Background

- UCITS / UCITS IV / UCITS V
- Closed end funds
- ISD/MiFID
- FSA Authorisation
- EU Member State Private Placement Regimes
- Alternative Investment Fund Managers Directive (AIFMD)
- A new regime for VC Funds?
UCITS

- Open ended, publicly marketable EU funds
- Exempted from AIFMD
- Restricted to ‘listed tradable securities’ – so no PE or Real Estate Funds
- Hedge Funds – ‘Newcits’
- Eligible assets rules – relevant to hedge funds and hedge fund of funds

UCITS IV:
- Procedures for mergers of UCITS funds
- Master feeders available for first time
- Standardised ‘Key Investor Information Document’
- Management Company passport
- Simplified/improved passporting mechanisms

UCITS V
Closed End Funds

- Caught by AIFMD
- But can be marketed publicly under Prospectus Directive if securities are ‘transferable’ – i.e. separate from AIFMD passport and therefore to the retail public
- May be appropriate for funds of funds, PE, Real Estate and other more illiquid strategies but ‘transferable securities’ requirement may be a problem
- No ability to sell open-ended fund using approved prospectus
Structuring Funds for European Investors – Regulatory Considerations

- Most Jurisdictions require marketing to be conducted by EU authorised marketers

- Some allow non-EU persons to market but marketing then more restricted e.g. Belgium (but must register locally); UK
Structuring Funds for European Investors - Regulatory Considerations

Private placement rules vary enormously but fall into 5 main categories:

- subject to a minimum investment amount (e.g. Belgium €250,000, Holland €50,000)
- by number of offerees - e.g. Denmark (8), Holland (100)
- by type of investors (e.g. institutional, large corporates, sophisticated individuals etc.) – Finland, Germany, Holland, Switzerland, UK
- all forms of active solicitation banned – France, Italy, Norway, Spain
- no restrictions - Sweden
AIFMD: Introduction / Timetable

- Proposed by EU Commission – April 2009
- Level 1 Directive effective 21 July 2011
- Implementing measures and guidelines now being developed by ESMA (level 2)
- Transposition by 22 July 2013
- EU AIFM can be authorised from 22 July 2013 and must be by 22 July 2014
Who will be affected?

- EU-established managers of AIFs (wherever established)

- Non-EU AIFMs marketing or managing AIFs within the EU (NB. Avoid directive if non-EU AIFM/non-EU AIF and no marketing into Europe)

- AIFM out-of-scope if AUM (incl assets acquired through leverage) less than €100m (or € 500m if the AIFs are unleveraged and closed-end for 5 years)

- Service providers to AIFMs/AIFs
Who will be affected?

- What’s an AIF? Any collective investment undertaking (including investment compartments thereof) other than UCITS. No asset class limits. Can be closed or open-ended.

- Raise capital from more than one investor with a view to investing it in accordance with a defined investment policy for the benefit of those investors.

- Not holding companies, employee participation schemes, pensions.
Which entity is the AIFM?

- Regular business is managing one or more AIFs
- Only one per fund
- Can be internal or external
- Excludes firms providing advice only
- Must engage in both portfolio management and risk management
Which Entity is the AIFM?

- Can delegate but cannot become “letter-box entity”
- AIFM Liability to AIF and investors unaffected by delegation
- Managers with EU and non-EU entities may have a choice: who it designate as AIFM?
- E.g. Can EU-based sub-adviser of U.S. Manager be designated as the AIFM?
- Is U.S. parent is delegate, must be ‘authorised or registered for the purpose of asset management and subject to supervision’
Impact of AIFMD

- AIFM to be authorised. EU AIFM to be subject to significant additional regulation – already subject to MiFID (required to be regulated, have minimum capital, subject to conduct of business rules etc.)

