

### **Finally Approved by the EU Parliament: The European Regulation of Alternative Investment Fund Managers**

**January 5, 2011**

The regulation of alternative investment funds (AIFs) and their managers (AIFMs) pursuant to the Directive on Alternative Investment Fund Managers (AIFM Directive) is one of the most significant legislative projects ever undertaken in the regulation of the European private equity and venture capital industry. It is also one of the most controversial pieces of financial market regulation within the European Union (EU).

The debate on the AIFM Directive has been ongoing within the EU since its first draft was published in April 2009. On November 11, 2010, the European Parliament approved, with a very large majority, the final draft of the AIFM Directive. Now, only a formal approval by the European Council is needed, and this may take place in the next few weeks. Once it is approved, the AIFM Directive will become effective in early 2011 and it could be implemented into national law by the EU Member States as soon as 2013.

#### **Introduction and Overview**

Currently, the activities of AIFs, particularly hedge funds and private equity funds, and of AIFMs are subject to national regulation by certain EU Member States; however, this regulation is not standardized throughout the EU. In certain European countries, there is almost no regulatory supervision of these funds or their managers. The purpose of the AIFM Directive is to bridge this gap and enhance financial stability in this area. The principle objectives of the AIFM Directive are therefore (i) the introduction of a system aimed at controlling systemic risks, (ii) the enhancement of investor protection, and (iii) the improvement of transparency. The following key regulations of the AIFM Directive are intended to help achieve these goals:

- Registration and reporting requirements for AIFMs
- The creation of initial capital requirements for AIFMs
- Provisions aimed at limiting “asset stripping,” in particular the limitation on distributions, capital reductions, share redemptions, or repurchases within 24 months after an AIF acquires control of a company
- The obligation to appoint an independent and qualified depositary, which will be held to a high standard of liability in relation to loss of financial instruments owned by an AIF and held by such depositary

- The creation of an EU-wide passport for authorized AIFMs to market their funds and, after a transition period of two years, a passporting system that will enable non-EU AIFMs, under certain conditions, to market non-EU funds to investors in the EU

## **Scope, Authorization, and Marketing**

### ***Scope***

The AIFM Directive will generally apply to all managers of AIFs that operate or market funds in the EU and that do not fall within the existing legislative framework of the Undertakings for Collective Investments in Transferable Securities (UCITS) Directive. This means that not only will managers of hedge funds and private equity funds fall within the scope of the AIFM Directive but also managers of other types of open-end and closed-end funds, such as real estate funds or shipping funds. The impact of the AIFM Directive will be felt more strongly in certain EU countries, such as Germany, where closed-end private equity funds and their managers have been largely unregulated. Even in countries such as France, where AIFMs are locally regulated, the requirements of the AIFM Directive will be, in certain cases, substantially more burdensome than existing regulations.

The AIFM Directive will apply irrespective of whether the AIF is domiciled inside or outside the EU or whether the AIFM provides its services directly or by delegation.

The AIFM Directive provides for a *de minimis* rule that exempts from the scope of the AIFM Directive managers that operate funds with assets that are worth less than €100 million in aggregate. In addition, managers that operate funds with assets that are worth less than €500 million in aggregate are exempted if the funds are not leveraged and exclude redemption rights for investors for a period of five years following the date of initial investment in the relevant AIF. The *de minimis* rule is based on the rationale that AIFMs that manage funds with assets of less than €100 million are not likely to impose a risk on the stability of the financial system. The same is deemed to apply to unleveraged funds. However, not many AIFMs will escape from the scope of the AIFM Directive under these fairly narrow *de minimis* rules. The AIFM Directive also stipulates exemptions for holding companies, certain national and supranational institutions, and AIFMs that manage AIFs whose only investors are the AIFM or an affiliate of the AIFM, unless one of those investors is itself an AIF.

### ***Authorization and Marketing***

The AIFM Directive includes an authorization requirement for AIFMs. It introduces an EU passport system for AIFMs that will allow AIFMs to market AIFs to professional investors throughout the EU on the basis of a single authorization. Once an AIFM is authorized to market an AIF in one EU Member State and complies with the rules of the AIFM Directive, it will be entitled upon notification to manage or market the fund to professional investors throughout the EU. The EU passport, however, will not entitle AIFMs to market funds to retail investors because marketing to retail investors is not addressed in the AIFM Directive. It will be up to individual EU Member States to allow the marketing of certain types of AIFs to retail investors in their jurisdictions.

