

FREQUENTLY ASKED QUESTIONS ABOUT EU'S ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

What is the Alternative Investment Fund Managers Directive and where does it apply?

The Alternative Investment Fund Managers Directive (the "AIFMD") came into force in 2011 and was required to be implemented by the European Economic Area (the "EEA") member states into their national laws by 2013. The AIFMD imposes various authorisation, registration, notification and organisational and disclosure requirements for the managers of certain funds and collective investment undertakings where the management and/or marketing of such vehicles takes place in the EEA.

In these FAQs, we will use the terms "EU" (European Union) and "EEA" interchangeably, since the non-EU EEA states have agreed to adopt the AIFMD and its related provisions.

What entities are within the scope of the AIFMD?

The AIFMD applies to alternative investment funds ("AIFs") and their managers ("AIFMs") where the management and/or marketing of the AIF takes place in any part of the EEA.

What is an AIF?

An AIF is defined as a collective investment undertaking, including investment compartments thereof, which:

- raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and
- does not require authorisation pursuant to the EU UCITS Directive (a UCITS fund is a fund intended for investment by ordinary EEA retail investors, and is similar to a U.S. mutual fund).

The European Securities and Markets Authority ("ESMA") has issued guidelines as to the interpretation of certain elements of the definition of AIF, such as "collective investment undertaking," "raising capital," "from a number of investors" and "defined investment policy."

The combined effect of the definition of AIF and ESMA's interpretation guidelines is that a huge number of funds and collective investment vehicles potentially fall within the scope of AIFMD, whether they are established inside or outside the EEA.

Are there any exceptions for certain types of funds?

The AIFMD expressly does not apply to the following entities:

- holding companies;
- certain pension schemes;
- supranational institutions and similar international organisations that manage AIFs where those AIFs act in the public interest;
- national central banks;
- national, regional and local governments and bodies or other institutions which manage social security and pension funds;
- employee participation schemes or employee saving schemes; and
- securitisation special purpose entities.

In addition, an AIFM is exempt from the AIFMD to the extent that it manages one or more AIFs whose only investors are the AIFM or the parent undertakings or subsidiaries of the AIFM or other subsidiaries of those parent undertakings, provided that none of those investors is itself an AIF.

In addition, only a small number of provisions of the AIFMD apply to the following AIFMs (“small AIFMs”):

- AIFMs that either directly or indirectly manage portfolios of AIFs whose assets under management (including any assets acquired through use of leverage) do not exceed an aggregate threshold of EUR 100,000,000; or
- AIFMs that either directly or indirectly manage portfolios of AIFs whose assets under management are unleveraged, have no redemption rights exercisable during a period of five years following the date of initial

investment in each AIF and whose assets do not exceed an aggregate threshold of EUR 500,000,000.

Small AIFMs are subject only to the obligations to:

- register with the competent authorities of their home EEA member state;
- identify themselves and the AIFs that they manage to the competent authorities of their EEA home member state;
- provide information on the investment strategies of the AIFs that they manage to those competent authorities;
- regularly provide those competent authorities with information on the main instruments in which they are trading and on the principal exposures and most important concentrations of the AIFs that they manage; and
- notify those competent authorities in the event that they no longer meet the conditions for being treated as small AIFMs.

As noted above, such small AIFMs are exempted from the majority of the provisions of the AIFMD, but consequently are not entitled to the benefit of the rights granted by the AIFMD to other AIFMs, most notably the marketing passport discussed below.

What is the jurisdictional scope of the AIFMD?

The AIFMD applies to:

- EU AIFMs which manage one or more AIFs, whether such AIFs are EU AIFs or non-EU AIFs;
- Non-EU AIFMs which manage one or more EU AIFs; and

- Non-EU AIFMs which market one or more AIFs in the EU, irrespective of whether such AIFs are EU AIFs or non-EU AIFs.

Is there any distinction between AIFs with different economic terms or legal structures?

