CLEARY GOTTLIEB Alert Memo

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EU Directive on Alternative Investment Fund Managers

On October 26, the EU Council of Ministers (the "Council") and the European Parliament reached agreement on the proposed Directive on Alternative Investment Fund Managers (the "AIFM Directive")[1]. The European Parliament will officially vote on the AIFM Directive during its November 10-11 session, bringing to a close a highly contentious 18-month debate triggered by the European Commission's rushed and poorly drafted proposal of April 2009. EU Member States will have two years to amend their national legislation to implement the AIFM Directive. Thus, the AIFM Directive will become applicable approximately as from January 1, 2013.

The AIFM Directive will regulate EU managers ("AIFMs") of "alternative investment funds" ("AIFs"), in particular hedge funds and private equity funds, as well as non-EU managers of EU AIFs and non-EU AIFs marketed to EU professional investors. The main areas of contention in the negotiations within the Council and between the Council and the European Parliament involved the treatment of non-EU AIFMs and AIFs and the obligations associated with EU companies controlled by private equity funds. The Belgian Presidency of the Council succeeded in overcoming resistance from France to giving equal treatment to non-EU AIFMs and AIFs, with well-publicized support from the U.S. Secretary of the Treasury.

The AIFM Directive will fundamentally change the structure of the alternative investment sector in the EU, introducing for the first time a harmonized set of rules for the management and marketing of AIFs to EU professional investors. The AIFM Directive is long and complex, and it raises many questions. In addition, the AIFM Directive's practical implications will depend to a large extent on "Level 2" implementing measures that are required to be adopted by the Commission or by the European Securities and Markets Authority ("ESMA"),[2] the successor to the Committee of European Securities Regulators ("CESR").

The main provisions of the AIFM Directive can be divided between provisions relating to (i) the directive's scope, (ii) operating conditions, (iii) disclosure and portfolio

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1 See press release: http://tinyurl.com/AIFM-press-release. See also the previously proposed AIFM text, dated October 20 2010: http://tinyurl.com/AIFM-Oct20

2 For more information on ESMA, please see http://tinyurl.com/CGSH-ESFS

companies, (iv) non-EU AIFMs, (v) marketing, and (vi) transition and grandfathering. The relevant provisions are discussed below.

I. SCOPE

The AIFM Directive applies to AIFMs established in the EU, regardless of the domicile or legal structure of the AIFs they manage. It will not apply (among other exemptions) to holding companies; financial vehicles in which the only investors are group companies; employee participation or saving schemes; and securitization special purpose entities. AIFMs would be exempt from parts (not all) of the AIFM Directive if the assets of the AIFs they manage do not exceed EUR 100 million, or EUR 500 million in the case of unleveraged funds that may not be redeemed for a period of five years following the date of initial investment in each AIF.

II. OPERATING CONDITIONS

The AIFM Directive will impose stringent requirements on the operations of AIFMs, including requirements relating to remuneration, independent valuations, independent depositaries, capital requirements, and leverage.[3]

A. REMUNERATION

The Commission's initial proposal did not address AIFM remuneration policies. Under pressure to harmonize remuneration policies in the aftermath of the financial crisis, however, the Council and the Parliament decided to add remuneration-related provisions to the AIFM Directive. These requirements are derived from the new EU rules on remuneration policies for credit institutions and investment firms, known as "CRD III."[4]

AIFMs subject to the AIFM Directive will be required to have remuneration policies and practices for staff whose professional activities materially impact the risk profiles of the AIFs under management, in accordance with 18 "principles" set out in Annex II. These principles include requirements that at least 50% of any variable remuneration consists of units or shares of the AIFs concerned or equivalent ownership interests; that at least 40% (or 60% in the case of particularly high amounts) of variable remuneration be deferred at least three to five years; and that variable remuneration be "considerably contracted" in the event of "subdued or negative performance." Carried interest, defined as a share in the profits of an AIF accrued to the AIFM as compensation

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[3] Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies

[4] For more information on CRD III, see http://tinyurl.com/CGSH-CRD-III

for the management of the AIF, but excluding a return on investment by the AIFM in the AIF, is treated as remuneration under the AIFM Directive.