The authorization will cover the provision of management services either for all types of funds or only for specific types. The authorization will only be granted if the AIFM, which can be a legal or natural person, is able to demonstrate that it has the necessary qualifications to operate the types of funds being contemplated. In relation to this, the AIFM must provide detailed information concerning, among other things, the planned activities, the identity and characteristic of the funds (including the identity of fund members and the governing fund documents), its internal governance arrangements (including

arrangements for outsourcing and remuneration policies and practices), risk management, valuation and safekeeping of assets, audit arrangements, and the systems of regulatory reporting, as well as arrangements made for the delegation and subdelegation of functions to third parties. The national authority or authorities of EU Member States, which are empowered by law or regulation to supervise AIFMs (each and together referred to as a Competent National Authority), must inform the European Securities and Markets Authority (ESMA), a new EU financial supervision authority that will be located in Paris as of 2011, of authorizations granted or withdrawn on a quarterly basis.

## **Special Rules for AIFMs/AIFs Domiciled Outside EU**

### ***Marketing Passport Regime for Third Countries***

One of the most controversial issues in the legislative process of the AIFM Directive has been the third-country issue, in particular, the granting of a passport to non-EU funds. Under previous drafts of the AIFM 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. These requirements would have created significant difficulties as it would have taken years to compare foreign regulations. Pursuant to the final text of the AIFM Directive, however, non-EU AIFMs will be permitted to obtain a passport from ESMA authorizing them to market their AIFs in the entire EU. 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 in the EU non-EU funds that they manage if they comply with all the requirements and obligations of the AIFM Directive, including, *inter alia*, transparency and capital requirements and the obligation to appoint a depositary as well as a valuation expert.

The passport approach seems to be more practical than previous concepts. However, many issues still remain unclear. One such issue is the supervision of non-EU AIFMs. The AIFM Directive establishes that a non-EU AIFM will be subject to the regulations under the AIFM Directive under the supervision of the Competent National Authority in its EU Member State of reference. It remains unclear, however, if this State of reference would be the EU Member State that would be mainly affected by the proposed marketing activities or if the State of reference should be chosen according to other criteria. This could mean that non-EU AIFMs will have to evaluate in which state they have the largest number of investors before choosing a reference state. It remains to be seen how EU regulators will effectively supervise non-EU AIFMs if they market in the EU, as effective supervision will require cooperation agreements between regulatory authorities in countries outside the EU.

The passport provisions will become effective two years after implementation of the AIFM Directive. Once the passport regime has entered into force, the AIFM 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 will have to comply with the relevant private placement rules in each jurisdiction where they will be marketed. Therefore, until then, non-EU AIFs will need to carefully monitor significant changes to the national private placement rules in the countries where their targeted investors are located.

## **Key Provisions of the AIFM Directive**

### ***Capital Requirements***

The AIFM Directive distinguishes between AIFs that are internally managed and those that are managed by appointed external AIFMs. Different minimum capital requirements apply to each category. An AIFM that is an internally managed AIF is required to maintain an initial minimum capital of €300,000, whereas an AIFM appointed as external manager of one or more AIFs is required to maintain an initial minimum capital of € 125,000. If the value of the assets managed by the AIFM exceeds €250 million, additional equity equaling 0.02% of the value of the AIF portfolio exceeding €250 million must be provided. The required aggregate amount, equal to the initial capital plus the additional equity amount, is limited to €10 million; 50% of any such additional equity may be provided by the relevant AIFM in the form of a bank guaranty.

Many practical distinctions between internal and external AIFMs remain to be worked out, particularly with respect to the treatment of closed-end funds.

### ***Risk and Liquidity Management***

Under the AIFM Directive, AIFMs will have to employ a general risk management system that must ensure, among other things, that risks associated with each investment position of the AIF and its overall effect on the AIF's portfolio can be properly identified, measured, managed, and monitored on an ongoing basis, including through the use of appropriate stress testing procedures. The functions of risk management and portfolio management must be kept separate. The risk management function must include at least a documented due diligence process for investments that implements risk measurement systems and ensures that the risk profile corresponds to size, portfolio structure, and investment strategies of the AIF as laid down in its rules or instruments of incorporation. AIFMs will be obligated to review the implemented risk management systems with appropriate frequency (not less than annually) and adjust it when necessary.

Pursuant to the AIFM Directive, a special liquidity risk management program must be installed to enable the AIFM to monitor the liquidity conditions of the AIF. Details specifying the requirements of the appropriate risk and liquidity management will be adopted by the EU Commission at a later time. Exemptions have been established for unleveraged closed-end AIFs.

### ***Disclosure Obligations***

*Disclosure to the Competent National Authority.* Once an AIF is in operation, the AIFM must convey to its respective Competent National Authority regular information on the markets and instruments in which the AIFM's funds trade, including principal exposures and concentration of risks, as well as the following information:

- The percentage of the AIFs' assets that are subject to special arrangements arising from their illiquid nature
- Any new arrangements for managing the liquidity of the AIFs
- The actual risk profile of the AIFs and the risk management tools employed by the AIFM to manage the market risk, liquidity risk, counterparty risk, and other risks, including operational risk
- The main categories of assets in which the AIFs have invested

- The results of stress tests performed under the AIFM Directive and performance data

On request by the Competent National Authority, the AIFM is required to submit (i) an annual report of each EU AIF it manages and of each non-EU AIF it markets in the EU and, (ii) for the end of each quarter, a detailed list of all AIFs that the respective AIFM manages.