The AIFMD expressly provides that it shall make no difference to the applicability of the AIFMD as to whether the AIF is open-ended or closed-ended, or whether the AIF is constituted pursuant to contract, trust law, statute or whether it has any other legal form. In addition, the legal structure of the AIFM will not affect the applicability of the AIFMD.

Which entity is considered to be the AIFM for the purpose of the AIFMD?

Each AIF within the scope of the AIFMD must have a single AIFM who is responsible for ensuring compliance with the AIFMD. The AIFM shall be either:

- an external manager, being a legal person appointed by the AIF or on its behalf to be responsible for managing the AIF; or
- where the legal form of the AIF permits internal management, and where the governing body of the AIF chooses not to appoint an external AIFM, then the AIFM will be considered to be the AIF itself.

What does “managing” mean in the context of an AIF?

It is defined as performing either or both of the portfolio management or risk management functions for the AIF.

How does the AIFMD interact with the Prospectus Directive?

There is potentially some overlap between the scope of the AIFMD and the scope of the Prospectus Directive

(for more details on the Prospectus Directive, see “Frequently Asked Questions about European Medium Term Note Programmes”). A closed-ended fund may be within the scope of both the AIFMD and the Prospectus Directive.

What types of requirements are imposed by the AIFMD on EU AIFMs?

An EU AIFM (other than a small AIFM) is required to obtain authorisation from the competent authority of its home member state. In order to obtain, and maintain, authorisation from the competent authority, the EU AIFM must:

- hold certain amounts of capital, both initial capital of at least EUR 125,000 plus additional capital depending upon the extent to which the total assets under management by that AIFM exceed EUR 250,000,000 (although the total amount of capital required will not exceed EUR 10,000,000);
- put in place remuneration policies and practices for staff whose professional activities have a material impact on the risk profile of the AIFM or on the risk profile of any of the AIFs that it manages;
- appoint a single, independent depositary for each AIF that it manages and markets in the EU or that has investors in the EU;
- operationally and hierarchically separate its risk management functions from its other operating units, including with respect to the functions of portfolio management;
- disclose certain information to investors in each AIF that is marketed into the EU, both initial and ongoing disclosure;

- make available an annual report in respect of each AIF that it markets in the EU; and
- observe periodic reporting requirements to the competent authorities of the home member state.

In addition to the above requirements that apply generally to EU AIFMs, there are additional requirements applicable to AIFMs of private equity funds. These requirements relate to notification of acquisitions of major holdings and control of non-listed companies to competent authorities, and disclosure obligations to the relevant company, its shareholders and the competent authorities, in the case of acquisition of control of a non-listed company, as well as prohibitions on asset stripping.

What are the criteria and requirements for the remuneration policies and practices for staff of the AIFMs?

The remuneration policy must ensure (amongst other things) that:

- it promotes sound and effective risk management and does not encourage risk-taking which is inconsistent with the risk profiles, rules or instruments of the AIFs that the AIFM manages;
- staff engaged in a control function are compensated in accordance with the achievement of their objectives linked to their functions, independent of the performance of the business areas they control;
- the remuneration of senior officers in risk management and compliance functions are overseen by a remuneration committee;

- if remuneration is performance-related, total compensation is based on a culmination of the individual's performance and the performance of the business unit or AIF concerned, as well as of the overall performance of the AIFM;
- guaranteed variable remuneration (e.g., bonus payments) should be exceptional and occur only in the context of hiring new staff and be limited to the first year;
- the fixed (e.g., base salary) and variable components of the total remuneration package are appropriately balanced and the fixed component is sufficiently high to allow a fully flexible policy on the variable component (including the possibility of there being no variable remuneration at all);
- a substantial portion (at least 50%) of any variable remuneration should consist of shares or units in the AIF concerned (or equivalent ownership or share-linked interest) unless the management of AIFs accounts for less than 50% of the total portfolio managed by the AIFM, in which case such 50% threshold does not apply;
- any variable component of remuneration comprising non-cash instruments is subject to retention requirements for a period after receipt;
- a substantial portion (at least 40%, or at least 60% where the variable component is a particularly high amount) of the variable component is deferred over a period that is appropriate in view of the life cycle, redemption policy and the nature of the risks

of the relevant AIFs (at least three to five years unless the life cycle of the AIF is shorter); and

- the total variable remuneration should be considerably reduced in the event of subdued or negative financial performance of the AIFM or AIF.

