THE PRACTICAL IMPLICATION OF THE AIFM DIRECTIVE ON NON-EUROPEAN GPS

After 18 long months of political turmoil, uncertainty, and fierce debate, the European Parliament finally adopted the controversial Alternative Investment Fund Managers Directive (the "Directive") at the end of last year. The Directive establishes a regulatory regime for all alternative fund managers ("AIFMs"), such as private equity and hedge fund managers that operate funds based in the European Union (the "EU") or market non-EU fund interests in the EU.

Background

The European Commission first proposed the Directive in April 2009. Since then, the draft has been subject to numerous revisions, amendments and compromise proposals. The European Parliament and European Council approved their versions of the proposal on May 17 and 18, 2009, respectively which subsequently led to a "trilogue" negotiation process to reconcile the different proposals. It was only at the end of October 2010 that the European Parliament announced that it had reached an agreement with the European Council on key aspects of the Directive. The text was voted on and passed, with a very large majority, at a plenary session of Parliament held on November 11, 2010. Now that the official text has been published, formal approval by the European Council remains pending, likely to take place in the next few weeks. The Directive will then become effective and Member States have a two year period in which to implement the text into national law.

Among the many issues debated and negotiated, the third country provisions addressing non-EU fund managers raising funds in the EU or marketing non-EU fund interests in the EU have been some of the most controversial. Many have argued that strict rules are required to protect (i) the European fund industry, by creating incentives towards relocation of offshore funds into the EU, and (ii) European investors, by requiring both EU and non-EU fund managers to comply with certain EU standards. Others have argued that a heavy-handed approach towards regulation would in fact have the opposite effect and ultimately harm AIFMs and restrict their flexibility in structuring funds in the most efficient way. Furthermore, onerous regulatory requirements would only serve to encourage reciprocal barriers to entry from other jurisdictions and ultimately encourage them to move outside the EU altogether. This would restrict the choice of European investors and, consequently, undermine competitiveness and hinder European economic recovery. The majority of the Directive's rules are likely to become effective by January 2013, however some of the rules affecting non-EU funds and non-EU fund managers will be deferred until 2015 or later. Thus, non-EU sponsors and managers may still actively raise funds in the EU, but will have to comply with a number of additional regulatory requirements beginning in January 2013. These are described below.

Scope of the Directive

The Directive regulates the marketing of Alternative Investment Funds ("AIFs") within the EU by AIFMs. As a result, it applies to EU fund managers and non-EU fund managers alike, including U.S., Asian or other overseas managers that use fund vehicle structures domiciled in the EU. It also applies to non-EU fund managers marketing interests in non-EU AIFs, such as Delaware, Cayman or Channel Islands vehicle structures, to investors within the EU. This includes where the AIFM provides its services directly or through delegation.

Fund-Raising in the EU

Beginning in January 2013, non-EU managers may actively fund raise in the EU provided that the following conditions are met:

- A regulatory cooperation agreement is in place between all of the relevant regulators (i.e., the regulator in the non-EU manager's home jurisdiction and the EU country where the fund raising occurs) under which the regulators agree to cooperate on monitoring and managing systemic risk. In addition, the home jurisdiction must not be designated by the Financial Action Task Force as a non-cooperative country or territory on anti-money laundering and terrorist financing;

- Non-EU managers comply with the following provisions of the Directive:

    - *Transparency and Disclosure:* the non-EU manager must prepare an annual fund report for investors in a prescribed format and disclose certain other detailed information to investors and will be subject to regulatory reporting requirements aimed at monitoring systemic risk. The European Commission will publish measures specifying the format and content of the reports. AIFMs will have to make certain disclosures to investors before they invest in an AIF, including with respect to:

        - Investment strategies, legal structure, and objectives;

        - Procedures by which the AIF may change its investment strategy and/or investment policy;

        - Information on jurisdiction, applicable law, and the existence of legal instruments providing for the recognition and enforcement of judgments in the jurisdiction where the AIF is established; and

        - The identity of the prime brokers, any material arrangement with such brokers, and the management of potential conflicts of interests.

        The AIFM Directive also requires AIFMs to disclosure to investors, on a periodic basis, the following:

        - The percentage of the AIF's assets that are subject to special arrangements arising from their illiquid nature;

        - Any new arrangements for managing the liquidity of the AIF;

        - The risk profile and risk management systems employed;

        - The identity of the depositary, auditor, and any other service providers together with a description of their obligations and the investors' rights;

        - Evaluation methods;

        - The liquidity characteristics and management;

        - The preferential treatment of other investors and the fees borne by the investor group;

        - Any changes to the maximum level of leverage that the AIFM may employ on behalf of the AIF, including the total amount of employed leverage;

        - Conflicts of interest; and

        - A description of any delegated management function (it is noteworthy that delegation is permitted provided it does not prevent effective supervision by the AIFM. Delegation will require prior notification to the Competent National Authority and is subject to a number of conditions, including creditworthiness, good reputation and expertise of the delegate).

