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AIFMD ESSENTIALS

A guide to the Alternative Investment Fund Managers Directive

MEMBER SERVICES

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FOREWORD

Michael Collins
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Although it is now four years since the Alternative Investment Fund Managers Directive (AIFMD) entered into force it has continued to evolve. At the EU level there have been various implementing measures and interpretive guidelines and the 28 Member States have all put their own gloss on the Directive's core provisions in their domestic implementation and application.

In light of these developments – and with the review of the Directive now receding – spring 2017 is the right time to produce an updated version of Invest Europe's AIFMD Essentials. As a member this is your comprehensive guide to the AIFMD, unique in explaining purely from a private equity perspective the Directive's key provisions from scope and authorisation to fund structuring, portfolio company management and the third country regime. The text has been fully reviewed to reflect all the key developments since we produced the first edition in 2013.

This guide is just one of the ways that Invest Europe ensures its members can stay abreast of a regulatory agenda that changes constantly. The member section of the website contains detailed guides on other regulatory issues and each month we have a policy call for members, providing the very latest updates on these issues and a chance for you to hear directly from our experienced public affairs team.

The AIFMD is by far the piece of EU law with the biggest direct impact on the private equity and venture capital industry. We remain committed to ensuring that Invest Europe members are well-informed about its current requirements and its evolution over time. I hope that you find the 2017 edition of AIFMD Essentials to be as useful as the 2013 edition.

Finally, I would like to thank all of the Invest Europe members who have given their valuable time to help to produce this guide.

SECTION 1

SCOPE

SCOPE

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Overview

The AIFMD regulates the management and marketing of alternative investment funds (AIFs) in the European Economic Area[1].

AIFs are a particular type of collective investment undertaking (referred to as funds) that raise capital from a number of investors with a view to investing that capital in accordance with a defined investment policy and which are not otherwise caught by the UCITS Directive. These include most types of private equity fund. This is because all investment vehicles, irrespective of legal form, are likely to be seen by national authorities as raising capital from investors for the purpose of collective investment. Whether or not specific vehicles, such as co-investment vehicles, are categorised as AIFs may differ between Member States based on national interpretations and the specific facts.

Fund management includes taking investment and divestment decisions and/or controlling investment-related risks, and may also include a number of ancillary activities such as marketing, administration and the provision of services to fund assets. Marketing is best understood as making fund-related securities available for purchase within the EEA by locally-based investors (so typically in private equity, offering participations in a fund). This includes both direct offerings and, for example, those made available indirectly through a placement agent.

Managers operating only closed-ended, unleveraged funds in the EEA with aggregate assets worth EUR 500 million or less (calculated on a rolling basis in accordance with the AIFMD Regulations), need only comply with national registration and reporting requirements. If these managers want the benefit of a passport to make an offering in different EEA Member States, then they must either opt-in to the scope of the AIFM Directive or make use of any other passport rights that may be available (e.g. under the EuVECA[2], EuSEF[3] or ELTIF[4] Regulations) or continue to rely, on a case-by-case basis, on applicable national placement rules to the extent that these are available.

Notes

1. The European Economic Area (EEA) unites the 28 EU Member States and the three EEA EFTA States (Iceland, Liechtenstein, and Norway). The AIFMD relates directly to the EU and was only incorporated into the EEA Agreement by Joint Committee Decision on 30 September 2016.
2. Regulation (345/2013) of the European Parliament and of the Council of 17 April 2013 on European venture capital funds.
3. Regulation (346/2013) of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds
4. Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds

SCOPE continued

General

The AIFMD is intended to establish a harmonised regulatory framework for the management and marketing of AIFs in the EEA.

The Directive regulates the manager (AIFM) rather than the AIF itself. An AIF may be additionally regulated and supervised at national level, for example if it is an Irish Qualified Investor Fund (QIF) or similar. The Directive applies to AIFMs established in any Member State of the EEA which manage one or more AIFs irrespective of where the AIF is established. In addition, the Directive partially applies to AIFMs that are established outside the EEA to the extent that they offer or place interests in EEA and non-EEA AIFs to investors resident or established within the EEA.

In the future the Directive should also apply to non-EEA managers managing AIFs established in or outside the EEA when and to the extent that the EU passporting provisions are extended to the jurisdictions in which they are established (see Section 6). The AIFMD does not apply to managers that neither manage nor market AIFs in the EEA.

The scope of the AIFMD is particularly important because it will also be relevant for other regulatory and fiscal initiatives within the EEA including for example, EMIR[5] at AIF and AIFM levels and Solvency II (insurance), IORPD (pension funds) and BSR (banks)[6] at investor level. This is because private equity and venture capital managers as "regulated entities", together with the AIF, are now defined participants in the EEA financial markets legal infrastructure.

Alternative Investment Funds

Collective investment undertakings (referred to as funds) can take any legal form. Funds are best understood as undertakings that apply capital raised from a number of passive investors for the purpose of collective investment with a view to achieving a pooled return.

Pooling occurs between investors participating in a legal arrangement (e.g. a company, limited partnership, contractual scheme or a trust) which results in the sharing of investment risks. A private equity fund comprising multiple partnerships will normally comprise multiple AIFs (unless, perhaps, the different pools are identical).

Funds (other than UCITS) constitute AIFs if they:

- raise 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.

Capital-raising is best understood as the process of facilitating subscriptions. An investment policy must be set out with a requisite level of definition in an offering or other communication. A defined investment policy is a fixed ongoing obligation that restricts the AIFM from carrying on general business (although the fact that it is not technically binding or full discretion is left to the AIFM should not be used to facilitate circumvention). The investment policy must be defined in relation to investors and, therefore, commercial investment undertakings acting in the ordinary course of trade would not have a defined investment policy for the purposes of the Directive[7].

Generally, an entity should not be considered as an AIF unless all the elements of the definition are present. The definition of AIF is sufficiently wide to include most investment vehicles and when determining whether an investment vehicle is an AIF it is important to consider these elements in the round. In this regard it is helpful to look at whether an AIFM is present, the purpose of which is to provide discretionary investment management (and/or risk management) services to the investment vehicle, rather than the investors being in charge of managing the assets themselves, and whether the vehicle itself is seeking to raise capital, to be spent in the future in accordance with a pre-defined policy, i.e. does the relevant vehicle look and behave like an AIF with a prospectus (or equivalent) and external investors.

Each AIFM will need to identify which entities (it is providing services to) constitute an AIF (see Figure 1 below).

Although ESMA has published technical guidance on these concepts in order to ensure common, uniform and consistent interpretation across the EEA, jurisdictional differences in interpretation do exist. This is because the term 'AIF' is not specifically defined by it and the concept of a collective investment undertaking has different established use across the EEA.

EEA AIF

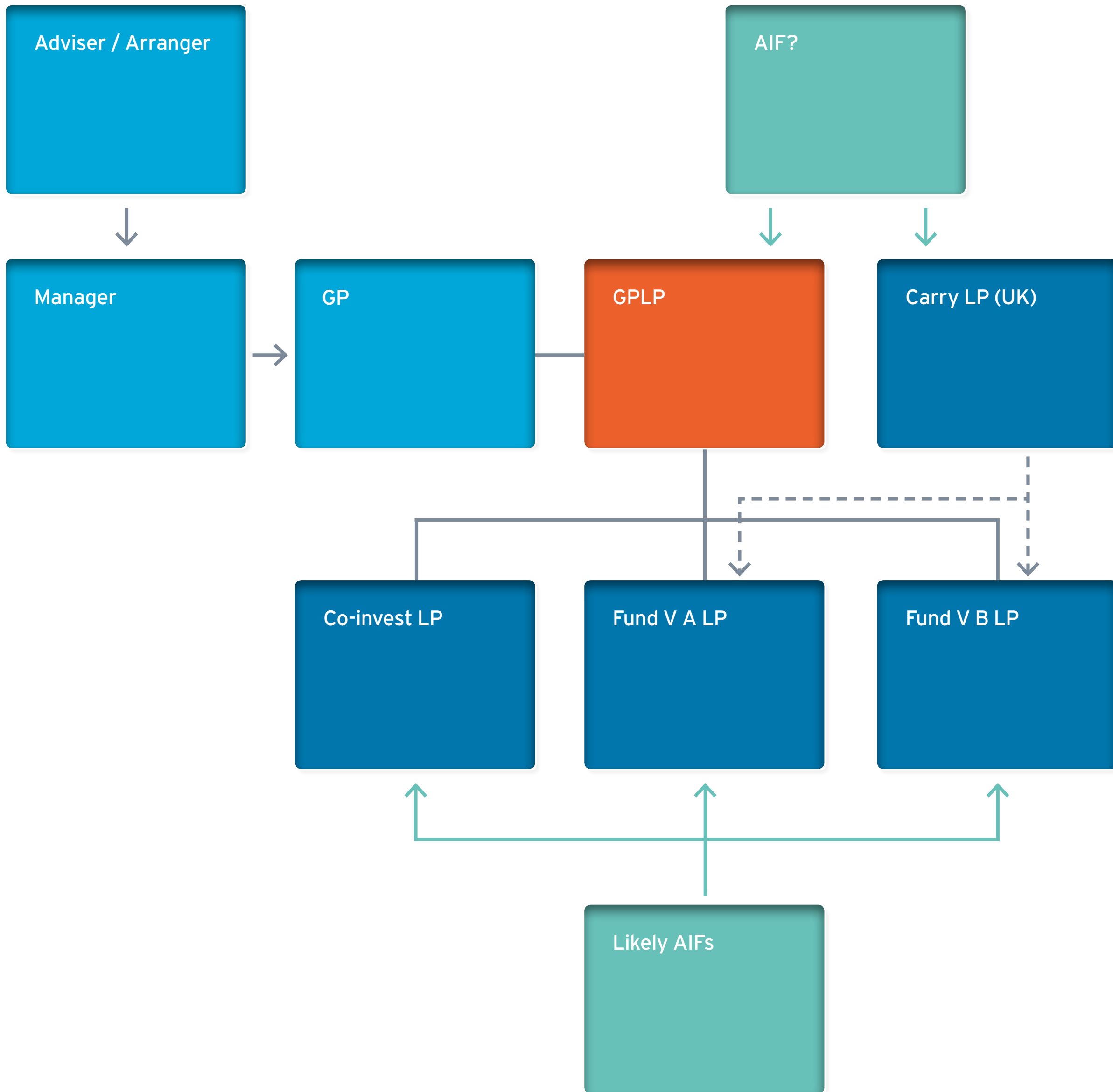
An AIF should be defined in accordance with the law of its domicile though regulators considering marketing in their jurisdiction are likely to apply their local interpretation. An AIF is an EEA AIF if it is authorised or registered as an AIF in a Member State or otherwise has a registered office in a Member State.

Notes

5. Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
6. For further details see http://www.investeurope.eu/about-private-equity/for-investors/investor-regulation/
7. Guidelines on the key concepts of the AIFMD issued by the European Securities Markets Authority (ESMA/2013/611) distinguish between collective investment undertakings whose policy is to generate a pooled return by reference to investment guidelines and undertakings which have a general commercial or industrial purpose.

SCOPE continued

Figure 1: Identifying AIFs



SCOPE continued

Out of scope

The following investment vehicles do not qualify as in-scope AIFs under the AIFMD:

1. Vehicles that fall outside the definition of an AIF in different jurisdictions:

These could include on a case-by-case basis:

a) Single investor funds, unless the single investor is simply a nominee for multiple investors or part of another arrangement achieving the same result;
b) Vehicles established for non-business related purposes where the purpose is not to achieve a return;
c) Undertakings carried on for a general commercial or industrial purpose and not collective investment;
d) Commercial joint ventures between active participants where, for example, i) no single party or parties is (are) in de facto control with the other parties being passive and/or ii) capital is not raised from external parties;
e) Private equity acquisition vehicles beneath a fund (including those where management participates);
f) Arrangements that do not pool capital and are separately managed, such as separate accounts or possibly some co-ownership arrangements (provided that they are not seen as an AIF in the relevant state);
g) Vehicles that do not raise external capital, such as some family offices and carried interest vehicles;
h) Staff carried interest and co-investment schemes (but probably not if participation is offered more widely to e.g. "friends" of the manager); and
i) Vehicles which are not naturally intended to have a binding investment policy, such as some pledge or club arrangements.

If a vehicle is not structured as a fund, then it is likely to be out-of-scope. The AIFMD is targeted at funds. Care should be taken, however, since the definition of an AIF is broad and regulators have made it clear that they will look to the substance of the arrangements. Furthermore, ESMA's guidance is concerned to ensure that structuring is not used to avoid the purpose of the AIFMD.

2. Funds managed by AIFMs falling below the applicable threshold tests (see pages 13 & 14);

3. Other exempted vehicles including:

a) AIFs whose only investors are other group companies of the manager, provided that none of those investors is an AIF;
b) holding companies, which are defined as companies carrying out a business strategy or strategies through their affiliates in order to contribute to their long-term value. Such companies should be operating for their own account if listed on a regulated market in Europe, although the mere fact of being listed is not in itself enough to warrant exemption, or not established for the purpose of generating returns for investors by the sale of its subsidiaries or affiliates. The term 'company' is intended here in a broad sense and understood generally to cover undertakings;
c) employee participation schemes and employee savings schemes, which are likely to include staff carried interest and co-investment schemes even when the staff are not technically employees; and
d) certain securitisation special purpose vehicles (as described by reference to ECB Regulation 24/2009) including most Collateralised Loan Obligation vehicles.

4. Any additional vehicles excluded at a national level:

- Such as, possibly, real estate investment trusts in certain Member States, though generally the classification of such REITs depends on whether the particular vehicle is regarded as having a general commercial or industrial purpose.

SCOPE continued

In or out of scope?

Determining whether an investment vehicle should be classified as an AIF is important as it will in part determine whether the vehicle and its manager are in or out of scope of the Directive.

Questions remain over the advantages and disadvantages of being in scope. Although in-scope funds benefit from the EU wide marketing passport and some reduced investor regulation they, through their managers, are heavily regulated. Out-of-scope funds on the other hand, remain somewhat simpler from a compliance perspective, are correspondingly cheaper to run and may not suffer as much from product risk, given the constantly changing EU legislative framework and the prospect of AIFMD II, though this has to be balanced against the risk that an out-of-scope vehicle may subsequently be re-characterised as being in scope.

Management

Each AIF based within the EEA must appoint an external management company as an AIFM unless its legal form permits internal management in which case there is a choice between internal and external management. It is this external AIFM, or the AIF itself where internally managed, which is subject to authorisation and regulation (including restrictions on its activities).

Internally or externally managed?

Internal and external management is not precisely defined by the AIFMD. An internally managed AIF would logically include a corporate AIF managed by its board of directors without appointing an external manager, but the position of a general partner of a limited partnership is less clear and, where the general partner is the AIFM, the limited partnership could be viewed as internally or externally managed depending on the jurisdiction. This distinction is important as, amongst other things, it determines what minimum capital requirements will apply.

"Managing" the AIF means providing by way of regular business at least the following:

- Portfolio management (taking investment and divestment decisions on behalf of the AIF); or
- Risk management (establishing and implementing risk management procedures and policies for identifying risks, e.g. ensuring a fund does not over commit, makes timely drawdowns and distributions, respects diversification rules, handles foreign exchange risks etc.).

This is a binary test that may result in an AIF having more than one manager. Where an AIF does have more than one manager, the managers must decide between themselves which is the AIFM that will be primarily responsible for ensuring compliance with the Directive (see Figure 2 below). The second manager who is not responsible for ensuring compliance with the Directive will need to become a delegate of the AIFM if investment management (as defined in the Directive) is taking place in the EEA because the AIFMD does not allow AIFs which are managed in the EEA to have more than one AIFM.

Dual managers

The need for dual managers could arise in a private equity context where, for example, a non-EEA (investment) manager managing an EEA AIF wanted to access the marketing passport. This could be achieved by appointing a duly authorised EEA manager assuming responsibility for risk management while delegating portfolio management to the non-EEA based investment manager.

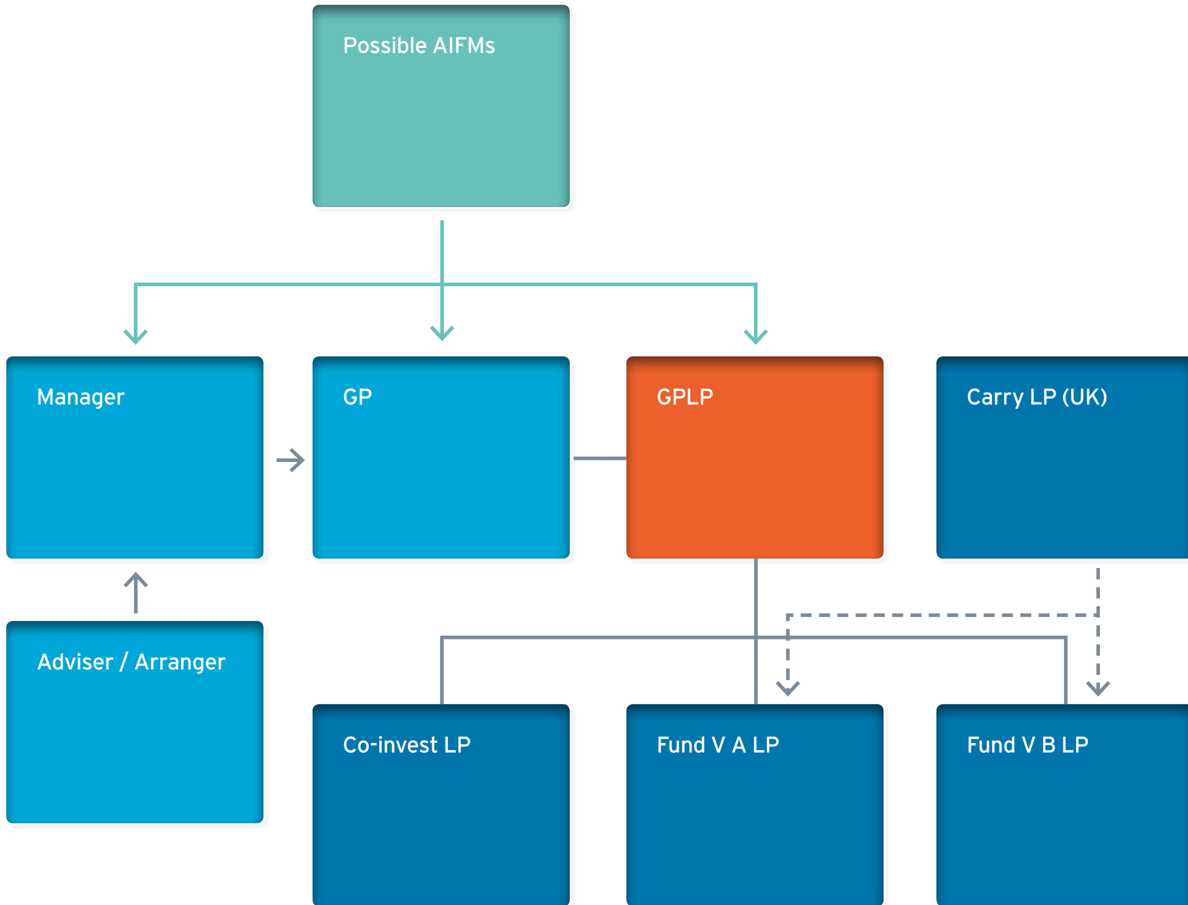
Whichever entity is an AIFM, the term "managing" will essentially consist of a limited number of activities where investment management or risk management is performed in a classic private equity context.

The manager may also perform ancillary activities such as administration or marketing of the AIF or other services related to fund assets; however, none of these ancillary activities on their own constitute investment management as defined in the Directive. ESMA has given guidance to the effect that an AIFM will always be deemed to be responsible for such ancillary activities and that, where another person performs them, this will be considered to be a delegation. This guidance is controversial.

Management should not be confused with other activities related to the assets of the AIF, and does not include standalone investment advice. Investment advice is identified as a non-core service.

SCOPE continued

Figure 2: Identifying AIFMs



SCOPE continued

Marketing

The term 'marketing' has a specific meaning under the AIFMD. It is defined as the offering, or placement within the EEA of fund-related securities to investors which are domiciled, or have a registered office, within the EEA where the offering or placement is by, at the initiative of or on behalf of the AIFM.

It does not ordinarily include broader promotional activities carried out by related parties (i.e. the key question is whether units or shares of an AIF are being made available by the AIFM for purchase by potential investors). It should be clear in most circumstances from the documents themselves when a contractual offering or placing is being made as opposed to a general promotion. In order to be "marketing" within the scope of the Directive, therefore an offer, or placing, must be at the initiative of the manager, and may be made directly by it, or indirectly by an agent acting on its behalf (such as a placement agent).

Some Member State regulators (including those in Germany, Luxembourg and the UK) have expressed that in their view "marketing" is something, which happens late in a fund-raising process, when the investor has all of the information they need to make a decision about whether or not to invest.

On that basis, the definition of marketing does not include pre-closing discussions or broader promotional activities including the provision of draft or generic documents to potential investors. On the other hand, such activities could be subject to local laws and rules, such as the financial promotion regime in the UK.

Other Member State regulators place less emphasis on the definition of "marketing" in the Directive and interpret the term as including earlier stage promotional activities.

Generally, secondary market activity in AIF interests does not involve "marketing" because it is not at the initiative of the AIFM or on behalf of the AIFM. This may be particularly relevant in relation to existing listed AIFs.

In addition, marketing does not occur where an EEA-based investor invests in an AIF at its own initiative. This is called 'reverse solicitation'. It is already a concept recognised in some countries where complex marketing restrictions apply. There is at the time of writing no consensus between EEA regulators as to what constitutes "reverse solicitation". Interpretations are likely to differ between Member States.

For example, it must in theory be possible for an existing investor in an AIF raised before the Directive came into force to approach the manager entirely at his own initiative with a view to investment in a successor AIF managed by the same manager (which had not been marketed to that investor owing to restrictions imposed by the Directive or local private placement regimes). Everything will turn on the facts in the particular case. However, it is possible that regulators and courts in some Member States might not agree.

It is therefore very important to create a clear audit trail if an investor proposes investment at his own initiative.

The terms 'unit' and 'share' are intended to be generic and may be interpreted as encompassing all forms of AIF-related interests (including partnership interests and some "hybrid" debt interests).

SCOPE continued

Managers whose AIF assets under management fall below certain thresholds

EEA-based AIFMs that manage:

- AIF portfolios whose aggregate assets, including any assets acquired through the use of leverage, in total do not exceed EUR 100 million; or
- Portfolios of AIFs whose aggregate assets in total do not exceed EUR 500 million where the AIF portfolios managed consist only of AIFs that are not leveraged and have no redemption rights exercisable during the first 5 years following the initial closing of such AIF (i.e. a typical private equity fund arrangement),

can be subject to a simplified registration and reporting regime in the relevant jurisdiction and are exempted from the other requirements of the AIFMD.