Do the same remuneration policies have to be applied by all EU AIFMs?

The AIFMD allows an AIFM to take a proportionate approach to its remuneration policies. In other words, an AIFM only has to comply with the remuneration principles in a way that is appropriate to its size, internal organisation and the nature, scope and complexity of its activities. This might, in exceptional circumstances, result in the disapplication of some of the above requirements, so long as such disapplication is consistent with the risk profile, risk appetite and strategy of the relevant AIFM.

The requirements that may be disapplied (either for identified staff or certain categories of identified staff) based on proportionality are:

- requirements relating to the “pay-out process,” including rules on paying variable remuneration in instruments other than cash, the retention and deferral of remuneration and the adjustment or clawback of variable remuneration resulting for an ex-post incorporation of risk; and
- the need to establish a remuneration committee.

Any AIFM considering that a disapplication of any of the above requirements is appropriate, needs to be able to explain its rationale to its competent authority.

What are the requirements in respect of depositaries?

For each AIF that an AIFM manages and markets in the EU, or that has investors in the EU, the AIFM is required to ensure that a single depositary is appointed in writing. A depositary can be an EU credit institution, or investment firm that is subject to capital adequacy requirements, or another category of institution which is subject to prudential regulation and ongoing supervision which is eligible to be a depositary under the UCITS legislation.

For any non-EU AIFs, the depositary may be a non-EU credit institution or entity similar to an investment firm, so long as it is subject to effective prudential regulation (including the minimum capital requirements) and supervision that has the same effect as EU regulation and supervision.

The depositary may not be the AIFM, and it must be established in the home member state of the AIF (for EU AIFs), and for non-EU AIFs, it must be established in the jurisdiction where the AIF is established or in the home member state of the AIF or in the member state of reference of the AIFM.

What are the requirements for separation of risk management and portfolio management functions?

An AIFM is required to operationally and hierarchically separate its risk management functions from other operating units, including the portfolio management functions. The hierarchical segregation means that the functional separation must be ensured throughout the hierarchical structure, up to its governing body. This means that the following conditions must be satisfied:

- all persons engaged in the performance of the risk management function must:

- not be supervised by persons who are responsible for performance of the operating units (including portfolio management);
 - not be engaged in the performance of the operating units (including portfolio management); and
 - be compensated in accordance with the achievement of the objectives linked to that function, independently of the performance of the operating units; and
- the remuneration of senior officers in the risk management function must be directly overseen by the risk management committee.

Does the principle of proportionality apply to such separation?

The applicable competent authority may decide that such separation is not required where the AIFM can demonstrate that specific safeguards against conflicts of interest would allow for the independent performance of its risk management functions, and that the risk management process is consistently effective.

What are the AIFMD requirements regarding disclosure?

The AIFMD requires that certain information about each AIF which is marketed into the EU be made available to investors before an investment decision is made. Such disclosure may, but does not have to be, included in a preliminary or final offering circular/private placement memorandum. The disclosure must include the following matters:

- a description of the investment strategy and objectives of the AIF;
- information regarding where any master AIF is established and where any underlying funds are established;
- details of the types of assets in which the AIF invests, the techniques it employs and any associated risks, investment restrictions and circumstances where it may use leverage, as well as any collateral and asset re-use arrangements;
- a description of the procedures by which an AIF may change its investment strategy and its investment policy;
- a description of the legal implications of the contractual relationship being entered into (*e.g.*, jurisdiction, applicable law, etc);
- the identity of the AIFM, depositary, auditor and other service providers (as well as their duties and investors' rights);
- a description of the AIF's valuation procedure and pricing methodology for valuing assets;
- the AIF's liquidity risk management, including redemption rights both in normal and in exceptional circumstances and existing redemption arrangements with investors;
- details of all fees, charges and expenses which are directly or indirectly borne by investors;
- any preferential treatment received by an investor (*e.g.*, by way of a side letter);
- the latest annual report;
- the latest net asset value of the AIF or the latest market price of a unit or share of the AIF; and

- where available, the historical performance of the AIF.

