Insight: Investment Funds

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EU Regulation of Investment Funds

EU Alternative Investment Fund Managers Directive: An outline for private fund managers

In November 2011 the European Parliament adopted a final, agreed text of the European AIFM Directive, after 18 months of fierce political debate. When implemented, the Directive will bring fundamental changes for alternative investment managers, their funds and service providers, whether located in, or outside, the EU.

Much of the detail under the Directive is still to come, with an estimated 90 or so secondary measures expected to follow before implementation in European Member States. The European Securities and Markets Authority ("ESMA") has launched a call for evidence on the so-called "Level 2" measures which will contain much of the detailed provisions of the Directive.

Scope

The Directive establishes a new EU regulatory regime for entities which manage alternative investment funds ("AIFs"), such as private equity, real estate and hedge funds, or which market such funds in the EU.

Whilst primarily aimed at EU based managers, non EU managers will also be impacted insofar as they either manage EU domiciled AIFs, or wish to market their AIFs (wherever domiciled) to EU investors.

Accordingly, the Directive applies to:

- EU AIFM which manage funds based in the EU or outside it
- Non EU AIFM which manage EU AIFs
- Non EU AIFM which market AIFs in the EU

Timetable

The Directive had been expected to be implemented across the EU in March 2013 although it now appears that this will be delayed to June 2013. Until then, there is no change to the current position, but given the significant new measures being introduced, AIFM should start planning for implementation of the Directive early insofar as possible.

The deadline for ESMA to respond to the European Commission on the many level 2 measures has recently been extended from September 2011 to November 2011.

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What is an AIFM?

An AIFM is any legal person whose regular business is managing one or more AIF. Managing, for these purposes, means providing at least portfolio management **and** risk management services to one or more AIFs. The intention of the Directive is that there is a *single* AIFM for each AIF. Entities which delegate their management functions to such an extent that they are considered a "letter box" entity cannot be an AIFM under the Directive.

Where an entity is acting within the scope of the Directive, it should no longer hold the MiFID permission of portfolio management, but instead, should have the permission of collective portfolio management under the AIFM Directive. An AIFM must not engage in any activities other than a prescribed list of activities relating to the management of an AIF – this may impact banks managing AIF, which may need to move their AIFM business into a separate company.

The Directive does not directly regulate the investment funds themselves and, in order to be a fund in relation to which the manager may be subject to the Directive, the AIF must raise capital from a number of investors. Thus, managers of family office vehicles are excluded from scope as are managers appointed under individual mandates. Certain other types of entity benefit from exemptions, including securitisation SPVs. In addition, the following may be partially exempt, but can opt-in to full compliance with the Directive in order to benefit from the passport:

- managers of AIF employing leverage where the assets under management are below EUR 100 million, and
- managers which do not employ leverage where assets under management are below EUR 500 million and where the fund is closed ended.

The application of the Directive to AIFM based outside the EU is discussed further below.

Authorisation

The consequence for an AIFM of being subject to the Directive is that the AIFM must obtain authorisation from the competent authorities in its home EU Member State (or, where the AIFM is not based in the EU, it must obtain authorisation from the competent authorities in the EU Member State that is most appropriate, based on a range of factors and in accordance with a prescribed procedure).

In order to be granted authorisation, an AIFM must comply with various requirements, including capital requirements and the requirement to have a depository, as set out below. Once granted, such authorisation will be valid for all Member States. An existing AIFM must submit an application for authorisation within one year of the deadline for implementing the Directive (so by June 2014 at the latest).

Key Provisions of the Directive

A manager authorised under the Directive will be subject to rules in the following areas:

- new and potentially substantial regulatory capital requirements
- the need to have a depositary for the AIFs it manages, with detailed criteria for the depositary
- conduct of business rules, including relating to conflicts of interest, liquidity management and leverage
- the need to have an external asset valuer, or a segregated internal valuation function
- restrictions on delegation, particularly as regards portfolio and risk management
- transparency and disclosure requirements covering investor reporting, regulatory reporting and disclosure on acquiring an EU portfolio company
- remuneration of senior staff
- private equity buy-outs and asset stripping
- restrictions on investing in securitisations unless 5% "skin in the game" has been retained by the originator or sponsor.

Annex 1 contains further detail on the above.

Passporting Arrangements

The AIFM Directive creates a single market passport. Where an AIFM has been authorised in one Member State, it will be entitled upon notification to manage and market funds to professional investors throughout the EU. However this will, in the first instance, be limited in scope and only apply to EU AIFM managing EU AIF.

