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CONTENTS

Speedread	1
Towards an International Insolvency Convention: Issues, Options and Feasibility Considerations	5
Gregor Baer	
Good Faith in English and US Contract Law: Divergent Theories, Practical Similarities	27
Christina Perry	
An Overview of the AIFMD for US Investment Managers	41
Bentley Anderson	
French Contract Law Reform	59
Peter Rosher	
Book review	73
Chambers corporate governance handbook	
Index	75

An Overview of the AIFMD for US Investment Managers

Bentley J Anderson*

The Alternative Investment Fund Managers Directive (AIFMD or the 'Directive') imposes significant obligations on US investment managers seeking to raise capital for alternative funds from investors domiciled in a Member State of the European Union (EU). These obligations include, among others, having to register with and periodically report descriptive and quantitative information to regulators regarding the alternative investment fund manager's business, provide detailed disclosure to prospective and current investors and, depending on the Member State, comply with requirements relating to the custody of fund assets with third parties not affiliated with the adviser. The AIFMD applies to investment managers domiciled in the EU who advise alternative funds, and to US investment managers providing advisory services to one or more EU-domiciled or non-EU-domiciled alternative investment funds (AIFs), or marketing an EU-domiciled or non-EU-domiciled AIF to investors domiciled in a Member State.¹

This article discusses the basic requirements that US alternative investment fund managers (AIFMs), including those managing AIFs with traditional and quantitative or algorithmic investment strategies, those managing private equity portfolios and US broker-dealers dually registered with the US Securities Exchange Commission (SEC) as investment advisers, must satisfy under the AIFMD, if they seek to raise new or additional capital from EU investors for one or more AIFs. The article describes the threshold

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1 Citations to the AIFMD in this article are to the text available through EUR-Lex: <http://eur-lex.europa.eu>.

requirements that a US AIFM must satisfy, including those relating to registration, reporting and disclosure.² The article focuses on the provisions of the AIFMD itself, rather than the provisions of a particular Member State's national private placement regime (NPPR), into which the AIFMD's requirements have been transposed. The article concludes with a summary of practical AIFMD compliance considerations bearing on a US AIFM's decision whether to raise new or additional capital from EU investors.

Historical background

Among the EU's consideration of remedial legislative proposals to address private sector 'shadow-banking' and financial intermediary losses following the 2008 financial crisis, the drafters of the AIFMD sought to enact a harmonised regulatory framework governing the activities of investment advisers to EU and non-EU AIFs that were marketed to EU investors. The perception was that future significant losses in or among AIFs could exacerbate a larger sell-off in the union's capital markets, which in turn could place material downward pressure on market values beyond the frontier of any particular Member State. The AIFMD was approved by the European Parliament in November 2010, and took effect in July 2011. Member States were then expected to transpose the AIFMD into their respective NPPRs no later than 22 July 2013. In fact, only a handful of Member States completed the transposition process by that deadline, although a large majority has completed the adoption process as of the date of this article.

As mentioned, the AIFMD's principles were intended to be transposed into local law, in the manner determined by the relevant Member State's legislative body. Significantly, this approach means that each Member State's NPPR remains in effect, as revised through the AIFMD principles adopted by that Member State's legislators. The absence of a harmonised, pan-EU private placement regime, accordingly, imposes on US AIFMs the obligation to comply with the provisions of the NPPR of each Member State in which it expects to manage or market an AIFM.

Important terminology

An AIFM includes any juridical or natural person whose regular business is to 'manage' one or more AIFs. An AIF is defined in the Directive as a 'collective investment undertaking which: raise[s] capital from a number of investors, with a view to investing it in accordance with a defined investment policy for

² This article includes no substantive discussion regarding the application of the AIFMD to an AIFM chartered or based in a Member State.

the benefit of those investors'.³ The definition of 'AIF' excludes an entity organised under the EU's 'Undertakings for the Collective Investment of Transferable Securities' (UCITS) regime. The AIFMD applies regardless of whether the AIF is open-end or closed-end, or which legal structure – a corporation or trust, for example – is used to form the fund. The definition of 'AIF' therefore captures most types of entities managed by US AIFMs, including private funds with traditional and quantitative trading strategies and private equity funds.

