The Alternative Investment Fund Managers Directive ("AIFMD")

The alternative investment funds industry is shortly to be subject to European authorisation and conduct of business requirements for the first time, with detailed rules on a very diverse range of issues such as: remuneration, leverage, delegation and the ability to manage more than one fund or perform other investment activities. AIFMD covers those responsible for the portfolio or risk management of all types of alternative investment funds, such as hedge funds, private equity funds and property and commodity funds. It also introduces a harmonised regime for the promotion of such funds to professional investors.

Background

In the UK, alternative collective investment schemes have been the subject of regulation for a number of years across some fairly uncoordinated areas such as marketing, operating and managing. At European level, however, other than in relation to the Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive (a directive which enables certain retail friendly schemes, which are operated on very prescriptive requirements, to be marketed across the EU), there has been little harmonised regulation of collective investment schemes or their operators or managers. The introduction of AIFMD at European level will result in a harmonised and very comprehensive regime.

AIFMD came into force on 21 July 2011 and, although we are still waiting for further technical implementing measures, must be transposed by Member States by 22 July 2013 - with compliance being required from this date.

The Directive provides many challenges to the alternative investment fund industry. This note provides an introduction to the Directive. The following questions should be borne in mind by managers of existing funds to help determine whether they will be within the scope of AIFMD:

- Do you provide portfolio management or risk management services to a non-UCITS fund? (This could be internally, e.g. as the board of an investment company, or externally, as a third party manager). If yes:
- Are you ultimately responsible for that service or has it been delegated to you with the person delegating retaining ultimate responsibility? If the former:
- Do you otherwise fall outside the scope of the Directive (see Exemptions below)? If the answer is no, it is likely that you will fall within AIFMD.

If a manager is caught by AIFMD, they will need to consider whether this has any business model implications as AIFMD limits their ability to perform certain activities when managing an alternative investment fund. Questions to consider are:

- Do you provide services other than portfolio management or risk management of collective investment schemes?
- Are you an internally managed collective investment scheme? If yes, do you currently manage more than one collective investment scheme?

If the answer to either of these questions is yes, it is possible that the manager will need to change their business model.

Scope

The Directive applies to the managers of ‘alternative investment funds’ ("AIFs"). Therefore it is not the fund that is regulated by AIFMD, only the manager of the fund (the “AIFM”).

Type of fund

AIFs are defined as 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 for the benefit of those investors; and
- is not already regulated under the UCITS Directive.
The 'alternative' in AIFMD title really means 'alternative to a UCITS fund' with the definition capturing a broad range of funds (regardless of asset class) including hedge funds, private equity funds, property and commodity funds. It should be remembered that the definition of AIF is not the same as the UK’s definition of collective investment scheme and, whilst there is considerable overlap, there is the potential for AIFMD to bring within scope arrangements not currently covered by UK regulation, such as venture capital trusts and investment companies.

Manager
An AIFM is any legal person whose regular business is performing portfolio and/or risk management for an AIF. Depending on the circumstances the AIFM may be internal to the AIF (e.g. where the AIF entity makes its own investment decisions in relation to its assets) or external (where a third party is appointed to manage the AIF’s assets). AIFMD contains provisions which affect any AIFM:
- based in the EU (whether managing an AIF based in the EU or outside);
- not based in the EU but managing an AIF based in the EU; and
- marketing an AIF in the EU (whether or not the AIF or AIFM is based in the EU).

The Directive only permits one AIFM per AIF. While AIFMD requires the AIFM to be authorised for performing both the portfolio management and risk management of the AIF, the trigger for authorisation is performing merely one of these activities. Therefore it is possible that funds that fall within the definition of an AIF may currently have more than one AIFM. The transposition of AIFMD will require this to be changed and it may be that current managers falling within the definition of an AIFM have to take on more responsibility than they currently have or structure their role differently (e.g. have their role formally delegated to them) so that it is another entity that is considered to be the AIFM.

Exemptions
AIFMD provides for a limited number of exemptions (including grandfathering provisions for certain existing fund structures) and also a lighter touch ‘registration’ regime for managers with limited assets under management.