Special requirements are imposed on AIFMs employing leverage. Such AIFMs are required to disclose to their respective Competent National Authority information regarding the overall level of leverage employed, the leverage arising from borrowing of cash or securities, and the leverage arising from positions held in derivatives, the rehypothecation of assets, and the main sources of leverage in their AIFs. Information gathered by a Competent National Authority must be shared with other authorities in the EU, i.e., with ESMA and the European Systemic Risk Board (ESRB), which will be responsible for macro-prudential oversight of the EU financial system starting in 2011. This information sharing is intended to facilitate the collective analysis of the impact of the leverage of AIFs managed by AIFMs in the EU, as well as a consistent regulatory response. For non-EU AIFMs, reporting regulations will be limited to any managed EU AIFs and non-EU AIFs marketed in the EU.

Where, in the opinion of ESMA, it is advisable to ensure sustainable growth or the stability and integrity of the financial system, ESMA may request that the EU Member States Competent National Authorities impose additional reporting requirements, the scope of which remains unclear.

*Disclosure to Investors.* The AIFM Directive is aimed at increasing transparency for investors. Therefore, AIFMs will have to make certain disclosures to investors before they invest in an AIF, in particular the following disclosures:

- The investment strategies, legal structure, and objectives of the AIF
- 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
- The identity of the prime brokers, any material arrangement with such brokers, and the management of potential conflicts of interests

The AIFM Directive additionally requires AIFMs to provide to investors, on a periodic basis, the following information:

- 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 used by the AIF
- The liquidity characteristics and management
- The preferential treatment of other investors and the fees borne by the investor community
- 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
- A description of any delegated management function

Details specifying the required frequency of the disclosures will be adopted by the EU Commission at a later date.

### ***Additional Transparency Requirements Applicable to Private Equity Funds***

The AIFM Directive establishes additional requirements for AIFMs that manage AIFs targeted at acquiring control of nonlisted companies, unless the nonlisted companies are small or medium-size enterprises<sup>1</sup> or special purpose vehicles that purchase, hold, or administer real estate. Control in this context means the acquisition of at least 50% of the voting rights of the company. AIFMs managing such AIFs are required to notify their respective Competent National Authority if the proportion of voting rights of the nonlisted company held by the AIF reaches, exceeds, or falls below the thresholds of 10%, 20%, 30%, 50%, and 75%. Additional reporting obligations, in particular towards the relevant company, apply when an AIF has acquired control. These reporting requirements, for example, include the disclosure of layoffs and employee staffing plans.

### ***Restrictions on Asset Stripping***

Whereas the original draft of the AIFM Directive did not include rules on asset stripping, the EU Commission introduced restriction on the disposal of assets of a nonlisted company when an AIF, individually or jointly, acquires control of such company. When an AIFM manages AIFs that acquire control of such nonlisted companies, such AIFM will not be allowed, within the first two years following the acquisition of control of any such company by the AIF, to implement any distribution, capital reduction, share redemption, and/or acquisition by the company of its own shares. This is intended to prevent equity investors from taking over a company merely to obtain quick profits.

### ***Restrictions on the Use of Leverage***

In order to ensure a proper assessment of the risks induced by the use of leverage by an AIFM with respect to the AIFs it manages, the AIFM will be required to demonstrate that the leverage limits for each AIF it manages are reasonable and how it complies at all times with those limits. The relevant Competent National Authority will assess the leverage related risks and may, after having notified ESMA and the ESRB, impose limits on the level of leverage that an AIFM may employ or other restrictions on the management of the AIF to limit risks to the stability of the financial system. Details specifying the circumstances in which the Competent National Authority should exercise this power, taking into account different strategies of AIFs and the different market conditions under which they operate, are to be adopted by the EU Commission at a later date.

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Enterprise Category	Headcount	Turnover	or	Balance Sheet Total
medium-sized	< 250	≤ €50 million		≤ €43 million
small	< 50	≤ €10 million		≤ €10 million
micro	< 10	≤ €2 million		≤ €2 million

## ***Evaluation***

Under the AIFM Directive, AIFMs are required to ensure a diligent and independent evaluation of the assets of each AIF they manage. An evaluation must be conducted at least once per calendar year with regard to closed-end funds and each time there is a change to the funds' equity. The exact meaning of the latter requirement still remains unclear. Any evaluation of a managed fund may be conducted by the AIFM or an independent evaluation expert. In case of an evaluation by the AIFM itself, the Competent National Authority may require a verification of the AIFM's evaluation by an external expert. AIFMs are required to secure a valuation of the net asset per share or unit of each fund. The evaluation requirement will impose a costly and time-intensive burden on AIFs.