For these purposes a manager must include assets under management (AUM) of AIFs which are managed by it directly, or indirectly through a company with which the manager is linked by common management or control, or by a substantive direct or indirect holding. This is an anti-avoidance provision and the mere fact that two managers of clearly separate funds are under common control should not require their assets to be aggregated for the purposes of applying the *de minimis* size thresholds to either of them.

For the purposes of applying the small fund managers' exemption, leverage is defined as any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash, or securities, or leverage embedded in derivative positions or otherwise.

The Level 2 Regulations also make clear that borrowing undertaken by private equity acquisition companies should not be considered to be leverage of the AIF, where its limited recourse nature does not increase the exposure of the AIF, so that, for example, the AIF does not guarantee portfolio company borrowing. There is scope for interpretation however, and national variations may exist.

If an AIF borrows monies on a short-term basis to pre-fund capital calls backed by investor commitments (i.e. a typical investor bridge facility), then this should not constitute leverage (as long as the borrowing is not expressed to have a permanent or rolling nature and it is always fully covered by undrawn commitments).

For these purposes, assets under management means gross asset value calculated in accordance with the valuation rules set out in the AIF's own constitutional documents. This is likely to be lower than committed capital.

Impact on Investors

No EEA investor (professional or not) is subject to the AIFMD in its capacity as an investor. The AIFMD only deals with the authorisation of AIFMs, i.e. managers, and the compliance burden falls squarely on them. Nonetheless, the impact of the cost of compliance is something that will impact investors insofar as any such costs are borne by the AIF. Conversely however, it should be noted that the regulatory capital cost of investing in AIFs covered by the Directive may be lower for some institutional investors than the cost of investing in AIFs which are not.

Professional investors (and non-professional investors, unless local or product placement rules apply) established in the EEA will be able to continue to invest in AIFs at their own initiative. Investors should note, however, the possibility that regulators in different Member States may take different views of what constitutes reverse solicitation and what is regarded as marketing by the AIFM.

Impact on Fund-of-Funds (FoF)

Authorisation is required under the AIFMD if a FoF manager intends either to manage or market an AIF within the EEA. The authorisation is applied to the FoF manager, as the AIFM of the FoF. Investments made by that FoF in underlying AIFs are made as an investor only, and the AIFM of the FoF has no obligations in relation to the management of the underlying AIF(s). A FoF (manager) is not restricted from investing in non-qualifying AIFs (such as (small) funds managed by registered managers or third country AIFs).

Please also note the specific marketing rules applicable to EEA feeder AIFs in Section 5.

SCOPE continued

Below Threshold Managers

EEA managers that are exempted from the AIFMD on the basis of the de minimis exemption (i.e. on the basis that their AUM are below the threshold) must nonetheless register with the relevant national authorities.

On registration, the manager must provide the authorities with details of the AIF(s) that it manages and their investment strategies and, once registered, the manager must regularly provide information to the national regulator on the main instruments in which it trades, the principal exposures and the most important concentrations of the AIF that it manages (which in a private equity context is likely to involve disclosing the largest portfolio company investments), to facilitate the ongoing monitoring of systemic risks. The precise nature of this registration regime varies from jurisdiction to jurisdiction and in some countries a full authorisation and compliance regime applies.

The AIFMD does not otherwise apply to managers with AUM below the threshold unless a Member State chooses to apply it in this way to AIFMs established in its jurisdiction. In particular, the Directive's rules concerning delegation of portfolio or risk management (one of which concerns "letter-box entities" – see page 58) will not apply to them.

While managers below the thresholds do not benefit from the passports granted by the Directive (i.e. to manage and market funds freely across the EEA following the notification process), they may be allowed to continue cross-border marketing in the EEA but this will depend upon the national placement regimes of each Member State. If a passport is desired or required, small fund managers may opt-in to the Directive or look to make use of any other passport rights under the EuVECA, EuSEF or ELTIF Regulations.

Impact on Investors

Investors should arrange their affairs to ensure that regulatory changes do not impact their ability to invest in all AIFs.

Investors will want to be able to access AIFs and so it will be important for investors to check that registered managers are able to market their AIFs under the appropriate regime (opting-in to use the AIFMD passport or using the relevant national placement regime) or to make sure that other arrangements are made ensuring they continue to have access to different investment opportunities, irrespective of where the AIF or manager may be domiciled. This may require greater proactivity on the part of investors.

Some investors may have a preference for investing only in regulated and/or authorised AIFs and managers and for those investors they ought to consider the impact of the AIFMD on their investment policy for AIFs managed by sub-threshold managers.

Impact on Fund-of-Funds

The FoF manager is the authorised AIFM and not the underlying managers. It should be of no consequence, therefore, whether or not an underlying manager is operating under a threshold exemption.

That underlying manager does, of course, need to inform its own investors, including a FoF, of any changed status.

An underlying manager deciding to forego the threshold exemption and opt-in to the entire AIFMD may incur additional costs altering the investment case on which a FoF may have made its original investment decision, so full consultation is advisable before any such decisions are taken.

SCOPE continued

Marketing of Third Country Funds

The AIFMD will only apply to third country private equity funds with a non-EEA AIFM where an actual offering or placement is made to professional investors in the EEA, and subject to any transitional relief permitted by particular Member States.

If such an offering is made, then the AIFM must comply either with the updated rules attaching to private placement (until 2018, unless extended) or the AIFMD third country passport regime (if and when applicable). Although the third country passport regime should have been implemented by 2015, following ESMA's initial reports on the subject[8], in which they concluded that there were no significant obstacles impeding the application of the AIFMD passport to Canada, Guernsey, Japan, Jersey and Switzerland, and its most recent advice published in July 2016 [9 10], it is now clear that non-EEA managers will have to wait until at least 2018 for a decision by the European Commission to extend the AIFMD passport to third countries. During the intervening period ESMA will continue its assessment of non-EEA countries and the European Council's Code of Conduct Group on Business Taxation will complete its assessment of jurisdictions from a tax perspective, the combined results of which will be made available to the European Commission in order to inform their ultimate decision on passporting arrangements.

The ability to use the national placement regimes within the EEA is dependent on the relevant cooperation agreements being put in place between the home regulatory authority of the AIFM and the AIF (if different) and each EEA Member State into which the AIF is marketed (see Section 6 and Annex 1). Although the vast majority of third country jurisdictions in which funds are commonly structured have concluded such agreements with all relevant EEA Member States, there are notable jurisdictional differences concerning the ease with which marketing through national placement can be achieved across the EEA.

Where a third country fund does not constitute an AIF in an EEA Member State, existing marketing rules will continue to apply. This would include the right to publish a prospectus in the EEA.

Impact on Investors

To enable continued access to third country AIFs, investors will need to ensure that the AIFMs of such AIFs have understood the arrangements, which apply so as to be able to continue to market under the various national placement regimes. In jurisdictions where national placement regimes are impossible to comply with in a commercial way, investors may need to rely on reverse solicitation.

Notes

8. ESMA's first advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs
9. ESMA's second advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs
10. ESMA advises on extension of funds passport to 12 non-EU countries

SECTION 2

AUTHORISATION & REGISTRATION PROCESS

AUTHORISATION & REGISTRATION PROCESS

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Authorisation under AIFMD or registration with national regulator?

EEA managers whose aggregate AUM exceed the AIFMD threshold[11] must apply for authorisation under the AIFMD.

An authorised AIFM:

- Must comply with the AIFMD, as implemented in the relevant national jurisdiction, in full; and
- (Upon notifying its intention to do so to its own regulator) is entitled to provide investment management services and/or market interests in EEA AIFs to professional investors across the EEA.

Sub-threshold EEA managers whose aggregate AUM do not exceed the AIFMD threshold:

- Must register with their local financial services regulator and comply with basic regulatory reporting obligations; or
- May apply for authorisation under the AIFMD on a voluntary basis in order to benefit from passporting rights.

Registered sub-threshold managers that do not opt-in to the AIFMD may, if eligible, register under the European Venture Capital Fund (EuVECA) or European Social Fund (EuSEF) Regulations in order to benefit from passporting rights under those respective regimes.

Notes

11. EUR 500 million for AIFMs which manage unleveraged funds with no redemption rights in the first five years and EUR 100 million for other AIFMs. See Section 1 for more information.

AUTHORISATION & REGISTRATION PROCESS continued

When must firms apply?

The authorisation regime for EEA managers came into effect when the AIFMD came into force on 22 July 2013. Those firms which were already acting as an AIFM prior to 22 July 2013 benefited from some transitional relief, but were required to apply for authorisation by 21 July 2014. Firms which began acting as AIFM after 21 July 2013 must become authorised with their national regulator before commencing to do so.

Sub-threshold EEA managers have been subject to registration from 22 July 2013 in accordance with national law applicable in their home jurisdiction.

In the longer term, non-EEA managers ought in principle also be able to apply for authorisation under the AIFMD in order to benefit from passporting rights (see Section 6 and Annex 1). However, it remains uncertain when the first non-EEA jurisdictions will benefit from extension of the passport. Until the authorisation and passporting regime has been extended to non-EEA managers the position of non-EEA firms managing an AIF incorporated in an EEA Member State, depends on the local law of the AIF's Member State.

Applying for registration (sub-threshold firms)

The practical aspects of the registration process will be determined by individual national regulators. However, the information to be provided on registration is prescribed by the AIFMD.

On registration, sub-threshold firms must provide the following information:

- Total AUM;
- A description of the investment strategy for each AIF managed (e.g. a copy of, or extract from, the offering memorandum) specifying at least:
  - The main categories of assets in which the AIF may invest;
  - Any industrial, geographic or other market sectors or specific classes of assets which are the focus of the investment strategy; and
  - A description of the AIF's borrowing or leverage policy.

This information must be updated annually, or more frequently if required by the regulator.

Applying for authorisation under the AIFMD

The practical aspects of the application process will be determined by individual national regulators. However, the content of the application is prescribed by the AIFMD.

The application must include:

- Information about the persons who effectively conduct the business of the AIFM *(core)*;
- Information on the direct or indirect 10%+ shareholders (or members) of the AIFM *(core)*;
- Details of the firm's organisational structure, including how it intends to comply with its obligations under the AIFMD *(core)*;
- Information on the firm's remuneration policies and practices *(core)*;
- Information on any delegation of functions *(non-core)*; and
- Information on the fund(s) to be managed, including:
  - Country of establishment (including where the master fund is established, if the fund is a feeder fund) *(core)*;
  - Investment strategy *(core)*;
  - Policy on use of leverage *(core)*;
  - Risk profile *(core)*;
  - Depositary information *(non-core)*;
  - The fund agreement or other constitutional document *(non-core)*;
  - The information required to be provided to investors before investment, as prescribed by the AIFMD *(non-core)*.

However, it is not necessary for a UCITS management company to duplicate information already provided under the UCITS Directive.

The regulator is obliged to determine the application for authorisation once the information identified above as "core" information has been provided. If, however, any "non-core" information is provided subsequently to the main application, the AIFM must not undertake fund management activities until at least one month after all required information (core and non-core) has been submitted. This applies even if authorisation has already been granted on the basis of the core information provided in the main application.

Once authorised, the firm must notify the regulator in advance of any material changes to this information. There is then a one-month waiting period (which may be extended by a further month) in which the regulator may reject the changes or impose restrictions.

How does the regulator determine whether authorisation should be granted?

To grant authorisation, the regulator must be satisfied that[12]:

- The AIFM will be able to comply with the AIFMD;
- The AIFM has sufficient regulatory capital, as prescribed by the AIFMD;
- The persons who effectively conduct the business of the AIFM are sufficiently experienced and of sufficiently good repute (and there must be at least two such persons);
- The substantial (10%+) shareholders of the AIFM are suitable;
- The head office and the registered office of the AIFM are in the same EEA Member State.

Notes
12. Authorised firms must meet these conditions at all times, and must notify the regulator in advance of any material changes.

AUTHORISATION & REGISTRATION PROCESS continued

The regulator may not grant authorisation if effective exercise of its regulatory function is prevented by the AIFM's close links with other persons or the laws governing such persons. The regulator will consult with other relevant EEA regulators if the AIFM is in the same corporate group as, or under common control with, an existing EEA-regulated firm.

The regulator must inform the AIFM within three months of submission of a complete application whether or not authorisation has been granted. The regulator may extend this period for up to three additional months if necessary.

If authorisation is granted, the regulator may restrict the scope of the authorisation; in particular, it may limit the AIFM to certain investment strategies.

Limitations on other business activities

An authorised AIFM may carry on the following business activities only:

- Investment management activities under the AIFMD; and
- Acting as a UCITS management company, if authorised under the UCITS Directive.

Investment management activities under the AIFMD include portfolio management and risk management.

As part of its AIFM functions, an AIFM may also undertake:

- Fund administration activities [13 14];
- Marketing activities; and
- Ancillary activities connected with the management of the AIF or its portfolio, such as providing corporate finance advisory services or real estate administration services to portfolio companies and running carried interest and staff co-investment schemes to the extent that these are not AIFs.

Firms may not be authorised under the AIFMD:

- To undertake portfolio management without also being authorised to undertake risk management, or vice versa; or
- To undertake only the ancillary activities of fund administration, marketing and/or providing corporate finance and real estate services to portfolio companies without also being authorised to undertake portfolio management and risk management for AIFs.

At the discretion of individual EEA Member States, external AIFMs may additionally be permitted to manage investment portfolios for individual clients (in effect, may offer separate managed accounts) and provide limited non-core services comprising investment advice, custody of fund interests and reception and transmission of orders pursuant to their AIFMD authorisation, but firms may not be authorised under the AIFMD:

- To perform only these additional services (as that would be a MiFID firm, not an AIFM); or
- To provide the limited non-core services without also being authorised to manage investment portfolios for individual clients.

Where an AIFM provides these additional services, certain MiFID provisions apply in relation to those activities.

Withdrawal of authorisation

The regulator may withdraw a firm's authorisation where the firm:

- Does not make use of the authorisation within 12 months;
- Has ceased acting as an AIFM for six months;
- Renounces the authorisation;
- Obtained authorisation by making false statements or other irregular means;
- No longer meets the conditions for authorisation;
- Has seriously or systematically infringed the AIFMD;

or where national law provides for withdrawal of authorisation by reason of matters falling outside the scope of the AIFMD.

Register of authorised AIFMs

ESMA will keep a central public register of all authorised AIFMs, as notified by EEA regulators on a quarterly basis.

Impact on Investors

Being able to identify if an AIFM is authorised under the AIFMD will be helpful to investors when conducting due diligence (and also when carrying out anti-money laundering compliance checks), as investors can be confident that a regulator has vetted an authorised AIFM as part of the authorisation process. It should be straightforward to check the register of the competent authority to determine an AIFM's status and will bring a degree of standardisation to the process when assessing AIFMs operating in different EU Member States.

Investors will need to be notified if an AIFM's authorisation is materially altered or withdrawn. Before committing to an AIF, investors may want to think about how they would respond to AIFMs who are authorised at the start of the life of the AIF, but who subsequently have their authorisation withdrawn. Investors may wish to ensure this is addressed in the AIF's governing documentation.

Investors may wish to consider how, if at all, their investment criteria are impacted by AIFMs who are sub-threshold and choose not to opt-in to the AIFMD (nor to the EuVECA or EuSEF). Likewise, investors may wish to consider how the AIFMD will affect the cost structures of the AIFs managed by AIFMs impacted by the AIFMD.

Notes

13. Legal and fund management accounting services; customer inquiries; valuation and pricing, including tax returns; regulatory compliance monitoring; maintenance of the unit/shareholder register; distribution of income; unit/shares issues and redemptions; contract settlements, including certificate dispatch; and record keeping.

14. ESMA has given guidance to the effect that an AIFM will always be deemed to be responsible for such ancillary activities and that, where another person performs them, this will be considered to be a delegation. This guidance is controversial.

SECTION 3

ONGOING COMPLIANCE REQUIREMENTS

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ONGOING COMPLIANCE REQUIREMENTS OVERVIEW

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Overview

The AIFMD covers the investment management of a very diverse range of AIFs and does not differentiate significantly between AIFs belonging to different alternative asset classes. With limited exceptions, the requirements laid out in the Directive are the same irrespective of the nature of the AIF under management.

This means that many requirements are not specifically tailored to private equity and venture capital and authorised AIFMs managing private equity or venture capital AIFs may have to adapt some aspects of their business model to comply.

This sub-section addresses the general organisational and conduct of business requirements applicable to all AIFMs and the following sub-sections address certain specific aspects of the compliance regime.

One area where the Directive does differentiate between strategies is the so-called 'portfolio company provisions'. These are expressly targeted at private equity and venture capital AIFMs and are addressed in Section 4, together with other compliance requirements affecting the investment process.

ONGOING COMPLIANCE REQUIREMENTS
OVERVIEW continued

Conduct of business regulation

General principles

The AIFMD introduces certain general principles with which AIFMs must comply on an ongoing basis. The general principles codify key investor protection concepts that have been applied within the private equity and venture capital industry and reflected in fund documentation for many years. Under the AIFMD, compliance by AIFMs with these obligations is supervised and enforced not only by investors but also by regulators.

An authorised AIFM is required to:

- Act honestly, fairly and with due skill, care and diligence in conducting its activities;
- Act in the best interests of: (a) the AIF(s) they manage and the AIF's investors; and (b) the integrity of the market, and comply with all applicable regulatory requirements (i.e. not just those that derive from the AIFMD) in a manner that promotes those best interests;
- Have and employ effectively the resources and procedures necessary for the proper performance of its business activities;
- Take all reasonable steps to avoid conflicts of interest or, where this is not possible, identify, prevent, manage, monitor and, where relevant, disclose those conflicts in order to: (a) prevent them from adversely affecting the interests of the AIF it manages and the AIF's investors; and (b) ensure that the AIF(s) it manages are fairly treated;
- Treat all AIF investors fairly.

The Level 2 Regulation elaborates on these general principles in significant ways, specifying criteria to be used by the relevant regulator to assess compliance by an AIFM with its high-level obligations. In practice, in many cases, the Level 2 Regulation requires the AIFM to establish (and periodically review) detailed and granular policies and procedures. Below, we summarise some of the more significant requirements.

Subscriptions and redemptions

The Level 2 Regulation requires AIFMs to provide investors with "essential information" regarding the execution or acceptance of a subscription or redemption order from investors unless another firm is required to provide investors with a confirmation, which includes the essential information.

AIFMs are also obliged to provide investors with information about the status of the order or acceptance of the subscription offer or both, upon request.

AIFMs are also required to provide investors with essential information when an investor subscribes for or (if relevant) redeems units in an AIF; however, in traditional closed-ended private equity AIFs these requirements would only apply to the initial acceptance of the commitment and not to the subsequent draw-downs and distributions.

The term "essential information" means the:

a) Identification/name of the AIFM;

b) Identification/name of the investor;

c) Date and time of receipt of the order (i.e. subscription/redemption request);

d) Date of execution;

e) Identification/name of the AIF; and

f) Gross value of the order, including charges for subscription or the net amount after charges for redemptions.

This requirement is not easily applied to limited partnership structures, and may necessitate some changes to the standard form of investor acceptance letter.

Fair treatment of investors

The AIFM must ensure that any preferential treatment accorded to one or more investors does not result in "an overall material disadvantage to other investors". No investor in an AIF may obtain preferential treatment unless this is disclosed in the AIF rules or instruments of incorporation.

Specifically, pre-investment disclosures to prospective investors (see the following sub-section, page 24) must include a description of how the AIFM ensures fair treatment of investors and, whenever an investor obtains preferential treatment or the right to preferential treatment, a description of that preferential treatment and the type of investors who obtain it. This requirement must be taken into account when considering how fund side letters should be described in offering documents, and how 'most-favoured-nation' processes should operate. There is also a requirement to ensure that AIF investors are not charged undue costs.

Conflicts of interest

The AIFM must take all reasonable steps to identify conflicts, and must have effective systems for identifying, preventing, managing and monitoring conflicts so as to prevent them from adversely affecting the interests of the AIFs and the AIF investors. Where this cannot be ensured, the nature and source of the conflict must be disclosed to investors in advance and appropriate procedures developed.

There are extensive and detailed requirements concerning the conflicts policy, conflicts map and supporting procedures which should be put in place.

ONGOING COMPLIANCE REQUIREMENTS
OVERVIEW continued

Inducements

The Level 2 Regulation applies an "inducements rule" to AIFMs, which is expressed in similar terms to that which already applies to MiFID firms.

The name of the rule is misleading because a payment or other incentive need not operate as an "inducement" to improper behaviour for the rule to be relevant.

In summary, the inducements rule concerns any fee, commission or non-monetary benefit which is paid or provided to or by the AIFM in relation to its AIFM functions. AIFMs may wish to work systematically through accounting ledgers to identify relevant fees or commissions, before considering what non-monetary benefits might exist.

Any such arrangement must be placed into one of three categories:

1. Fees, commissions or non-monetary benefits paid or provided to or by the AIF or a person on behalf of the AIF (e.g. management fees).
2. Fees, commissions or non-monetary benefits which are "proper fees", such as legal fees or fees paid to regulators, which by their nature do not give rise to conflicts of interest. It is thought that the requirement that a fee must be "proper" may also mean that it must not be excessive.
3. All other fees, commissions or non-monetary benefits. These are only permitted to exist if three conditions are satisfied:
   i) They do not conflict with the AIFM's duty to act in the best interest of the AIF or investors;
   ii) The arrangement is "designed to enhance the quality of the...service" provided by the AIFM to the AIF; and
   iii) The existence, nature and amount of the fee, commission or benefit is clearly disclosed to investors in a manner that is comprehensive, accurate and understandable, prior to the provision by the AIFM of the relevant service to the AIF. If that is not possible, then the method of calculating it must be disclosed instead. Disclosure of some details may be deferred but the AIFM will be under a continuing obligation to provide further details to investors on request.

In a private equity and venture capital context, this rule is likely to be particularly relevant to fees paid to the AIFM by portfolio companies, such as transaction arrangement fees, monitoring fees or fees for the provision of directors. An AIFM should be prepared to justify why such fees meet the three conditions listed above. It may be part of the justification that such fees are offset against the management fee, or that the manager bears the costs of aborted deals as a quid pro quo.

Risk management

The AIFM is required to establish a permanent risk management function, which must generally be "functionally and hierarchically" separate from the portfolio management function although it need not be fully separate if certain minimum conditions are met. The Level 2 Regulations set out detailed requirements for an AIFM's risk management function and risk management systems.

