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EU Alternative Investment Fund Managers Directive - Implications for non-EU based Alternative Investment Fund Managers

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Background

Following a period of extensive negotiation between European legislators and lobbyists from the alternative investment fund industry, the Alternative Investment Fund Managers Directive (the "Directive") was finally approved by the European Parliament on 11 November 2010. The Directive encompasses a harmonized regime for the authorisation of all alternative investment fund mangers established within the EU ("EU AIFM") together with the imposition of certain operational and transparency requirements on such managers. The Directive also has important implications for managers of alternative investment funds that are based outside of the EU ("non-EU AIFM") and intend to market their alternative investment funds ("AIFs") to EU investors or manage EU AIFs[1].

The Directive has been subject to a high degree of politicised debate not least in relation to the constraints that were originally placed on the ability of non-EU AIFMs to market their funds to European investors in earlier drafts of the Directive. It is with this in mind that this alert focuses on the scope and the extent of the Directive's effect on non-EU AIFMs who will look to market their fund products to European investors. While the focus of this alert relates to the marketing issues for non-EU AIFMs, this alert will also briefly summarize the future legislative process of the Directive and make reference to some of the broader implications of the Directive on EU AIFMs (which may become relevant to non-EU AIFMs in the future).

Summary of Marketing Implications for Non-EU AIFM

Following the publication of the agreed text of the Directive, it is now clear that non-EU AIFMs will continue to be able to market their funds to EU investors in accordance with national private placement regimes (in addition to certain other requirements which are discussed in further detail below). It is possible that in the course of 2015, non-EU AIFMs will have the choice as to whether to continue marketing their fund products in accordance with national private placement regimes or pursuant to an EU wide passport (the passport will require that the non-EU AIFM subjects itself to full authorisation under the Directive). While the position is still uncertain, it is possible that in the longer term (from 2018 at the earliest) national private placement regimes will be abolished in the EU and non-EU AIFMs will be required to become authorised in the EU if they wish to market their funds to EU investors.

Legislative Process

Following the vote at the European Parliament on 11 November, the final text of the Directive will be prepared for official publication in the Official Journal of the European Union whereupon it will

become legally binding (this will most likely take place in early 2011). Member States will be required to transpose the Directive into their own national law within two years following publication in the Official Journal (i.e. by early 2013). Following adoption of the final text in early 2011, a further intense period of "Level II" secondary rule making will commence which will be largely influenced by the new European Securities and Markets Authority ("ESMA")[2]. The precise workings of this process are still relatively uncertain but the broad objective will be to provide detail, clarification and authority to many of the provisions of the Directive.

Summary of the Effect of the Directive on EU AIFM

The Directive lays down rules for the authorisation, ongoing operation and transparency of EU AIFM. The scope of the Directive is broad and it captures a wide range of fund manager including those who manage venture capital funds, private equity funds, private equity real estate funds and hedge funds (excluding managers of UCITS type funds). The Directive is stated not to apply to certain entities/structures including the following: holding companies, national, regional and governmental organizations (including sovereign wealth funds) and securitization special purpose entities.

Once the Directive has been transposed into national law, all EU AIFMs will be subject to detailed authorisation requirements pursuant to which they will (above certain de minimis thresholds) need to seek authorisation in order to manage an AIF (whether or not the AIF is based inside or outside the EU). Amongst other requirements, EU AIFMs will be subject to the following:

- rules regarding the AIFM's own capital requirements,
- rules regarding the remuneration of principals of the AIFM,
- obligations on the use of independent depositaries (with less onerous provisions applying to private equity and private equity real estate AIFs),
- valuation and reporting requirements (to investors and regulators),
- required investor disclosures,
- disclosure obligations in relation to leveraged funds (and possible stipulations as to the limits on any leverage incurred by AIFs managed by an EU AIFM), and
- for the purposes of private equity AIFMs (excluding private equity real estate AIFMs), specific disclosure obligations in relation to the acquisition and disposal of substantial stakes in EU-based non-listed companies and limitations in relation to certain corporate transactions of such companies within 2 years of the acquisition of control (so-called "asset-stripping provisions").

Marketing Issues for EU AIFM

The Directive introduces a marketing passport pursuant to which an EU AIFM that is authorised in one EU Member State will be able to market EU AIFs to all professional investors in other Member States following a process of pre-filing and clearance by their own regulators without any additional or registration requirements. This intra-EU passporting regime will be automatically available to EU AIFMs managing EU AIFs (once authorised) and its success or otherwise will be critical in determining whether the passport is extended to non-EU AIFMs in due course.