AIFMs will have to provide aggregate information on remuneration, split in various ways, under the disclosure provisions summarized below.

ESMA is required to produce guidelines on sound remuneration policies under the AIFM Directive, in consultation with the new European Banking Authority. These guidelines will indicate how regulators may take into account the size of the AIFM and the size of AIF they manage, their internal organization and the nature, the scope and the complexity of their activities.

B. VALUATION

AIFMs must establish "appropriate and consistent procedures" for the valuation of the assets of each AIF under management. The valuation procedures must require that assets be valued and net asset value per share or unit be calculated at least once a year. In relation to open-ended AIFs, valuations must also be carried out with appropriate frequency, having regard both to the assets held by the fund and their issuance and redemption frequency. Closed-end AIFs must carry out valuations following any increase or decrease of the capital of an AIF.

The Commission originally proposed that fund assets be valued by independent external "valuators." The final text provides that valuation may be carried out by independent valuators or by the AIFM itself. If an external valuator is used, the valuator must meet requirements designed to ensure that it is qualified. If the AIFM performs valuations itself, the valuation function must be performed independently from management and remuneration policy, and the AIFM must put measures in place to minimize and control conflicts of interest, and to prevent undue influence on employees. When an external valuator does not perform the valuation function, Member States may require valuations to be externally verified.

C. DEPOSITARIES

AIFMs must appoint an independent depositary for each AIF under management. Among other things, the depositary will receive payments from investors and keep them in segregated accounts, safe-keep AIFs' financial instruments and verify the ownership of other assets.

Depositaries will be permitted to delegate functions, provided that specified conditions are met, including an objective reason for the delegation. Generally, depositaries will be strictly liable to AIF investors for losses suffered as a result of negligent or intentional failure to perform their obligations, although in limited circumstances liability for a loss of financial instruments may be transferred by contract to a delegatee of the depositary.

Depositaries may be EU-based credit institutions, investment firms, or firms permitted to act as depositaries for a UCITS Directive governed retail fund. Depositaries must be established in the same Member State as the relevant AIF (subject to a possibility of derogation for four years). Certain AIFs with no redemption rights may appoint other entities to act as depositary. Non-EU AIFs may also appoint depositaries based in their home jurisdictions, subject to conditions.

D. CAPITAL REQUIREMENTS

AIFMs will be required to maintain "own funds" of at least EUR 125,000 plus 0.02% of the amount by which the value of the portfolio of the AIFM exceeds EUR 250 million, up to EUR 10 million. However, an AIFM's own funds may never be less than the amount required for investment firms under the Capital Adequacy Directive, *i.e.*, one-quarter of annual operating expenses. AIFMs must invest these own funds in liquid assets or assets that are quickly convertible to cash; they may not take speculative positions.

E. LEVERAGE

Unlike the original Commission proposal, the AIFM Directive will not empower the Commission (or other regulators) to impose generally applicable leverage limits. Unlike certain European Parliament proposals, moreover, the AIFM Directive will not regulate leverage at the portfolio company level. Instead, AIFMs must set leverage limits for the AIFs they manage, and they must demonstrate that the leverage limits for each AIF they manage are reasonable. AIFMs managing AIFs that use leverage on a "substantial basis" at the fund level are required to provide information to their home Member State regulators about the leverage techniques they employ and the overall level of leverage employed by each AIF they manage. The home Member State regulator may impose limits to the level of leverage that an AIFM may employ in emergencies, and in consultation with ESMA and other regulatory authorities.

III. DISCLOSURE AND PORTFOLIO COMPANY REQUIREMENTS

The AIFM Directive includes detailed disclosure requirements, distinguishing between those applicable to AIFMs generally and those applicable to AIFMs when AIFs they manage acquire major holdings or control of EU companies. The AIFM Directive also contains an article intended to prevent "asset stripping" of private equity portfolio

companies; this article was one of the most contentious in the negotiations between the Council and the European Parliament.