When the Directive refers to "risk management", it does not mean management of the business risks attaching to the AIFM's business. It refers instead to the management of each AIF's investment risk so as to ensure that the AIF's investment portfolio stays within pre-defined risk limits and is consistent with the risk profile disclosed to investors in the offering documents.

This makes sense in the context of, say, a hedge fund strategy where there is a distinction between the portfolio managers who take investment decisions and the back-office control function. It makes less sense in a private equity context where the risk management element of investing is a core part of the portfolio management function. This distinction is not truly recognised in the AIFMD, but firms are permitted to apply some of the risk management requirements on a proportionate basis, provided there are adequate safeguards to ensure that the function is performed independently.

Firms managing leveraged (or open-ended) funds are additionally required to adopt liquidity management systems and procedures to manage the AIF's liquidity profile and liquidity risk.

Organisational requirements

The AIFM must deploy adequate resources, both human and technical, in the conduct of its business. The AIFM must employ sufficient personnel with the skills, knowledge and expertise necessary for performance of their roles.

The AIFMD requires AIFMs to maintain a permanent and independent compliance function, and larger or more complex firms may additionally require an internal audit function. The AIFM must also have sound administrative and accounting procedures and appropriate controls relating to matters such as electronic data processing, personal account trading, business continuity and record keeping.

Governance

The AIFMD requires AIFMs to maintain, and document, appropriate governance arrangements. Functions and responsibilities must be clearly allocated and documented, and the AIFM must have effective internal communication and reporting procedures.

Those running the AIFM's business must:

- Have adequate collective knowledge, skills and experience to be able to understand the business and the risks involved;
- Commit sufficient time to their role; and
- Act with integrity and "independence of mind",

and the AIFM must devote adequate resources to their induction and training.

The firm's senior management have overall responsibility for approving each AIF's investment strategy and ensuring general adherence to the investment policy and risk limits for each AIF. Senior management are also responsible for the effectiveness of the firm's compliance arrangements, including its valuation policies and procedures, compliance function, risk management policy and procedures, and remuneration policy.

ONGOING COMPLIANCE REQUIREMENTS TRANSPARENCY

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Disclosure to investors

An AIFM must, for each EEA AIF it manages and for each AIF it markets in the EEA, make available to investors the following information before they invest in the AIF and on any subsequent material change thereof, including, but not limited to, a description of:

- The investment strategy and objectives of the AIF;
- The types of assets which the AIF may invest in, and techniques it may employ;
- Associated risks (including an outline of risk management systems, the way the manager will assess the sensitivity of the portfolio to such risks and, if risk limits have been or are likely to be exceeded, a description of the circumstances and the remedial measures taken);
- Any investment restrictions;
- Types and sources of leverage permitted and associated risks, the maximum level of leverage which the AIFM may employ on behalf of the AIF; the implementing Regulation elaborates on the disclosures which must be made concerning leverage, if relevant;
- The main legal implications of the contractual relationship entered into by the investor;
- The identity of the AIFM, the AIF's depositary, auditor and any other service providers;
- A description of any delegated management function and any safekeeping function delegated by the depositary, and any conflicts of interest that may arise from the delegation;
- The AIF's valuation procedure and pricing methodology;
- All fees, charges and expenses and the maximum amounts thereof which are directly and indirectly borne by the investors;
- The latest net asset value of the AIF and historic performance information (where available); and
- Any preferential treatment for individual investors, the type of investors that are granted preferential treatment, and their links (if any) to the AIF and the AIFM (see page 22 as to the impact on side letter arrangements and the fund closing process).

In addition to the above disclosures specified under AIFMD, the Securities Financing Transactions Regulations (SFT Regulations)[15] also require AIFMs to include in their AIFMD pre-investment disclosures a description of any securities financing transactions and total return swaps which the AIFM is authorised to use, and a clear statement that those transactions and instruments are used.

Notes
15. Regulation (EU) 2015/2365 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012

ONGOING COMPLIANCE REQUIREMENTS
TRANSPARENCY continued

In addition to pre-investment disclosures summarised above, an AIFM must, for each EEA AIF it manages and for each AIFit markets in the EEA:

- Periodically disclose to investors the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature, any new arrangements for managing the liquidity of the AIF and the current risk profile of the AIF and risk management systems employed by the AIFM to manage those risks; and
- Where the AIF employs leverage, regularly disclose any changes to the maximum level of leverage, any right of the reuse of collateral or any guarantee granted under the leveraging arrangement and the total amount of leverage employed by that AIF.

Impact on Investors

A standardised approach to the presentation of this information would make it easier for investors to check that they have received the required information. There is a timing challenge here as any preferential terms are generally negotiated during the marketing of an AIF, so it is possible that one investor has committed to investment prior to preferential terms being negotiated with another investor. A full most-favoured-nation provision in the fund constitutional documents may help to mitigate this timing risk.

Impact on Fund-of-Funds

A key point FoF managers should be aware of is that this requirement to disclose information to investors also applies to investors in their funds. A FoF manager is also specifically required to disclose information on where the underlying funds in which it invests are established, although in practice FoF managers are often keen to preserve flexibility and therefore provide broad disclosures.

FAQs:

Is there a prescribed format in which this information has to be provided?

No. As noted above, it might well be of assistance to investors for this to be provided in a standardised format but thus far there is no such practice. Further, whilst some managers are providing this information in a single place such as a schedule to the offer document, others are simply amending the relevant sections of their existing documents to provide the relevant additional information. No consensus appears yet to have arisen. Whilst certain regulators require a detailed checklist indicating where all the relevant data points can be found, which would point towards the "schedule" approach, others are taking the view that this could be confusing for investors and it is therefore better to have all relevant information about a particular topic in the same place.

What happens if we negotiate revised terms with an investor after the disclosures have been made? Do we need to revise the document?

Since the disclosures include details of preferential treatment actually granted to investors the starting point for this question must be "yes". However, as noted above, detailed reference to the most-favoured-nation clause may mitigate this on the basis that if the types of preferential treatment expected to be granted and the types of investor to which they are expected to be granted are initially disclosed, and this is then in line with the preferential treatment actually granted, no further disclosure should be required.

What should be disclosed in respect of the requirement to disclose the latest annual report, NAV and historic performance of the AIF in the context of a new AIF being launched?

Typically here there is simply a disclosure that relevant AIF is in the process of being launched such that at present it has no assets, its NAV is zero, and there is no historic performance information or annual report available.

For a non-EEA AIF being marketed under private placement rules how do we address the various data points that are not really relevant (e.g. depositary)?

Much like the above, where there are data points that are simply not relevant for a non-EEA AIF it is normal to expressly indicate that as a non-EEA AIF the fund is not required to comply with the relevant provision as opposed to not addressing the point at all. Where as a matter of practice the AIF seeks to comply or already complies with similar domestic provisions this is usually disclosed.

Are the SFT Regulations really relevant for private equity and venture capital firms?

Whilst Invest Europe member firms may be unlikely to enter into most securities financing transactions (e.g. repurchase transactions, securities or commodities lending or borrowing, buy-sell backs or sell-buy backs) it is possible that they might enter into a total return swap in relation to a particular transaction, and there is some debate about the potential for "margin lending transactions" under the SFT Regulations to catch normal leveraged buy-out transactions, so these requirements should be considered, though in many cases they won't be relevant.

How frequently must the "periodic" and "regular" disclosures relating to illiquid assets and leverage be made?

This is not entirely clear. It certainly seems reasonable to take the view that "periodic" reports can be made in the annual report, but "regular" reports, to the extent that an AIF is leveraged, should likely be made more regularly and AIFMs may wish to include these disclosures in their more frequent reports to investors, either half-yearly or quarterly.

ONGOING COMPLIANCE REQUIREMENTS
TRANSPARENCY continued

Annual Reports

The AIFM must prepare an annual report in respect of each EEA AIF it manages and each AIF it markets in the EEA. This must be completed no later than six months following the end of the financial year (or possibly within four months for AIFs subject to the Transparency Directive, e.g. listed AIFs – see further below).

There should be no need to prepare an annual report for accounting periods ending before the AIFM becomes subject to the AIFMD (now that the transitional periods have expired this is only likely to be relevant in the case of a sub-threshold AIFM "opting in" or crossing the threshold and becoming full scope). The AIFM should still be entitled to obtain authorisation, a management or marketing passport and/or to market on a private placement basis before it has prepared, and had audited, its first AIFMD-compliant annual report, provided all other conditions are met.

The annual report must be provided to:

- Investors, on request; and
- The home EEA Member State competent authority of the AIFM and, where applicable, of the AIF.

A non-EEA manager must also provide the annual report to the competent authority in each jurisdiction in which it has marketed. It is to be hoped that such AIFMs will not be required to continue providing annual reports to regulators in jurisdictions in which they marketed unsuccessfully and have no investors.

Public disclosure is not required.

Content of the annual report

The annual report must include:

- An audited balance sheet or statement of assets and liabilities; the Level 2 Regulation specifies in some detail the items which must be included and the way the information must be presented;
- An audited income and expenditure account;
- A report on the fund's activities over the year (again, the Level 2 Regulation elaborates);
- Any material changes during the financial year covered in respect of the information required to be disclosed to investors pre-investment (see above); such changes are deemed material if there is a substantial likelihood that a reasonable investor becoming aware of the information would reconsider its investment in the AIF; and
- Certain disclosures about remuneration of certain staff of the AIFM (see also sub-section, Remuneration, page 41).

Disclosures in the annual report about remuneration

The following items must be disclosed:

- The total amount of remuneration paid by the AIFM to its staff for the financial year, including (a) the split between fixed and variable remuneration; (b) the number of beneficiaries; and (c) carried interest where relevant; and
- The aggregate amount of remuneration for senior management and members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

Such disclosures concerning the AIFM must be broken down by AIF (insofar as this information exists or is readily available), with a description of how the allocation has been arrived at.

There is some choice as to how to present the first item:

i) As a simple total relating to the entire staff of the AIFM, and the number of them;

ii) As the total remuneration of those staff of the AIFM who are fully or partly involved in the activities of the AIF, including the number of them; and/or

iii) As the proportion of the total remuneration of the staff of the AIFM attributable to the relevant AIF, and the number of them.

The annual report must also include general information on remuneration policies and practices – enough to provide an understanding of the risk profile of the AIF and the measures it adopts to avoid or manage conflicts of interest.

AIFs subject to the Transparency Directive

AIFs subject to the Transparency Directive[16] (e.g. a listed private equity investment trust to the extent it falls to be categorised as an AIF) may fulfil their obligation to disclose the above details by including them within the public annual report required by the Transparency Directive. In this case, that report must be available within four (rather than six) months of the end of the financial year. If such details are not covered in the public annual report they must be included in a separate report made available only to investors on request, in which case the normal six-month deadline applies.

Preparation and audit of accounting information

The accounting information in the annual report must be:

- Prepared in accordance with the fund rules and in accordance with accounting standards applicable to the AIF or (for non-EEA AIFs) the country where the AIF has its registered office (although there remains some uncertainty, it is thought that this means whatever accounting policy is provided for in the AIF's constitutional documents unless mandatory local law specifies some other accounting standards applicable to the vehicle – the AIFMD itself does not specify any); and
- Audited by an EEA auditor or (for non-EEA AIFs and where permitted by Member States) subjected to an audit meeting international audit standards in force in the country where the AIF has its registered office.

No alternatives are specified for AIFs without a registered office.

Notes

16. Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC

ONGOING COMPLIANCE REQUIREMENTS
TRANSPARENCY continued

Impact on Investors

In practical terms investors will continue to receive annual reports much as they have in the past. Under the AIFMD, however, the main difference will be that the reports will contain more information regarding remuneration than in the past.

Impact on Fund-of-Funds

The main challenge for FoF managers will be the practical one of meeting the reporting timetable. The FoF manager's ability to report will be driven by how promptly the underlying managers report to the FoF. If those underlying managers take the full six-month window to report (or are managers outside the scope of the AIFMD and who may therefore plan to take longer to report), then it is challenging to expect the FoF manager to report within the same timeframe. Some flexibility may be necessary to ensure that the FoF manager is able to meet its mandated deadline in the event of late reporting from its underlying managers.

FoF managers should be aware that any of their existing AIFs, which did not make any further investments after transposition in 2013, do not need to produce an annual report.

Those FoF managers who are managing listed or public investment companies should note that the four-month annual report publication timeframe specified by the Transparency Directive still applies.

FAQs:

Are investors typically requesting the annual report?

Some AIFMs are amending their existing annual fund reports to include the required information such that investors do not need to request the annual report as they are provided with a copy as a matter of course. Others say that the AIFMD-compliant annual report will be made available on request.

Are AIFMs still required to provide the annual report to regulators where they have not managed to attract any investors?

The position varies in different jurisdictions. In some jurisdictions (i.e., the UK, Luxembourg), if a manager is unsuccessful in marketing and notifies the regulator that they are no longer marketing, the manager's obligations under Article 42 fall away. The position is less clear in other jurisdictions.

How are AIFMs dealing with the "material change" requirements?

Material changes, e.g. made to the fund documentation during the fundraising, trigger a 30-day hold period before such changes can become effective. In a closed-ended fund closing process, material changes negotiated by subsequent closing investors may thus have serious impacts on the closing process since the process for implementing these changes may both become longer and more cumbersome.

How are these remuneration disclosures typically being approached in practice?

Since many managers have sought to dis-apply certain provisions of AIFMD on proportionality grounds, it is typically the case that the disclosures are addressed in the most minimal way possible in line with (i) above, though the larger the manager and the more complicated its business model the less likely that it will have been able to dis-apply remuneration provisions and the more likely it will have provided the more detailed disclosures in line with (iii) above.

In connection with general information on remuneration policies and practices it is not uncommon to see a disclosure that simply indicates that the manager has in place remuneration policies and practices in line with the risk profile of the AIF (which is typically summarised elsewhere in the document) adopted with a view to avoiding conflicts of interest.

ONGOING COMPLIANCE REQUIREMENTS
TRANSPARENCY continued

Regulatory Reporting

The AIFMD, together with the Level 2 Regulations, introduce new regulatory reporting requirements for AIFMs including all AIFMs based in the EEA as well as non-EEA AIFMs which either manage an EEA AIF or market within the EEA. Reporting is made to relevant national regulators.

The reporting template breaks down into four broad parts:

1. The first part covers information on the main instruments traded by the AIFM and individual exposures, including information about investment strategy, geographical focus, individual exposures and portfolio turnover;
2. The second part covers information on an AIF's strategies, the main instruments which it trades, its principal exposures at the reporting date, most important portfolio concentrations, principal markets and investor concentration;
3. The third part covers information on individual exposures, value of turnover, dominant influence (for private equity funds), market risk profile, counterparty risk profile, liquidity profile (including investor redemptions and side letters), borrowing risk, exposure risk and historical risk profile; and
4. The fourth part covers information on AIFs employing leverage on a substantial basis.

Only the first 2 parts of the proposed template need to be completed by AIFMs falling below the threshold tests. All "full scope" EEA and non-EEA AIFMs must report more extensively by completing the third part of the template. AIFMs which manage AIFs employing leverage on a substantial basis (i.e. three times its net asset value) must further complete part 4.

Frequency of reporting:

a) For AIFMs managing portfolios of AIFs with total AUM above the threshold exemptions but not more than EUR 1 billion, reporting is half-yearly.

b) For AIFMs managing portfolios of AIFs with total AUM in excess of EUR 1 billion, reporting is quarterly.

c) For AIFMs falling within paragraph a) above, for each AIF with total AUM in excess of EUR 500 million, reporting must be quarterly for that particular AIF.

d) **For all AIFMs managing AIFs which are unleveraged and invest in non-listed companies to acquire control (private equity), reporting is annual.**

Reporting periods are likely to be based on calendar years and must be made within one month of the end of each reporting period. If the AIF is a fund-of-funds, this period may be extended by 15 days.

National regulators can require additional reporting under the AIFMD where necessary for the effective monitoring of systemic risk.

ESMA took the view that there was need to supplement the AIFMD Regulation with further guidelines on reporting obligations to ensure the greater standardisation of information sent to national competent authorities to facilitate the easy exchange of information.

FAQs:

How have AIFMs found regulatory reporting to be in practice?

Very difficult – certainly more difficult than the pre-investment disclosure requirements and annual reporting requirements.

Although the data points required are set out quite clearly in the Level 2 Regulation, ESMA has taken a further step of seeking to standardise the information required (as summarised above) and there has been little consistency in the approaches adopted by national regulators.

The requirement for electronic reporting – and the different system requirements across national regulators – have made this particularly challenging, not least because not all national regulators are yet equipped to receive these reports.

This has led to a number of existing service providers such as administrators seeking to add this to their offering, and there appears to be a trend towards managers outsourcing this regulatory reporting obligation.

Where a non-EEA feeder AIF with a non-EEA AIFM is registered for marketing in the EEA must regulatory reporting be undertaken in respect of the master fund?

The position varies between Member States.

ONGOING COMPLIANCE REQUIREMENTS
CAPITAL REQUIREMENTS

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General

AIFMs will be required:

i) To have a minimum amount of "initial capital" plus a minimum amount of "own funds";

ii) To maintain qualifying professional indemnity insurance (PII) or additional own funds to cover professional negligence liability; and

ii) To invest own funds in liquid assets or assets readily convertible to cash and not in "speculative positions".

There are two important qualifications to these standard requirements:

1. An AIFM which is also authorised as a UCITS management company will only be subject to the requirements in (ii) and (iii) (as the UCITS Directive sets the initial capital and own funds requirements for this type of investment manager); and
2. An AIFM which obtains a "top-up permission" to conduct certain MiFID activities (to the extent that option is made available in its Member State), such as discretionary investment management, will be subject to both the AIFMD capital requirements and the capital requirements deriving from the Capital Requirements Regulation ("CRR").

ONGOING COMPLIANCE REQUIREMENTS
CAPITAL REQUIREMENTS continued

What are "initial capital" and "own funds"?

The definitions of these terms in the AIFMD cross-refer to the repealed Banking Consolidation Directive, but since 1 January 2014, provisions in the CRR have deemed these references to be equivalent definitions in that regulation. "Initial capital" and "own funds" are two ways of measuring what are essentially "shareholder funds" (after deducting adjustments, e.g. for accrued losses). Certain types of preference shares and subordinated debt can be counted towards "own funds".

Member States may permit AIFMs to meet up to 50% of their own funds requirement through a guarantee from certain banks or insurers. Not all Member States permit this option.

The revised definitions of "initial capital" and "own funds" in the CRR have resulted in more complex, and generally stricter, tests for the inclusion of items in an AIFM's regulatory capital. However, where an AIFM incorporated as a company previously relied on simple ordinary share capital and retained earnings to meet the initial capital and own funds requirements under the AIFMD prior to the amendments introduced by the CRR, those items will typically remain eligible under the revised rules. For AIFMs that are established as partnerships or other structures, the application of the CRR definitions may be more complex.

Initial capital requirement

An internally managed AIF will be required to maintain initial capital of EUR 300,000 at the time of authorisation.

An AIFM managing external AIFs will have to maintain initial capital of at least EUR 125,000 at the time of authorisation.

Own funds requirement

An AIFM (whether it is an external AIFM or an internally managed AIF) will have to maintain own funds equal to:

a) The higher of:

i) Its initial capital requirement + 0.02% of fund assets under management in excess of EUR 250 million (up to EUR 10 million); and

ii) ¼ of the AIFM's annual fixed overheads; plus

b) One of the following, selected by the AIFM (and in practice therefore the lower), to cover professional liability risks:

i) 0.01% of assets under management (the "additional own funds requirement") which the applicable regulator has discretion to reduce to 0.008% case-by-case; or

ii) If the AIFM is relying on professional indemnity insurance cover to meet the Directive requirements, then a further amount equal to the PII policy excess plus the value of any exclusions.

Fixed overheads are as defined for the purposes of the CRR. The rules specifying how fixed overheads should be calculated in this context are contained in a delegated regulation adopted by the European Commission. Broadly speaking, these rules require fixed overheads to be calculated by taking the total expenses of the AIFM for the preceding year and subtracting a number of discretionary payments (for example, fully discretionary staff bonuses or profit shares) and certain other non-mandatory fees, commissions and non-recurring expenses arising from non-ordinary activities.

When calculating funds under management for these purposes it may be necessary to include the AUM of grandfathered AIFs (see Section 1). This may differ between EEA Member States.

The own funds requirement applies only at solo level (i.e. the level of the AIFM's unconsolidated balance sheet) and not on a consolidated basis.

The table below sets out an example of how an external AIFM with EUR 1 billion AUM would calculate its own funds requirements. The arrows indicate the likely outcome and total amount of own funds required.

OWN FUNDS ≥	AMOUNT (€)	
a) Higher of:		
i) €125k + 0.02% AuM > €250m; and	275,000	←
ii) ¼ of fixed overheads; **plus**	225,000	
b) Choice of:		
i) 0.01% of AuM (or 0.008%); or	100,000	←
ii) PII excess + exclusions cover	200,000	
TOTAL OWN FUNDS REQUIREMENT	**375,000**	

Professional Indemnity Insurance

Covering Professional Liability risk by way of professional indemnity insurance

AIFMs which elect to use professional indemnity insurance to cover professional liability risk must check that the policy meets certain requirements. These include the risks which must be covered by the insurance policy, together with minimum requirements for the policy, including that:

- The policy shall have an initial term of no less than one year;
- It shall have a notice period for cancellation of at least 90 days;
- The cover for each individual claim must be at least equal to 0.7% of the value of the portfolios of the AIFs managed by the AIFM;
- The cover for claims in aggregate per year must be at least equal to 0.9% of the value of the portfolios of the AIFs managed by the AIFM.

In addition, any defined excess must be fully covered by additional own funds. It is currently expected that for many AIFMs, these additional requirements will make professional indemnity insurance a more expensive option than the additional own funds option referred to above.

ONGOING COMPLIANCE REQUIREMENTS
CAPITAL REQUIREMENTS continued

Liquid Assets

The liquid assets requirement is to hold own funds (including any additional own funds) in "liquid assets or assets readily convertible into cash" equal to:

a) The higher of:

i) 0.02% of fund assets under management in excess of EUR 250 million (up to EUR 10 million);

ii) ¼ of fixed annual overheads; *plus*

b) One of the following, selected by the AIFM (and in practice the lower):

(i) 0.01% of assets under management, which the relevant regulator may reduce to 0.008% case-by-case; or

(ii) If the AIFM is relying on professional indemnity insurance cover to meet the Directive requirements, then a further amount equal to the professional indemnity insurance excess plus any exclusions.

The table below sets out an example of how an external AIFM with EUR 1 billion AUM would calculate its liquid assets requirement. The arrows indicate the likely outcome and total amount of liquid assets required.

