the short term.

Professional indemnity insurance

The AIFMD requires that both internal AIFMs and external AIFMs hold either

(a) additional own funds; or

(b) professional indemnity insurance

to cover potential professional liability risks. The risks which the additional capital or insurance will need to cover, conditions for determining the coverage of insurance and appropriateness of additional own funds, and the process for determining ongoing adjustments to the level of capital or insurance will be the subject of implementing measures.

10. Asset stripping

Restrictions on asset stripping

When an AIF, individually or jointly, acquires control of a non-listed company or of an issuer, the AIFM of such AIF is restricted from:

- (i) facilitating, supporting or instructing; or
- (ii) voting on behalf of the AIF (insofar as it is able to do so) in favour of,

any distribution, capital reduction, share redemption and/or acquisition of own shares by the company (to the extent described below under the heading “Scope of the restrictions”), for a period of 24 months following the acquisition of control of such company.

These provisions were added at a late stage in response to perceived, but largely unsupported, concerns in relation to the activities of private equity fund managers.

In any event, the AIFM is required to use its “best efforts” (an onerous standard) to prevent distributions, capital reductions, share redemptions and/or share buy backs by the company within the same 24 month period. This means that passivity is not an option.

The asset stripping restrictions do not apply to the acquisition of control of the following non-listed companies:

- small and medium enterprises (as set out in the Commission Recommendation 2003/361/EC and **Figure 1 below**)
- special purpose vehicles that exclusively purchase, hold or administer real estate.

“Control”

For non-listed companies, “control” for these purposes means more than 50 per cent, of the voting rights held by the AIF in the non-listed company, including any undertaking controlled by that AIF and any voting rights of any natural or legal person acting on behalf of the AIF (or an undertaking controlled by the AIF). Shares in respect of which the voting rights have been suspended shall also be included.

For issuers “control” means as defined in Article 5(3) of the Takeover Directive, which requires reference to the rules of the Member State in which the issuer has its registered office. For UK issuers, “control” (as defined in the Takeover Code) means an interest or interests in shares carrying in aggregate 30 per cent, or more of the voting rights of a company, irrespective of whether such interest or interests gain de facto control.

Figure 1

Enterprise classification under Commission recommendation 2003/361/EC	Head count	Turnover OR (million €)	Balance Sheet Total (million €)
Medium	< 250	≤ 50	≤ 43
Small	< 50	≤ 10	≤ 10
Micro	< 10	≤ 2	≤ 2

Scope of the restrictions

The obligations imposed on AIFMs in relation to asset stripping apply to:

- a) any distributions made to shareholders where, on the closing date of the last financial year of the company, the net assets of the company (as set out in its annual accounts) are, or following such a distribution would become, lower than the amount of subscribed capital plus the reserves of the company which may not be distributed by law (where the uncalled part of the subscribed capital is not included in the assets shown in the balance sheet, this amount must be deducted from the amount of subscribed capital);
- b) any distributions made to shareholders where the amount would exceed the company’s profits at the end of the last financial year (plus any profits brought forward and sums drawn from reserves available for this purpose, less any losses brought forward and sums placed in reserve in accordance with the law); and
- c) to the extent that the company is permitted to purchase its own shares, such acquisitions by the company, including:
 - (i) shares previously acquired and held by the company; and
 - (ii) shares acquired by a person acting in his own name but on the company’s behalf,

that would have the effect of reducing the net assets below the amount mentioned in paragraph (a) above (subject to the conditions and exceptions laid out in Article 20(1)(b)-(h) of the Second Company Law Directive (as set out in **Figure 2 below**).

The term “distribution” is defined as including the payment of dividends and of interest relating to shares.

Essentially ‘distributable profits’ can be distributed although it would appear that special dividends would often not be permitted for the two years following acquisition of control. The restrictions on capital reductions do not apply to a reduction in the subscribed capital the purpose of which is to offset losses incurred, or the include sums of money in a non-distributable reserve provided that, following the reduction, the amount of such reserve is not more than 10% of the reduced subscribed capital.

Figure 2

Exceptions applicable to the restriction on the acquisition of own shares (in relation to asset stripping) as laid out in Article 20 (1) (b) - (h) of the Second Company Law Directive.

- (1) shares acquired as a result of a universal transfer of assets;
- (2) fully paid-up shares acquired free of charge or by banks and other financial institutions as purchasing commission;
- (3) shares acquired by virtue of a legal obligation or resulting from a court ruling for the protection of minority shareholders in the event, particularly, or a merger, a change in the company's object or form, transfer abroad of the registered office, or the introduction of restrictions on the transfer of shares;
- (4) shares acquired from a shareholder in the event of failure to pay them up;
- (5) shares acquired in order to indemnify minority shareholders in associated companies;
- (6) fully paid-up shares acquired under a sale enforced by a court order for the payment of a debt owed to the company by the owner of the shares;
- (7) fully paid-up shares issued by an investment company with fixed capital and acquired at the investor's request by that company or by an associate company.

11. Remuneration

Scope

The AIFMD requires all AIFMs to have and implement policies and practices governing the remuneration of certain categories of their employees.

