

AIFM Directive — Almost There

On October 19, 2010, finance ministers of the European Union (“EU”) Member States unanimously agreed to support a compromise text of the Alternative Investment Fund Managers Directive (“AIFMD”) prepared by Belgium (currently in the chair of the European Council). This text will form the basis for “trialogue” discussions among the European Council, the European Parliament and the European Commission, with the aim of producing a final agreed version. The European Parliament is due to debate the AIFMD on November 10, 2010, and to vote on the text the following day.

Although the “trialogue” discussions among the parties over the AIFMD broke down earlier this year, all the indications are that this time the result will be different. This is in large measure because the issue that caused disagreement last time — the position of “third country” (non-EU) alternative investment fund managers (“AIFMs”), and therefore including U.S. investment managers and advisers — has been resolved by creating a dual system, broadly along the following lines.

- If the third country AIFM complies with the entire AIFMD, and the country in which the third country alternative investment fund (“AIF”) is located satisfies certain conditions relating to co-operation and tax information-sharing, and is not on the Financial Action Task Force (“FATF”) “blacklist” of non-co-operative countries and territories (all requirements that the U.S., for example, satisfies), that AIFM may exercise passport rights in the same way as an EU AIFM. In this context it will have a “Member State of reference” (the EU Member State in which most of the marketing is expected to occur) that will act in the same way as a home Member State for an EU AIFM when the passport is exercised. This would, for example, enable a U.S.-based AIFM to market a Cayman fund to professional investors throughout the European Union, which is the result that U.S. Treasury Secretary Geithner had been wanting to achieve through his various letters to EU figures (including EU Commissioner Barnier). However, the passport regime for non-EU AIFMs will not come into effect until two years after the rest of the AIFMD; until then, non-EU AIFMs will have to rely on private placements in individual Member States.
- Otherwise, the third country AIFM may market a non-EU fund on a private placement basis in any Member State provided that it complies with the transparency provisions of the directive in Articles 22-24 (which in broad terms require the AIFM to produce an annual report for each AIF that it manages, make specified disclosures to investors, and report on various aspects of the AIF’s investments to the AIFM’s supervisor, including details of principal exposures, liquidity arrangements, and risk management tools that it employs); there are cooperation arrangements between the EU Member State where the marketing takes place and the supervisors of the AIFM and, if different, the supervisors of the country where the AIF is established; and the country in which the AIFM (and, if different, the AIF) is located are not on the FATF “blacklist” of non-co-operative countries and territories.

Under these provisions, therefore, private placements can continue much as they are now. However, there are three caveats to be borne in mind. First, individual Member States can add stricter conditions to those set out in the AIFMD. Secondly, the AIFMD does not require Member States to offer private

placement regimes, so in theory, once the AIFMD comes into force individual Member States could choose not to implement this provision. Thirdly, and most importantly — presumably as a concession to enable agreement to be reached — the AIFMD contains provisions that would result in the disappearance of the private placement regime five years after the AIFMD comes into force, provided that the new European Securities and Markets Authority (“ESMA”) concludes that there are no “significant obstacles” to dispensing with the private placement regime and keeping the passport regime as the only regime whereby non-EU AIFMs can market non-EU AIFs. (One interesting by-product of the AIFMD is the role that ESMA is to have as a pan-European supervisory and monitoring body, which raises the question of whether, over time, ESMA will increasingly acquire powers that individual EU Member State regulators have or would have had.)

That means that the timeline will probably look like this:

- AIFMD comes into force: early 2013;
- Passport regime for non-EU AIFMs starts: early 2015;
- Private placement regimes end: early 2018.

The end of the private placement regime (and the requirement to comply with the AIFMD in its entirety) seems extremely onerous for a non-EU AIFM that intends to market AIFs in only one or two EU Member States. In this situation, the non-EU AIFM would need to satisfy (among others) provisions in the AIFMD relating to capital requirements, depositaries, leverage and remuneration. One obvious possibility is that unless there is a large degree of overlap between their own domestic requirements and the requirements of the AIFMD, non-EU AIFMs will simply not bother with marketing in the EU (particularly if they intend to target investors in only one or two Member States), and will wait for EU investors to come to them — which the AIFMD allows (see further below).

Two other aspects that are worth attention at this stage:

- On the basis of the definition of “marketing,” there is no attempt in the Belgian text to prevent investors in the EU from contacting a non-EU AIFM and investing in funds managed by that AIFM where there has been no approach by the AIFM, even if the AIFM does not satisfy any provisions of the AIFMD. Accordingly, EU pension fund managers will be able to contact U.S. AIFMs and invest in alternative funds managed by those AIFMs, even if the U.S. AIFM has decided not to market those funds in the EU (and thus not to comply with the provisions of the AIFMD).
- In general, depositaries have strict liability for loss of custody investments, even if they have delegated custodial functions to sub-custodians. However, providing that (1) all the requirements for delegation are met (including that the sub-custodian is subject to prudential regulation and independent periodical audit), (2) the AIF (or the AIFM acting on behalf of the AIF) agrees with the depositary in writing, and (3) the sub-custodian explicitly agrees to be liable for loss of custody instruments, the depositary may discharge itself of that liability.

Assuming that the version of the AIFMD that is finally passed will in all material respects be the same as the version approved by EU finance ministers, the Directive will undoubtedly result in an increased compliance burden for the alternative investment industry. Furthermore, the likely disappearance of national private placement regimes in 2018 will force non-EU AIFMs into choosing between the cost of complying with the AIFMD, or abandoning the EU market altogether. That said, the impact of what is currently being proposed is significantly less than in some of the earlier drafts,

which would have made it virtually impossible for non-EU AIFMs to market AIFs in the EU, prevented delegation to non-EU service providers, and barred EU investors from making investments with non-EU AIFMs that did not comply with the AIFMD. For that, the current text of the AIFMD deserves one cheer, at the very least.

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