LIQUID ASSETS ≥	AMOUNT (€)
a) Higher of:	
i) 0.02% AuM > €250m; and	150,000
ii) ¼ of fixed overheads; **plus**	225,000 ←
b) Choice of:	
i) 0.01% of AuM (or 0.008%); or	100,000 ←
ii) PII excess + exclusions cover	200,000
TOTAL LIQUID ASSETS REQUIREMENT	**325,000**

Certain regulators have given examples of liquid assets including:

- Cash;
- Readily realisable investments (not held for short-term resale);
- Debtors, readily convertible to cash within one month.

This liquid assets requirement was an entirely new requirement in EEA financial services law at the time of the AIFMD. It means AIFMs are restricted in their ability to use own funds as working capital, and is a significant difference from the current requirements for MiFID investment firms.

Other requirements

Apart from the capital rules summarised above, an AIFM is also required to maintain financial resources adequate to its assessed risk profile.

AIFMs must also maintain a historical loss database to record all operational failures, loss and damage. The AIFM must use this database when formulating its risk management framework and make internal reports on operational risk exposures and losses. AIFMs are additionally required to maintain an operational risk management policy and procedure.

The historical loss database requirement and operational risk procedures were originally drawn from the Banking Consolidation Directive.

Impact on Investors

AIFMs may have less available capital to invest alongside their investors as a consequence of the initial capital requirements. The alignment of interest between investors and managers, which is a core characteristic of the private equity and venture capital model, may be adversely impacted as a consequence of this.

Impact on Fund-of-Funds

There are no specific implications for FoF managers that are any different than for other AIFMs. A FoF manager must put aside the required amount of initial capital and ensure that such sums are kept on short-term availability, at all times.

ONGOING COMPLIANCE REQUIREMENTS
THE DEPOSITARY AND ITS ROLE

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When a depositary should be appointed

Q. Is the AIFM sub-threshold? (i.e. total AUM €500m or less, no leverage, 5 year lock-up?)

YES

No depositary requirement, until/unless sub-threshold AIFM becomes a full-scope AIFM or deliberately opts into the AIFMD to obtain a marketing passport.

NO

Q. Where is the full-scope AIFM located?

EU AIFM

Q. Where is the AIF?

EU AIF

Requirement
EU AIFs must have a depositary located in their home Member State.

Timing
When applying for the marketing passport.

Non-EU AIF

Requirement
If marketing via private placement, a depositary is required but depositary liability may be relaxed ("depo-lite"). Once third country passports are available, a non-EU AIF with such marketing passport will need to appoint a depositary as if it were an EU AIF.

Timing
When marketing/applying for a third country passport (as applicable).

Non-EU AIFM

For both EU and non-EU AIFs

Requirement
No depositary needed unless the AIF is marketed on a private placement basis and the relevant Member State imposes a stricter approach within their private placement requirements.

Timing
When marketing.

ONGOING COMPLIANCE REQUIREMENTS
THE DEPOSITARY AND ITS ROLE continued

What does the depositary do?

Under the terms of the AIFMD the depositary must:

a) Ensure that fund cash flows are properly monitored; the Level 2 Regulation requires the depositary to implement effective and proper procedures to reconcile cash flow movements and perform *daily* reconciliations – less frequent reconciliations are permitted in the case of "infrequent cash movements", which may be relevant to some private equity funds. To be clear, cash is not a custody asset and cash monitoring should not be confused with safekeeping obligations and the duty is limited to the fund itself, no look-through obligation applies;

b) Ensure all investor subscription payments and all funds are received and booked in segregated accounts with:

- A central bank;
- An EEA credit institution;
- A bank authorised in a third country; or
- Another entity "of the same nature", which is subject to effectively enforced prudential regulation and supervision to the same effect as that under EEA law;

c) Hold in custody the Financial Instruments belonging to the AIF that:

- Can be physically delivered (e.g. bearer instruments); or
- Can be registered in a financial instruments account opened in the depositary's books

The above are called "custody assets", and the Level 2 Regulation provides more detail as to what falls within this concept;

d) For all other assets of the AIF (so called "non-custody assets" – see further below), verify whether the AIF (or the AIFM on its behalf) has ownership of the asset and, if so, maintain a record evidencing ownership; this obligation will apply on a "look-through" basis to the non-custody assets;

e) Ensure transactions in units/shares are carried out in accordance with applicable national law and the fund rules;

f) Ensure shares/units are valued in accordance with applicable national law, the fund rules and AIFMD valuation requirements (see the sub-section on Valuation on page 38);

g) Carry out the AIFM's instructions, unless they conflict with applicable national law or the fund rules;

h) Ensure timely remittance of consideration for transactions in fund assets;

i) Ensure fund income is applied in accordance with applicable national law and the fund rules (as set out in the AIF's governing documentation); and

j) Act independently, honestly, fairly and professionally and in the interest of the fund and fund investors. These requirements will necessarily lead to the depositary being involved to some extent in or in the run up to both fund closings and transaction closings, which may have both cost and timetable implications.

It is envisaged that a depositary will carry out all the tasks above but the Directive does facilitate the delegation of the tasks referred to in (c) and (d) above, provided that:

- The purpose of the delegation is not to avoid AIFMD requirements;
- The depositary can show an "objective reason" for delegating;
- The depositary exercises due skill, care and diligence in the selection, appointment, periodic review and ongoing monitoring of its delegate; and
- The depositary ensures, on an ongoing basis, that its delegate:
  - Has appropriate structures and expertise;
  - If it will have sub-custody of financial instruments, is subject to:
    - Effective prudential regulation (including capital requirements) and supervision; and
    - Periodic external audit;
  - Segregates the depositary's client assets from its own assets and those of the depositary;
  - Does not re-use fund assets without informing the depositary in advance and obtaining the prior consent of the fund (or the AIFM acting on its behalf); and
  - Performs the delegated functions in compliance with the standard of care required by the AIFMD for depositaries.

ONGOING COMPLIANCE REQUIREMENTS
THE DEPOSITARY AND ITS ROLE continued

Depositary vs depositary lite

An EEA AIF must appoint a "Depositary" to act for the AIF providing full depositary services in accordance with the AIFMD.

However, in certain third country marketing circumstances e.g. where a non-EEA AIF is being marketed in certain jurisdictions within the EEA (including Germany and Denmark) "Depositary Lite" services are required. There are small differences between the two levels of service as detailed below – although from a day-to-day operational point of view the processes are primarily the same in respect of AIFs which qualify as private equity and venture capital funds.

FULL DEPOSITARY	DEPOSITARY "LITE"
Appointed by an EEA AIFM where the AIF is in full scope and is required to appoint a depositary.	Appointed by a non-EEA AIF where there is a requirement to market this AIF within the EEA and certain jurisdictions require the appointment of a depositary which may be established within the EEA or outside.
A single depositary must be appointed for each AIF – which means that if and when Financial Instruments are held, the depositary (assuming it is a depositary which does not qualify as a financial institution or an assimilated entity and which may not safeguard Financial Instruments) will select, and delegate this task to a separate depositary bank for the Financial Instruments.	Multiple depositaries can be appointed i.e. one depositary for "non-custody assets" and one or more depositary(ies) for "financial assets". Alternatively one depositary can be appointed for cash monitoring, another for asset verification and a third for compliance oversight – although this rarely happens in reality.
The depositary has "strict liability" for the loss of financial instruments – whether the loss was made by a delegate or not.	No such "strict liability" for loss of financial instruments.

How does this apply to Private Equity Funds?

Most private equity funds hold "non-custody assets" and will seek to appoint a depositary who is used to acting with the private equity asset class.

The three key functions of the depositary will remain namely:

1. **Cash Monitoring**
   Ensuring on a day-to-day basis that cash is applied for the benefit of the fund
2. **Asset Verification**
   Ensuring that assets are properly registered in the name of the fund
3. **Oversight and Compliance**
   A level of oversight is required over the manager's operating processes

The principal difference between an open-ended liquid/listed assets type fund (a hedge, retail or similar fund) and an AIF holding "non-custody assets" is that the depositary will "verify" the ownership of the asset rather than hold the asset in safe custody.

Verification requires the depositary to independently verify that all the assets owned by the AIF are properly registered in the name of the AIF (or the AIFM for the AIF) and remain registered in the name of the AIF for the period of ownership by the AIF. This can be achieved in a number of ways, generally without the need of the involvement of the AIFM or its lawyers. The depositary's work should be carried out independently of the AIFM and given the nature of most assets should be straightforward assuming the depositary understands the asset class and is familiar with the complex structures of deals and fund structures, etc.

However, where the AIF holds 'Financial Instruments' they must be held in custody by a financial institution or similar depositary. It would be expected that any private equity depositary would have delegation arrangements in place with such a depositary to accommodate client needs.

Under the terms of the AIFMD, 'financial instruments' are defined to include those instruments specified in Annex 1, section C of the Markets in Financial Instruments Directive. In broad terms, this includes:

- Transferable securities;
- Money-market instruments;
- Units in collective investment undertakings; and
- Various derivative contracts.

Held in custody

Financial instruments will be considered to be capable of being 'held in custody' in the following circumstances:

- **Bearer securities:** Financial instruments that can be physically delivered to the depositary will always be considered to be 'held in custody'.
- **Electronically settled securities:** The following financial instruments will be considered to be 'held in custody' when they are registered or held in an account directly or indirectly in the name of the depositary:
  a) Transferable securities (including those that embed derivatives);
  b) Money market instruments; and
  c) Units in collective investment undertakings.
- **Optional:** Financial instruments capable of being held in custody at the request of the relevant parties.

ONGOING COMPLIANCE REQUIREMENTS
THE DEPOSITARY AND ITS ROLE continued

Look-through obligation

The Level 2 Regulation includes a "look-through" requirement for depositaries in relation to indirect ownership of non-custody assets (i.e. non-financial assets).

- The depositary must verify the ownership of any underlying non-custody assets held by financial and/or legal structures established by the AIF or the AIFM for the purposes of investing in non-custody assets and that are controlled directly or indirectly by the AIF or the AIFM acting on behalf of the AIF.
- The depositary should apply a "look-through approach" to the AIF's entire asset structure, i.e. look through the chain of ownership to any intermediary entity established and controlled (directly or indirectly) by the AIF that is interposed between the AIF and its target investments. The look-through requirement seeks to ensure that investor protection is not weakened by an AIF's use of intermediate vehicles to invest in certain assets.

Whether a depositary must look through to the non-custody assets of any underlying AIF/ SPV of an AIF depends on whether or not the AIF, or the AIFM on behalf of the AIF

a) Directly or indirectly controls the underlying AIF/SPV structure; and

b) Established the underlying AIF/SPV structure for the purposes of investing in the underlying assets.

The concept of control in the AIFMD is based on accounting consolidation tests. These tests consider:

a) Voting control;

b) The right to exercise dominant influence over the underlying fund/SPV; or

c) The right to appoint or remove a majority of members on the administrative or supervisory bodies of the underlying AIF/SPV.

Control, for the purposes of "look-through", is both direct and indirect. This means that depositaries must ensure safekeeping of such assets as far down the chain of control as is necessary until the tests for control are no longer met. Where "look-through" applies, it is only in respect of safekeeping duties and not in relation to a depositary's other obligations under the AIFMD (cash monitoring, verification of valuation procedures of shares/units, ensuring appropriate reconciliation of subscriptions and redemptions, detecting timely settlement of transactions and ensuring appropriate application of income distribution) none of which would apply in respect of the assets of the underlying AIF/SPV.

In addition to the requirement that the relevant structure is controlled directly or indirectly by the AIF, the structure must also be established by the AIF or its AIFM on behalf of the AIF for the purpose of investing in the underlying assets. Therefore, where an AIF acquires a controlling interest in an AIF/SPV without the AIF establishing that underlying fund/SPV, the depositary will not be subject to the "look-through" obligations that would otherwise arise.

Where an AIF invests in another AIF and this AIF has a different depositary that is responsible for the ownership verification and record-keeping duties in the meaning of the AIFMD, the depositary is not required to look-through to the target AIF's investments. For FoF managers, since the AIFs in which the FoF manager invests represent the target investments, the depositary is not required to look-through to the assets of the underlying AIFs.

For master/feeder AIFs, since the target investments are the underlying assets of the master AIF, the depositary of the feeder AIF should look-through to the assets of the master AIF, unless the master AIF has a different depositary that meets the requirements of the AIFMD.

Does the Directive regulate depositaries?

Depositaries are not registered or regulated under the AIFMD directly. Rather, the AIFMD sets out the functions which a depositary must perform and the circumstances in which a depositary will be liable for causing loss to investors, the AIF and/or the AIFM.

Depositaries are regulated by their local regulators. It is the AIFM, which is responsible for ensuring that a depositary is appointed in accordance with the requirements of the AIFMD, for each AIF it manages.

Appointment

There must be a written contract appointing the depositary as depositary of the AIF.

The Level 2 Regulation specifies in some detail the mandatory content of that contract, including a description of the service to be provided, statements concerning the depositary's liability, termination rights, information exchange arrangements, and operational information concerning the accounts concerned. As the AIFM is responsible under the AIFMD for ensuring that the depositary is appointed in a manner which complies with the legislative requirements, it is likely that the AIFM will wish to be a party to the contract, irrespective of whether it formally appoints the depositary.

ONGOING COMPLIANCE REQUIREMENTS
THE DEPOSITARY AND ITS ROLE continued

Who can be a depositary?

A depositary for an EEA AIF must be:

a) An EEA credit institution;

b) A MiFID investment firm subject to the same CRD capital requirements as credit institutions; or

c) A prudentially regulated and supervised institution of a type that (at the date the AIFMD entered into force) is eligible to be a UCITS depositary under the UCITS IV Directive.

For non-EEA AIF, the depositary may also be an entity "of the same nature" as one within (a) or (b) above, provided that it is subject to effectively enforced prudential regulation and supervision to the same effect as that under EEA law.

Additional flexibility is provided for (primarily) AIFs (and in particular private equity and real estate AIFs) whose investors have no redemption rights for five years from the date of their initial investment.

The depositary to these funds may be an entity (e.g. in certain countries a fund administrator or auditor) which:

- Carries out depositary functions as part of professional or business activities;
- Is subject to mandatory professional registration recognised by law, to legal or regulatory provisions or to rules of professional conduct; and
- Can furnish sufficient financial and professional guarantees.

Depositaries are regulated by their national regulators and must comply with the regulatory requirements, including capital adequacy, as required by the location.

Who cannot be a depositary?

An AIFM cannot be a depositary. However, a member of the AIFM's group could be a depositary, provided they fulfil the requisite requirements and subject to each Member State's requirements, if any.

Where can the depositary be established?

The AIFMD imposes limits on who may be a depositary based on where the depositary is established. A depositary is "established" where it has its registered office and in each jurisdiction where it has a branch.

1. EEA AIFs

For EEA AIFs, the depositary must be established in the AIF's home Member State.

2. Non-EEA AIFs

The depositary of a non-EEA AIF must be established in the AIFM's home Member State (or Member State of reference, in the case of a third-country AIFM). Alternatively, the depositary may be established in the third country in which the AIF is established if the following conditions are met:

- Cooperation and information exchange arrangements must be in place between the depositary's regulator, the AIFM's home Member State competent authority and the competent authority in each Member State where the AIF is intended to be marketed;
- OECD-compliant tax information exchange agreements must be in place between the depositary's jurisdiction, the AIFM's home Member State and each Member State where the AIF will be marketed;
- Depositaries in the country where the depositary is established must be subject to effectively enforced prudential regulation and supervision to the same effect as that under EEA law. The Commission must adopt criteria to determine this;
- The depositary's jurisdiction must not be listed by the Financial Action Task Force (FATF) as a Non-Cooperative Country and Territory; and
- The depositary must have agreed to:
  - Accept liability to the AIF or investors on the basis provided by the AIFMD (see below); and
  - Comply with the AIFMD requirements relating to delegation by depositaries.

These qualifying conditions apply at all times. It is of course possible that after the initial appointment, one or more of the qualifying conditions cease(s) to be fulfilled. This would result in the AIFM being in breach of its obligations under the AIFMD.

Liability of depositary

The depositary will be liable to the AIF or its investors for certain losses.

In the course of negotiation of the AIFMD, there was a debate over whether the depositary should have "no fault" or "strict" liability for losses or whether this should be fault based liability. The final version of the AIFMD imposes each type of liability on the depositary, depending on the type of loss.

Strict/no fault liability

Where financial instruments held in custody are lost, the depositary is obliged to return identical financial instruments or the corresponding amount to the AIF (or the AIFM on its behalf) without undue delay.

There is also near strict liability for loss by sub-custodians (whether or not affiliated with the depositary). The exact meaning of "loss" is not clear; it is defined very broadly and could include cases where the AIF/AIFM did not have good title to the instruments in the first place.

However, there are two exceptions to this liability:

1. Where the depositary can prove that the loss resulted from an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. The depositary would have to show that despite rigorous and comprehensive due diligence, it could not have prevented the loss. This requirement will be deemed to be fulfilled if the loss arises due to certain "force majeure" type events (e.g. wars, laws and regulations) but the exception as a whole is very narrow.
2. Where financial instruments held by a sub-custodian are lost and the depositary:

ONGOING COMPLIANCE REQUIREMENTS
THE DEPOSITARY AND ITS ROLE continued

- Has agreed in writing with the AIF (or the AIFM on its behalf) that the depositary may (in a written contract with the sub-custodian) transfer its liability for lost assets to the sub-custodian; and
- Can prove that:
  - It has met all of its obligations under the AIFMD in relation to the delegation;
  - It has a written contract with the sub-custodian which effects the transfer of liability to the sub-custodian and makes it possible for the AIF (or, on its behalf, the AIFM or the depositary) to claim against the sub-custodian in respect of the loss.

Additional criteria must be met where the sub-custodian is one in respect of whom preconditions for delegation have been disapplied.

Fault-based liability

The depositary is also liable to the AIF or investors in the AIF for "all other losses" suffered by them as a result of its negligent or intentional failure to perform its obligations.

Liability and indemnification

Strict liability only attaches to loss of financial instruments held in custody. Otherwise, a depositary is only liable for its negligent or intentional failure to comply with its obligations under the AIFMD. This liability is also likely to be mirrored under its terms of engagement.

Where financial instruments are not held in custody, there is nothing in the AIFMD restricting depositaries from seeking to limit liability or benefit from indemnification provisions. Any benefit from reduced liability should be reflected in the fee model adopted by the depositary.

Restrictions on the depositary

The AIFMD prohibits a depositary from:

- Re-using fund assets without the prior consent of the AIF (or the AIFM acting on its behalf);
- Conducting activities in relation to the AIF that may create conflicts of interest, unless:
  - It has "functionally and hierarchically" separated those activities from its depositary tasks; and
  - Any potential conflicts of interest are properly identified, managed, monitored and disclosed to the AIF's investors.

Disclosures to investors and competent authorities

AIFMs applying for authorisation must disclose details of their AIFs' depositary arrangements to their home Member State competent authority, including any delegation by the depositary (see also section headed "Limits on delegation" above). This information must also be made available to investors in the AIF before they invest, and must be updated to reflect any material changes.

The depositary must make available on request to its own competent authority and to the competent authorities of the AIF and/or AIFM information which it obtains when undertaking its duties which may be necessary for those authorities.

Investors must also be informed, pre-investment, of any agreement to transfer liability for loss of custody assets to a sub-custodian (and any changes to this must be notified to investors without delay).

Issues to consider on the selection of a depositary

The AIFMD has been in place for some time now and although the concept of depositary was initially new to the private equity community both depositaries and clients have settled into an operational "routine". For those who have yet to consider appointing a depositary points to consider are as follows:

- Where both the AIF administrator and the depositary are part of the same group, and information may be shared between them, they must operate as independent companies to avoid potential conflicts of interest;
- Any depositary should by now have an experienced and knowledgeable team who have a deep knowledge of the asset class;
- The role and actions of the depositary should not infringe on the day-to-day business of the AIF or the AIFM – and if anything should be flexible to fit around the manager's day-to-day practice – adapting its processes to meet the individual processes of the client;
- The manager's own AIFM licence imposes organisational and operational requirements on portfolio management, risk management, liquidity management, and requires it to monitor investment strategies, performance, capital and compliance. The depositary will need to satisfy itself that such policies are in place (normally as part of its initial review process followed by annual reviews);
- But once the compliance check has been satisfactorily completed, the depositary oversight obligation over deals, closings etc. should be minimal. There should be no need for a depositary to be involved in any investment transaction until after completion when it will seek to carry out the "asset verification" process;
- Similarly, the cash monitoring process should carry on in the background with little or no day-to-day impact on the AIFM. Use of automated systems should assist in the process wherever appropriate; and
- Consideration should be given to the availability of other services – if the same organisation can assist with Annex IV Reporting (especially for non-EEA managers) this may be of benefit.

ONGOING COMPLIANCE REQUIREMENTS VALUATION

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Overview

For each of their AIFs, AIFMs are required:

- To have procedures for the proper and independent valuation of the AIF's assets; and
- To ensure that the net asset value ("NAV") of the AIF's assets per share or unit issued by the AIF is calculated (the "NAV calculation") and disclosed to investors.

The AIFM can perform the valuation function itself or can appoint an external valuer. It is not required to appoint an external valuer. If the AIFM carries out the valuation function, the valuation task must be functionally independent from portfolio management and the AIFM must mitigate any conflicts of interest that arise.

Valuation means valuing the AIF's assets (and liabilities), including the exercise of subjective judgement (where necessary) on the valuation of individual assets.

A recital to the Level 2 Regulation states that obtaining individual asset values from the AIFM, pricing sources or an external valuer, and incorporating them into the calculation of the net asset value, is not a part of the valuation function. Therefore, a third party administrator that collects asset prices from the AIFM or from external sources in order to carry out the calculation of the net asset value is not treated as an external valuer for the purpose of AIFMD.

ONGOING COMPLIANCE REQUIREMENTS
VALUATION continued

Valuation rules and procedures

The Level 2 Regulation sets out the AIFM's obligations for maintaining accounting records and provides additional detail about the valuation procedures, valuation frequency and professional guarantees. In addition, the Level 2 Regulation sets out the depositary's duties for overseeing the application of the AIFM's valuation procedures.

The Level 2 Regulation requires the AIFM to keep accounting records such that all assets and liabilities can be directly identified at all times and to establish, implement and maintain accounting and valuation policies so as to ensure the net asset value of each AIF is accurately calculated.

The Level 2 Regulation requires an AIFM to establish, maintain, implement and review valuation policies and procedures, and to specify their content. These should be consistently applied to all assets, over time and across all AIFs managed by the AIFM. Also, the risk management function should review the valuation policies and procedures. The process for reviewing individual asset valuations should be documented and should include at least the checks and controls specified in the Regulation.

The Level 2 Regulation also requires the AIFM to ensure that procedures for calculating the net asset value per unit are documented and their application is regularly verified by the AIFM.