AIFM employees that are required to be governed by such policies include senior management, risk takers and control functions, along with "any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of the AIF they manage".

An AIFM's remuneration policies and practices are required to be consistent with, and promote, sound and effective risk management. They should not encourage risk-taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the relevant AIF(s).

The substance of an AIFM's remuneration policies and practices should be determined in accordance with the 18 principles set out in Section 1 of Annex II of the Directive. The principles (which in certain cases are more akin to rules in terms of their prescriptive drafting) apply to:

- remuneration of any type paid by an AIFM;
- any amount paid directly by the AIF itself, including carried interest; and
- any transfer of shares or units of the AIF, made to the benefit of any of the relevant categories of staff.

As noted in our previous briefings, it is not clear what applying the principles to payments made by AIFs will mean in practice and it is to be hoped that this is not an attempt at regulating performance fees as between a fund and a fund manager.

Proportionality and the application of the remuneration principles

The AIFMD provides that the AIFM shall comply with the remuneration principles in a way, and to the extent, that is appropriate to its size, internal organisation and the nature, scope and complexity of its activities.

It is important to note that a number of the principles, and the concept of proportionate application as set out in the paragraph above, substantively mirror the provisions contained in the revised remuneration code issued by the FSA (the "Remuneration Code") which reflects the requirements of the amended Capital Requirements Directive and the provisions of the UK Financial Services Act 2010.

While the FSA has confirmed that the Remuneration Code will apply in principle to a number of asset managers, the Committee of European Banking Supervisors ("CEBS") guidance on the amendments to the Capital Requirements Directive (on which the FSA Remuneration Code is based) provides that certain elements may, on proportionality grounds, be significantly diluted or even negated for "non-complex" firms. It is therefore expected that a number of asset managers will take advantage of these proportionate application provisions, and elect to limit the scope of the Remuneration Code to their business prior to the implementation of the Directive. If an AIFM does take this approach, it may be difficult, depending on further guidance on the Directive, to argue that not applying the principles and/or rules remains "proportionate" following implementation of the Directive. The fact that the remuneration rules derived from the Directive will solely apply to AIFMs leads to the logical conclusion that the European Parliament is of the view that the rules will need to be applied at least to some extent in each case. As a result, the coming into force of the rules implementing the remuneration provisions of the Directive may necessitate a change in policy of AIFMs that are already subject to the Remuneration Code as well as those AIFMs that are not.

Remuneration principles

The principles cover both general statements regarding the aims of the remuneration policy of an AIFM (for example, that the remuneration is consistent with and promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, fund rules or instruments of incorporation of the AIF(s) it manages), certain specific limitations (some of which are referred to below) and principles regarding implementation and monitoring of remuneration policies.

The principles will all be subject to more detailed implementing rules but some of the noteworthy issues raised by the principles include:

- fixed and variable components of total remuneration need to be appropriately balanced – this may lead to firms considering whether to increase base pay and reduce bonus multiples;
- a substantial proportion (which is at least 40 per cent.) of the variable remuneration component is to be deferred over a period which is appropriate in view of the life cycle and redemption policy of the AIF concerned, should be correctly aligned with the nature of the risks of the AIF in question (in any case, the period should be at least 3 to 5 years unless the lifecycle of the AIF is shorter) and deferred remuneration arrangements should vest no faster than on a pro rata basis;
- in the case where the variable remuneration component is particularly high (which the FSA have currently taken to mean £500,000 in the Remuneration Code context), at least 60 per cent. of that amount will need to be deferred;
- where remuneration is performance related, the total amount of remuneration should be based on a combined assessment of the performance of the individual and of the business unit or the AIF concerned and the overall results of the AIFM, and when assessing individual performance, financial as well as non-financial criteria should be taken into account;
- in certain circumstances where a single AIF accounts for more than 50 per cent. of the total AUM of an AIFM and subject to the structure and rules of the AIF, at least 50 per cent. of any variable remuneration shall consist of units or shares of the AIF concerned, equivalent ownership interests or share linked instruments or equivalent non-cash instruments – the possible application of this principle is not clear as drafted in the Directive and implementing rules will need to clarify its application in respect of AIFMs that manage a number of funds and who have individual teams managing particular AIFs;
- variable remuneration, including any deferred portion, should only vest or be paid if it is “sustainable” according to the financial situation of the AIFM as a whole and justified according to the performance of the business unit, the AIF and the individual concerned;
- it is also noted that total variable remuneration is to be “considerably contracted” where there is subdued or negative financial performance of the AIFM or of the AIF, taking into account both current compensation and reductions in payouts of amounts previously earned, including through malus or clawback arrangements - it should be noted that there are no other references to malus or clawback arrangements so it remains unclear whether such arrangements will need to be part of an AIFM’s remuneration policy;

- guaranteed minimum bonuses are to be “exceptional” and occur only in relation to the first year of employment of new staff;
- payments on termination of a contract are to reflect performance achieved over time and should be designed in a way not to reward failure; and
- staff members will need to be required to undertake not to use personal hedging strategies or remuneration and liability related insurance to undermine the risk alignment effects embedded in their remuneration arrangements.