Exemptions
Key exemptions are:
- Group AIFMs: an AIFM managing funds whose only investors are either its parent or its subsidiary undertakings, or subsidiary undertakings of its parents;
- Holding companies: a detailed definition is set out in the Directive and ESMA have consulted on whether further elaboration is required. In essence, the Directive is not intended to capture companies that carry out their business strategies through subsidiaries or associated companies in order to contribute to their long-term value;
- Insurance contracts and joint ventures: there is no definition of these terms in AIFMD and again ESMA has consulted on whether further clarification is needed. Possible identifying factors proposed by the FSA in relation to joint ventures are (1) all participants being involved to some extent in the day to day management of the AIF; and/or (2) the AIF does not raise capital from the public;
- Family offices: a full definition of ‘family office’ is not given (although reference is made to ‘family office vehicles which invest the private wealth of investors without raising external capital’), ESMA has consulted on whether further definition is needed and the FSA has proposed the following key elements to help identify AIFs that would benefit from this exclusion: (1) there is a family relationship between investors; (2) the money or assets are in some way connected to the relationship and there is no raising of capital from investors outside of the relationship; and (3) the money or assets and the relationship between investors are likely to pre-date the relationship between the investors and the AIF or AIFM. It is therefore likely that this exemption will not be available to multi-family offices; and

Grandfathering provisions
Managers of existing closed-ended AIFs:
- which do not make any further investments after 22 July 2013 are exempt; or
whose subscription period ended prior to 21 July 2011 and have a life-span expiring prior to 22 July 2016 are not subject to the majority of AIFMD, although certain disclosure obligations contained in the Directive will still apply.

Registration regime for smaller and unleveraged funds
AIFMD provides a much lighter touch regime for AIFMs with total assets under management in AIFs not exceeding either (i) €100m; or (ii) where the AIFs managed are all unleveraged and all have a lock-in period of at least 5 years, €500m.

These smaller AIFMs are subject only to a registration requirement and not the more onerous authorisation and other requirements considered below. However, Member States can choose to impose the full AIFMD requirements on such managers. The Treasury has consulted on various approaches to take, acknowledging the balancing act between applying the AIFMD requirements in full to all (which would result in a significant increase in regulation for those AIFs not currently regulated and for which only registration would be required) and applying only the registration requirements to applicable AIFMs (resulting in substantial de-regulation for those firms that are currently authorised, but which would fall under the relevant thresholds). The approach the Treasury will ultimately take remains to be seen.

Where AIFM’s are only subject to the lighter touch regime, they will not benefit from AIFMD’s passporting provisions (discussed below). In order to do so, the AIFMD will need to ‘opt up’ for full authorisation.

New requirements for managers
Subject to the exemptions considered above, AIFMD will impose on AIFMs a range of structural and compliance requirements including:

- to apply for authorisation from the AIFM’s Home State regulator;
- minimum capital requirements for the AIFM (at least €300,000 for internally managed AIFs and €125,000 plus a percentage of AUM for external managers);
- compliance with conduct of business rules (such as managing conflicts of interests and fair treatment of investors) and implementation of risk and liquidity management measures;
- limitations on remuneration practices (including requirements for deferred payment of variable remuneration and for share or unit based payments);
- independent valuation of fund assets;
- requiring external depositaries to safeguard fund assets and monitor cashflows (and requirements regarding depositaries liabilities for safeguarding such assets);
- strict rules on the AIFM delegating its functions (including prior notification to the relevant regulator);
- limits on and disclosure of the use of leverage; and
- disclosure of information to the regulator and to investors (including the requirement to make an annual report for each AIF managed).

Activities of the AIFM
AIFMD provides that AIFMs may only engage in those activities set out in the Directive. These activities only relate to the management of an AIF. Whilst the Directive does allow for Member States to permit a limited number of ancillary investment activities, it is clear that a single investment firm will not be able to be both an AIFM and a general investment service provider. Whilst the Directive makes it clear that entities appropriately authorised under the Markets in Financial Instruments Directive (MiFID) or the Banking Consolidation Directive (BCD) will be able to provide investment services to AIFs, in its discussion paper earlier this year, ESMA stated that such a firm will not be able to seek authorisation as an AIFM. Whether this approach to authorisation will be adopted is not yet known (implementing measures to flesh out the meaning of the requirements of the Directive are expected in Q3-4 2012 from the EU Commission), but it is clear that firms will need to consider whether they are currently performing the AIFM role and if they currently conduct other investment business alongside this, whether they need to restructure to allow them to continue to do so.
The Directive draws a distinction between internally and externally managed AIFs and does not allow an internally managed AIF to carry on any activities other than the internal management of that AIF. This will be of particular interest to AIFs structured as partnerships (such as limited partnerships) as it is possible that, if the structure is deemed to be an internally managed AIF, the general partner would not be permitted under the Directive to be a partner (general or otherwise) of any other AIF.

