

The EU Directive on Alternative Investment Fund Managers

The AIFMD seeks to create a regulatory framework that affects not only EU funds and their EU managers but also managers and funds established outside the EU. The introduction will depend on the outcome of reviews by, and the issuance of advice by, the new European Securities and Markets Authority (ESMA) and the implementation by the Commission of secondary legislation in the form of delegated acts.

The AIFMD will be passed under the four-tier "Lamfalussy process" for EU financial services legislation. "Lamfalussy" directives are split into two levels – the "Level 1" directive, which establishes the guiding principles of the legislation, and "Level 2" implementing measures. FMConsult understand that, in the case of the AIFMD, the Commission has a preference for the "Level 2" implementing measures taking the form of regulations, rather than directives. Regulations are of direct effect and therefore do not leave any room for Member States to adjust the provisions of the legislation to the circumstances of their markets,

Article 4 defines what constitutes an alternative investment fund:

*"AIF" or 'alternative investment fund' means any collective investment undertaking, including investment compartments thereof,
(i) 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
(ii) which does not require authorisation pursuant to [the UCITS Directive]."*

Although "collective investment undertaking" is not defined in the AIFMD, it is likely that not only collective investment schemes such as limited partnerships would be considered collective investment undertakings, but also closed-ended investment companies such as investment trusts and venture capital trusts. This is in line with the definition of the same term in the Prospectus Directive and with the view of the UK Financial Services Authority as stated in draft guidance in the context of MiFID (albeit that both pre-dated publication of the Commission proposal for the AIFMD).

What does it mean for Managers of Non-European ("Non-EU") Funds?

The EU Directive on Alternative Investment Fund Managers ("Directive") has now been approved by both the European Parliament and the Council of the European Union (the "EU") and against all odds the final text makes it clear that the Non-EU Hedge Fund will exist going forward whether they are managed or marketed in the EU or elsewhere.

In summary the Directive will regulate the marketing of Funds established outside of Europe through the provisions relating to Third countries, and in particular "Chapter VII" of the Directive. Fund Managers will continue to be able to market Non-EU Funds to EU investors under private placement rules, accept "passive placement" of EU investors and run managed accounts for EU investors. FMConsult fully expect the Non-EU jurisdictions to work with the EU authorities to allow Non-EU Funds to qualify for an EU passport in due course.

The Directive regulates marketing to EU investors based on:

- (a) where the Manager is based;
- (b) where the Fund is established; and
- (c) when the marketing is to take place.

Phase 1: Now until early 2013

The Directive only has application once it is implemented by the relevant member states. Each EU nation has two years to implement the Directive. Assuming the Directive is finalised at an EU level in January 2011 (as expected), it will be implemented in 2013. Until then, there is no change to how Managers based in the EU or outside the EU can market their Funds to EU investors.

Phase 2: 2013 to 2015

Once the Directive comes into force at a national level, the regime governing marketing to EU investors will be determined by where the Manager and the Fund is based. If a Manager is established in the EU and is managing a Fund established in the EU it will be able to apply for a passport to market its EU Fund to "professional investors" across the EU. If the Manager is not established in the EU or the Fund is not established in the EU, then the current private placement regimes will apply to enable the marketing of the Fund within the EU.

Phase 3: 2015 to 2018

Two years after the Directive is implemented, the ESMA will recommend whether or not the passport regime should be extended to third countries. The EU Commission, with the consent of the Parliament and the Council, will then decide whether or not to follow that recommendation.

If it is agreed that the passport regime should be extended to include third countries then there will be a period of a further three years where third country Funds and third country managers may choose whether or not to apply for the passport or to continue to use a private placement regime; after which private placement will fall away and third country Funds and third country managers will only be able to market in the EU with a passport. If ESMA, the Commission, the Council or the Parliament decide that the passport regime should not be extended to third countries then the private placement regime will continue indefinitely.

Phase 4: 2018 and beyond

If the passport regime is made available to third countries, then managers and Funds from outside the EU will only be able to market to EU investors with such passport. If the passport regime is not extended, then the private placement regime will continue indefinitely.

Summary of the Private Placement Regime

Currently, marketing to EU investors is governed by individual member state national law. That approach will continue until at least 2018 (as above) provided that, once the Directive has been implemented (2013), there are appropriate co-operation arrangements in place between the relevant EU and third country regulator(s) and the third country is not listed as unco-operative by the Financial Action Task Force ("FATF").

Exactly who the cooperation agreements must be between depends on the location of the Fund, the Manager and the country in which the Fund is to be distributed.

- (a) In the case of an EU manager of a Third Country Fund (e.g. a London manager of a Cayman Fund) the cooperation agreement must be in place between the Manager's regulator (e.g. the Financial Services Authority (the "FSA")) and the Fund's regulator (e.g. the Cayman Islands Monetary Authority ("CIMA")).
- (b) In the case of a third country manager of an EU Fund (e.g. a US manager of an Irish Fund) the cooperation agreement must be between the Manager's regulator (e.g. the Securities and Exchange Commission (the "SEC")) and the Fund's regulator (e.g. the Central Bank of Ireland).
- (c) In the case of a third country manager of a third country Fund, the cooperation arrangements will need to be between the Manager's regulator (e.g. the SEC), the Fund's regulator (e.g. CIMA) and regulators in each of the EU member states in which the Fund will be marketed (e.g. the FSA). Current arrangements are sufficient but there is a further two years for that to be determined or addressed.