The Level 2 Regulation specifies the nature of the professional guarantees that are required to be provided by an external valuer.

Valuation frequency

Valuations must be performed at least once a year. For closed-ended AIFs, valuations must also be carried out whenever there is an increase or decrease in the AIF's capital.

"Capital" is not defined but is taken at least to include an issue of units or shares in the AIF at a value linked to the value of the AIF's assets. Managers will need to form their own view as to whether a valuation should be carried out on an ordinary drawdown or distribution.

More frequent valuation requirements apply to open-ended AIFs.

Who can perform valuations?

The AIFM may perform valuations itself, or arrange for an independent external valuer to perform this function. In practice, most private equity or venture capital firms have performed valuations themselves, with appropriate internal and external support.

AIFMs that carry out their own valuations must ensure independence between the valuation and portfolio management functions. The AIFM must put in place measures to mitigate conflicts of interest arising in connection with in-house valuation (e.g. arising from the AIFM's remuneration policy), and to prevent undue influence on staff. In guidance produced by several supervisory authorities within the EU, the individuals performing valuations should not also perform portfolio management, should not be directly supervised by those responsible for the performance of the portfolio management and should be incentivised substantially in accordance with objectives linked to the valuation function.

These supervisory authorities have also provided the following guidance:

- The process of valuing the assets of an AIF could involve more than one person. However, one person should be responsible for the valuation function for each individual asset in an AIF's portfolio. Where the valuation process involves more than one person, it is the person making the final determination of the individual asset's value who undertakes the valuation function for that asset.
- An AIFM that performs valuations itself may obtain assistance from other contributors in coming to its final valuation, such as external price providers, but it must be responsible for the final determination of an asset value itself. An AIFM can also make use of external valuation advisers but should not be bound to accept the adviser's recommended values for particular assets.
- An AIFM's portfolio managers can provide input or advice to the person undertaking the valuation function, but may not make the final determination of an asset value. The person responsible for valuations should make reasonable efforts to verify recommended values and to form an independent view on whether a recommendation is reliable.
- An AIFM's valuation policy should specify the circumstances where the person responsible for the valuation function may seek the advice of portfolio managers, the controls in place to ensure there is an appropriate degree of objectivity in finalizing values and the review process for the individual values of the assets.
- If a valuation committee that includes portfolio managers makes the final determination of an asset's value, the portfolio managers must participate in an advisory capacity only, not exert undue influence on final valuations and not have a vote on the final asset values. In such cases, the voting members of the committee should collectively have sufficient seniority and competence to form an independent view on whether the portfolio managers' recommendations are reliable.

ONGOING COMPLIANCE REQUIREMENTS
VALUATION continued

Appointing an external valuer

A number of conditions must be met where an external valuer is appointed. Sub-delegation by external valuers is not permitted.

- The external valuer must be independent from the AIFM, the AIF and any other person that is closely linked to the AIFM or the AIF.
- The AIFM must notify the appointment to its home Member State regulator, which (in certain circumstances) can require a different external valuer to be appointed.
- The AIFM must also be able to demonstrate that the appointment is objectively justifiable, does not inhibit effective supervision of the AIFM or its ability to act in investors' best interests and can be terminated immediately when this is in the interest of investors.
- The AIFM must also ensure that the external valuer is subject to mandatory professional registration/rules of professional conduct, can furnish sufficient professional guarantees, is capable of performing, and is qualified to and has sufficient resources to perform, the valuations, was selected with all due care, can be effectively monitored and instructed by the AIFM and that the external valuer's relevant staff are sufficiently experienced and of good repute.

An AIF's depositary may act as the AIF's external valuer, provided that it "functionally and hierarchically" separates its depositary and valuation functions and the potential conflicts of interest are properly identified, managed, monitored and disclosed to investors.

According to guidance from several supervisory authorities within the EU, an AIFM can use several external valuers for different types of assets and an AIFM can perform the valuation function itself for some types of assets, and appoint an external valuer for other types of assets.

Liability issues

The AIFM will be responsible for valuations, whether or not an external valuer is appointed.

Under the AIFMD, an AIFM's liability to the fund and the investors cannot be affected by the fact that an AIFM has appointed an external valuer and the external valuer must be liable to the AIFM for any losses suffered by the AIFM as a result of the valuer's negligence or intentional failure to perform its tasks.

Impact on Managers

As noted above, most private equity or venture capital firms will perform valuations themselves, with appropriate internal and external support. Fund administrators have not generally acted as an "external valuer" of the type contemplated by AIFMD.

Managers that perform the valuation function themselves must ensure a degree of independence between the individual responsible for asset values and individual portfolio managers and other individuals who may have an interest in the result. This may be challenging for smaller managers. All managers must, as a minimum, identify and manage conflicts of interest.

Impact on Fund-of-Funds

There are no different implications which are specific to FoF managers. Like any AIFM, FoF managers may elect to conduct valuation internally or to appoint an external valuer.

For smaller FoF managers, there is a practical requirement for 'functional independence' from portfolio management and the remuneration policy. This is likely to be challenging for smaller FoF managers who may not currently employ sufficient people to be able to separate these activities.

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ONGOING COMPLIANCE REQUIREMENTS
REMUNERATION

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General

The remuneration provisions in the AIFMD were based on those in the Banking Consolidation Directive (BCD), which has now been repealed and replaced (for banks and certain types of investment firm) by the Fourth Capital Requirements Directive (CRD IV). The European Commission is now working on a CRD V.

The BCD provisions may continue to apply to certain investment firms under a Member State discretion contained in CRD IV. The European Commission and European Banking Authority are working on a new prudential (including remuneration) regime for certain investment firms.

The stated intention behind those provisions was to ensure that pay for senior staff – in particular bonuses and other "variable remuneration" – aligned the interests of those staff with the bank's interests. Many of the principles were transposed into the AIFMD with little or no change, even though they were designed for banks. This means that while it may not be easy for private equity (or other) fund managers to apply the rules in a way which is letter-by-letter consistent with the law, the industry is well placed to meet the underlying objective of sound and effective risk management, given the well-established use of co-investment and carried interest arrangements designed to align the interests of senior private equity manager staff and investors in the AIF.

The AIFMD requires EEA AIFMs to put in place remuneration policies and practices for certain senior staff, designed to promote sound and effective risk management and not to encourage risk taking which is inconsistent with the risk profiles and rules of the AIF.

The main question for most private equity and venture capital AIFMs will be how and to what extent the prescriptive requirements in the AIFMD for aligning risk with remuneration can be satisfied by the AIFM's incentive arrangements including salary, benefits, bonus and carried interest.

ONGOING COMPLIANCE REQUIREMENTS
REMUNERATION continued

In July 2013, the European Securities and Markets Authority (ESMA) published its final guidelines on sound remuneration principles under the AIFMD (ESMA/2013/232). The guidelines apply to national regulators on a comply or explain basis, and, where they have been adopted by national regulators, apply directly to AIFMs. In March 2016, ESMA published a further set of final guidelines on sound remuneration policies under the UCITS Directive and the AIFMD (ESMA/2016/411). Those guidelines contained a limited amendment to the original guidelines for AIFMs, which confirmed that non-AIFM sectoral prudential rules can apply to members of an AIFM's staff in a group context. For example, where an AIFM is part of the same group as a bank, certain of the AIFM's staff may be subject to group remuneration requirements under CRD IV, as well as being subject to AIFMD-derived requirements. Apart from that change, the AIFM guidelines were not amended. Despite the fact that they have been in existence for several years, the guidelines nonetheless remain open to a wide range of interpretations in several respects. National regulators have adopted a range of practices to implement the guidelines, most of which are not published.

Remuneration continues to be a key political topic. Alongside the UCITS remuneration guidelines published in March 2016, ESMA also published a letter addressed to the European Commission, Parliament and Council suggesting that the principle of proportionality in the AIFM remuneration rules could be clarified through legislative amendments. Similar legislative amendments have been proposed under CRD V. There remains a particular concern that developments in relation to the CRD IV and CRD V remuneration regime may eventually affect the interpretation or application of rules under the AIFMD. Firms should therefore continue to monitor the implications of the rules in light of possible future legislative changes, as well as for changes in regulators' interpretations and practice.

Non-EEA AIFMs of non-EEA AIFs will not be forced to become subject to the AIFMD's pay regulation rules until three years after the third country passport becomes available, at the earliest. For them, the ESMA guidelines will not be directly relevant. Rather, they must consider disclosures about aggregated remuneration to be made in the Annual Report concerning the AIF (see page 26). The guidelines may nevertheless help to inform their approach to disclosure.

What is "remuneration" for these purposes?

The AIFMD does not define "remuneration", but does state that the requirements apply to:

a) Remuneration of any type paid by the AIFM;

b) Any amount paid directly by the AIF, including "carried interest" (as poorly defined); and

c) Any transfer of shares or units of the AIF.

ESMA takes the view that carried interest is to be treated for these narrow regulatory purposes as if it were remuneration. Of course, carried interest is not remuneration. ESMA expressly recognises that the AIFMD's provisions concerning remuneration are extended to carried interest for regulatory purposes only.

The ESMA guidelines for UCITS managers suggest that, when seeking to apply the remuneration requirements to carried interest, it may be appropriate to value carried interest in the year in which a participant becomes entitled to it. It may nevertheless be necessary to report the value of carried interest returns distributed in the Annual Report of the AIF.

ESMA provides that co-investment is not remuneration provided it is "pro rata" to investors. It is not clear what this means. As a general proposition, returns on investment (other than carried interest) are not to be treated as remuneration.

ESMA provides that returns on co-investment funded by loan from the AIFM should be considered to be remuneration for the purposes of the rules and guidelines "if the loan has not been reimbursed by the time the return is paid".

ESMA gave guidance on payments made by the AIF to the AIFM. For example, some firms route a portion of co-investment or carried interest through the AIFM, as opposed to it being distributed directly to individuals or through separate co-investment or carried interest vehicles. The guidance provides that such payments should be treated as remuneration "whenever payments... are made directly by the AIF to the AIFM for the benefit of the relevant categories of staff of the AIFM for professional services rendered, which may otherwise result in a circumvention of the relevant remuneration rules". Reimbursement of costs and expenses is disregarded. It is not clear what this means.

More helpfully, ESMA clarified that distributions received by partners of an AIFM should not be treated as remuneration for the purposes of the rules and guidance unless "the material outcome of [such payments is] a circumvention of the relevant remuneration rules, any intention to circumvent such rules being irrelevant...".

The same principle should apply to dividends paid to owner-managers of AIFMs not structured as partnerships but having similar characteristics.

ONGOING COMPLIANCE REQUIREMENTS
REMUNERATION continued

Proportionality

There is flexibility for an AIFM to take a proportionate approach, by complying with the principles "in a way and to the extent that is appropriate to [the AIFM's] size, internal organisation and the nature, scope and complexity of [the AIFM's] activities".

In its guidelines, ESMA expressly recognises that certain remuneration principles (including those requiring deferral of a proportion of variable pay, payment in units and ex-post risk adjustment) may be satisfied if an AIFM puts in place a carried interest model which aligns the interests of the AIFM with those of its investors. This is extremely welcome and important to the industry. Although the ESMA guidelines only illustrate one example of a carried interest structure it is generally similar to the model employed by many Invest Europe members.

Carried interest models other than the example given by ESMA may also satisfy the policy objectives of alignment of interest with investors and avoiding incentives for inappropriate risk taking. Each AIFM must assess the application of the principles to its overall variable remuneration arrangements on a case-by-case basis by reference to those policy objectives. Certain Member State regulators have confirmed this approach.

ESMA's guidelines currently recognise that certain (though not all) other remuneration principles may be disapplied on grounds of proportionality. Relevant principles include those which require deferral of a proportion of variable pay, payment in units and ex-post risk adjustment (the "pay-out process rules"). This must be justified by each firm on a case-by-case basis. ESMA says that proportionality may operate on a firm-by-firm and/or individual-by-individual basis.

However, as mentioned above, the correct interpretation of the proportionality principle has recently become a contentious issue. In 2015, the European Banking Authority (EBA) suggested that similar language contained in CRD IV might not be able to be used to justify the disapplication of remuneration principles (including pay-out process rules) under the CRD IV regime. However, the EBA's final CRD IV remuneration guidelines published in December 2015 did not explicitly repeat this interpretation, although they did not disclaim it either.
In a letter to the European institutions in March 2016, ESMA supported the potential disapplication of the AIFM pay-out process rules in specific circumstances, as well as the application of lower minimum quantitative thresholds where appropriate, but noted that the existing understanding of the proportionality principle had now been called into question. ESMA explicitly recognised that the fund management sector is different from the banking sector and suggested that the European legislators may wish to clarify the correct application of proportionality through changes to the AIFMD itself. The European Commission has proposed legislative amendments under CRD V but it is unclear whether similar proposals will be made in respect of AIFMD. Until any potential amendments have been enacted, firms should continue to adopt the current approach of considering whether disapplication of the pay-out process rules can be justified on a case-by-case basis.

AIFMs will need to assess and may need to take advice on the grounds upon which AIFMs may justify disapplication of the principles on grounds of proportionality. There may be a range of outcomes depending on the precise details of the arrangements and how the regulator in a particular Member State may look upon them.

However, some private equity and venture capital AIFMs may conclude that the fact that they have in place a carried interest model (meeting the policy objectives described above) gives good grounds for disapplication of (at least) the pay-out process rules. When making this assessment, the AIFM should consider whether, in the particular case, the most important element of variable incentive is carried interest. If it is not, the alignment effect may break down. It is also likely to be critical that the carried interest model is expressly agreed by investors, for example in the AIF's constitutional documents. There may be other grounds on which private equity and venture capital firms may reach the same conclusion.

Where justified, the pay-out process rules can be disapplied in relation to the carried interest arrangement itself, but they can also be disapplied in relation to other forms of variable remuneration including annual bonuses.

Some AIFMs may not be able to demonstrate that their carried interest models satisfy the appropriate alignment requirements of the AIFMD, nor justify disapplication of the pay-out process rules. In some cases, a particular member of Identified Staff may not participate in the carried interest. For these or other reasons, such AIFMs may be obliged to defer a proportion of variable pay (such as any annual bonus) and to apply ex-post risk adjustment to that deferred element. However, to the extent that a private equity or venture capital firm operates only closed-ended AIFs, that alone should be good grounds to disapply the principle requiring payment in units, since it is practically impossible to pay in units. Some firms may exceptionally be able to pay instead in other instruments, such as shares in the AIFM or its parent, if the management group is listed.

Paying staff in control functions

(e.g. compliance, risk management, legal)

It is consistent with the ESMA guidelines to incentivise staff in control functions substantially through their participation in a carried interest arrangement having the features described above.

The ESMA guidelines provide that such variable pay should not be determined "*solely* by AIFM-wide performance".

ONGOING COMPLIANCE REQUIREMENTS
REMUNERATION continued

Which staff must be covered?

An AIFM's remuneration policies and practices must cover any categories of staff whose professional activities have a material impact on the risk profile of the funds it manages (known as "Identified Staff"). Depending on their impact on risk, these might include:

- Senior management;
- "Risk takers" (likely to include senior investment executives who may not also be senior management);
- Employees whose remuneration takes them into the same bracket as senior management and risk takers; and
- "Control functions" (including the firm's compliance officer, for example).

Certain rules apply to all staff of the AIFM, for example restrictions on guaranteed variable remuneration. The table in Annex II to the ESMA guidelines gives guidance about which of the remuneration principles apply to all staff and which apply only to Identified Staff.[17]

What are the requirements?

When establishing and applying their remuneration policies and practices AIFMs must comply with a number of principles, which are listed in Annex II to the AIFMD. The overarching requirement is for the AIFM to have a remuneration policy that is consistent with and promotes sound and effective risk management. It must include conflict avoidance measures and must be in line with the business strategy, objectives, values and interests of the AIFM and its AIFs/investors.

The policy and its implementation must be periodically reviewed.

Key additional requirements (or "principles") include:

- A requirement for fixed remuneration (e.g. salary) and variable remuneration (e.g. bonus) to be appropriately balanced;
- A requirement that between 40% and 60% (for higher earners) of variable remuneration should be deferred over at least three years;
- A requirement that at least 50% of variable remuneration (both the deferred and undeferred elements) must be paid in units or shares in the relevant fund (or similar instruments), which should also be subject to an appropriate retention policy. This 50% requirement is subject to limited adjustment (e.g. where the AIFM also manages significant amounts in separately managed accounts);
- Provisions on the payment and vesting of deferred amounts, depending on the AIFM's financial situation and the performance of the relevant individual, business unit and AIF;
- Provision for the contraction (or non-payment) of variable remuneration due where the AIFM or the AIF performs poorly, and for claw-back of amounts already paid;
- Requirements in relation to performance-related remuneration, so that (for example) the assessment of performance:
  - Includes risk adjustment mechanisms;
  - Takes account of non-financial as well as financial criteria;
  - Is set in a multi-year framework appropriate to the life cycle of the fund; and
  - Is based on a combination of individual performance and performance of the business unit, fund and the AIFM as a whole;
- Restrictions on guaranteed bonuses; and
- Requirements for staff in control functions to be compensated by reference to objectives linked to those functions (i.e. independently of the performance of business areas they control).

Payment in units

For these purposes, "units" is a generic term meaning interests in the AIF. This could include, for example, limited partnership interests.

The ESMA guidelines recommend that, where a proportion of variable remuneration must be paid in units, the units should relate "mainly" to the AIF managed by the individual. There is an odd caveat, though, that this should not lead to excessive concentration "facilitating an excessive risk-taking" by the individual. It is not clear what this means. It may be grounds for staff to participate more widely in the funds managed by the AIFM and not exclusively in funds managed by the individual being part of a particular investment committee.

Where an AIFM manages closed-ended AIFs or otherwise cannot award or transfer units in AIFs to Identified Staff, it may award "equivalent ownership interests". There is not much guidance as to what this means. It could encompass "phantom" AIF interests or shares in the AIFM or its parent undertaking, particularly where the AIFM or its parent has shares admitted to trading on a public market.

Notes
17. Guidelines on sound remuneration policies under the AIFMD

ONGOING COMPLIANCE REQUIREMENTS
REMUNERATION continued

Remuneration committee

AIFMs that are significant in terms of their size or the size of the funds they manage will also be required to have a remuneration committee which consists of (including its chair) non-executive members of the management body.

ESMA acknowledges that, for some firms, it may be disproportionate to establish a remuneration committee. It gives a non-exhaustive list of factors to be taken into account, including:

a) Whether or not the AIFM is listed;

b) The legal structure of the AIFM;

c) The number of employees of the AIFM;

d) The AIFM's assets under management;

e) Whether the AIFM is also a UCITS manager; and

f) Whether or not the AIFM has obtained "top-up" permission to provide certain MiFID investment services.

In elaborating on the factor of size, ESMA gives examples of firms which may not need to establish a remuneration committee. They include AIFMs with AUM not greater than EUR 1.25 billion and not more than 50 employees. However, even a firm which is larger than this may conclude that it would be disproportionate to establish a remuneration committee taking into account other factors. Certain Member State regulators have elaborated on this guidance. ESMA acknowledges that AIFMs which are part of banking, insurance or investment groups may look to a group remuneration committee external to the AIFM, provided that the rules governing its composition, role and functions are equivalent to those required by the guidelines.

Application of the remuneration principles to delegates of the AIFM

The ESMA guidelines require AIFMs to ensure that, to the extent that portfolio management or risk management activities are delegated by the AIFM, the delegate is either:

a) Itself subject to pay regulation of equivalent effect; or

b) Made subject to contractual obligations which are of similar effect in order to prevent "circumvention".

In applying the new requirements concerning delegates, it will be important for firms to establish to whom the AIFM delegates "portfolio management or risk management". For example, in some structures, an AIFM may procure investment advice from an advisory affiliate. This may not involve the delegation of either portfolio management or risk management activities. Where delegation happens, if the delegate is an investment firm subject to CRD IV (or to rules originally established under the BCD, by virtue of an exemption under CRD IV which allows BCD rules to continue to be applied), it is likely already to be subject to EU pay regulation. However, delegates which are only subject to the MiFID remuneration guidelines published by ESMA in July 2013 are unlikely to be deemed to be subject to "pay regulation of equivalent effect", given the limited nature of those guidelines.

Where the delegate is not subject to equivalent pay regulation, the guidelines require contractual arrangements to cover any payments made to the delegate's "Identified Staff". That term is defined to include staff of the delegate "whose professional activities have a material impact on the risk profiles of the AIF that the AIFM manages". In some delegation arrangements, the role of the delegate will not be sufficiently important for any of the delegate's staff to fall into this category.

Disclosure requirements

AIFMs applying for authorisation will be required to disclose details of their remuneration policies and practices to their home Member State competent authority.

The AIFM must also prepare an annual report in respect of each EEA AIF it manages and each AIF it markets in the EEA, and this must contain certain information in relation to remuneration (see page 26).

SECTION 4

FUND MANAGEMENT & PORTFOLIO COMPANY PROVISIONS

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FUND MANAGEMENT & PORTFOLIO COMPANY PROVISIONS

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Fund Management

Private equity and venture capital fund managers do not typically undertake day-to-day management of portfolio companies themselves. These companies will be managed by appointed management teams. That said, the investors in each portfolio company will have agreed a strategy with each other and management in advance and exercise shareholder rights within a defined framework to implement and refine that strategy. The relevant provisions of the AIFMD relating to portfolio companies therefore should be understood and applied in this context.

The portfolio company provisions apply to non-EEA AIFMs who market AIFs in the EEA, as well as to EEA AIFMs.

AIFMs need to review the contractual documentation entered into with portfolio companies as well as general company law provisions applicable in the relevant jurisdiction, to ensure that they are able to comply with the disclosure and notification requirements outlined in this section. They should also be aware that, in some respects, the AIFMD has created an unlevel playing field, whereby other forms of owners are not subject to the same obligations and restrictions. It is important to consider deal structures in light of these notification requirements and so-called "asset stripping" provisions.

Although in this section most attention has been focused on the portfolio company provisions, the AIFMD, and more particularly the Level 2 Regulation, also contains a number of other provisions, which directly affect EEA AIFMs' investment management processes and policies. So, although most fund managers have robust due diligence procedures in place which consider whether the investment is in line with the AIF's objectives, it is important to ensure that the investment process is documented in the way, and covers the matters, required by the AIFMD and the Level 2 Regulation as outlined in this section. Voting strategies also now have to be formulated and recorded, if this was not already being done.

The Level 2 Regulation contains detailed rules on best execution, order handling, aggregation and allocation and the choice of counterparties for some types of transactions. Frequently some of these requirements do not apply to private equity transactions or do not have a significant impact on the way firms operate. In the private equity context such requirements are most likely to become relevant when an AIF invests by way of a public-to-private deal or exits an investment by way of an Initial Public Offering. Firms do however need to consider the extent to which they apply to their business and implement the relevant policies and procedures to ensure compliance or to demonstrate why they do not apply.