Each AIF must have a single AIFM. The term 'manage' includes providing portfolio management or risk management services to an AIF; the former includes managing one or more portfolios of financial instruments on the basis of the AIFM's discretionary investment authority, and the latter refers to services involving the identification, measurement and monitoring of risks related to the AIF's investment strategy. The AIF may be internally or externally managed. An AIF is internally managed where management services are provided by the governing body of the AIF (eg, the fund's board of directors), or by one or more employees of the AIF. An externally managed AIF is a vehicle that receives management services provided by a registered or authorised AIFM.

Threshold requirements of the AIFMD

The Directive imposes differing requirements on managers depending on the jurisdiction in which the AIFM is organised, as well as the jurisdiction(s) in which the AIF is managed and was organised. The principal distinctions made in the AIFMD are among:

- an AIFM that has its registered office in a Member State and markets an EU or non-EU AIF to non-EU or EU investors;
- a non-EU AIFM (including a US AIFM), which markets an EU AIF to EU investors; and
- a non-EU AIFM (including a US AIFM), which markets a non-EU AIF to EU investors.

³ Directive 2011/61/EU of the European Parliament and of the Council, 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 [2011] OJ L174 (AIFMD), at Art 4(1)(a)(i), OJ L174/16.

The last two categories clearly include US investment managers who have current relationships with, or who seek to raise capital from, EU investors.⁴

An EU AIFM managing an EU AIF is subject to the full set of AIFMD obligations, including compliance with a set of general principles governing the conduct of its business. These obligations include, among others, that the EU AIFM will 'act honestly, with due skill, care and diligence, and fairly in conducting their activities'; 'act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market'; and 'take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable, disclose, those conflicts of interest to investors in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated'.⁵

An EU AIFM marketing an EU AIF to EU investors is also expected to comply with a number of operational and risk management requirements. For example, the manager is required to maintain a minimum capitalisation of its investment management business, starting with an 'initial capital' of €300,000 for internally managed AIFs and €125,000 for an external manager of an AIF.⁶ In addition, the EU AIFM is expected to develop and implement a remuneration policy, including authority for the AIFM to claw back compensation previously paid, applicable to the adviser's 'senior management, risk-takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of the AIFMs or of AIFs they manage'.⁷ The EU AIFM must also implement and maintain systems intended to identify, measure, manage and monitor the investment risks of the AIF,⁸ and to identify, assess and manage the AIF's liquidity risks.⁹

In contrast, non-EU AIFMs (including US AIFMs) managing and marketing non-EU AIFs, are required to comply only with some of the obligations that EU AIFMs must satisfy.¹⁰ The first of these requirements

4 As discussed below, the marketing passport that would allow an AIFM registered in one Member State to market an AIF in another Member State, without being required to satisfy additional registration requirements in the second Member State, is currently available only to EU AIFMs marketing EU AIFs, and is not currently available to non-EU AIFMs, including US AIFMs, marketing EU or non-EU AIFs to EU investors.

5 AIFMD at Art 12(1) (a), (b) and (d), OJ L174/23.

6 *Ibid* Art 9, OJ L174/22.

7 *Ibid* Annex II, OJ L174/70. This annex identifies requirements to be covered in the EU AIFM's remuneration policy. See also Art 13, OJ L174/24.

8 *Ibid* Art 15, OJ L174/15.

9 *Ibid* Art 16, OJ L174/25.

10 The reduced set of compliance obligations is sometimes referred to as 'AIFMD lite'.

is that the US AIFM fulfils certain investor disclosure and ‘transparency’ obligations, and to register with and provide certain information to the relevant local regulator(s). The disclosure to investors may take the form of a supplement to the AIF’s existing offering documents, including a confidential private placement memorandum (PPM). However, depending on its business model and practices, a US AIFM may also be required to provide a level of information far beyond the scope of what it is accustomed to communicating to private fund investors in a PPM. For example, a US AIFM must periodically provide AIF investors with information regarding the remuneration of the manager’s staff; the manager’s valuation policies and procedures; the compliance obligations of service-providers who support the AIF; fees and charges payable by investors; where relevant, the AIF’s use of leverage calculated consistent with the specific methods identified in the AIFMD; the processes utilised by the US AIFM to manage market risk, liquidity risk and counter-party risk; any preferential liquidity or other arrangements with selected investors (eg, including disclosure regarding ‘side-letters’ among an investor, the AIF and the AIFM); and the percentage of the AIF’s assets that are considered illiquid. This information is also required to be included in the annual report that the AIFM must provide to investors within six months of the adviser’s financial year-end.¹¹

