



AI FM Directive Update

As most people in the alternative investment funds industry are no doubt aware, the lengthy wrangling over the Directive on Alternative Investment Fund Managers has finally resulted in an agreed compromise text approved by the European Parliament on 11 November 2010. A practical guide (in summary form) as to what this means for fund managers and the funds they manage is set out below.

Private Placement and Passive Marketing Retained

As described under “Marketing” below it should be noted that the existing national private placement regimes (subject to enhanced reporting and disclosure requirements and, in respect of private equity funds, certain portfolio company distribution restrictions) are to be maintained until at least 2018.

No earlier than 2015, the EU may introduce a passporting regime under which non-EU funds may be marketed throughout the EU. At such time, the scope of the directive will effectively be extended in full to any manager marketing funds in the EU and therefore indirectly to the funds managed by it.

The Directive expressly does not prohibit or affect passive marketing (or “reverse solicitation”) in respect of funds or managers.

Scope

The Directive regulates managers and therefore, indirectly, the funds they manage. The Directive applies to:

- An EU manager irrespective of whether it manages an EU fund or a non-EU fund
- A non-EU manager
 - o managing an EU fund wherever marketed
 - o marketing an EU or a non-EU fund to EU Persons.

This means that a non-EU manager managing or marketing a non-EU fund is not caught by the Directive simply by having EU investors unless there is marketing to EU persons.

For the purposes of the Directive, an ‘EU manager’ is a manager with its registered office in the EU. An ‘EU fund’ is a fund authorised, registered or with its registered office in the EU. An ‘EU person’ is a person domiciled in the

EU. A 'fund' includes both an open-ended and a closed-ended fund and may include certain joint venture and co-investment vehicles which investors and managers would not normally consider in this context.

There are reduced requirements for small managers (AUM EUR100m or less, or AUM EUR500m or less where there is no leverage and at least a 5 year lock up on redemptions).

Timing

With the Directive likely to come into full legal effect in the first quarter of 2011, individual member states of the EU will have two years within which to implement the Directive into their national laws.

Implications

The Directive includes a number of provisions which will change the way managers and their funds are currently structured. The key areas are as follows:

- **Capital**

Managers must be capitalised to at least EUR125,000. Where managers do not meet this requirement, a change to the manager's capital structure may be required.

- **Delegation**

Under the Directive, delegation of any of its functions by the manager will be subject to certain requirements. Delegation of portfolio management or risk management functions may only be made to regulated undertakings or with approval of competent regulatory authority. This is likely to necessitate amendments to existing contracts with service providers and amendment of the offering memorandum to reflect these changes.

- **Depositary/Custodian**

An approved custodian must be appointed (unless a non-EU Fund is being managed by an EU manager and marketed outside the EU). There are different categories of custodian depending on whether the fund is open-ended or closed-ended. This may require an appointment of or a change to the custodian.

There are limits on the ability of the custodian to sub-contract and stricter liability requirements for custodians. The custodian will have specified responsibilities as to the assets of the fund and responsibility for certain administrative functions. This means that a review and amendment of the custodian agreement may be required.

A prime broker may not act as custodian unless the custody function is properly separated from its other functions and assets are held in a properly segregated account. Where a prime broker currently acts as custodian, a new custodian may need to be appointed.

- **Enhanced Transparency**

The Directive imposes enhanced disclosure requirements which will necessitate a review and update of the fund's offering memorandum.

All managers including private equity fund managers must provide audited annual reports of the fund to EU regulators within six months of financial year end and must use best efforts to ensure that non-listed investee companies which they control also produce audited annual reports.

- **Limits on Distributions**

Private equity fund managers are restricted from facilitating distributions from their fund's investee companies for a period of 24 months from the date of acquisition of control over such investee company by the fund.

- **Pay**

The Directive contains provisions relating to how remuneration is to be structured. This is of relevance only to managers who have employees and those provisions include regulations relating to how and when employees of managers can be paid.

- **Marketing**

EU managers approved in one EU state may market EU funds across the entire EU from January 2013 without seeking approval from other EU regulators; this is known as the 'passport'.

This passport may be offered to non-EU managers in 2015. If so, non-EU managers must comply with the entirety of the Directive in order to be eligible for the passport.

It is intended that a new body, the European Securities and Markets Authority ("ESMA"), will be established to, amongst other things, oversee the regulation of managers by regulatory authorities in EU member states and issue guidelines in relation to that regulation.

Managers may market to EU persons via national private placement regimes without a passport until 2018 (and in each case provided that there are cooperation agreements for exchange of information in place between the relevant EU and non-EU regulators) as follows:

- an EU manager marketing a non-EU fund must comply with the Directive in full other than the custodian requirements (see above).
- a non-EU manager marketing an EU fund or a non-EU fund to EU persons must comply with the enhanced transparency requirements of the Directive (see above).

Passive marketing in the EU is outside the scope of the Directive and so will continue unaffected.

Conclusion

The Directive is far reaching and has wide implications for managers and funds. It is recommended that managers review their existing fund structures and documents and consult with counsel to make any necessary changes. Given that many of the specific requirements are yet to be determined by secondary legislation, managers would be well advised to ensure that documentation for existing and future funds are designed to be sufficiently flexible to cater for these uncertainties.

Appleby is confident that each of the jurisdictions in which it has a presence will meet or exceed the requirements of the Directive in relation to international regulatory co-operation, anti-money laundering compliance, effective regulation and tax information exchange by the time the directive is transposed into national law in EU member states, ensuring a continuing strong contribution to both inward and outward investment in the EU.

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