Finally, although delegation and depositary provisions are not covered in this section, it should be noted that:

a) Sometimes an investment process may require delegation of an aspect of the task to a third party and when this is the case it is necessary to check whether the Directive delegation rules apply (and comply if necessary). However, in each case there needs to be a careful assessment of whether there is delegation of a function within the meaning of the AIFMD, as opposed to using a third party to provide information or assistance; and

b) The depositary's monitoring obligations are likely to mean that it will require some involvement in the investment process and allowance needs to be made for this in order to ensure smooth completion of transactions.

FUND MANAGEMENT & PORTFOLIO COMPANY PROVISIONS continued

Portfolio Company Provisions

The notification, disclosure and asset stripping provisions below only apply in relation to portfolio companies whose registered office is in the EEA.

Notification of an interest in a company

When an AIF acquires or disposes of shares in an unlisted portfolio company which has its registered office in the EEA, the relevant AIFM is obliged to notify its competent authority (within 10 working days) if the proportion of shares held reaches, exceeds or falls below the thresholds of 10%, 20%, 30%, 50% and 75%. This applies even if there is no control position, and so applies also to AIFs acquiring minority stakes.

Initial disclosures when a company is "controlled" by an AIF

The AIFMD also includes additional disclosure and notification requirements for AIFMs, which manage funds that acquire "control" of portfolio companies (either alone, or in combination with other AIFs on the basis of an agreement between them or their AIFMs). The provisions only apply in relation to portfolio companies (other than SMEs and certain real estate SPVs – see further below on page 50) with their registered office in the EEA.

Meaning of "control"

In the case of an unlisted company, an AIF (or combination of AIFs) has "control" if they have more than 50% of the voting rights of the company (subject to various anti-abuse provisions which aggregate shares held by related entities). For "issuers", which (broadly) means companies that are listed on a stock market, "control" is defined by reference to the way in which Member States define it for the purposes of the Takeover Directive[18] (which in many countries is at or around 30%, but which varies across the EEA and ranges from 25% to 66%[21]).

As mentioned above, an AIF will be taken to have "control" over an unlisted company or an issuer when its AIFM is cooperating with one or more other AIFMs and AIFs managed by those AIFMs jointly acquire control of the target. In such circumstances, each AIF will be attributed the aggregate level of control of all acquiring AIFs. For example, if two AIFs managed by separate AIFMs each acquire 30% of the voting rights of a target as part of the same transaction aimed at acquiring control, each AIF will be deemed to have over 50% of the voting rights for the purposes of the portfolio company provisions.

Notification on acquisition of control of an unlisted company

When there is an acquisition of control of an unlisted company, the AIFM(s) managing the relevant AIF(s) is obliged to notify that fact to:

- The company;
- The shareholders of which the identities and addresses are available to the AIFM or can be made available by the company, or through a register to which the AIFM has or can get access; and
- The competent authority of the home Member State of the AIFM.

This notification also has to include details of the voting rights held (although it is not entirely clear if this applies only to those shares held by the AIF), the "conditions under which control has been reached" (including the identity of the different shareholders involved, any person entitled to exercise voting rights on their behalf and, if applicable, the chain of undertakings through which voting rights are effectively held), and the date on which the AIF(s) acquired control.

Disclosures on acquisition of control

As well as the notification referred to above, there are further disclosure requirements on an acquisition of control. These apply in relation to "issuers", as well as unlisted companies.

These disclosure provisions require AIFMs to notify the company, shareholders and competent authority of:

- The identity of the AIFMs which either individually or in agreement with another AIFM manage the AIF(s) that have acquired control;
- The policy for "preventing and managing conflicts of interest, in particular between the AIFM, the AIF and the company" and including "the specific safeguards established" to ensure that any agreement between the AIFM and/or the AIF and the company is at arms-length; and
- The policy for external and internal communication relating to the company, in particular as regards employees.

In relation to unlisted companies the regulator in the AIFM's home state may also require the information to be disclosed to the regulator in the Member State of the unlisted company if the company is in a different Member State.

Notes
18. Article 5(3) of Directive 2004/25/EC
19. See Report on the Implementation of the Directive on Takeover Bids, 2007 (21.02.2007 SEC (2007) 268)

FUND MANAGEMENT & PORTFOLIO COMPANY PROVISIONS continued

Notification of future intentions

Where control is acquired of an unlisted company the AIF must disclose "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". This information must be made available to the company and its shareholders, and the AIFM must use its best efforts to ensure that the board passes the information on to employee representatives (or, if there are none, to the employees themselves).

This wording is taken from the Takeover Directive and has been subject to interpretation by case law in that context, which confirms that this obligation can be fulfilled by fair but general information. This could mean including a general statement in the offer document that the existing employment rights of the target company's employees will be safeguarded (or fully safeguarded).

Where control is acquired in a public company there are other provisions under existing European law, including the Takeover Directive, which need to be applied. For example, the offer document must include information on a broad range of issues including restrictions on transfers of shares or limitations on voting rights as well as details on rules governing board appointments and the board members' powers.

Notification and disclosure to employees

The AIFM is obliged to request the board of directors of the company to pass all of the above information on to the representatives of employees (or, if there are none, the employees themselves). The AIFM has to use its "best efforts" to make sure that the employee representatives (or employees) are informed.

Provisions in the AIFMD seek to protect confidential information, which could damage the company, from disclosure to employees.

Information concerning financing

Finally, there are obligations (which only seem to apply in the case of acquisition of control of an unlisted company[20]) to provide competent authorities and investors in the AIF with "information on the financing of the acquisition". This may include disclosure of the principal "sources and uses" of funds and their principal terms.

Additional information about controlled companies in annual reports

When an unlisted company (other than an SME or real estate holding company) is controlled by an AIF (either individually or jointly) each AIF or the controlling AIFs (as the case may be) has to ensure that additional information is disclosed on an annual basis. It can do this in one of two ways:

- It can either "request and use its best efforts to make sure" that the company's own annual report includes the additional disclosures, or
- It can include the additional information in the AIF's annual report to investors (prepared in accordance with Article 22 AIFMD and as discussed in Section 3, sub-section, Transparency).

In both cases, there are provisions to make sure that employee representatives (through the company's board) and investors in the AIF receive the information disclosed.

The information which must be disclosed includes:

- A fair review of the development of the company's business representing the situation at the end of the period covered by the annual report;
- An indication of any important events that have occurred since the end of the financial year;
- An indication of the company's likely future development; and
- Certain information concerning any acquisitions of own shares by the company.

Notes

20. Although Recital 56 says they should also apply in relation to issuers.

Scope
Authorisation & Registration Process
Ongoing Compliance Requirements
Fund Management & Portfolio Company Provisions
Fundraising & Structuring
Third Country Funds & Fund Managers
Annex 1

FUND MANAGEMENT & PORTFOLIO COMPANY PROVISIONS continued

Asset Stripping Provisions

Provisions in the AIFMD to prevent "asset stripping" by AIFMs impose additional restrictions on distributions, capital reductions, share redemptions or purchases of own shares by "controlled" portfolio companies (listed and unlisted) during the first two years of an AIF's ownership.

Although drawn from European company law, these restrictions apply to all types of companies owned by private equity funds, and therefore (depending on how the Second Company Law Directive has been implemented in a Member State) go further than is the case in many Member States at the moment.

The way the rules are framed means that they apply obligations to the AIFM rather than the company itself. The AIFM is not allowed to "facilitate, support or instruct" any of the prohibited actions, nor can it vote in favour of them, and must use "best efforts" to prevent them.

The restrictions imposed do not prevent all payments to shareholders during the two-year period, but broadly they only allow "distributable profits" to be paid out, and only then when the company's net assets would remain at or above the level of the subscribed capital plus undistributable reserves (although the prohibition on returning undistributable reserves is framed with reference to local laws, so companies in Member States that have more liberal laws about the distribution of share premium are at a distinct advantage). Distributions which are prohibited include "dividends and interest relating to shares", and there are additional exceptions for certain share re-purchases or capital reductions.

Existing company law rules on distributions and other payments to shareholders by private companies vary across EEA Member States, and so the impact of these changes varies from country to country. However, these prohibitions may prevent, for example, special dividends being paid following a recapitalisation of the company, and certain other forms of partial exit. They may therefore have an impact on exit strategies and deal structuring.

Application to acquisitions of targets with existing subsidiaries

In a situation where an AIF has acquired a company with existing subsidiaries, or when it incorporates one or more (EEA or non-EEA) holding companies to sit between the target company and the AIF, it will be necessary for the AIFM to conduct an analysis of which EEA entities within the target group the asset stripping provisions will apply to. The provisions of the Directive are rather unclear on this point, as they are drafted in a way which assumes that the acquisition target is a single entity rather than a group of entities.

When conducting their analysis, AIFMs should therefore bear in mind the purpose of the asset stripping provisions, which is to safeguard against the extraction of value from target groups, and should apply the provisions within the group structure accordingly.

There are a number of other uncertainties in relation to the application of the rules to specific situations: for example, the effect of a fund temporarily reducing its holding to below 50% and then increasing it again, and what, if anything, an AIFM must do in relation to companies it sells within the two-year period.

Exclusion for SMEs and real estate holding companies

The AIFMD does not impose the additional notification and disclosure requirements in relation to portfolio companies, which are SMEs. SMEs are defined as companies which employ fewer than 250 persons and which have an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million. There is also an exception for special purpose vehicles which purchase, hold or administer real estate.

There are also exclusions from the asset stripping provisions for SMEs and real estate special purpose vehicles.

Impact on Investors

The requirements in relation to additional information on controlled companies may result in a greater consistency of information supplied in annual reports across different AIFs in which they are invested. There may also be slightly more clarity and consistency on reporting across AIFs on how acquired companies are financed.

Impact on Fund-of-Funds

A FoF which does not co-invest directly in portfolio companies is unlikely to be subject to these notification and asset stripping provisions as they apply to the respective owner AIF in which the FoF is invested. An AIFM which is authorised principally as a FoF AIFM, however, but which also manages direct investment portfolios, would be subject to these provisions.

FUND MANAGEMENT & PORTFOLIO COMPANY PROVISIONS continued

Other provisions affecting the investment process

(Many of which will not be relevant for a 'non-trading'[21] private equity and venture capital AIF)

Due diligence and record keeping

The Level 2 Regulation requires AIFMs to establish formal written due diligence procedures which must be regularly reviewed and updated to ensure compliance with the AIF's objectives, strategy and risk limits.

Where the AIFM plans to acquire less liquid assets after negotiations, which will be the case for almost all private equity investments, it is obliged to:

- Produce and regularly update a business plan;
- Select transactions consistent with the business plan;
- Assess each selected transaction against other opportunities and related risks (e.g. legal, fiscal and financial, human and material resources, management and exit strategies);
- Perform the due diligence exercise prior to execution;
- Monitor performance against the business plan; and
- Retain records of the transactions considered and due diligence exercise conducted for at least five years.

In addition to the new record keeping obligations relating to due diligence, the AIFM must keep records of transactions actually made. Most private equity and venture capital transactions only need the usual records to be kept (e.g. name of AIF, legal transaction documents and price). Where the relevant transaction is entered into on an execution venue (i.e. regulated exchanges or certain regulated trading platforms) as is the case in a Public-to-Private transaction, considerable detail is required. This is unlikely to be relevant in the private equity context since any interests acquired are unlikely to be executed on a regulated trading platform.

Exercising voting rights

The Level 2 Regulation also contains rules on the exercise of voting rights by AIFMs. AIFMs are obliged to develop and implement strategies for determining when and how any voting rights held in the AIF's portfolio(s) are to be exercised for the exclusive benefit of the relevant AIF and its investors.

The AIFM's voting strategy must include procedures to:

a) Monitor relevant corporate actions;

b) Ensure voting is in line with the AIF's investment objectives; and

c) Prevent or manage conflicts. AIFMs should provide investors with a summary description of their voting strategy and details of the actions taken on the basis of the strategy, upon request.

Best execution

Best execution obligations apply to transactions that are transmitted or executed on certain regulated markets and trading venues, or where a choice of execution venue is available. In the private equity context this will likely only arise in public-to-private deals, PIPEs, gilts or money market instruments held pending investment in private equity, or hedging or other derivatives.

Broadly, this requires AIFMs to have a best execution policy in place which is designed to ensure that AIFMs take all reasonable steps to (a) obtain the best possible result for the AIF or the investors; or (b) confirm that the firms to which the AIFM passes the order provides best execution.

The best execution factors include: the price, costs, speed, likelihood of execution and settlement, size, nature of the order and any other consideration relevant to the execution of an order. The AIFM has some discretion in assessing the relative importance of these factors in the light of the AIF's objectives, investment policy and risks, the order and assets concerned and the execution venues potentially available.

Where the AIFM places an order with other firms for execution, the best execution policy should identify, in respect to each class of financial instrument, the firms with which the orders may be placed; and AIFMs are required to provide investors with 'appropriate information' regarding the policy and any material changes to it.

Monitoring and reviewing the best execution policy

AIFMs are required to monitor the effectiveness of their best execution policy, including the quality of execution by firms to which orders are passed, and identify and correct any deficiencies found.

The policy should be reviewed at least annually and must be reviewed whenever a material change occurs which affects the AIFM's ability to provide best execution.

An AIFM must be able to demonstrate that they have executed orders or placed orders with other firms on behalf of the AIF in accordance with its best execution policy.

Notes

21. For example, where fund interests are acquired outside of a regulated exchange or trading platform.

FUND MANAGEMENT & PORTFOLIO COMPANY PROVISIONS continued

Impact on Managers

Investments in real estate and partnership interests and certain other negotiated arrangements are not subject to the detailed best execution requirements in the Level 2 Regulation.

Most private equity AIFMs already have detailed due diligence and investment decision taking procedures and rarely need to deal in the type of investment or for investors where orders are time sensitive and need detailed handling and aggregation processes or where there is a relevant choice of counterparty. These factors mean that it is unlikely that the order execution and handling and due diligence requirements will have had a material impact on the day-to-day operations of AIFMs in the private equity or venture capital sector.

However, it is necessary to review and amend existing investment processes to ensure compliance, including recording voting strategies. The very fact that transactions subject to the best execution, choice of counterparty and securitisation provisions are likely to be relatively rare means that additional care needs to be taken to identify relevant transactions in order to ensure that they are carried out correctly.

Order handling, aggregation and allocation

In practice, although the order handling, aggregation and allocation rules apply to private equity and venture capital AIFMs in full, it is rarely the case that the nature of the transactions undertaken, and the parties for whom they are undertaken, require very detailed processes and procedures to handle orders.

AIFMs must establish procedures and arrangements which facilitate the prompt, fair and expeditious execution of an AIF's orders (including decisions the AIFM takes to deal for the AIFM), including ensuring that:

a) Orders are promptly and accurately recorded and allocated; and

b) Comparable AIF orders are executed sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable, or the interests of the AIF or the investors require otherwise.

Financial instruments, sums of money or other assets received in settlement of the executed orders must be promptly and correctly delivered or registered in the account of the relevant AIF. The AIFM must have arrangements in place to prevent the misuse of information regarding AIF orders.

In a normal private equity transaction the timing of the transaction and its completion is negotiated contractually and applies to all co-investing parties in accordance with any co-investment agreement, rather than the AIFM deciding timing of execution and whether or not to aggregate orders. Nevertheless, the allocation of transactions between funds and other investors is important. Policies on allocation will need to comply with the Regulation requirements as well as order handling and order aggregation policies being formulated in case they are ever relevant.

Broadly, AIFMs are allowed to aggregate an AIF order with an order of another AIF, a UCITS, or a client, or with an order made by the AIFM when investing its own funds where:

- It is reasonably likely that aggregation will not work to the disadvantage of any other AIF, UCITS, or client; and
- The AIFM has an order allocation policy in place. The policy must contain 'sufficient' precise terms for the fair allocation of orders that are aggregated, including how the volume and price of orders determines allocations and the treatment of partial executions.

Choice of counterparties

If an AIFM plans to enter into an OTC derivatives transaction (even if just for hedging purposes), securities lending or repo transaction then it will be subject to new due diligence obligations requiring the AIFM to ensure that the counterparty is (a) subject to ongoing supervision by a public authority (b) financially sound (in relation to which the AIFM can take account of whether the counterparty is subject to prudential regulation including capital requirements and effective supervision); and (c) has the necessary organisational structure and resources to perform the relevant services.

Securitisation transactions

In the rare case that a private equity AIFM considers investing in a securitisation position, including where such a situation might arise in a refinancing or exit, extensive new restrictions will apply. AIFMs are not allowed to assume exposure to a securitisation unless the originator, sponsor or original lender has explicitly disclosed to the AIFM that it retains a material net economic interest (as described in the Level 2 Regulation) of at least 5%. Even when it does so the AIFM is responsible for carrying out extensive qualitative tests and having appropriate policies and procedures for that purpose.

SECTION 5

FUNDRAISING & STRUCTURING

FUNDRAISING & STRUCTURING

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General

Fund structuring and marketing have increased in complexity in the AIFMD world. The "right" structure of an AIF will depend not only on tax but also regulatory aspects. When determining the structure one needs to take into consideration the targeted investor base (for marketing regulatory reasons) and the manager set-up (for manager regulatory aspects), all of which is governed by the AIFMD rules.

In terms of marketing regulation, the general principle is that an EEA AIFM managing EEA AIFs and marketing to professional investors in another EEA Member State is subject to the EU passport regime, which implies full compliance with the AIFMD rules (including among others marketing notification and disclosure requirements, see Section 3, sub-section, Transparency).

In certain EEA Member States an exemption from full compliance is available, in case the manager manages on an aggregate basis less than EUR 500 million assets under management provided that it only manages unleveraged funds which provide no redemption rights within the first 5 years (see Section 1). Such so-called "sub-threshold managers" which are exempt from most of the AIFMD requirements under the laws of their home country do not benefit from the passport. Marketing for such sub-threshold managers on a cross-border basis has become extremely difficult, in many countries impossible.

Non-EEA managers are subject to certain minimum requirements under the AIFMD and the national private placement rules of each Member State. There are big differences among those regimes. In certain countries private placement is in practice not available, in other countries private placement is subject to registration and in other countries private placement is subject to approval requirements. In all countries the marketing by such non-EEA manager is subject to certain minimum requirements which are set forth in the AIFMD and must be met in each EEA country.

FUNDRAISING & STRUCTURING continued

What is "marketing"?

The AIFMD defines marketing as the direct and indirect offering or placement at the initiative of the AIFM, or on behalf of the AIFM, of units or shares of an AIF it manages to, or with, investors in the EEA.

This definition does, however, leave space for a broad range of different interpretations by national legislators. The interpretation of marketing is key as only a fundraising activity which is deemed to be "marketing" will trigger the AIFMD requirements. For example, in the UK "marketing" is understood to involve making a fund interest available for investment, for example by circulating a substantially final PPM, LPA and subscription document (even if those documents may be further negotiated with the investor before final closing). In Germany the regulator appears to consider any offer relating to an AIF to be "marketing" if (i) the AIF was already launched (i.e. when at least one investor has subscribed a unit or a share) or (ii) its investment rules are ready for subscription.

In France marketing is defined broadly as presenting units or shares in an AIF on French territory by various means (advertising, direct marketing, advice) with a view to encouraging an investor to subscribe to or purchase them. However, recently the French regulator has issued guidance to the effect that marketing to (a) French funds-of-funds and (b) discretionary investment managers in France does not constitute AIFMD 'marketing' from a French perspective.

The marketing definition in Luxembourg requires a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union. Therefore, in Luxembourg marketing takes place when the AIF, the AIFM or an intermediary on their behalf seeks to raise capital by actively making units or shares of an AIF available for firm purchase by a potential investor.

Overall, in many (but not all) EEA countries, marketing is not deemed to exist if the AIF has not yet been formed. In the private equity and venture capital context, raising capital usually starts with general negotiations about possible investment opportunities, the presentation of key persons and the provision of teaser documents only. Such non-binding meetings should be seen as permitted "pre-marketing" in most EEA countries as long as no fund documentation is provided and the fund has not yet been established. However, as soon as the fund has been established and / or fund documentation has been provided to prospective investors enabling them to make final investment decisions, in many EEA countries such an activity would be seen as marketing and hence trigger notification requirements. In practice it should be verified for each country what is understood as permitted pre-marketing and when the boundary to regulated marketing is reached.

It has been discussed whether the sales of secondary positions in an AIF can generally constitute "marketing". The better view seems to be that this is not the case at least where such secondary sale transaction has not been structured for the purpose of avoiding the marketing rule. However, the question has not been clearly answered by all regulators.

What is "reverse solicitation"?

Pursuant to the AIFMD definition, "marketing" implies that the units or shares of an AIF are offered or placed at the initiative of the AIFM. Therefore, offering which occurs at the initiative of the investor ("reverse solicitation") should not be deemed "marketing" within this meaning.

This is consistent as well with the recitals to the AIFMD, which provide:

> "This Directive should not affect the current situation, whereby a professional investor established in the Union may invest in AIFs on its own initiative, irrespective of where the AIFM and/or the AIF is established."

In light of the above, the concept of reverse solicitation should be accepted in each EEA Member State. However, in practice the understanding of what is still regarded an unsolicited offering at the initiative of an investor varies from one EEA Member State to another. Depending on the interpretation of such terms there is more or less scope of reverse solicitation in the respective Member States.

In Germany the regulator has not issued guidance on the exact scope of reverse solicitation. It seems that the regulator is taking a rather restrictive view in practice, demanding that the exact product be requested by the potential investor, which may also not be "invited" by the AIFM to make such a request.

In Luxembourg reverse solicitation is understood as providing information regarding an AIF and making units or shares of that AIF available for purchase to a potential investor in response to initiative taken by that investor (or an agent of that investor) without any solicitation made by the AIF or its AIFM (or an intermediary acting on their behalf) in relation to the relevant AIF. Therefore, in Luxembourg reverse solicitation requires the following two conditions to be present cumulatively: the investor (or an agent of the investor) has approached the AIFM or the AIF on its own initiative with the intention of investing in (or, initially, receiving information regarding) AIF(s) managed by such AIFM, and neither the AIFM, nor the AIF (nor any intermediary acting on their behalf) has solicited the investor to invest in the relevant AIF.

In France reverse solicitation is understood as the purchase, sale or subscription of units or shares in an AIF in response to a client's unsolicited request to purchase a specifically designated AIF, provided that the investor is authorised to do so.

Reverse solicitation is also recognized under UK law. Here it is understood as an offering or placement of units or shares of an AIF to an investor at that investor's genuine initiative.