## ***Depository Requirements***

Under the AIFM Directive, an AIFM must appoint an independent depository for each managed AIF. The depository must be an EU credit institution, an EU investment firm, or a similar institution. The depository will receive all payments made by investors, safe-keep any financial instruments belonging to the AIF, and verify whether the AIF has obtained ownership of all other assets in which the AIF has invested. Throughout the legislative process, the depository requirement, including the depository's liability, was one of the most debated issues. The AIFM Directive imposes liability on a depository in relation to the loss of financial instruments owned by an AIF and held by the depository. A depository will only be able to avoid such liability "if it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite its reasonable efforts."

Although the initial draft of the AIFM Directive dealt with regulating depositaries' liability, the EU Parliament felt that too much leeway was granted to depositaries to delegate this liability. Under the final text of the AIFM Directive, a depository, when delegating tasks, will have to provide a contract that allows the AIF or the AIFM to claim damages against the entity to which the tasks were delegated. AIFMs will be obliged to inform investors, prior to such investors' investment in the relevant AIF, of any arrangement made by the depository to contractually discharge itself of liability. Also, AIFMs must inform investors without delay of any amendments to such arrangements.

The requirement to appoint a depository will increase the cost of depository services as the risks of liability for loss will be priced into the fees charged for depository services. Due to the wide liability provisions, some custodians may even decide to reduce their service programs. It is interesting to note that, once these depository requirements are introduced for AIFs, there may well be no reason to continue to apply lower standards to depositaries of UCITS. It seems likely that the next reform of the UCITS Directive may introduce a similar regime.

## ***Outsourcing***

An authorized AIFM will be allowed to delegate certain administrative functions to different entities or persons if such delegation does not prevent effective supervision by the AIFM. The delegation will be subject to prior notification to the Competent National Authority and must satisfy certain conditions. The third party must be creditworthy and the persons who effectively carry out the business must have a good reputation and sufficient experience. If the delegation relates to portfolio management, the third party must be a licensed AIFM that is authorized to manage AIFs of the same type. Where the delegation relates to portfolio management and is given to a third-country undertaking, the AIFM will need to ensure co-operation between the Competent National Authorities of, respectively, the AIFM and the third-country undertaking. The AIFM has to demonstrate that it is in a position to monitor effectively

at any time the delegated activity, to give further instructions, or to withdraw the delegation with immediate effect. In any case, the AIFM remains responsible for the third party's continued adherence to the rules of the AIFM Directive. To a limited extent only, the third party is allowed to subdelegate its functions further. The AIFM will not be able to delegate its functions if, as a result, it would no longer be considered to be the manager of the AIF and to the extent that it would be deemed to be merely a letter-box entity. Details specifying the conditions for fulfilling such outsourcing requirements will be adopted by the EU Commission at a later date.

### ***Remuneration***

Unlike the initial draft, the final text of the AIFM Directive provides for remuneration rules whereby ESMA is required to ensure the existence of guidelines on sound remuneration policies in the AIFM sector. AIFMs are required to establish and maintain, for those categories of staff whose professional activities have a material impact on the risk profiles of the AIFs they manage, remuneration policies and practices that are consistent with sound and effective risk management. These employees should at least include senior management, risk takers, control functions, and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers.

### **Conclusion**

The AIFM Directive imposes many obligations on AIFMs ranging from registration and authorization obligations to submission to ongoing regulatory supervision and monitoring. The final text of the AIFM Directive now even includes remuneration rules for AIFMs. However, even after adoption of the final text of the AIFM Directive, the extent and practical impact of many of these obligations remain unclear. This particularly applies to the frequency and scope of transparency and disclosure requirements as well as the scope of the powers of an AIFM's Competent National Authority, such as the power to impose limits on the level of leverage that an AIFM may employ. Compared to the status quo, the AIFM Directive will impose higher bureaucracy expenditures on AIFs and the AIFMs marketing the AIFs.

The introduction of a passport system by the AIFM Directive, applying a single set of rules for non-EU AIFMs, will impose additional requirements and administrative costs on non-EU AIFs targeting the European markets. One can argue that, instead of protecting investors, this may have a protectionist effect. The EU Commission, however, takes the position that this approach will ensure a level playing field and a consistently high level of transparency and protection for European investors.

Although there is general agreement that the activities of AIFMs and the marketing of AIFs, in particular hedge funds, need to be regulated in order to ensure the stability of the financial system and enhance investor protection, the AIFM Directive does not seem to differentiate sufficiently between the different types of AIFs it is trying to regulate; as a result, for certain fund types, the AIFM Directive appears to establish an excessively expensive and bureaucratic regulatory system compared to the level of risk involved.

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