Disclosure of significant interests
AIFMD imposes disclosure obligations on the acquisition of substantial stakes (starting at 10% of the voting rights) in certain unlisted EU incorporated companies (see Restrictions on asset stripping below for details of those companies not covered by this requirement). Where more than 50% of the voting rights of such a company are acquired, the AIFM must disclose to the company, its shareholders and its employees its intentions with regard to the future business of the company and the likely repercussions on employment (including any material change in the conditions of employment).

Restrictions on asset stripping
In addition to the disclosures required above, where more than 50% of the voting rights are acquired, AIFMD prevents the AIFM, for a period of 24 months following the acquisition of the control, from facilitating, supporting, instructing or voting for certain actions which AIFMD refers to as ‘asset stripping’. Broadly, ‘asset stripping’ occurs where the company effects any distribution (or acquisition of own shares) which either (a) results in reducing the company’s net assets to below the total amount of the company’s subscribed capital and undistributable reserves; or (b) exceeds the amount of profits for the previous year and any other profits brought forward.

The rules on disclosure of significant interests and asset stripping do not apply to special purpose vehicles established to purchase, hold or administer real estate or small and medium sized enterprises (i.e. an entity which employs fewer than 250 persons and which either has an annual turnover not exceeding EUR 50 million, or an annual balance sheet total not exceeding EUR 43 million).

Marketing Passport
AIFMD provides AIFMs authorised by a Member State with a framework for marketing units or shares in AIFs to professional investors across the EU without the need to seek approval from any other Member State. This marketing passport will initially only be available to EU-based AIFMs of EU based AIFs. Non-EU AIFs and AIFMs will continue to be governed by national private placement regimes until at least 2015 when the EU Commission will consider whether to extend the passporting provisions.

The Directive does not envisage an equivalent passport for offers to retail investors. However, it does allow for Member States to permit AIFMs to market AIFs (EU or non-EU) to retail investors and to impose stricter requirements to such marketing than those applicable to marketing to professional investors. There is, however, one caveat: any such requirements cannot be stricter for EU AIFs marketed on a cross-border basis into the Member State than for those marketed domestically.
Timing

As mentioned above, AIFMD must be transposed by Member States by 22 July 2013. At this time EU AIFMs performing activities under AIFMD will be subject to and required to comply with the provisions of AIFMD (as transposed by national law), although the Directive allows for a further period of a year for EU AIFMs to seek authorisation from their local regulator to become authorised (the FSA has stated that its successor, the FCA, is aiming to be in a position to accept applications from Q2 2013).

As mentioned above, the rules relating to the authorisation and passporting of non-EU AIFMs and AIFs are subject to further implementing legislation by the EU Commission. Set out below are the key headline dates:

- 21 July 2011: Directive in force
- 22 July 2013: Deadline for transposition of AIFMD into national law of Member States
- 22 July 2013: Requirements of AIFMD apply to EU AIFMs
- 22 July 2013: Passport available for EU AIFMs / AIFs
- 22 July 2013: Deadline for EU AIFMs to apply for authorisation under AIFMD
- October 2015*: Introduction of authorisation requirement for non-EU AIFM and passport for non-EU AIFM / AIF
- 2019*: End of national placement regime

* These dates are ‘at the earliest’ estimates and dependent on advice from ESMA on the functioning of the passport for EU AIFMs / AIFs and the adoption of implementing legislation by the EU Commission
Next Steps

Implementation
As mentioned above there are a number of areas where further clarification is expected. The FSA is also considering the opportunity presented by the Directive to ‘streamline’ its Handbook’s fund management rules. This is likely to result in the COLL sourcebook being replaced with a new sourcebook for fund management rules generally (currently referred to as ‘FUND’).

In addition the FSA and Treasury are considering whether a new regulated activity of managing AIFs needs to be created and whether the transposition of AIFMD gives rise to any other changes to FSMA and the Regulated Activities Order (e.g. what is to happen to the current UK concept of ‘collective investment scheme’).

For managers
The above is a necessary part of the process of transposing the Directive. However, now is the time for managers to consider whether they will be within the scope of AIFMD and, if so, the likely business implications. Relevant considerations are:

- where establishing or structuring new funds that will be AIFs under the Directive, managers will need to take into account the impact of AIFMD where those funds will be in existence after 22 July 2013;
- as discussed above, the Directive limits the activities of AIFMs. This will be important when structuring new funds, but will also require current managers who will be AIFMs under the Directive to consider whether their business needs to be restructured; and
- where fund structures cross between EU and non-EU jurisdictions, the full implications of AIFMD will need to be assessed.

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