The definitions of reverse solicitation read similarly in the various Member States, but with potentially very different results in the practical application. It is therefore advisable to verify with local counsel on a case-by-case basis each time the AIFM is contacted by a potential investor and would like to rely on reverse solicitation.

FUNDRAISING & STRUCTURING continued

Notification Requirements/ Sign-off by Competent Authority

EEA AIFM with EEA AIF

Before an EEA AIFM (and also a future non-EEA AIFM benefiting from the passport) can start marketing, it must comply with certain notification requirements and submit certain information in respect of the AIF it intends to market in the EEA.

The AIFM is required to submit a notification to the competent authorities of its home Member State in respect of each AIF that it intends to market. The notification must include, among other things, a program of operations identifying the AIF and information on where the AIF is established, the AIF rules or instruments of incorporation, the identity of the depositary of the AIF and any information on the AIF available to investors. It must also include all information required to be disclosed to investors prior to investment (see Section 3, sub-section, Transparency).

No later than 20 working days after receipt of the complete notification file, the competent authority will inform the AIFM whether it may start marketing the AIF identified in the notification.

If the AIFM intends to market the AIF in a Member State other than its home Member State, then the competent authority of the home Member State/Member State of reference of the AIFM will transmit the complete notification file to the competent authorities of each Member State in which the AIF is proposed to be marketed. This will be done within 20 working days of issuing approval and the AIFM will be informed without delay that this has taken place. The AIFM may start marketing the AIF in the host Member State(s) as of the date of that notification. A regulator may refuse permission to market only if the management of the AIF will not be in accordance with the Directive, or the AIFM is generally not in compliance with its obligations under the Directive.

Some host Member States charge an initial and/or annual fee to an EEA AIFM which markets an EEA AIF with a passport (e.g. Germany, France, Luxembourg). In our view, this is a violation of European law.

In case the documentation that was submitted to the home regulator in the course of the marketing filing undergoes material changes as a result of negotiations with investors, those amendments require the approval of the home regulator before a closing can take place.

In practice, this raises the question when an amendment is deemed to be "material" triggering such additional one-month approval period. The question is very relevant in the private equity domain where it is common for investors to negotiate the fund documentation and amendments, typically in favour of investors, are agreed upon. It seems that many regulators take the view that any change which is material within the meaning of Article 106 of the Level 2 Regulation will be deemed material for these purposes as well. In other words, any change that is subject to disclosure requirements to investors pursuant to Article 22 AIFMD would also trigger the additional approval requirement and postpone the closing of an AIF.

It is advisable to verify with local counsel of the home Member State of the AIFM what is deemed to be material by such national regulator. Depending on the outcome and the scope of pre-marketing in the EEA Member States in which potential investors are being approached (see above), it may be preferable to wait on the passport filing until the documents are fully negotiated with investors.

Special rules as to marketing apply to EEA feeder AIFs: EEA feeder AIFs ("Feeder AIF"), broadly defined as AIFs which invest 85% or more of their assets in another AIF, the "Master AIF"), may only be marketed under the above regime if they are investing into a Master AIF that is also an EEA AIF managed by an authorised EEA AIFM. Other EEA Feeder AIFs may be marketed on the same basis as third country AIFs.

Special requirements apply with respect to the marketing of non-EEA AIFs managed by non-EEA AIFMs or EEA AIFMs (see Section 6).

Impact on fundraising process

In order to admit investors, the AIFM will need to inform its regulatory authorities and submit the relevant documentation before any marketing activity takes place (see above on page 55).

The requirement to present the competent authorities with documentation prior to the start of the marketing process stems from a belief that private equity and venture capital funds are 'sold' when in fact they are partnership negotiations that take place over a period of time, usually many months. However, throughout the private equity and venture capital fundraising process the terms are often negotiated and hence the documentation submitted will be subject to numerous amendments. However, only "material" changes to the information provided will have to be submitted to the competent authorities at least one month in advance (or, in the event of an unplanned change, immediately after the change takes place). Whether marketing activities must stop while this review takes place varies between jurisdictions and is not always clear. For example, in Germany the provision of material changes to the regulator does not stop the marketing process.

An amendment to the investment policy, replacement of the AIFM or depositary in the structure, and assuming leverage for the first time are examples of changes that should be material from a regulatory perspective. Changing key person terms is likely to be material as well.

FUNDRAISING & STRUCTURING continued

Summary: Marketing for EEA AIFMs with EEA AIFs

Passport

The AIFM must comply with the AIFMD in full.

Notification to the competent authorities of the EEA AIFM's home Member State is required in case of marketing of EEA AIF interests in other Member States.

Amendments trigger additional approval period.

National placement regime

Certain EEA Member States provide for exemptions for small AIFMs below the threshold. In such case the sub-threshold AIFM can typically market freely to investors in its home Member State but marketing on a cross-border basis to investors in other EEA Member States is very restricted and even impossible in certain Member States (e.g. France, the Netherlands and Italy).

If these AIFMs want the benefit of a passport to make an offering in different EEA Member States, then they must either opt in to the scope of the AIFMD or make use of any other passport rights that may be available under other EU regimes (i.e., under the EuVECA or EuSEF Regulations).

Impact on Investors

With regard to new AIFs being raised/fundraisings, investors should establish, as part of their due diligence, whether the AIFM is required to comply with the AIFMD. If the AIFM is subject to the AIFMD but is not authorised, then the reasons for this ought to be established.

Investors are permitted to invest at their own initiative, including in AIFs managed by non-AIFMD compliant AIFMs. What exactly is to be understood by "at its own initiative", however, remains subject to the interpretation of the national legislators and the national reverse solicitation concept (see Section 1 and above).

Impact on Fund-of-Funds

It is possible that FoF AIFMs may need to consider several different investment structures to feed into a single AIF to accommodate the particular and diverse criteria of their investors. Each investment structure could potentially qualify as an AIF and should be examined carefully.

FoF will have to consider the additional costs which arise at the FoF level and potentially at the target fund level as well.

Impact on Placement Agents

Where a placement agent is being used, such placement agent and the AIFM must ensure that the AIFMD marketing requirements are met. As stated above, the better view is that secondary sales should not be 'marketing' by the GP (a view supported in the UK). In case investors themselves decide to sell their shares in an AIF and engage an intermediary to act on their behalf, no marketing within the meaning of the Directive should be assumed because the offering or placement of such shares is not at the initiative of the AIFM, or on behalf of the AIFM.

Structuring Aspects

The new marketing requirements also have had an impact on structuring considerations. An AIFM based outside the EEA which is marketing to investors in the EEA must check whether the target countries in which it intends to market retain their placement regimes and whether any additional requirements will apply in the future. An EEA-based AIFM which exceeds the threshold will have to apply for an AIFM authorisation.

Once such authorisation is received, and the passport right exercised, it would no longer have to worry about local marketing restrictions. However, until the authorisation is obtained no passport can be relied upon and the AIFM must verify if and under what circumstances it can market in the respective target country.

Marketing for sub-threshold AIFMs has become extremely difficult on a cross-border basis, because many EEA countries no longer permit the marketing into their country by sub-threshold managers unless the AIFM qualifies for the EuVECA or EuSEF regime.

It is up to the AIFM to notify the regulatory authority prior to marketing and to ensure that all AIFMD requirements are met. However, it is not always easy to determine the AIFM in a fund structure.

In many limited partnership structures, the (managing) general partner would be deemed to be the AIFM under the AIFMD. However, it is also possible that the managing general partner appoints an external manager as the AIFM; this scenario has to be distinguished from scenarios where the general partner merely delegates certain management functions but remains the AIFM of the AIF. If AIFM functions are delegated (e.g. portfolio management or risk management), the AIFM will remain liable to the AIF and to the investors and must be able to control the services performed by the delegate on an ongoing basis. The delegation will only be possible to a regulated entity (unless the competent authority has waived this requirement) and subject to meeting the delegation requirements set out in the section below.

An adviser providing non-discretionary investment advice to the AIFM should not be considered an AIFM if such adviser will not take final investment decisions. Advisers do not carry out risk or portfolio management; they provide information and assistance to the AIFM who carries out the actual risk and portfolio management.

Delegation

Overview

The AIFMD imposes requirements on an AIFM when delegating any of the functions set out in Annex I of the AIFMD (i.e. portfolio management, risk management, administrator functions, marketing and activities related to the assets of AIFs). In particular, ESMA stated that where a third party performs any function set out in Annex I of the AIFMD (including the investment management functions which the AIFM shall at least perform as well as other functions that the AIFM may additionally perform), this should be considered as having been delegated by the AIFM to the third party. This statement is raising concerns and questions as it could mean for example that the appointment of a placement agent which assumes marketing activities would fall under the delegation rules. It is still being discussed whether that was indeed intended and is seen differently among the Member States. However, the engagement of a mere advisor (providing deal sourcing, monitoring the portfolio, rendering the due diligence processes prior to an investment etc.) does not qualify as delegation. Specific additional restrictions apply when delegating portfolio management or risk management functions. Such requirements and restrictions do not apply where purely administrative or technical functions are delegated (so called non-core services delegation).

As only a single AIFM may be authorised to manage an AIF, a global manager with international offices will need to ensure that it has the correct delegations in place with regard to portfolio management or risk management. These delegations should be identified in the AIFM's authorisation submission.

Disclosures to investors and competent authorities

An AIFM applying for authorisation will be required to disclose its delegation arrangements (including the identity of the delegate and a description of any potential conflicts of interest) to its home Member State competent authority, and must then give its competent authority advance notice of any new delegation.

Moreover, details of any delegation of management functions, the identity of the delegate and a description of any potential conflicts of interest must be made available to investors before they invest. This information must be updated to reflect any material changes.

Liability

Delegation does not affect the liability of the AIFM for the matters delegated. Hence, the obligations of the AIFM to the AIF and its investors are not altered as a result of the delegation. However, the AIFM and the delegate may agree on an indemnification for the benefit of the AIFM.

General requirements relating to delegation

The general conditions to be met with respect to a delegation (other than a delegation of pure administrative functions) are as follows:

- Any delegation must be justifiable with "objective reasons"; for such objective reasons, the following criteria, in particular, shall be considered:
  - Optimizing of business functions and processes;
  - Cost saving;
  - Expertise of the delegate in administration or in specific markets or investments.
- The AIFM must be able to demonstrate that the delegate:
  - Is capable of performing, qualified to perform and has sufficient resources to perform, the functions delegated;
  - Was selected with all due care; and
  - Can be effectively monitored and instructed by the AIFM;
- The delegation:
  - Must not inhibit effective supervision of the AIFM or its ability to act in investors' best interests; and
  - Must be capable of immediate termination when this is in the interest of investors; and
- The delegate's relevant staff must be sufficiently experienced and of good repute.

An AIFM must not delegate its portfolio and risk management functions to the extent that, in essence, it is no longer the manager of the relevant AIF (i.e., it becomes a "letter-box entity").

An AIFM is deemed a letter-box entity and shall no longer be considered to be the AIFM of the AIF in, at a minimum, any of the following situations:

- The AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- The AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions in particular in relation to the implementation of the general investment policy and investment strategies;
- The AIFM loses its contractual rights to inquire, inspect, have access or give instructions to its delegates or the exercise of such rights becomes impossible in practice;
- The AIFM delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself. When assessing the extent of delegation, competent authorities shall assess the entire delegation structure taking into account not only the assets managed under delegation but also the following qualitative criteria:
  - The types of assets the AIF or the AIFM acting on behalf of the AIF is invested in, and the importance of the assets managed under delegation for the risk and return profile of the AIF;
  - The importance of the assets under delegation for the achievement of the investment goals of the AIF;
  - The geographical and sectoral spread of the AIF's investments,
  - The risk profile of the AIF;
  - The type of investment strategies pursued by the AIF or the AIFM acting on behalf of the AIF;
  - The types of tasks delegated in relation to those retained; and
  - The configuration of delegates and their sub-delegates, their geographical sphere of operation and their corporate structure, including whether the delegation is conferred on an entity belonging to the same corporate group as the AIFM.

FUNDRAISING & STRUCTURING continued

Regarding the last point above, it is still totally unclear how the qualitative criteria will be read and what impact they will have. It remains to be seen how national regulators will interpret these rules. We understand that the qualitative criteria are meant to soften the quantitative rule of the preceding sentence. Hence, even if an AIFM has delegated more functions than it retains, it may still be admissible if the importance of the functions retained by the AIFM supports the conclusion that it is not a letter-box entity. Much legal uncertainty remains with regard to this requirement.

For example, the UK supervisory authority has indicated that, when assessing whether a UK AIFM is a letter-box entity, it will undertake a proportionate supervisory assessment, which will be more qualitative than quantitative; the AIFM will be expected to exercise effective oversight and control over risk and portfolio management in an active way and on a continuous basis; the governing body of the AIFM must not abdicate their responsibility.

Sub-delegation

Delegation by a delegate or sub-delegate ("sub-delegation") is generally permitted, provided that:

- The AIFM has consented in advance;
- The AIFM has given prior notice of the sub-delegation to its home Member State competent authority; and
- The requirements applicable to a delegation of the function are also met in relation to the sub-delegation.

The notification to the home Member State competent authority must contain details of the delegate, the name of the competent authority where the sub-delegate is authorised or registered, the delegated functions, the AIFs affected by the sub-delegation, a copy of the written consent by the AIFM and the intended effective date of the sub-delegation. The delegate must review the services provided by its sub-delegates on an ongoing basis. Additional restrictions apply on sub-delegation of portfolio or risk management.

Restrictions on delegating portfolio or risk management

Additional restrictions apply when an AIFM delegates portfolio management or risk management. These functions may not be delegated or sub-delegated to:

- The depositary or any delegate of the depositary;
- A non-EEA undertaking, unless cooperation between that undertaking's regulator and the AIFM's home Member State competent authority is "ensured";
- Any entity that is not authorised/registered and supervised for asset management, unless the AIFM's home Member State competent authority has given its prior consent; or
- Any other entity whose interests may conflict with the AIFM or the fund investors unless:
  - The entity "functionally and hierarchically" separates its delegated tasks from any other potentially conflicting tasks; and
  - The potential conflicts are properly identified, managed, monitored and disclosed to fund investors.

The following entities are deemed to be authorised/registered for the purpose of asset management and subject to supervision:

- Management companies authorised under Directive 2009/65/EC;
- Investment firms authorised under Directive 2004/39/EC to perform portfolio management;
- Credit institutions authorised under Directive 2013/36/EU having the authorisation to perform portfolio management under Directive 2004/39/EC;
- External AIFMs authorised under Directive 2011/61/EU; and
- Third country entities authorised or registered for the purpose of asset management and effectively supervised by a competent authority in those countries.

An AIFM must review the services provided by its delegates on an ongoing basis and must particularly ensure that the delegate carries out the delegated functions effectively and in compliance with applicable law and regulatory requirements.

Impact on Investors

There is no significant impact on investors beyond checking that the requisite information has been received and that the necessary authorisations are in place. The primary responsibility for this lies with the competent authorities, which will maintain a register of authorised AIFMs. Investors will have access to this register.

Impact on Fund-of-Funds

There are no additional implications which are specific to FoF managers beyond those for any other AIFM. The principal consideration will be to ensure that the correct delegations are in place where the FoF manager is an international manager with international branches or subsidiaries which may be undertaking either or both of the core functions of portfolio management and risk management. A FoF manager must identify any planned delegations in its submission for authorisation.

Depending on the domicile of the AIF and the domicile of the potential investors it intends to target fund structuring may well change in the AIFMD world. The principle will be that an EEA AIFM managing EEA AIFs will be subject to the EEA passport regime triggering notification/approval and disclosure requirements as set out below (regarding disclosure requirements, see also Section 3, sub-section, Transparency). For all non-EEA AIFMs and those which fall below the size threshold (see Section 1), it will be up to the national legislators to retain or not their placement regime subject to the minimum requirements foreseen under the AIFMD (see Section 6).

SECTION 6

THIRD COUNTRY FUNDS & FUND MANAGERS

THIRD COUNTRY FUNDS & FUND MANAGERS

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Although the AIFMD is a European Union Directive (with EEA relevance), the AIFMD could still have relevance for a manager that does not have its registered office in the EEA, depending on its activities.

Under the AIFMD, such a manager will be treated as a 'non-EEA AIFM'.

The AIFMD applies to non-EEA AIFMs if, and to the extent that, they manage EEA AIFs, or market AIF interests (in EEA or non-EEA AIFs) to EEA investors. Unlike EEA AIFMs, however, non-EEA AIFMs are not currently eligible to apply for authorisation under the AIFMD or to benefit from the AIFMD "marketing passport". Rather, the AIFMD provides for certain transitional periods leading to the planned final position of the full application of the AIFMD to non-EEA AIFMs managing EEA AIFs or marketing AIF interests to EEA investors. This final position is subject to certain EU legislative measures being implemented, and there is no certainty as to whether or when such measures will be implemented.

The position for non-EEA AIFs and AIFMs can be broken down as follows.

THIRD COUNTRY FUNDS & FUND MANAGERS continued

1. Current position until introduction of the passport (2018 at the earliest)

All non-EEA AIFMs may market AIF interests to EEA professional investors only pursuant to Member State placement regimes. National placement regimes must include minimum requirements set out in the AIFMD, and may include additional conditions imposed under Member State law. Member States are not required to offer placement regimes at all, and some, such as Italy, have not. If Member States do elect to offer such placement regimes, the regimes must comply with the requirements set out below on pages 65 et seqq.

Non-EEA AIFMs may manage EEA AIFs during this period if permitted by national law in the relevant Member State.

Non-EEA AIFs may continue to make investments throughout the EEA. If the AIF has been marketed to EEA investors pursuant to an AIFMD-compliant national placement regime, however, then the AIFM must comply with the AIFMD portfolio company provisions (see Section 4) in addition to the requirements applicable to its marketing activities.

EEA AIFMs marketing non-EEA AIF interests to EEA investors will have to comply with all obligations under the AIFMD (other than certain depositary obligations), but will not benefit from the passport when marketing interests in those non-EEA AIFs to EEA investors.

2. From 2018 (at the earliest) to 2021 (at the earliest)

During a three-year period, the third country passport will be available, in parallel with and as an alternative to national placement regimes (to the extent they remain in place and subject to some additional minimum AIFMD conditions).

More concretely:

If and when the Commission's delegated act to give effect to a third country passport enters into force, non-EEA AIFMs from relevant jurisdictions will be eligible to apply for full authorisation under the AIFMD (enabling them to market funds to EEA professional investors and/or manage EEA funds on the same basis as EEA AIFMs).

Authorised EEA AIFMs marketing non-EEA AIFs established in qualifying jurisdictions (i.e. established in one of the non-EEA countries to which the AIFMD passport is extended) to EEA investors will be able to benefit from the AIFMD marketing passport without any additional authorisation (as they will already be AIFMD-compliant in relation to those AIFs).

Non-EEA AIFMs may also continue to use national placement regimes for marketing to EEA investors as described above if, and to the extent, such regimes remain in place (which would be a matter for each EEA Member State to determine).

3. From 2021 onwards

Three years after extension of the passport to non-EEA AIFMs as discussed above, and subject to another positive opinion from ESMA and the relevant measures being passed by the relevant EU institutions, national placement regimes will no longer be available for non-EEA AIFMs.

The earliest the elimination of placement regimes could take effect would be 2021. At that point, non-EEA AIFMs will likely be able to market AIF interests to EEA investors only if that non-EEA AIFM is from a qualifying jurisdiction and is authorised by an EEA regulator under the AIFMD; non-EEA AIFMs not meeting these conditions will not be able to market AIF interests in the EEA under either the national placement regimes or the AIFMD.

Non-EEA AIFMs

The treatment of non-EEA AIFMs was one of the most controversial issues in the drafting of the AIFMD. The final text was intended to create a level playing field between EEA and non-EEA AIFMs, but the regime permitting non-EEA AIFMs to become authorised under the AIFMD and enjoy the same market access as EEA AIFMs has been delayed and will not become available until/before 2018 (at the earliest).

In July 2015 and subsequently in July 2016, ESMA advised the European Commission on whether the passport should be extended to non-EEA AIFMs and non-EEA AIFs for certain key jurisdictions. ESMA based its opinion and advice on, among other things, the use made of the passport for EEA AIFs and any problems encountered during its use; the effectiveness of the collection and sharing of information by national regulators, ESMA and ESRB (European Systemic Risk Board); compliance with the rules on marketing and managing AIFs during the transitional period; and potential market disruptions and distortions.

Based on ESMA's positive opinion and advice, the Commission was generally supposed to adopt a delegated act (within three months) specifying the date when the regime enabling non-EEA AIFMs to become authorised under the AIFMD, and non-EEA AIF interests to be marketed with the passport, would enter into force. However, ESMA suggested that the Commission may wait until positive advice on sufficient non-EEA jurisdictions is available while taking into account the effect on the markets triggering the extension of the passport may have.

For each jurisdiction as to which ESMA's advice is positive, the Commission will draft implementing measures to allow non-EEA AIFMs from those jurisdictions to apply for authorisation under the AIFMD on the same basis as EEA AIFMs. ESMA is required to issue a positive advice if it considers that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risk. The consequences if ESMA's advice is negative are not clear.

The Commission has not yet acted on ESMA's advice. Before giving the "green light" to access the AIFMD regime, the Commission prefers to wait for a clear guidance from ESMA and also for an EU list of non-cooperative tax jurisdictions. Hence, the Commission will not make any decision before 2018. In the meantime, ESMA continues to work on its assessment of the other non-EEA jurisdictions in order to provide a positive advice for a sufficient number of countries but there is no concrete timeline established.

THIRD COUNTRY FUNDS & FUND MANAGERS continued

To qualify, a non-EEA jurisdiction must:

i) Have appropriate regulatory cooperation arrangements in place with relevant Member State regulators;

ii) Have OECD tax information exchange agreements in place with relevant Member States; and

iii) Not be designated as a Non-Cooperative Country and Territory by the Financial Action Task Force on anti-money laundering and terrorist financing.

ESMA has negotiated memoranda of understanding ("MOUs") with the regulatory authorities in many third countries, including the countries already assessed in ESMA's advice. MOUs need to be entered into on a bilateral basis by each relevant Member State regulator. In addition, local law in the AIFM's home jurisdiction must not prevent effective supervision of the AIFM by its EEA regulator.

A non-EEA AIFM wishing to manage an EEA AIF or market any AIF in the EEA in reliance on the marketing passport must apply for authorisation to the regulator in its "Member State of reference" (see below), which will be treated as the non-EEA AIFM's home Member State regulator for purposes of the AIFMD.