        The EU Commission will specify the frequency of the disclosures required at a later date.

    - *Portfolio Company Disclosures:* if a private equity fund acquires or disposes of a substantial stake in an EU company, the manager must formally notify the regulators. Additional disclosures to the regulators, company, shareholders and employees are required if a controlling stake is acquired.
    - *"Asset-Stripping" Restrictions:* the Directive restricts, in the case of certain private equity funds, certain shareholder distributions for a period of 24 months after a controlling acquisition of an EU company (to prevent dividend recapitalizations during the period). This is intended to prevent equity investors seeking short-term gain.

- The non-EU manager is aware of the securities laws of each EU country in which it intends to raise funds, which may impose more onerous rules.
- The non-EU manager will not be required to become authorised under the Directive.

Passport Regime

Non-EU managers may be able to participate in the "passport" regime (i.e., they can fund raise in every EU country without obtaining separate regulatory authorization in each country). This option will only be available if the European Securities and Markets Authority ("ESMA") issues a positive opinion and advice on the creation of the third country passport and makes its available to non-EU managers. This is currently proposed for the beginning of 2015, two years after the implementation of the Directive. If the passport regime becomes available, non-EU managers would become authorized and regulated on the same basis as EU managers with respect to the passporting rights.

Under previous drafts of the Directive, non-EU AIFMs were only permitted to market AIFs within the EU if the country where the AIFM was domiciled had adopted regulatory legislation similar to the AIFM Directive and such legislation was effectively enforced. The Directive now stipulates that non-EU AIFMs will, however, only be issued passports if they are located in countries that meet minimum regulatory standards and have agreements in place with EU Member States that allow an exchange of information. U.S. AIFMs, for example, may be able to market non-EU funds that they manage in the EU if they comply with all the requirements and obligations of the Directive, including, inter alia, transparency and capital requirements and the obligation to appoint a depositary and a valuation expert. The passport regime compliance obligations are onerous and carry administrative costs. Non-EU managers may therefore elect to forgo the passporting rights and fund raise subject to the minimum directive requirements described above and, until 2018, the country-by-country private placement regimes.

The Directive provides for a three-year period of parallel application of its rules with the private placement rules of the EU Member States. This means that until 2018, non-EU funds must comply with the private placement rules in each jurisdiction where they will be marketed. The Directive contains provisions that would ultimately terminate the national private placement regimes, leaving full authorization as the only option for non-EU firms that wish to fund raise in the EU.

The passport regime set forth in the Directive is generally more practical than prior proposals. However, many issues still remain unclear, including, for example, as regards the issue of supervision. The Directive establishes that a non-EU AIFM will be subject to the regulations under the Directive under the supervision of the Competent National Authority in its EU Member State of reference. It is unclear if this State of reference would be the EU Member State that is mainly affected by the proposed marketing activities or if the State of reference should be chosen according to other criteria. Non-EU AIFMS may find that they have to assess their investor base to determine in which state they have the largest number of investors before choosing a reference state. Furthermore, effective supervision will require some form of cooperation between the regulatory authorities outside the EU. It is far from certain whether non-EU regulators will be willing to accept the additional responsibility to supervise compliance with the EU requirements in addition to their own compliance obligations in their own respective jurisdictions.

Conclusions

The final text of the Directive is better than feared in key areas such as the third country provisions and the preservation of private placements. However, the passport regime, if adopted, will impose a heavy administrative and compliance cost. It is questionable whether this approach will, while providing a level playing field and a greater level of transparency, serve to protect investors who may ultimately and indirectly bear the expense. Furthermore, the "one-size fits all" approach of the Directive, namely, the lack of differentiation between the types of AIFMs regulated by the Directive, is very likely to have far-reaching implications for many participants in the market place.

Whilst broad agreement has been reached on very contentious issues, the legislative process is far from complete. The Council will be required to formally approve the text which will then be translated into the official languages of the EU Members. Once it has been finalised, the text will be published in the Official Journal of the European Union. This is a long and arduous process and is likely to take months. The two year deadline for implementation by Member States is from the date of publication in the Official Journal, estimated to be 2013. This year will herald a period of secondary rule making. ESMA will play a pivotal role in this process and has already been delegated with broad jurisdiction and authority in 11 different areas, including issuing extensive guidelines, measures and recommendations. The true extent and practical implication of many of the new obligations remains unclear and will only unfold over time.

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