A US AIFM will also be required to register with and report regularly to the relevant Member State regulator in the jurisdiction in which the AIF is marketed. The nature and scope of the applicable registration requirements depend on the provisions of the relevant Member State’s NPPR.¹² In the UK, for example, the registration process involves only the preparation and submission of a relatively straightforward form and spreadsheet, and the payment of a relatively minor fee. Once the registration is filed with the local regulator, the Financial Conduct Authority (FCA), the US AIFM may commence marketing the fund to UK-domiciled prospective investors. Other Member States have substantially more complicated and detailed registration requirements, and may entirely prohibit the US AIFM from marketing the fund until the local regulator confirms the registered status of the AIFM.

The frequency of reporting to a Member State regulator after registration is determined by the non-EU AIFM’s total assets under management, and the extent of any leverage used in the portfolios managed by the adviser. If the AIFM manages one or more AIFs with total assets greater than €1bn, then it must report to the relevant Member State regulator at least quarterly. The same reporting frequency applies to any US AIFM that manages an AIF,

¹¹ AIFMD at Preamble, para 48, OJ L174/7.

¹² Depending on the jurisdiction, this document may require inclusion of approximately the same, or far more, information as that required by Annex IV to the AIFMD.

which, individually, has assets greater than €500m. The reporting frequency may also differ depending on whether the AIFM manages a private equity-orientated AIF, rather than an AIF following one or more active trading strategies. For AIFs that are master-feeder structures, information must be provided to the Member State regulator regarding the feeder fund, and not the master fund, given that the feeder fund is the vehicle marketed to EU investors.¹³ The AIFM is also required to make available to the relevant regulator(s) a copy of the annual report that it provided to investors.

A US AIFM's second basic compliance obligation when considering marketing an AIF in a Member State is to ensure that 'an appropriate cooperation arrangement' or information exchange agreement has been executed and adopted by the regulator of the Member State in which the AIF will be marketed, the regulator of the jurisdiction in which the AIF was chartered¹⁴ and the principal regulator in the jurisdiction in which the AIFM's home office is located.¹⁵ For US AIFMs, the relevant regulator is the SEC. The principle underlying this requirement is that formal information-sharing arrangements among regulators will allow each of them to pursue inquiries into the conduct of investment advisers to alternative funds providing services across their respective borders.

Finally, neither the non-EU AIFM nor the AIF may be established in a jurisdiction included on the list of 'non-cooperative' countries and territories maintained by the Financial Action Task Force (FATF).¹⁶ The list includes jurisdictions identified by the FATF as supporting or allowing money laundering or terrorist financing activities. The US, Cayman Islands, British Virgin Islands and Bermuda are not included on the FATF's list of non-cooperating jurisdictions.

Member States are free to adopt provisions applicable to US and other non-EU AIFMs that supplement, but do not prevent the implementation of, the AIFMD's requirements. Some Member States have adopted such measures, which have resulted in more complex, and potentially more expensive, compliance obligations for non-EU AIFMs marketing AIFs in those jurisdictions. In Germany, for example, the non-EU AIFM must appoint at least one unrelated 'depository' to custody the assets of the AIF, monitor cash levels retained by the AIF and provide administrative oversight

13 However, a Member State regulator may require that information relating to the master fund be made available by the AIFM on request. See, eg, Financial Conduct Authority (UK), 'Reporting Transparency Information to the FCA, Questions and Answers' (November 2014), Question 2, p 8.

14 For many US AIFMs advising non-US AIFs, the most widely used jurisdictions are likely to include Cayman Islands, the British Virgin Islands and Bermuda.

15 AIFMD at Art 40(2) (a), OJ L174/52.

16 *Ibid* Art 40(2) (b), OJ L174/52.

over processing asset and cash transfers to and from the AIF. In theory, the custody component of the depositary function may be performed by a prime broker to the AIF, and the cash management component of its duties may be performed by the prime broker or by the fund's administrator. But if neither of those entities is capable or willing to provide administrative oversight services, then the non-EU AIFM may be required to appoint an additional vendor to satisfy the AIFMD's requirements regarding depositaries.