Summary of the Effect of the Directive on Non-EU AIFM

The Directive applies to non-EU AIFMs to the extent that they intend to either: (i) market one or more AIF in the EU (irrespective of whether or not the AIF is an EU based or non-EU based AIF);

or (ii) manage one or more EU AIF. The marketing obligations in relation to non-EU AIFM will be implemented in stages with 2013, 2015 and 2018 all being key dates in the future development of the Directive.

Marketing Issues for Non-EU AIFMs – Maintenance of National Private Placement Regimes Until at Least 2018

Non-EU AIFMs will not be able to take advantage of an EU marketing passport until 2015 at the earliest. Prior to that date and until at least 2018, non-EU AIFMs will continue to be able to market AIFs (whether they are EU or non-EU AIFs) in EU Member States pursuant to national private placement rules subject to the following additional conditions:

1. Co-operation Agreements

A supervisory co-operation agreement will need to be in place between the regulator of the EU Member State in which the fund is to be marketed and the third country regulator of the non-EU AIFM. To the extent that the non-EU AIFM is seeking to market an EU AIF, there must be a similar agreement between the competent authorities of those jurisdictions and to the extent that the non-EU AIF is established in another jurisdiction to the non-EU AIFM, there must also be a cooperation agreement between the regulators of the jurisdiction of the non-EU AIF and the EU Member States in which the Fund is to be marketed. It is still not presently clear what form the "co-operation agreement" needs to take and much will depend upon the further guidance from ESMA but we do not anticipate that this will provide significant difficulty for AIFs established and/or managed in most non-EU G20 countries which have already established bilateral regulatory agreements with many EU Member State regulators.

Moreover, initial indications from the Cayman Islands and the Channels Islands indicate that they consider that AIFM based in their jurisdictions (such as a Cayman or Channel Islands general partner of a Cayman or Channel Islands limited partnership) will not be constrained by this requirement. It is of note that Jersey is a founding signatory of the International Organization of Securities Commission's ("IOSCO") multilateral memorandum of understanding and already has bilateral regulatory agreements with eleven EU Member States (Guernsey is also an IOSCO signatory and has bilateral agreements with eight EU Member States). The Cayman Islands also has established regulatory agreements with certain EU Member States and the Cayman Islands Monetary Authority is in current negotiations to formalise several others.

2. Financial Action Task Force Compliance

The third country where the non-EU AIFM and the non-EU AIF are established must not be on the Financial Action Task Force ("FATF") blacklist for the purposes of money laundering and terrorist financing. It should be noted that none of the Cayman Islands or the Channel Islands are on the blacklist with certain classic "offshore" jurisdictions actually having been rated higher than certain EU Member States by the IMF. It is not anticipated that this will be an onerous requirement for most non-EU AIFMs to satisfy in relation to themselves and their AIFs.

3. Transparency and Reporting

The non-EU AIFM will need to comply with certain transparency and reporting requirements in the Directive. Essentially disclosures in relation to each AIF marketed by the non-EU AIFM will need to be made to the regulators of the EU Member States in which that AIF has been marketed and has accepted investors. The disclosure obligations can be distinguished between "marketing" and "post-marketing" obligations.

(i) Marketing Obligations

In terms of marketing, the non-EU AIFM will need to ensure that certain disclosures are made to prospective EU based investors in relation to the AIF. The Directive contains a list of requirements that must be found in the relevant disclosures to investors which are consistent with the current content of typical private placements but with an extra level of investor protection. Notable inclusions are as follows: a description of the investment strategy and objectives of the AIF, a description of the procedures by which the AIF may change its investment strategy, a description of the main legal obligations of the contractual relationship entered into for the purposes of the investment, descriptions of valuation and pricing methodologies, a description of all fees and expenses to be borne by investors and how the AIFM ensures fair treatment of investors (including a description of what types of investors might receive preferential treatment).