- From 2015, non-EU AIFMs need to be authorised under AIFMD to manage EU AIFs

- Capital requirements - €125,000 for external AIFM plus 0.02% of AUM over €250m (subject to €10 million cap) or at least €300,000 for internal AIFM plus PI cover or additional capital to cover potential liability risks arising from professional negligence

- Conduct of business standards/risk management standards etc for AIFMs

- Remuneration policy requirements
Impact of AIFMD

- Procedures for independent valuation of assets
- Restriction on delegation of AIFM functions – eg solicitation agent
- New depositary role
- Enhance transparency to investors and regulators
- European “passport”
- Possible leverage limits
- Wide powers of inspection/intervention for regulators
Marketing and Third Country Issues

- **Passport**
  - principal benefit of AIFMD
  - allows marketing to professional investors only
  - from 22 July 2013 for EU AIFMs/EU AIFs
  - potentially from 2015 for EU AIFMs/non-EU AIFs or non-EU AIFMs/non-EU AIFs but subject to full compliance with Directive
Marketing and Third Country Issues

Passport

- Get-out if:
  (i) Impossible to combine compliance with mandatory provision of local law
  (ii) Local law has an “equivalent rule” having the same regulatory purpose and offering the same level of protection to investors
- Which jurisdictions will pursue equivalence? U.S.? Cayman?
Marketing and Third Country Issues

- Passport
  - Notification to home authority
  - Fairly extensive disclosure
  - Able to market in no more than 20 working days
  - Better than “host state” notification
  - Where non-EU AIFM need “Member State of Reference” and legal representative in EU (does not need to be a subsidiary)
  - How viable is this approach with regard to U.S. managers?
  - Can you influence the selection of Member State of Reference?
Passport

- Will allow active/broader marketing into Denmark, France, Italy, Norway and Spain from 2013 (for EU AIFMs)
- But passport could restrict marketing in e.g. Belgium, Holland, Germany, UK
- However, AIFMD does envisage that Member States may permit marketing to ‘retail investors’ locally
Marketing and Third Country Issues

- **Private Placement**
  - At Member States’ discretion
  - Rules could be tightened in some jurisdictions
  - May end in 2018/2019
  - New conditions
Marketing and Third Country Issues

- Private Placement
  - EU AIFM/Non-EU AIF
    - whole Directive applies to manager except provisions re depositary location and liability
  - Non-EU AIFM/Non-EU AIF (eg. Cayman Fund, U.S. Manager)
    - subject to AIFM complying with A.22 (Annual Report), A.23 (Disclosure to Investors), A.24 (Reporting to Regulator) and (if relevant) A.26-30 (Acquiring Control of Non-Listed Companies – Disclosure requirements/Asset Stripping)
Marketing and Third Country Issues

Private Placement

- Non-EU AIFM/Non-EU AIF

  - Disclosure of types and sources of leverage, description of liquidity risk management, transfer of assets to prime broker and re-use arrangements

  - Three-way co-operation arrangements required between regulators (including regulator in each Member State where fund marketed) – is SEC engaging with this?

  - Neither AIF nor AIFM may be established in a jurisdiction that is designated as non-co-operative by FATF
Marketing and Third Country Issues

- Article 22 (Annual Report)

  - Balance sheet and income statement (in accordance with accounting standards in jurisdiction of fund)
  
  - Remuneration disclosures – total amount of remuneration for financial year, split into fixed and variable remuneration, paid by the AIFM to its staff, and number of beneficiaries; also, where relevant, carried interest
  
  - Aggregate amount of remuneration broken down by senior management and members of staff of the AIFM who have a material impact on the risk profile of the AIF
  
  - Audit meeting international auditing standards in fund jurisdiction
Marketing and Third Country Issues