As discussed below, a US AIFM may avoid some or all of these threshold requirements by complying with one or more available exemptions under the AIFMD, or by ensuring that it is not engaged in 'marketing' the AIF to EU investors. However, if no such exemption is available, or if the US AIFM is engaged in 'marketing' the AIF, then the adviser must satisfy each of the three basic obligations. The failure to comply with any of these three requirements will prevent a US AIFM from being able lawfully to market AIF securities to investors domiciled in a Member State.

Exemptions/'reverse solicitation'

The AIFMD includes several exclusions from its coverage. For example, the AIFMD does not apply to holding companies, family investment vehicles, national central banks, employee participation schemes and certain types of special purpose vehicles utilised in securitisation transactions.¹⁷ The Directive further excludes AIFMs that manage funds the investors in which are limited to the manager itself and/or companies under common control with or by the AIFM.

Distinct from these exclusions, the AIFMD provides a partial exemption for 'small managers'. A small AIFM is an adviser with cumulative AIF assets of less than €100m, or with cumulative AIF assets of less than €500m, as long as the fund does not utilise leverage and investor capital is subject to a lock-up period of at least five years.¹⁸ A manager that satisfies these requirements would be required to comply with reduced registration and reporting obligations to the relevant Member State regulator.

As mentioned above, one of the means by which a US AIFM could become subject to the AIFMD is by marketing an EU or non-EU AIF to an EU investor. The term 'marketing' is defined as any 'direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union'.¹⁹ The UK's regulation adopting the AIFMD

¹⁷ *Ibid* Preamble, para 8, OJ L174/2.

¹⁸ *Ibid* para 17, OJ L174/3.

¹⁹ *Ibid* Art 4(1)(x), OJ L174/18.

did not define the terms 'offering' or 'placement'. But as formulated by the FCA, an 'offering or placement' occurs:

'when a person seeks to raise capital by making a unit of share of an AIF available for purchase by a potential investor. This includes situations which constitute a contractual offer that can be accepted by a potential investor in order to make the investment and form a binding contract, and situations which constitute an invitation to the investor to make an offer to subscribe for the investment.'²⁰

Hence the AIFMD, and the UK's transposition of the Directive, appear to acknowledge by their respective terms that 'marketing' does not occur where the investor contacts the AIFM on its own initiative, rather than in response to a marketing communication from the AIFM. The potentially difficult issue for a US AIFM is determining whether, under particular circumstances, there is a legally sufficient basis on which to conclude that the prospective EU investor contacted the manager on its own, without any conduct or communication by the AIFM that could be interpreted by the relevant Member State regulator, in hindsight, as not involving a 'solicitation' or 'invitation' to the EU investor to consider the investment.

There is support for a US AIFM that is not registered with a Member State regulator accepting capital from an EU investor through a 'reverse solicitation'. This term describes a request to a non-EU AIFM from a prospective investor at its own initiative, and not in response to a marketing communication from the manager, that the latter provide the prospective investor with information regarding a particular AIF (or AIFs).²¹ A US AIFM that lawfully accepts capital from an EU investor through a reverse solicitation need not comply with the registration and investor disclosure requirements of the AIFMD as embodied in the relevant Member State's NPPR. But it is the US AIFM's responsibility to determine whether it has engaged in 'marketing' or has limited itself to responding only to prospective investor requests for information regarding AIFs managed by that adviser; the former will obligate the US AIFM to comply with the NPPR requirements of that jurisdiction, while the latter will signify that the investment adviser has no such compliance obligations. Accordingly, it is important for a US AIFM to assess at all times its communications with prospective and current investors for any indication that it has crossed the line from responding to a reverse solicitation to engaging in 'marketing' without first having satisfied the AIFMD's requirements for doing so.

20 Financial Conduct Authority (UK), 'AIFMD Marketing', in 'The Perimeter Guidance Manual' (the 'Perimeter Guide'), at Section 8.37.5, p 8/129.

21 Neither the term 'reverse solicitation', nor a frequent companion phrase, 'passive marketing', is defined in the AIFMD.