In addition, certain periodic disclosures of information must be made available to investors. These include:

- material changes in the initial disclosure information given;
- certain additional information, including the percentage of the AIF's assets that are subject to special arrangements because they are illiquid, any new liquidity management arrangements and regular disclosures of the level of the AIF's leverage.

With respect to illiquid assets, there must be disclosed, at least at the same time as the annual report is made available:

- an overview of any special arrangements in place, including whether they relate to side pockets, gates or other similar arrangements;
- the valuation methodology applied to assets which are subject to such arrangements; and
- how management and performance fees apply to these assets.

In the case of any new arrangements for managing an AIF's liquidity, AIFMs must notify any investors of any material changes to liquidity management systems and procedures, as well as of activated gates, side pockets or similar special arrangements or where they decide to suspend redemptions. In addition AIFMs must disclose the risk profile of the AIF and the main features of the risk management systems employed to manage the risk exposure of the AIF.

With respect to AIFs that employ leverage, AIFMs must disclose to investors information on changes to the maximum level of leverage calculated in accordance

with the gross and commitment methods for calculating the AIFs exposure, and any right of re-use of collateral or any guarantee under leverage arrangements.

What are the requirements in relation to annual reports?

Each AIFM must provide an annual report in respect of each AIF that it manages and each AIF that it markets in the EU, no later than six months following the end of the financial year of the AIF (prepared in accordance with the accounting standards of the country where the AIF has its registered office). The annual report must be provided to investors (on request), and also to the competent authorities of the AIFM's home member state and, where applicable, the home member state of the AIF.

The annual report must contain the following elements:

- a balance sheet or a statement of assets and liabilities;
- an income and expenditure account for the financial year;
- a report on the activities of the financial year;
- any material changes in the information disclosed to investors during the financial year covered by the report;
- the total amount of remuneration for the financial year (split into fixed and variable remuneration) paid by the AIFM to its staff members, the number of beneficiaries of such remuneration and (where relevant) details of carried interest paid by the AIF; and
- the aggregate amount of remuneration, broken down by senior management and members of

the staff of the AIFM whose actions have a material impact on the risk profile of the AIF.

What are the requirements in terms of regulatory reporting?

An AIFM must regularly report to the competent authority of its home member state in relation to the:

- principal markets and instruments in which it trades on behalf of the AIFs that it manages;
- main instruments in which it is trading;
- markets of which it is a member or where it actively trades; and
- principal exposures and most important concentrations of each of the AIFs that it manages.

In addition, an AIFM shall, for each EU AIF that it manages and for each AIF that it markets in the EU, provide the following information to the competent authority of its home member state:

- 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;
- the current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks, including operational risk;
- information on the main categories of assets in which the AIF invested; and
- the results of stress tests required to be performed, to identify, measure, manage and monitor the risks associated with each

investment position of the AIF and their overall effect on the AIF's portfolio.

What is the AIFMD passport?

Once an AIFM has obtained authorisation in an EEA member state, it may market units or shares of any EU AIF that it manages to professional investors in any other member state, once it has complied with certain additional conditions, such as notifying the competent authorities of its home member state in respect of the EU AIF that it intends to market.

In addition, an EU AIFM that is authorised in one EU member state may manage an AIF established in another member state either directly or by establishing a branch, provided that the AIFM is authorised to manage that type of AIF.

Does the AIFMD Passport extend to marketing to retail investors?

No, but the AIFMD does permit individual member states to allow the marketing of AIFs to non-professional investors in their jurisdiction, and to impose stricter requirements and conditions for such marketing than they impose for marketing to professional investors. However, they may not apply different standards in this regard to domestic AIFs than they do to non-domestic EU AIFs.

Which AIFs and AIFMs are able to use the passport?

