CLEARY GOTTLIEB

ALERT MEMORANDUM

BRUSSELS AND LONDON
AUGUST 2013

clearygottlieb.com

EU Directive on Alternative Investment Fund Managers Enters Into Force

By July 22, 2013, all Member States of the European Union (the "EU") were required to have implemented Directive 2011/61 on Alternative Investment Fund Managers (the "AIFM Directive").[1] Although many Member States have implemented the AIFM Directive, including France, Germany, Ireland, Luxembourg, the Netherlands and the UK, a number of Member States, including Italy, did not meet the deadline. Even the countries that did meet the deadline still need to publish additional guidelines and implementing measures, some of which may have significant implications for managers ("AIFMs") of "alternative investment funds" ("AIFs") and investors.

The AIFM Directive regulates EU AIFMs, 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 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 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 companies, (iv) non-EU AIFMs, (v) marketing, and (vi) transition and grandfathering. The AIFM Directive is supplemented by "Level 2" implementing measures and guidelines adopted by the Commission and the European Securities and Markets Authority ("ESMA").[2]

The key provisions of the AIFM Directive and the related implementing measures are discussed below, together with the effect of the AIFM Directive in Member States that have not yet implemented the AIFM Directive.

---

1 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

2 In particular, Commission Delegated Regulation of 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regards to exemptions, general operating conditions, depositories, leverage, transparency and supervision.

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 to (among other exempt entities) holding companies; financial vehicles in which the only investors are group companies; employee participation or saving schemes; and securitization special purpose entities. AIFMs will be exempt from parts (not all) of the AIFM Directive if the assets of the AIFs they manage do not exceed €100 million, or €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.

A. REMUNERATION

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 of the AIFM Directive. 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 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 has published guidelines[3] on sound remuneration policies under the AIFM Directive that 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. In particular, ESMA's guidelines provide that qualifying carried interest

[3] ESMA Guidelines on sound remuneration policies under the AIFMD, available at http://www.esma.europa.eu/system/files/2013-232_aifmd_guidelines_on_remuneration_-_en.pdf.

structures can be taken into account in determining whether an AIFM satisfies many of the AIFM Directive's remuneration-related requirements.

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-ended AIFs must carry out valuations following any increase or decrease of the capital of an AIF.

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 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 that they manage. 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 delegate of the depositary.

Depositaries may be EU-based credit institutions, investment firms, or firms permitted to act as depositaries for a retail fund subject to the UCITS Directive.[4] Depositaries must be established in the same Member State as the relevant AIF (although competent authorities will have some discretion, until July 22, 2017, to allow a depositary to be established in another Member State if it is an EU credit institution). Certain AIFs whose investors have 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 €125,000 plus 0.02% of the amount by which the value of the portfolio of the AIFM exceeds €250 million, up to €10 million. However, an AIFM's own funds may never be less than the amount required for investment firms under the Capital Adequacy Directive,[5] *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. Under the Commission's implementing rules, AIFMs will have to maintain additional own funds and/or insurance to cover liability risks.

E. LEVERAGE

AIFMs must set leverage limits for the AIFs they manage and demonstrate that those leverage limits 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, but only 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.

---

4 Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast).

5 Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast).

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 those AIFs, changes to the maximum permitted leverage, and whether there is a right to re-use collateral under the leveraging arrangement.

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 an EU company 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.[6]

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

[6] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids.

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"

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.[7]

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. The final text is intended to create a level playing field between EU and non-EU AIFMs, but the regime – commonly referred to as the "third country passport 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 late 2015 at the earliest.

Once the passport regime becomes available, 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 to the regulator in its "Member State of reference", which will be responsible for ensuring the non-EU AIFM's compliance with its management- and marketing-related obligations under the AIFM Directive. The choice of the Member State of reference depends on factors including the jurisdictions in which any EU AIFs that are marketed by the non-EU AIFM are established, 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 non-EU AIFM intends to market interests in those AIFs.