Non-EEA AIFMs becoming authorised under the AIFMD will be required to comply with the AIFMD in full, unless a legal requirement in the non-EEA AIFM's home jurisdiction directly conflicts with an obligation under the AIFMD and the AIFM can demonstrate that it is subject to an equivalent domestic rule having the same regulatory purpose and offering the same level of protection to investors. ESMA is required to give advice on the appropriateness of an exemption in case of incompatibility with an equivalent rule, and the availability of such waivers is expected to be extremely limited.

The authorisation process is largely the same as for EEA AIFMs (see Section 2), except that a Member State of reference must be identified to act in place of the home Member State regulator, and the non-EEA AIFM will need to appoint a legal representative in that Member State of reference.

Member State of reference

Broadly speaking, a non-EEA AIFM's Member State of reference will be the predominant EEA jurisdiction in which the non-EEA AIFM manages or markets AIFs, although the detailed rules are relatively complex.

In situations where there are several possible Member States of reference (e.g., where the non-EEA AIFM markets AIFs in different EEA jurisdictions), the non-EEA AIFM must submit a request[22] to the regulators of all Member States that could potentially be the Member State of reference, who then jointly determine where the non-EEA AIFM should become authorised.

The regulators in all possible Member States of reference will jointly decide which of them will be the Member State of reference within a month of receipt of the non-EEA AIFM's request to determine its Member State of reference. This period may be extended if further information and documents are requested by the regulators. ESMA will advise on the appropriateness of the choice of Member State of reference.

Where a non-EEA AIFM intends to market more than one non-EEA AIF to EEA investors, the Member State of reference will be the one where the non-EEA AIFM intends to develop effective marketing for most of those non-EEA AIFs.

Unfortunately, neither the AIFMD nor the Commission's Regulation on Member State of Reference indicate whether other relevant factors may be taken into account in deciding upon the Member State of reference. Factors to be considered may include the non-EEA AIFM's preference, whether affiliates of the non-EEA AIFM are already regulated by a Member State regulator, or the Member State regulator's working language.

If the AIFM changes its marketing strategy within two years after its initial authorisation and this change would have affected the determination of the Member State of reference, the AIFM must notify the competent authorities of the initial Member State of reference and indicate its new Member State of reference based on the new strategy. The AIFM will justify its assessment by disclosing its new marketing strategy to its initial Member State of reference. At the same time, the AIFM will provide information on the entity that would be its new legal representative after the change, including at least the identity and the location of the new legal representative.

Legal representative

Non-EEA AIFMs registering under the AIFMD will be required to appoint a "legal representative" in their Member State of reference. The legal representative will, together with the AIFM itself, be the contact point for investors, ESMA and EEA regulators as regards the activities for which the AIFM is authorised in the EEA. The legal representative must at least be sufficiently equipped to perform the AIFMD compliance function.

Marketing of interests in Non-EEA AIFs

Non-EEA AIFMs

Member States may, but are not obliged to, retain national placement regimes for non-EEA AIFMs from qualifying jurisdictions until at least 2021. Such non-EEA AIFMs will be able to market interests in non-EEA AIFs without a passport subject to compliance with the AIFMD's transparency and disclosure requirements (see Section 3, sub-section, Transparency) and portfolio company provisions (see Section 4), plus any additional conditions imposed by Member State law.

To be a qualifying jurisdiction for this purpose, the jurisdiction must:

1. Have in place cooperation arrangements with the competent/supervisory authorities in the relevant EEA jurisdictions; and
2. Not be designated by FATF as a Non-Cooperative Country and Territory.

Notes

22. Such a request must contain the information set out in the Commission's Implementing Regulation establishing a procedure for determining the Member State of Reference of a non-EEA AIFM.

THIRD COUNTRY FUNDS & FUND MANAGERS continued

EEA AIFMs

National placement regimes for EEA AIFMs marketing interests in non-EEA AIFs established in qualifying jurisdictions may also be retained until at least 2021, although it is anticipated that most will utilise the third country passport once available (which will be no earlier than some time in 2018).

All AIFMs after the introduction of the passport (2018 at the earliest)

After the introduction of the passport, not realistically expected to be before Q4 2018 (at the earliest), again subject to positive advice from ESMA, and the effectiveness of relevant implementing measures by the relevant EU institutions, all AIFMs authorised under the AIFMD will be entitled to market interests in non-EEA AIFs they manage (assuming that these non-EEA AIFs are established in a qualifying jurisdiction) to EEA professional investors using a passport, provided that:

i) The jurisdiction of the AIF or the AIFM meets the eligibility requirements summarized above;

ii) OECD tax information exchange agreements apply between the relevant jurisdictions; and

iii) The local law in the non-EEA jurisdiction does not prevent effective supervision by the relevant EEA regulator.

Role of ESMA

ESMA has and will have an important role in the application of the AIFMD to non-EEA AIFMs and AIFs.

Under the AIFMD, ESMA was required to render its opinion on the operation of the AIFMD passport regime and its opinion on the extension of the regime to non-EEA AIFMs by 22 July 2015, failing which the Commission could set a new deadline. In the event, ESMA decided not to issue a single opinion and advice, but to issue multiple opinions and advice on a country-by-country basis. As ESMA's opinion and advice issued in July 2015 covered only a few jurisdictions, the Commission gave ESMA a new deadline of 30 June 2016.

In the advice issued on 19 July 2016, ESMA advised the Commission on whether the AIFMD passport should be extended and apply to the management and/or marketing of AIFs by non-EEA AIFMs from the following countries: Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Isle of Man, Japan, Jersey, Singapore, Switzerland, and the USA. The advice yielded positive results for Guernsey, Jersey, Switzerland, Canada and Japan. A generally positive advice, subject to certain conditions, was issued for the USA, Australia as well as (with reservations pertaining to retail funds) Singapore and Hong Kong. For the USA specifically, ESMA noted that there would be no level playing field for U.S. managers accessing the European market and EEA managers accessing the U.S. market when marketing to professional investors involving a public offering (as defined in the U.S. Investment Company Act of 1940). The EEA manager would be subject to additional registration requirements in the USA. To address this imbalance, ESMA contemplated to extend the passport to the USA with certain restrictions and suggested three options: granting the passports only to (i) U.S. funds dedicated to professional investors and marketed in the EU without any public offering, (ii) U.S. funds that are not mutual funds (open-ended companies as defined in the U.S. Investment Company Act of 1940), or (iii) U.S. funds which restricted investment to professional investors as defined in AIFMD. Due to the timeline, ESMA was not able to come to a conclusion regarding Bermuda, the Cayman Islands and the Isle of Man.

Currently, ESMA continues its work on the assessment of (other) non-EEA countries and will continue to issue opinions and advice with respect to the extension of the passport to AIFMs from non-EEA jurisdictions. However, there is no concrete timeline when to expect the next batch of assessments.

With respect to each country for which ESMA's advice is positive, the Commission will prepare a delegated act extending the passport, but the delegated act will only enter into force after approval by the other EU institutions. The Commission has not yet acted on ESMA's advice and as of now, the earliest the delegated act could realistically enter into force would be 2018.

Similarly, three years after the entry into force of the passport regime for non-EEA AIFMs and non-EEA AIFs (i.e., at the earliest 2021), ESMA is required to issue an opinion and advice on the functioning of the passport. If the advice is positive, the Commission would adopt another delegated act setting out the date on which all EEA national placement regimes must be terminated.

Impact on Investors

All authorised AIFMs will be entered on a central register maintained by competent authorities and held centrally by ESMA. Investors will, therefore, be able to identify which AIFMs are authorised under the AIFMD.

Investors wanting to invest in a third country AIF (or an AIF managed by a non-EEA manager) ought to confirm with the manager of that AIF that the manager has taken steps to understand the implications of the AIFMD, including its ability to fund raise. As noted in Section 5 above, the AIFMD does allow for investors to commit to AIFs at their own initiative (reverse solicitation) although investors should confirm with the AIFM in these circumstances if it is comfortable to allow the investor to invest on this basis.

The restrictions on marketing interests in non-EEA AIFs may, in practice, mean that it will become more difficult for EEA investors to access non-EEA AIFs, as some non-EEA AIFMs may decide not to comply with the requirements of Member State placement regimes or (if and when the passport is extended to their jurisdictions) to seek authorisation as a non-EEA AIFM under the AIFMD third-country passport regime. However, the AIFMD does not preclude a non-EEA AIFM from selling interests in non-EEA AIFs to EEA investors so long as the AIFM does not engage in marketing to EEA investors. Thus, investors should be able to continue to invest if they proactively contact non-EEA sponsors to request information about future AIFs.

ANNEX 1

Guide to Marketing in the EEA for Third Country AIFs and AIFMs

ANNEX 1

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The table on the following pages summarises how non-EEA AIFMs marketing any type of AIF to EEA investors and how EEA AIFMs marketing non-EEA AIFs to EEA investors are affected by the Directive.[23]

Notes

23. ESMA issued an opinion on the functioning of the passport for EU AIFMs and on the national private placement regimes on 30 July 2015, followed by additional advice on granting the passport to managers and funds established in third countries on 19 July 2016. In its assessment, ESMA decided to adopt a country-by-country approach (such that this approach ultimately may result in the passport being extended to AIFMs/AIFs established only in a sub-set of non-EEA jurisdictions) and so far, has completed its review of 12 third countries. The advice was positive for Guernsey, Jersey, Switzerland, Canada and Japan. Generally positive advice, subject to certain conditions, was issued for the USA and Australia, as well as (with reservations pertaining to retail funds) Singapore and Hong Kong. For the USA specifically, ESMA noted that there would be no level playing field for U.S. managers accessing the European market and EEA managers accessing the U.S. market when making a public offering (as defined in the U.S. Investment Company Act of 1940). The EEA manager would be subject to additional registration requirements in the USA. To address this imbalance, ESMA contemplated extending the passport to the USA with certain restrictions and suggested three options: granting the passport only to U.S. AIFMs with (i) U.S. funds dedicated to professional investors and marketed in the EU without any public offering, (ii) U.S. funds that are not mutual funds (open-ended companies as defined in the U.S. Investment Company Act of 1940), or (iii) U.S. funds which restrict investment to professional investors as defined in AIFMD. Due to the timeline, ESMA was not able to come to a conclusion regarding Bermuda, the Cayman Islands and the Isle of Man. ESMA continues its work on the assessment of (other) non-EEA countries.

ANNEX 1 continued

Scenario 1: Non-EEA AIFM – EEA AIF

	DETAILS
Passport[24] likely not being extended to third country AIFs and AIFMs until 2018	A non-EEA AIFM managing an EEA AIF will be required to obtain authorisation under the AIFMD as soon as the regime for non-EEA AIFMs becomes available (likely not until 2018)[25]. Once authorised, the AIFM must comply with the AIFMD in full[26]. In addition, the following conditions must be fulfilled: • Appropriate cooperation arrangements are in place between the regulator in the country where the AIFM is established and the regulator in the EEA Member State in which the AIFM has obtained authorisation (i.e. the AIFM's Member State of reference) (and, if different, the regulator in the EEA Member State in which the AIF is established). • The jurisdiction where the AIFM is established is not listed as a non-cooperative country or territory by the FATF on anti-money laundering and terrorist financing. • A tax information sharing agreement which fully complies with standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital is in place between the country where the AIFM is established and the EEA Member State in which the AIFM has obtained authorisation (the AIFM's Member State of reference). • Domestic law and regulation applicable to the AIFM does not prevent the relevant EEA regulator from supervising the AIFM effectively. • The non-EEA AIFM has appointed a legal representative in the EEA Member State in which it has obtained authorisation (the AIFM's Member State of reference). Notification to the non-EEA AIFM's Member State of reference is required if marketing of EEA AIF interests is intended in the non-EEA AIFM's Member State of reference or any other EEA Member States. Note also that, in addition to benefitting from the marketing passport, any AIFM authorised under the AIFMD will be entitled to passport its investment management services (i.e. will not need to be separately licensed in each EEA jurisdiction in which it manages AIFs).

Notes

24. The passport only entitles AIFMs to market fund interests to professional investors. EU jurisdictions may impose additional restrictions on marketing, or prohibit marketing, to retail investors.

25. There are detailed rules that determine the EU jurisdiction in which the AIFM should seek authorisation.

26. There is a very limited power to derogate if the AIFM can demonstrate that AIFMD compliance is incompatible with a mandatory legal requirement to which it is subject and that other requirement has the same regulatory purpose and offers the same level of investor protection as the AIFMD provision.

ANNEX 1 continued

	DETAILS
National placement regimes[27] discretion is granted to EEA Member States to continue to make national placement regimes available for third-country AIFs and AIFMs until at least 3 years after the third country passport becomes available	Until the introduction of the passport (likely not until 2018), a non-EEA AIFM may manage an EEA AIF if permitted by national law in the relevant EEA jurisdiction. Until the introduction of the passport, the AIF may be marketed to EEA investors to the extent permitted under national placement regimes provided however that the EEA AIF must have appointed one or several persons to perform certain depositary functions. The passport is not likely to be extended to third country AIFs and AIFMs until 2018. More specifically: At a minimum, national placement regimes must require non-EEA AIFMs to comply with the following provisions of the AIFMD: **Chapter IV: Transparency requirements** • The AIFM will need to disclose to its investors, among other things, information about the AIF's investment policy and performance, investor protection measures, leverage, liquidity and service providers (like the depositary). The disclosures must be made prior to investment and updated on any material change. • The AIFM will need to produce an annual report for each AIF containing audited financials, a narrative report on the AIF's activities over the year, aggregated remuneration disclosures and details of any material changes to the investor disclosures. • The AIFM will be subject to regulatory reporting obligations in each Member State in which its AIF actively is marketed or from which an investor has invested in its AIF according to a pro-forma reporting template. Frequency of reporting will depend on a number of factors, such as the value of assets under management. **Chapter V: Portfolio Company requirements**[28] • Notification of acquisitions. The AIFM must make a basic regulatory filing when the voting percentage held by its AIF in an EEA company exceeds or falls below 10%, 20%, 30%, 50% or 75%. • Disclosures on acquisition of control:[29] Additional disclosures to regulators, other shareholders and the portfolio company's board of directors and employees of certain information including the identity of the AIFM, intentions with regard to the future business of the company and likely impact on employment and changes to conditions of employment. • Where the AIF has control, additional annual report information reviewing the last financial year, important post-year end events and likely future developments. • Anti-asset stripping: For the first two years after control has been acquired, the AIFM must not facilitate, support, instruct or vote in favour of any distribution to shareholders, capital reduction, share redemption or acquisition of own shares by the portfolio company that would (broadly speaking) result in a reduction in the company's net assets or be made otherwise than out of distributable profits. To the extent a viable national private placement regime is made available in an EEA Member State, it will only be available where: • Appropriate cooperation arrangements for systemic risk oversight are in place between the regulator in each Member State where the AIF is marketed and the supervisory authorities of the jurisdiction(s) where the AIFM and the AIF are established. • The jurisdictions where the AIFM and the AIF are established are not listed as non-cooperative countries or territories by the FATF on anti-money laundering and terrorist financing. From 2018 at the earliest (triggered by the requirement to get authorisation to manage, or continue to manage, an EEA AIF), the AIFM will need to comply with the full AIFMD (see 'Passport' above).

Notes

27. In most countries the use of the passport will be voluntary, in the sense that until three years after the third country passport becomes available, non-EEA AIFMs should have a choice between becoming authorised and benefiting from the passport, on the one hand, and continuing to market under national placement regimes, on the other hand. In some countries, however, national regimes will be abolished and marketing will only be permitted by authorised AIFMs. If national placement regimes are terminated in 2021 (assuming the passport is extended in 2018), authorisation will be the legal regime applicable for all fund managers that want to actively solicit EEA investors.

28. SME portfolio companies and certain real estate special purpose vehicles are excluded.

29. Additional obligations arise where the AIF managed by the AIFM directly or indirectly acquires control (50% of voting rights for unlisted companies, 30%-33% on a take-private) of an EEA portfolio company.

ANNEX 1 continued

Scenario 2: Non-EEA AIFM – Non-EEA AIF

	DETAILS
Passport likely not being extended to third country AIFs and AIFMs until 2018	To benefit from the passport, the AIFM must become authorised by the regulator in its EEA Member State of reference on the same basis as an EEA firm, and must comply with the AIFMD in full[30]. In addition, the following conditions must be fulfilled: • Appropriate cooperation arrangements are in place between the regulator(s) in the jurisdiction(s) where the AIFM and the AIF are established and the regulator in the EEA Member State in which the AIFM has obtained authorisation (the AIFM's Member State of reference). • The jurisdiction(s) where the AIFM and the AIF are established are not listed as a non-cooperative country and territory by the FATF on anti-money laundering and terrorist financing. • A tax information sharing agreement which fully complies with standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital is in place between the countries where the AIF and the AIFM are established and the EEA Member State in which the AIFM has obtained authorisation (the AIFM's Member State of reference), and between the country where the AIF is established and all EEA Member States into which it is to be marketed. • Domestic law and regulation applicable to the AIFM does not prevent the relevant EEA regulator from supervising the AIFM effectively. • The non-EEA AIFM has appointed a legal representative in the EEA Member State in which it has obtained authorisation (the AIFM's Member State of reference). Notification to the non-EEA AIFM's Member State of reference is required if marketing of non-EEA AIF interests is intended in the non-EEA AIFM's Member State of reference or any other EEA Member States.

Scope
Authorisation & Registration Process
Ongoing Compliance Requirements
Fund Management & Portfolio Company Provisions
Fundraising & Structuring
Third Country Funds & Fund Managers
Annex 1

Notes

30. There is a very limited power to derogate if the AIFM can demonstrate that AIFMD compliance is incompatible with a mandatory legal requirement to which it is subject and that other requirement has the same regulatory purpose and offers the same level of investor protection as the AIFMD provision.

ANNEX 1 continued

	DETAILS
National placement regimes discretion is granted to EEA Member States to continue to make national placement regimes available for third-country AIFs and AIFMs until at least 3 years after the third country passport becomes available	Until 2021 at the earliest (assuming the passport is extended in 2018), EEA Member States may – but are not required to – permit non-EEA AIFMs to market AIF interests to investors domiciled or with their registered office in that jurisdiction. Those jurisdictions that offer national placement regimes may impose specific requirements for that jurisdiction. These requirements may be procedural (e.g. a requirement to register with the regulator before marketing) or more substantive (e.g. a requirement to appoint a depositary to perform certain depositary functions in respect of the AIF). At a minimum, national placement regimes must require non-EEA AIFMs to comply with the following provisions of the AIFMD: **Chapter IV: Transparency requirements** • The AIFM will need to disclose to its investors, among other things, information about the AIF's investment policy and performance, investor protection measures, leverage, liquidity and service providers (like the depositary). The disclosures must be made prior to investment and updated on any material change. • The AIFM will need to produce an annual report for each AIF containing audited financials, a narrative report on the AIF's activities over the year, aggregated remuneration disclosures and details of any material changes to the investor disclosures. • The AIFM will be subject to regulatory reporting obligations in each Member State in which its AIF actively is marketed or from which an investor has invested in its AIF according to a pro-forma reporting template. Frequency of reporting will depend on a number of factors, such as the value of assets under management. **Chapter V: Portfolio Company requirements**[31] • Notification of acquisitions. The AIFM must make a basic regulatory filing when the voting percentage held by its AIF in an EEA company exceeds or falls below 10%, 20%, 30%, 50% or 75%. • Disclosures on acquisition of control:[32] Additional disclosures to regulators, other shareholders and the portfolio company's board of directors and employees of certain information including the identity of the AIFM, intentions with regard to the future business of the company and likely impact on employment and changes to conditions of employment. • Where the AIF has control, additional annual report information reviewing the last financial year, important post-year-end events and likely future developments. • Anti-asset stripping: For the first two years after control has been acquired, the AIFM must not facilitate, support, instruct or vote in favour of any distribution to shareholders, capital reduction, share redemption or acquisition of own shares by the portfolio company that would (broadly speaking) result in a reduction in the company's net assets or be made otherwise than out of distributable profits. To the extent a viable national private placement regime is made available in an EEA Member State, it will only be available where: • Appropriate cooperation arrangements for systemic risk oversight are in place between the regulator in each Member State where the AIF is marketed and the supervisory authorities of the jurisdiction(s) where the AIFM and the AIF are established. • The jurisdictions where the AIFM and the AIF are established are not listed as non-cooperative countries or territories by the FATF on anti-money laundering and terrorist financing. From 2018 at the earliest and where the AIFM wants to utilise a passport to market its AIF to EEA professional investors, the AIFM will need to comply with the full AIFMD (see 'Passport' above).

Notes

31. SME portfolio companies and certain real estate special purpose vehicles are excluded.

32. Additional obligations arise where the AIF managed by the AIFM directly or indirectly acquires control (50% of voting rights for unlisted companies, 30%-33% on a take-private) of an EEA portfolio company.

ANNEX 1 continued

Scenario 3: EEA AIFM – Non-EEA AIF[33]

	DETAILS
Passport likely not being extended to third country AIFs and AIFMs until 2018	To benefit from the passport, the EEA AIFM must comply with the AIFMD in full. In addition, the following conditions must be fulfilled: • Appropriate cooperation arrangements are in place between the regulator in the AIFM's home Member State and the regulator in the third country where the non-EEA AIF is established. • The jurisdiction where the AIF is established is not listed as a non-cooperative country and territory by the FATF on anti-money laundering and terrorist financing. • A tax information sharing agreement which fully complies with standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital is in place between the AIFM's home Member State and the country where the AIF is established, and between the country where the AIF is established and all EEA Member States into which it is to be marketed. Notification to the EEA AIFM's home Member State is required if marketing of non-EEA AIF interests is intended in the home Member State or any other EEA Member States.

	DETAILS
National placement regimes discretion is granted to EEA Member States to continue to make national placement regimes available for third-country AIFs and AIFMs until at least 3 years after the third country passport becomes available	In the transitional period to 2021 at the earliest (assuming the passport is extended in 2018), Member States may – but are not required to – permit EEA AIFMs to market non-EEA AIFs to professional investors, provided that: • The AIFM complies with the full AIFMD in relation to those AIFs, excluding aspects of Article 21 on depositary requirements[34]. • Appropriate cooperation arrangements are in place between the regulator in the AIFM's home Member State and the regulator in the third country where the non-EEA AIF is established. • The jurisdiction where the AIF is established is not listed as a non-cooperative country and territory by the FATF on anti-money laundering and terrorist financing.

Notes

33. As an EEA AIFM, authorisation under the AIFMD will be required. This means compliance with the full AIFMD (except for (a) Chapter VI and (b) where the non-EEA AIF is not marketed in Europe, Article 21 and 22). Appropriate cooperation agreements also need to be in place between the regulator in the AIFM's home Member State and the regulator in the third country where the non-EEA AIF is established.

34. Note that the AIFM must ensure that one or more entities are appointed to carry out certain depositary functions.

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