Non EU Aspects

The issue of so called "third country funds" (non EU AIF managed by EU or non EU AIFM) has been thorny. Non EU Managers can continue to market funds according to EU Member State national placement regimes until 2018, subject to certain conditions.

Annex 2 contains further detail for non EU Managers.

Marketing of Funds by Others

The Directive prohibits persons, such as placement agents or financial advisers, which are not AIFM, from marketing AIF to EU investors unless the AIF could be marketed to investors under the Directive. The scope of this provision is unclear but we read it as being intended to have the effect that non EU AIFs may not be marketed in the EU unless the Manager itself could market the fund in the EU pursuant to, and in compliance with, the Directive.

What now?

The Directive only sets out the framework, requiring the European Commission and ESMA to flesh out many detailed implementing measures over the coming months and years. However, managers should now start considering the implications of the Directive for their business models, particularly those which are based in the EU or which source significant amounts of capital from EU investors. Given the many types of funds, groups and structures that are potentially affected by the Directive, tailored approaches to the Directive based on a fund manager's particular circumstances are the likely way forward for managers seeking to organise their businesses in the most advantageous way.

Annex 1

Some Key Provisions

Capital Requirements

An internally managed AIF must maintain initial capital of €300,000.

Externally appointed AIFM must have initial capital of at least €125,000 plus an additional amount of 0.02 per cent of gross assets under management exceeding €250 million up to a maximum of €10 million in capital. Bank guarantees of part of the additional amount may qualify, subject to regulator's discretion.

Own funds are generally to be placed in "safe" and liquid assets.

AIFM must also maintain professional indemnity insurance or additional own funds to cover professional negligence liability.

The Level 2 measures will need to clarify what "gross assets under management" means in the context of private equity funds, and also whether or not a limited partnership managed by its general partner is an internally managed AIF.

Depositary

A single depositary for the safekeeping and administration of the AIF's assets must be appointed which should also deal with the receipt and payment of funds to investors. There are certain limited exceptions from the requirement for a depositary in relation to non EU AIFs.

The depositary must be an EU bank, an EU investment firm or a body permitted to act as a UCITS depositary, or, for non EU funds, a similar non EU bank or investment firm.

In relation to hedge funds, a prime broker may not act as depositary unless there is functional separation of the prime broker and depositary operations and conflicts are managed although delegation by the depositary to the prime broker may be permitted in certain circumstances.

In relation to private equity funds, the Directive suggests that an administrator, registrar, notary or lawyer may be permitted to be the depositary, although they would have to take on the responsibilities and nearly-strict liability prescribed by the Directive.

Conduct of Business, Operating Conditions, Liquidity Management and Leverage

AIFM will be subject to various conduct of business requirements. These include obligations to act honestly, with due skill, care and diligence and fairly, to act in the best interests of the AIF or the investors of the AIF it manages and the integrity of the market, prevent, deal and disclose conflicts and treat all AIF investors fairly. No investor may obtain preferential treatment unless this is disclosed .

AIFM will be required to separate the functions of risk management from portfolio management, both functionally and hierarchically. The separation will be reviewed by regulators of the AIFM home Member State on a proportionate basis but in any event they must show that specific safeguards are in place against conflicts of interest to allow for the independent performance of risk management activities.

AIFM must implement "adequate" risk management systems to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or can be exposed. These are to be reviewed at least annually and adapted as necessary.

A range of other measures are also required which include the use of stress testing procedures to ensure that the risks associated with each investment position of the AIF and their overall effect on the AIF's portfolio can be identified, measured, managed and monitored.

For AIF which are not unleveraged closed-ended AIF, the AIFM must employ a liquidity management system and adopt procedures which enable it to monitor the liquidity risk. An AIFM will be required to use stress tests under normal and exceptional liquidity conditions to assess the liquidity risk of AIF and to monitor the liquidity of AIF accordingly.

AIFM must set a maximum level of leverage which the AIFM may employ on behalf of each AIF it manages as well as extent of the right of the re-use of collateral or guarantee that could be granted under the leveraging arrangement, taking into account, a range of factors, including (i) the type of AIF, (ii) the strategy, (iii) the sources of leverage, (iv) any other inter-linkage or relevant relationships with other financial services institutions, which could pose systemic risk, (v) the need to limit the exposure to any one counterparty, (vi) the extent to which the leverage is collateralised, (vii) the assets liability ratio and (viii) the scale, nature and extent of the AIFM's activity in the markets concerned.