Currently, the AIFMD passport can be used in the following combinations of circumstances:

- an EU AIFM managing one or more EU AIFs, but not marketing AIFs in other member states;

- an EU AIFM managing one or more EU AIFs and marketing one or more EU AIFs in other member states;
- an EU AIFM managing one or more non-EU AIFs which are not marketed in any EEA member state;

Is it possible for non-EU AIFMs/non-EU AIFs to market/be marketed in the EEA?

Currently the AIFMD passport is not available for these circumstances. Therefore, at the moment, an EU AIFM wishing to market non-EU AIFs, or a non-EU AIFM wishing to market any AIF, may only do so in accordance with the national private placement regime (“NPPR”) of each EEA member state in which marketing is to take place. In this case, the AIFM must comply with the rules specified for each relevant NPPR, and these rules may differ as between member states. In certain member states, marketing under the private placement regime may not be feasible. There are certain minimum conditions that must be met before marketing under any private placement regime may take effect, but each member state may impose conditions additional to these.

The minimum conditions for private placement regime marketing are:

- the AIFM must comply with the above transparency, investor disclosure and regulatory reporting requirements of the AIFMD;
- there must be in place cooperation arrangements and information exchange agreements between the competent authority of the member state in which marketing is to take place, the competent authority or

supervisory authority of the domicile of the AIF, and the supervisory authority of the country where the non-EEA AIFM is established;

- at the time of marketing, neither the AIF nor the AIFM may be authorised or registered in a country which is listed as a “non-cooperative Country or Territory” by the Financial Action Task Force on anti-money laundering and terrorist financing.

What is the definition of “marketing” and when does “pre-marketing” become “marketing” for which authorisation or compliance with private placement regimes is required?

The AIFMD defines marketing as 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 EEA”. This definition has been further interpreted by the competent authorities of certain jurisdictions and some jurisdictions have a much narrower interpretation of “marketing” than other jurisdictions, thus allowing more activities to be carried out by way of permissible “pre-marketing.”

Are reverse solicitation/reverse enquiries or passive marketing allowed?

The AIFMD definition of marketing makes clear that marketing has to be performed at the initiative of the AIFM or on its behalf. Therefore, a genuine reverse solicitation situation will not automatically fall within the scope of the AIFMD, and local legal advice should be taken as to the attitude of different competent authorities towards reverse solicitation/passive marketing in their jurisdiction.

When will the AIFMD passport be available for non-EU AIFMs and non-EU AIFs?

The AIFMD envisaged that the European Commission would have taken a position, some time ago, as to whether or not the AIFMD passport should be extended to AIFMs and AIFs from certain non-EU countries. ESMA has delivered an opinion and technical advice to the European Commission on whether the passporting regime should be extended to AIFMs and AIFs from certain non-EU jurisdictions. However, to date, the European Commission has taken no further action to extend the AIFMD passport to any non-EU AIFMs or non-EU AIFs.

What methods of marketing in the EEA will be available to non-EU AIFMs once the AIFMD passport is extended to them?

The AIFMD envisaged an initial period of at least three years, once the AIFMD had been extended to non-EU AIFMs/non-EU AIFs, within which it would be possible for non-EU AIFMs either:

- to obtain authorisation in one particular EEA member state (its designated “member state of reference”) and then use the AIFMD passport to market AIFs in any other EEA member states; or
- alternatively, to utilise the private placement regimes in individual EEA member states without the requirement to obtain authorisation.

However, the AIFMD envisaged that after that three-year period, subject to obtaining opinions from ESMA on the functioning of the passport regime and the functioning of the NPPRs, that the European Commission would then adopt a delegated act to

abolish the MPPRs. This would mean that, thereafter, the only method of marketing AIFs in the EEA would be via the mechanism of obtaining authorisation and utilising the marketing passport, whether the AIF or AIFM in question is established inside or outside the EEA. However, since the marketing passport has not yet been extended to any non-EU AIF or non-EU AIFM, it is not yet clear whether or when the NPPRs will cease to exist.

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