(ii) Post Marketing Obligations

Once investors are admitted to an AIF, the disclosures relate to the delivery of annual financial reporting (to both investors and the regulators of the EU Member States in which it has investors) and certain other reporting requirements. The annual report must contain the following as a minimum: (a) a balance-sheet or statement of assets and liabilities; (b) an income and expenditure account for the financial year; (c) a report on the activities of the financial year; and (d) any material deviation from initial disclosures to investors. In terms of other reporting, the AIFM will need to report "regularly" to the competent authority of the EU Member States from which it has admitted investors on the following: the main instruments on which it is trading, the markets of which it is a member or on which it actively trades and the principal exposures and most important concentrations of each AIF it manages. AIFM will also need to make available certain information regarding the overall level of leverage where leverage is employed on a "substantial basis" (as yet undetermined). Obviously, these requirements are more targeted towards hedge fund AIFMs. Private equity AIFMs will however be impacted by certain required portfolio company disclosures in relation to the acquisition and disposal of substantial stakes in EU based non-listed companies and the "asset-stripping" provisions noted above.

Marketing Issues for Non-EU AIFMs – EU Passport and Authorisation from 2015

While the initial position is that non-EU AIFM will be able to market their funds on the basis of national private placement rules (and subject to the three conditions above), the obvious intent is that these private placement rules will be phased out and replaced with a "EU passport" for non-EU AIFMs in the future.

From 2015 onwards it will be possible for non-EU AIFMs to market their AIFs to EU investors based on either the national private placement rules (as supplemented by the three conditions above) or pursuant to a passport regime in a dual marketing system (the proposed EU passport being subject to a positive report from ESMA as to its use in relation to non-EU AIFMs and their AIFs and certain secondary legislation). In order to take advantage of the passport regime, the non-EU AIFM will need to submit to the entire requirements of the Directive by amongst other matters seeking authorisation of a "legal representative" of the AIFM in an "EU Member State of reference". The Directive provides for a series of tests to determine the "EU Member State of reference" with which the non-EU AIFM will have most connection with a variety of factors taken into account including: the location of the EU AIF (assuming that the AIF is based in the EU), the EU Member State where the largest amount of assets are managed or the EU Member State that will be subject to the most marketing.

The requirements for the authorisation of non-EU AIFMs are not considered in any further detail in this alert but it should be noted that the compliance obligations for firms authorised under the Directive are onerous and non-EU AIFMs will need to balance the compliance costs arising out of

authorisation against the benefits of being able to raise funds with a EU passport. Non-EU AIFMs will also need to take into account the fact that some EU member states are expected to tighten their private placement rules (Germany and France being the obvious candidates) which may mean that authorisation is more favorable for non-EU AIFMs that raise the majority of their capital from these jurisdictions.

Marketing Issues for Non-EU AIFMs – Potential Abolition of Private Placement Regimes from 2018

The Directive provides that ESMA will issue a further opinion in 2018 regarding the abolition of national private placement regimes and whether such regimes should be replaced in their entirety with the passport mechanism. The logical consequence of such abolition would be that all non-EU AIFMs that wish to market their funds to EU investors would need to become authorised in the EU.

It is far from clear however that the current legislative intent to oblige EU authorisation on all non-EU AIFMs seeking investment from EU investors will actually be matched with reality.

Reverse Solicitation and Passive Marketing Excluded from Scope

It is interesting that the Directive excludes from scope reverse solicitation and passive marketing (despite earlier drafts of the Directive that provided that such processes would be within its scope). Accordingly, well-branded non-EU AIFMs with an established EU investor base may find that they can bypass the entirety of the Directive by taking advantage of these exclusions.

Conclusions

The Directive has come a long way from the "protectionist" stance that was taken in relation to non-EU AIFMs in earlier drafts. In the short to medium term, it is clear that non-EU AIFMs will be able to continue marketing their funds to EU investors pursuant to national private placement regimes and by complying with certain limited provisions of the Directive. It will be interesting to see whether non-EU AIFMs will opt into the passport regime (assuming that this is extended to non-EU AIFMs in 2015) and much will depend upon how EU Member States adapt their private placement regimes in the early years of the Directive and the extent to which non-EU AIFMs are otherwise able to navigate around the Directive by relying on passive marketing and other solutions. In the longer term (i.e. from 2018 onwards), the possibility remains that there will be a requirement on non-EU AIFMs to seek authorisation in the EU if they wish to market their funds to EU investors but the relative success of the lobbying and negotiation process over the last year or so demonstrates that much can still change in the development of the Directive.

Paul Hastings' London office continues to explore a variety of solutions for non-EU AIFMs who wish market their fund products to European investors without incurring unnecessary exposure to the terms of the Directive.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] The rules in relation to the "management of EU AIFs" by non-EU AIFMs are not considered in further detail in this alert.

[2] Note that ESMA is provided with significant responsibilities in relation to the practice and functioning of the Directive.