- Article 23 (Disclosure for Investors)
  - Requirements appear to require disclosure to all investors (not just EU)
  - Detailed information similar to what would be in prospectus anyway but need to notify material changes thereof
  - Some details may go beyond what would be provided anyway – e.g. types and sources of leverage; description of liquidity risk management, including the redemption rights in normal and exceptional circumstances, description of ‘preferential treatment’ received by any investor; information on the transfer of assets to the prime broker and re-use
  - Periodic disclosures required also – e.g. on risk management systems, total amount of leverage employed
Marketing and Third Country Issues

- Article 24 (Reporting to Regulators)
  - Principal exposures; main instruments being traded;
  - Risk management systems employed; arrangements for managing liquidity
  - Detailed information on use of leverage if ‘employing leverage on a substantial basis’ – including 5 largest sources of leverage and amount of leverage from each
Marketing and Third Country Issues

➢ Reverse Solicitation

  – but how reliable?
  – no direct or indirect offering or placement
Depositary

- Single depositary
- AIFM cannot be depositary
- Prime broker can only be depositary if ‘functional and hierarchical’ separation and conflicts managed etc.
- Does not apply to Non-EU AIF/Non-EU AIFM marketed under private placement or Non-EU AIF/EU AIFM if not marketed in EU
- Where depositary requirement applies to Non-EU AIF, depositary’s jurisdiction (which can be in the jurisdiction of the fund but not the manager) must not be listed by FATF as a Non-Co-operative Country or Territory
Depositary

- Also third country depositary must be subject to effective prudential regulation, including minimum capital requirements, and supervision which have the same effect as EU law and are effectively enforced.
Depositary’s role

- safe custody of financial instruments
- asset verification
- cash flow monitoring
- ensuring shares valued in accordance with law
- monitor AIFM’s compliance with law/AIF rules
Depositary’s Liability

- Strict liability when custodied investments are lost
- Unless
  - depositary proves that loss resulted from an external event beyond its reasonable control; or
  - sub-custodian has contractually assumed liability to AIF
- Depositary cannot cap liability
- Additional cost of depositary services - 100-150 basis points?
Managed Funds Association Views

- Call for coordinated global approach re: data requests – better to collect from prime brokers/other market participants?
- AUM should include only assets of EU-based funds, assets of non-EU based funds beneficially owned by EU investors and assets managed in the EU (compare: Dodd-Frank)
- Transparency requirements in A.22, A.23 and A.24 are difficult to understand in the context of non-EU AIFMs/non-EU AIFs using private placement as the rest of the Directive does not (or should not) apply
AIFMD Strategies for U.S. Managers

➢ Try to remain out of the scope of AIFMD

**ADVANTAGES**
- eliminates new EU compliance burden
- still scope for U.S. manager to act as delegate of EU manager
- cheap

**DISADVANTAGES**
- no EU distribution
- limited flexibility
AIFMD Strategies for U.S. Managers

➢ Ride private placement into the grave?

**ADVANTAGES**

- Minimises EU compliance burden whilst accessing EU money
- Reverse solicitation also available
- Can still potentially retain EU-based sub-advisor/solicitation agent

**DISADVANTAGES**

- Will U.S. be ready?
- This route expected to end in 2019
- Private placement exemptions may be tightened
- Some jurisdictions already ‘out of bounds’
AIFMD Strategies for U.S. Managers

➢ Plan to passport from 2015

**ADVANTAGES**

- Time to prepare
- Additional EU distribution

**DISADVANTAGES**

- Significant EU regulatory burden
- Conflicts with SEC regulation?
- Availability of passporting option uncertain
- How much of a benefit will passport really be?
AIFMD Strategies for U.S. Managers

Opt into AIFMD from 2013 by establishing EU-based self managed fund or EU-based AIFM

ADVANTAGES

– First mover advantage
– AIFMD ‘brand potential’
– Investor preference for regulated fund?
– Possibility that funds using derivatives for investment may need to switch from UCITS to AIFMD

DISADVANTAGES

– Cost of regulatory burden
– Time/energy required to obtain EU manager licence
– Self-managed fund may only work for illiquid strategies (eg P/E, real estate)