ESMA will be responsible for producing guidelines on sound remuneration policies which comply with the principles set out in Annex II of the AIFMD.

Remuneration committees

AIFMs that are significant in terms of their size or the size of the AIFs they manage, their internal organisation and the nature, scope and the complexity of their activities will be required to establish a remuneration committee that shall be responsible for decisions regarding remuneration. Implementing measures and market practice will need to be reviewed in time to establish which AIFMs will be expected to establish a remuneration committee.

As with a number of other provisions contained in the Directive, the true impact of the remuneration provisions will not be entirely clear until enacting legislation and rules are published. While it is reasonable and sensible to ensure that the interests of an AIFM, its staff and investors are aligned, a balance must be struck whereby the remuneration rules do not stifle growth by de-motivating AIFMs. It is important therefore that even in times of economic difficulty or depressed asset values that the AIFM does not consider that there is no or little reward involved in continuing to manage an AIF.

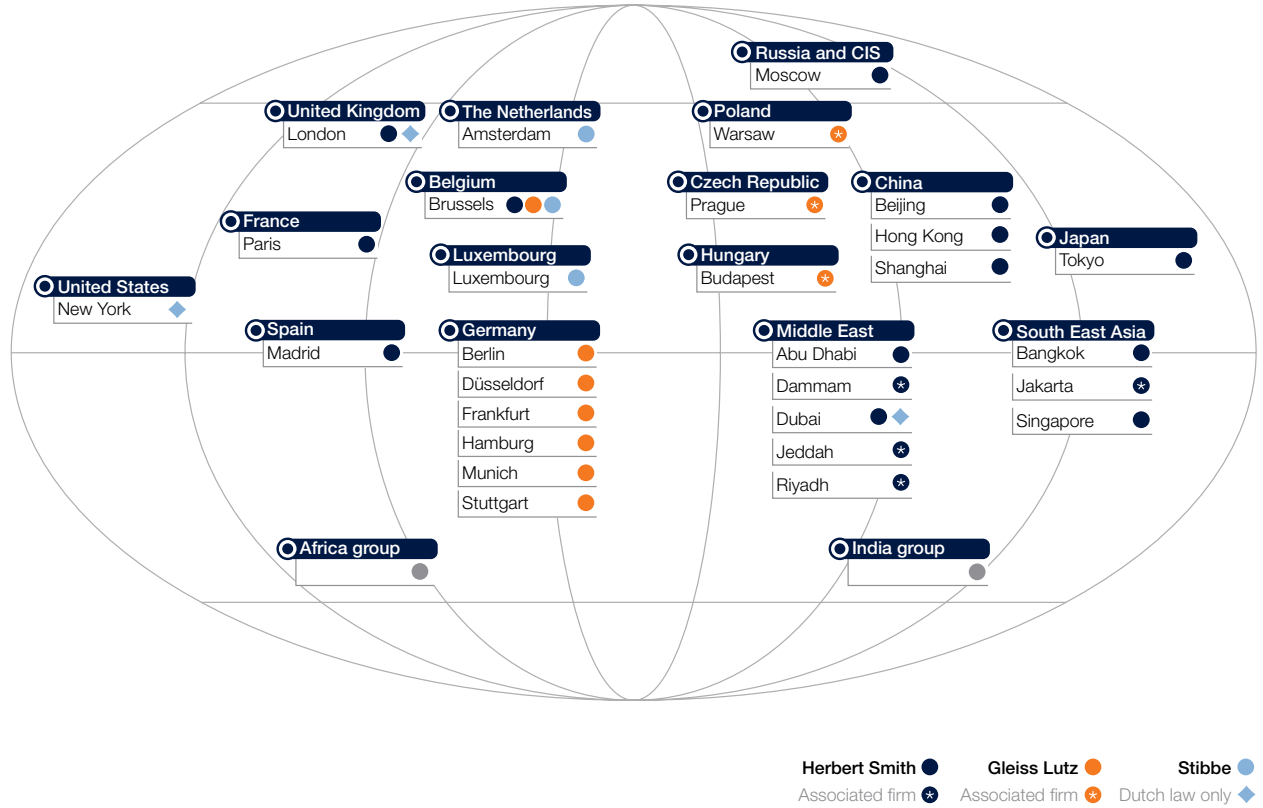
Disclosure of remuneration

AIFMs must make available a financial report for each EU AIF (and for each non-EU AIF it markets into the EU). As discussed above in **Section 7 of the Reference Manual**, the annual report must disclose:

- the total amount of remuneration for the financial year, split into fixed and variable remuneration paid by the AIFM to its staff members, and the number of beneficiaries, and, where relevant, carried interests paid by the AIF; and
- the aggregate amount of remuneration broken down by senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

It will be important to understand if the disclosure relates to all remuneration paid at the AIFM level or just that attributable to the AIF in respect of which the annual report is being produced (as to not so limit it could result in some misleading and skewed disclosures). It will also be important to confirm whether or not the financial year being referred to is that of the AIF in respect of which the annual report is being produced or that of the AIFM. It is this disclosure of remuneration provisions of the AIFMD which may prompt the most thought on re-structuring and the use of delegation.

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