Although this sounds involved, in practice FMConsult expect that these arrangements will not be problematic for Funds established in, say, the Caribbean. There are already bilateral cooperation agreements in place between many of the relevant regulators in the Caribbean and the US. There is also an existing IOSCO Memorandum of Understanding to which the relevant regulators in the Cayman Islands, the BVI, the USA and 23 out of 27 EU member states are already signatories which provides for cooperation arrangements in a manner which is consistent with the obligations of the Directive. Although it is yet to be confirmed whether these existing arrangements will be sufficient as they stand or require modification,

the framework and substance of these arrangements are already in place, long standing and comprehensive. There should be no difficulty finalising them in the two years prior to implementation. Furthermore both the Cayman Islands and the BVI are compliant with FATF guidelines on anti-money laundering.

For a third country manager to use the private placement regime it will also need to comply with the "transparency" requirements of the Directive. The "transparency" requirements effectively comprise reporting and disclosure obligations. In summary:

- (a) an annual report to be filed with the relevant EU regulators within six months of the financial year end;
- (b) the Directive introduces disclosure requirements the majority of which would already be satisfied by a well drafted offering document; and
- (c) periodic reporting to EU regulator(s) in relation to trading activity; risk management; leverage information; and systemically relevant information.

However, third country managers will not have to comply with any other aspects of the Directive, including remuneration restrictions, leverage restrictions or depository requirements.

EU managers will have to comply with the Directive irrespective of where their Fund is established. However, if they choose to privately place a Fund established in a third country then they will not have to comply with the depository requirements of the Directive. Therefore, while they would not be able to avail themselves of a passport they would be able to continue to market their Funds to the same category of investors to whom they currently market to without having to introduce a depository to the structure.

Exemptions

There are certain circumstances in which the Directive will not apply at all. These include:

- (a) hedge funds with AUM €100 million or less; private equity funds of AUM €500 million or less;
- (b) securitisation special purpose companies;
- (c) single investor Funds (i.e. managed accounts); and
- (d) Funds that are only sold in the EU on a "passive placement" or "reverse solicitation" basis.

The latter two exemptions are particularly important for managers located outside the EU since it means that they can accept subscriptions from EU investors if they do not initiate the approach (passive placement) and it also means that managed accounts can be run for single EU investors outside of the scope of the Directive.

I am a US Manager of a Cayman Fund - what does this mean for my ability to access EU Investors?

For the next two years: Nothing changes at all for the next two years - you can continue to market your Funds under private placement rules as you have to date.

From 2013 to 2015: You will be able to continue to privately place your Cayman Fund in the EU by complying with the "transparency" provisions of the Directive and any applicable EU member state requirements. Otherwise, the Directive will not apply to you; but equally you will not be able to obtain a passport for cross border marketing within the EU.

From 2015 to 2018:

- (a) You may be able to obtain a passport for cross border marketing in the EU. That will require a decision to that effect by ESMA, the Commission, the Parliament and the Council in about 2015, two years after implementation.
- (b) If so, to get the passport you will have to comply with the Directive in full; you will have to apply for authorisation/supervision by an "adopted" EU regulator; and the US and the Cayman Islands will have to both pass the "three tests" set out above.
- (c) If you do not get a passport you will continue to be able to use the private placement regime until at least 2018.

From 2018 and beyond:

(a) If the passport is introduced for third countries, you will be required to obtain one to continue to market in the EU. We expect your Cayman and BVI Funds to be eligible for a passport, if it is made available.

(b) If the passport is not made available to third countries in 2015, private placement will continue to be available indefinitely.

Always: You will always be able to:

(a) retain existing EU investors in your existing Funds;

(b) reverse solicit or passively place your Fund in the EU; and

(c) run managed accounts for single EU investors.

The most likely outcome for a US manager with a Cayman Fund is the status quo: the ability to privately place, subject to local law, until at least 2018 with additional reporting and disclosure obligations; the ability to reverse solicit EU investors; and the ability to run managed accounts for single EU investors.

I am a UK Manager of a Cayman Fund - what does this mean for my ability to access EU Investors?

For the next two years: Nothing changes at all for the next two years - you can continue to market your Funds as you have to date.

From 2013 to 2015: You will be able to continue to privately place your Cayman Fund in the EU. You will have to comply with the Directive EXCEPT Article 21 in relation to Depositories. That could be a significant advantage.

From 2015 to 2018:

(a) You may be able to get a passport to market your Cayman Fund. That will require a decision to that effect by ESMA, the Commission, the Parliament and the Council two years after implementation. Cayman is fully expected to meet the three tests set out above

(b) If you do not get a passport you will continue to be able to use the private placement regime until at least 2018.

From 2018 and beyond: If the passport is introduced for third countries, you will be required to obtain one to continue to market your Cayman Fund in the EU. If the passport is not expanded to third countries in 2015, private placement will remain available indefinitely.

Always: You will always be able to:

(a) retain existing EU investors in your existing Funds;

(b) reverse solicit or passively place your Fund in the EU;

(c) run managed accounts for single EU investors.

So what does this mean for my choice of fund domicile?

For existing Funds: the status quo; i.e. the ability to privately place, subject to local law, until at least 2018; the ability to reverse solicit EU investors; and the ability to run managed accounts for single EU investors. Unless the Fund's target investor base is particularly Eurocentric, it is unlikely to be desirable to re-domicile the existing Fund and, even if the target investor base is Eurocentric, an additional parallel European Fund (Irish Funds being particularly popular), or feeder fund, is likely to be as easy to establish and will compliment your existing BVI or Cayman Funds and will maximise global distribution opportunities.

For new Funds: a careful consideration of whether the benefits of the EU passport will offset the detriment of the depository requirement; the ease of establishing a Fund in Cayman and the global distribution opportunities a Cayman Fund enjoys. Parallel structures may, in certain circumstances, be the most effective outcome.