It is to be hoped that ESMA will recognise that these provisions have quite different application to different types of fund – eg hedge funds and private equity funds – and that the detailed Level 2 rules will differentiate accordingly, rather than applying a "one size fits all" approach.

Valuation

An AIFM is required to have procedures for proper and independent valuation of each the assets of each AIF that it manages and to ensure that the net asset value is calculated and disclosed to investors. This function may be performed by the AIFM or an independent valuer at least annually and in certain prescribed circumstances. If the AIFM performs the valuation, the valuation and portfolio management functions must be independent.

In relation to private equity funds, again it is to be hoped that ESMA will recognise that the concept of "net asset value" is fairly meaningless, and permit the funds to continue to use valuation guidelines such as the International Private Equity Valuation (IPEV) Guidelines.

Delegation

Restrictions on delegation apply and details of delegation must be disclosed to regulators. AIFMs must be able to justify the delegation structure with objective reasons and where the delegation concerns portfolio management or risk management, the mandate must generally only be given to authorised asset management undertakings subject to supervision. The AIFM's liability towards the AIF and its investors may not be affected by the delegation or any sub-delegation. There are additional restrictions on sub-delegation, which is not permitted unless the AIFM has consented to the sub-delegation and the home member state of the AIFM has been informed of the sub-delegation before it happens.

Transparency and Disclosure

The AIFM Directive imposes disclosure obligations on AIFM to ensure investors are better protected and kept well informed.

A tailored regime will apply in respect of unlevered funds with long 'lock in' periods and assets of less than €500 million and other funds with up to €100 million of assets under management. Such funds will need to register with national authorities and comply with harmonised transparency requirements in addition to any requirements applied at national level but such funds would need to "opt in" to full compliance with the Directive in order to avail themselves of passporting rights.

For all other funds falling under the scope of the Directive, there are significant transparency measures imposed requiring that a range of information is reported to investors so as to ensure: (i) conflicts are avoided, managed or disclosed, (ii) a fund's assets are safeguarded by an independent depositary, (iii) fund valuations are performed independently, (iv) strict conditions are complied with when an AIFM delegates functions to third parties and (v) that AIFM employ systems to manage the risks to which a fund is exposed.

The transparency requirements include a requirement for production of an Annual Report, disclosure to investors and reporting obligations to competent Authorities.

Remuneration

AIFM will be required to implement policies which promote sound risk management and which do not encourage risk taking which is not in accordance with the risk profile of the AIF or its rules. This will apply in respect of pay and bonuses to senior managers and those who have a significant impact on the fund's risk profile.

The Directive provides for the following in relation to remuneration:

- at least 40% of bonuses must be deferred for between three to five years. Deferral of 60% applies in respect of remuneration which is "particularly high".
- 50% of bonuses must be paid in units or shares.

ESMA will ensure the existence of guidelines which comply with the principles as set out in the Directive. It is to be hoped that the above will be applied proportionately in practice, in the way in which the regulators are currently interpreting and applying the remuneration rules under the Capital Requirements Directive, for example.

Disclosures required in relation to Portfolio Companies

The Directive requires disclosure of significant holdings in companies by private equity funds and, where they acquire control, there will be a requirement to make further disclosure of their intentions with respect to the future business and financing of the company. The objective is to increase transparency for the public and the employees of companies acquired by private equity funds.

The requirement does not apply in respect of small and medium sized enterprises (those employing fewer than 250 people in the EU and having either an annual net turnover not exceeding €50 million or a balance sheet total not exceeding €43 million) and SPVs with the purpose of purchasing, holding or administering real estate.

When an AIF acquires, disposes of or holds shares in an unlisted company, its AIFM must notify the authorities in the home Member State of the AIFM of the proportion of the voting rights held by the AIF when that proportion reaches, exceeds or falls below 10 per cent, 20 per cent, 30 per cent, 50 per cent and 75 per cent.

When an AIF acquires control over an unlisted company, its AIFM must notify the company, its other shareholders and the authorities in the home Member State of the AIFM. In the notification to the company, the AIFM must request the board of directors to inform the employees, without undue delay, of the acquisition of control by the AIF. The AIFM must also inform the company and its shareholders of 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, and request the directors to make this information available to the employees.

In addition, the Directive provides for specific provisions regarding the AIF annual report where an AIF is exercising control of unlisted companies. Such additional information would for example include any important events that have occurred since the end of the financial year, the company's likely future development and other information concerning acquisition of shares.