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.

---

[7] Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (Recast).

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 granting an 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 interests in AIFs to professional investors.[8] The applicable rules depend on whether or not the AIFM and/or the AIF in question is established in the EU.

A. EU AIF INTERESTS

The AIFM Directive will allow an authorized AIFM to market to professional investors 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 "marketing passport," subject to compliance with a similar notification 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 do not discriminate against cross-border marketing.

B. NON-EU AIF INTERESTS

Additional conditions apply to the marketing of non-EU AIF interests. Until at least late 2018, AIFMs will be able to 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

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

regimes[9] 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.

From late 2015, authorized AIFMs should be entitled to market interests in non-EU AIFs 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

The AIFM Directive includes several transitional and grandfathering provisions. In general, an AIFM operating in the EU prior to July 22, 2013 must bring its activities into compliance with the AIFM Directive, including submitting an application for authorization within one year of July 22, 2013, unless either of two exceptions applies:

- AIFMs insofar as they manage closed-ended AIFs that make no additional investments and are not marketed after July 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 continue without authorization, but these AIFMs must comply with the disclosure requirements outlined above.

The one-year period for existing AIFMs subject to the AIFM Directive to submit an application for authorization effectively creates a one-year "grace period." Member State authorities take differing views regarding the AIFMs that can benefit from the grace period (for instance whether non-EU AIFMs benefit from the grace period and under what conditions) and the AIF interests that can be marketed by existing AIFMs in reliance on the grace period (for instance whether qualifying AIFMs may only continue marketing commenced before July 22, 2013 or whether such AIFMs can also commence marketing of new or existing AIFs after July 22, 2013).

[9] 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.

VII. EFFECT OF NON-IMPLEMENTATION OF THE AIFM DIRECTIVE

As noted, while a number of key Member States have implemented the AIFM Directive, many Member States have not. Although many of the tardy Member States can be expected to transpose the AIFM Directive into national law by the end of 2013, late transposition raises a number of complex legal issues for AIFMs authorized in Member States that have transposed the AIFM Directive and wish to market or manage AIFs in countries that have not; for AIFMs established in Member States that have not yet transposed the AIFM Directive and as such cannot yet be authorized under the AIFM Directive; and for non-EU AIFMs wishing to market AIF interests in Member States that have not yet transposed the AIFM Directive.

According to an opinion published by ESMA,[10] if an AIFM is authorized by the competent authority in a Member State that has transposed the AIFM Directive, the competent authorities of countries that have not transposed the AIFM Directive may not refuse a notification that the authorized AIFM intends to market AIF interests, so that authorized AIFMs will be able to rely on the marketing passport even in countries that have not transposed the AIFM Directive. Similarly, ESMA believes that an AIFM authorized in a Member State that has transposed the AIFM Directive can rely on the management passport to manage an AIF in a Member State that has not transposed the AIFM Directive.

The situation of AIFMs established in countries that have not yet transposed the AIFM Directive is more complex. Although ESMA does not address the situation of such AIFMs in detail, such AIFMs presumably cannot exercise either the marketing or the management passport because they cannot (yet) be authorized under the AIFM Directive. ESMA notes that Member States may be liable for damages where losses are sustained as a result of a failure to transpose a directive.

For non-EU AIFMs, the late transposition of the AIFM Directive in some Member States should have limited effects, since non-EU AIFMs cannot benefit from the marketing or management passport in any event. Non-EU AIFMs wishing to market AIF interests in Member States that have not yet transposed the AIFM Directive will continue to be subject to the existing national rules, without the need to comply with the minimum conditions the AIFM Directive requires Member States to introduce into their national private placement regimes.

* * *

[10] ESMA Opinion, on practical arrangements for the late transposition of the AIFMD, available at http://www.esma.europa.eu/content/Practical-arrangements-late-transposition-AIFMD.

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 at http://www.cgsh.com/banking_and_financial_institutions/.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Bank of China Tower, 39th Floor
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099