A. GENERAL DISCLOSURE REQUIREMENTS

AIFMs will be subject to extensive disclosure obligations, both before investors commit and on an ongoing basis thereafter. Matters to be disclosed include the AIFM's performance of its duties under the AIFM Directive and particular features of the AIFs that it markets and manages. Among other things, disclosure obligations relate to the AIFM's investment strategy, valuation procedures, liquidity and risk management policies and arrangements under which any investors receive preferential treatment.

In addition, AIFMs must make available annual reports for each AIF they manage, including audited accounts, a report on the AIF's activities, a description of any material changes in prospectus information, and disclosure on remuneration.

AIFMs managing or marketing EU AIFs employing leverage must also disclose the total amount of leverage employed by that AIF, changes to the maximum permitted leverage, and whether under the leveraging arrangement, there is a right to re-use collateral.

B. MAJOR HOLDINGS AND CONTROL

AIFMs must notify their home Member State regulators, target companies and other shareholders when AIFs managed by them increase or decrease their shareholdings in a non-listed company through the voting rights thresholds of 10%, 20%, 30%, 50% and 75%.

In addition, AIFMs managing AIFs that acquire "control" of EU companies will have to make certain disclosures to the company, its other shareholders, and the AIFM's home Member State regulator relating to the identity of the controlling AIF, its policy for managing conflicts of interest, and the policy for "communication relating to the company in particular as regards employees". For non-listed companies, "control" is defined as more than 50% of voting rights. For public companies, control is defined by reference to the threshold set by each Member State under the Takeover Directive.[5]

In the case of non-listed companies, the AIFM is also required to inform the company and its other shareholders of its business plan for the company and the likely consequences of its plans for the employment and conditions of employment of the company's employees. AIFMs will also have to provide additional information, in either the annual report of the relevant AIF or that of the portfolio company, including a "fair

[5] Directive 2004/25/EC of the European Parliament and of the Council of April 21, 2004 on Takeover Bids.

review of the development of the company's business", recent "important events," likely "future developments" and share buybacks.

AIFMs are obliged to use "best efforts" to ensure that the directors of controlled companies provide this information, in turn, to employee representatives.

C. "ASSET STRIPPING"

Members of the European Parliament proposed a variety of requirements to prevent "asset stripping" by private equity AIFs of EU portfolio companies. The compromise finally adopted is based on the EU's Second Company Law Directive, which applies to public listed companies. Under the AIFM Directive, for a 24-month period following an AIF's acquisition of control of a non-listed company or public company, the AIF's manager is required not to procure and to use its best efforts to prevent any distribution to shareholders (including as a result of capital reductions), or share buybacks that would violate the Second Company Law Directive.

IV. NON-EU AIFMS

The treatment of non-EU fund managers was one of the most controversial issues in the drafting of the AIFM Directive, with France vigorously opposing equal treatment for non-EU AIFMs. The final text is intended to create a level playing field between EU and non-EU AIFM, but the regime permitting non-EU AIFMs to register under the AIFM Directive and enjoy the same market access as EU AIFMs will only become available in 2015.

Two years after the deadline for implementation of the AIFM Directive, non-EU AIFMs from qualifying jurisdictions will be able to apply for authorization under the AIFM Directive. To qualify, non-EU jurisdictions must have appropriate cooperation agreements with Member State regulators, comply with money-laundering and terrorist financing rules and have tax cooperation agreements complying with the OECD Model Tax Convention.

A non-EU AIFM wishing to make use of this regime must apply with the regulator in its "Member State of reference", which will be responsible for compliance with its management and marketing related obligations under the AIFM Directive. Non-EU AIFMs registering under the AIFM Directive will be required to comply with all of the AIFM Directive's requirements and to have a "legal representative" in their Member State of reference.

The choice of the Member State of reference depends on factors including the jurisdictions of any EU AIFs that are marketed, the jurisdiction of the AIF with the largest amount of assets, or – in the case of non-EU AIFs – the EU jurisdictions in which

the AIFM intends to market AIF interests. ESMA is required to advise on the appropriateness of the choice of Member State of reference.