Asset Stripping

The Directive imposes rules designed to prevent so-called "asset stripping". Where an AIF acquires control of an EU company, the AIFM must use its best efforts to prevent that company affecting distributions, capital reductions, share redemptions and/or the acquisition of own shares, in the first two years after the AIF acquires control, where:

- the net assets stated in the company's annual accounts for its last financial year are, or following the distribution or acquisition of own shares would become, lower than the company's subscribed capital plus those reserves which may not be distributed by law or the company's statutes; or
- the distribution would exceed the amount of the 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 to reserve in accordance with law or the company's statutes.

These provisions could potentially prevent a company from making a distribution when it could otherwise lawfully do so, and also restrict a private equity fund from carrying out legitimate reorganisations and refinancings or to divest part of the target business and pay the sale proceeds to the fund by way of a dividend. Private equity managers will need to carefully consider the structuring of any acquisition of an EU company which is likely to make disposals.

Investment in Securitisations

AIFM will be prevented from investing in securitisations unless the originator or sponsor has retained a 5% skin in the game. Further detail on the rules is to follow at Level 2. Similar requirements are to be imposed on UCITS.

Annex 2

Implications for non EU managers

2013 – 2015

A non EU manager will be permitted to manage EU domiciled AIFs, and market AIFs (wherever domiciled) in the EU in accordance with national private placement rules (similar to the current position), provided that:

- an annual audited report containing specified financial (including remuneration) information is prepared for the fund, and prescribed information relating to the fund is disclosed to investors and reported to regulators;
- information exchange agreements are in place between the regulators of the EU countries in which the fund is to be marketed on the one hand, and the non EU manager's home regulator and the fund's supervisory authority on the other; and
- the fund's domicile is not on the Financial Action Task Force blacklist.

It should be noted that, from 2013, EU countries will be entitled to restrict their private placement regimes. This could mean that those countries which are not well disposed to non EU managers could effectively prevent non EU managers from marketing their funds to domestic investors.

EU managers of AIFs which obtain authorisation pursuant to the Directive will be able to obtain a "passport" to market their funds to professional investors throughout the EU from implementation of the Directive in 2013. Accordingly, from 2013 – 2015 (and possibly longer), non EU managers may be at a disadvantage in terms of access to EU investors for their AIFs, compared to EU managers with the "passport".

Non EU private equity firms will also have to comply with disclosure obligations on stakebuilding (starting at 10% of voting rights) in unlisted EU companies, and more onerous obligations where "control" of listed or unlisted EU companies is obtained. As noted above, there are also requirements designed to prevent "asset stripping" of EU companies controlled by funds.

2015 – 2018

Subject to review and recommendation by ESMA, non EU managers may become eligible to be authorised and regulated on the same basis as EU based firms, and to obtain a "passport" to market their funds to professional investors throughout the EU. The definition of "professional investor" is a narrow one and will exclude many high net worth and sophisticated individuals. A non EU manager wishing to follow this route will need to apply to a particular EU regulator for authorisation, submit to that regulator's supervision and appoint a legal representative in that jurisdiction to liaise with the regulator. There will also need to be OECD compliant tax information exchange agreements in place between the fund's home jurisdiction and all Member States into which it is marketed.

The national private placement regimes will continue in parallel to the "passport" route at least until 2018. Since authorisation under the Directive brings with it very onerous compliance requirements, non EU managers may well prefer to continue to market their funds under the national private placement regimes, unless these become unduly restrictive.

From June 2015, non EU firms managing EU domiciled funds will need to be authorised under the Directive, however there is a lighter "registration only" regime for smaller fund managers.

2018 onwards

Assuming that the "passport" regime is implemented in 2015, the Directive envisages that the national private placement regimes could be terminated entirely, leaving full authorisation under the Directive as the only option for non EU managers wishing to continue marketing their AIFs to EU investors. However, this will not happen before mid 2018 and is subject to a further review and recommendation by ESMA. It is also possible that the national private placement regimes will continue indefinitely.

Passive Marketing

There is an important exemption for passive marketing or reverse solicitation, so that EU investors will be able to invest in funds managed by non EU managers which do not choose to comply with the Directive at their own initiative, provided there is no active marketing or solicitation by the manager or the fund. However, it is not yet clear what the scope of this exemption will be in practice, or the extent to which EU investors will be willing to invest on this basis.

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