If a non-EU AIFM would be subject, in its home jurisdiction, to a requirement that conflicts with an obligation under the AIFM Directive, the AIFM may be exempted from compliance with the AIFM Directive requirement if it can show that it is subject to an equivalent rule having the same regulatory purpose and offering the same level of protection to the investors of the relevant AIF. Again, ESMA is required to give advice on the appropriateness of exemption in case of incompatibility with an equivalent rule.

V. MARKETING

In recognition of the harmonized requirements for the management of AIFs in the EU, the AIFM Directive will create a "single internal market" for the marketing of AIF interests to professional investors. The applicable rules depend on whether or not the AIFM in question is established in the EU.

A. EU AIF INTERESTS

The AIFM Directive will allow an authorized AIFM to market to professional investors[6] interests in EU-based AIFs that it manages after notifying its home Member State regulator. The regulator may only prevent marketing of interests in EU AIFs where the information provided in the notification demonstrates that the AIF concerned will not be managed in accordance with the AIFM Directive. Once the competent authorities in the AIFM's home Member State have granted marketing permission, an authorized AIFM may market EU AIF interests in other Member States under the EU "passport," subject to compliance with a similar notice procedure. "Feeder AIFs," defined as AIFs that invest 85% or more of their assets in another AIF (*i.e.*, the "master AIF"), may only benefit from the marketing passport if the master AIF is also an EU AIF managed by an authorized AIFM.

Member State authorities may also allow marketing of AIFs to retail investors within their own territories and may impose stricter requirements on the AIF or AIFM than required by the AIFM Directive, provided that any additional requirements for marketing to retail investors may not discriminate against cross-border marketing.

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6 "Professional investors" are defined by reference to the MiFID definition of "professional client," which includes institutional and large corporate investors, as well as certain other persons (including individuals) who may "opt in" if they meet certain tests.

B. NON-EU AIF INTERESTS

Additional conditions apply to the marketing of non-EU AIF interests, reflecting the divergence of opinion between Member States as to the treatment of non-EU AIFs.

Until 2018, AIFMs can market non-EU AIF interests without a passport subject to compliance with the AIFM Directive (in the case of EU AIFMs) or national private placement regimes[7] and the AIFM Directive's disclosure requirements (in the case of non-EU AIFMs). In addition, cooperation arrangements must be in place between the AIF's home regulator and the supervisory authority in the jurisdiction where the non-EU AIF's interests are to be marketed.

As from 2015, authorized AIFMs will be entitled to market interests in non-EU AIF they manage to EU professional investors, with the EU marketing passport, if the jurisdiction of the non-EU AIF meets certain conditions. The non-EU jurisdiction in question must (i) have appropriate cooperation arrangements in place with the AIFM's home Member State or Member State of reference, (ii) comply with money-laundering and terrorist-financing rules, and (iii) have tax agreements in place that comply with the OECD Model Tax Convention.

VI. TRANSITIONAL AND GRANDFATHERING PROVISIONS

As noted, the EU Member State legislation implementing the AIFM Directive will enter into force about January 1, 2013. The AIFM Directive includes several transition and grandfathering provisions.

In general, an AIFM operating in the EU prior to January 1, 2013 must bring its activities into compliance with the AIFM Directive, including submitting an application for authorization within one year, unless either of two exceptions apply:

- AIFM that manage closed-ended AIF that make no additional investments and are not marketed after 2013 may continue their activities without applying for authorization.

- An AIFM that continues to make investments but whose subscription period ended prior to November 2010 and is expected to be wound up by 2016 may

[7] At present, there is little consistency between the private placement regimes operated by EU Member States. Some jurisdictions formally prohibit marketing of all funds, with the exception of those classified as UCITS. Member States more commonly permit marketing of AIFs to qualified investors, as defined by the Prospectus Directive. Certain states, including the United Kingdom, have developed a specific national regime for the marketing of fund interests.

continue without authorization, but these AIFMs must comply with the disclosure requirements outlined above.

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For additional information, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under banking and finance in the "Practices" section of our website (www.clearygottlieb.com) if you have any questions.

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