As should be clear, relying on a strategy of obtaining new or additional investor capital through reverse solicitations poses potentially significant regulatory risks to a US AIFM. Data regarding assets being allocated to AIFMs, including non-EU AIFMs, are and will continue to be collected and analysed by the European Securities and Markets Authority (ESMA) and the various Member State securities regulators. If those regulators believe that a significant number of AIF assets have been allocated to a particular US AIFM that is not registered with a Member State regulator, ESMA or a Member State regulator may determine to closely scrutinise that manager regarding the processes by which it has raised capital from EU-domiciled investors. As discussed below, if a regulator concludes that the US AIFM has violated the AIFMD, the regulator may, depending on the jurisdiction, pursue civil and even possibly criminal sanctions against the manager. Additionally, a violation of the AIFMD may vitiate the investment agreement between the AIF and the investor, and thereby provide the affected investor(s) with a means to recover any losses sustained from its investment. A US AIFM should therefore carefully consider how, or even whether, it will seek to raise capital among EU investors without first registering with a Member State regulator.

Further complicating a US AIFM's reliance on reverse solicitation is the fact that the use of this 'carve-out' depends on the specific terms of the NPPR to which the manager may be subject: each Member State's NPPR may define 'reverse solicitation' (or the relevant analogous concept under local law) differently. Most Member State regulators have provided little, if any, commentary or clarification regarding the availability or scope of reverse solicitation. An example to the contrary is the position taken by the FCA. The UK regulator has stated that a 'confirmation from the investor that the offering or placement of units of shares of the AIF was made at its initiative, should normally be sufficient to demonstrate that this is the case, provided this is obtained before the offer or placement takes place'.²² According to the FCA, the reverse solicitation must specifically identify the AIF about which, and the US AIFM from which, the prospective investor seeks information, and cannot simply be a generalised request for information about the AIF or US AIFM. On the other hand, the FCA has stated that 'marketing' occurs when the AIFM, or its agent,²³ makes AIF securities 'available for purchase' by the prospective investor. This phrasing suggests that communications by the US AIFM to the prospective investor prior to the point at which the investor

²² Perimeter Guide at Section 8.37.11G (2), p 8/131. The Perimeter Guide also makes clear that the confirmation from the prospective investor may not be relied upon if it 'has been obtained to circumvent the requirements of AIFMD'.

²³ For example, through a capital introduction service sponsored by a prime broker to the AIF.

would be legally bound to invest would not be considered 'marketing'. It would therefore seem probable that providing a draft PPM, without any other documents (and specifically without a subscription agreement), to the prospective investor by or on behalf of the US AIFM would not be considered under the FCA's regime as marketing the fund.

As another example, in France, the securities regulator, the *Autorité des Marchés Financiers* (AMF), has implemented a similarly broad interpretation of marketing. In particular, the regulator has stated that an 'offering' or 'placement' of an AIF's securities includes 'presenting them on French territory by different means (advertising, direct marketing, advice) with a view to encouraging an investor to subscribe for or purchase' the securities.²⁴ As further clarification, the AMF explained that the AIF's securities will be presumed to have been marketed in France if investors targeted by a formal or informal marketing effort hold securities issued by that AIF. However, the regulator has preserved the ability of US AIFMs to rely on a narrow interpretation of reverse solicitation by excluding from the definition of 'marketing' the purchase or sale of the AIF's securities in response to 'a client's unsolicited request to purchase a specifically designated UCITS or AIF'. At the same time, the regulator has not identified the nature or quantum of evidence that a US AIFM would be required to maintain to demonstrate, in a given instance, that an investment in a non-EU AIF by a French investor was made on the basis of a reverse solicitation.

In sum, reverse solicitation may provide benefits to a smaller US AIFM that is not currently positioned to satisfy the many registrations, reporting and other requirements created by a Member State's NPPR. But the US AIFM ultimately will be required to determine in advance its ability reliably to comply with the reverse solicitation requirements applicable under the NPPR for each of the Member States in which it anticipates receiving investor capital; no generalised approach to compliance with reverse solicitation concepts are likely satisfactorily to address the regulatory risks associated with a US AIFM's 'passive marketing' of AIFs in the EU. A US AIFM should therefore be sensitive to understanding whether a particular communication or set of communications from a prospective investor will satisfy the specific local law requirements under which reverse solicitation is permitted. Communications from a prospective investor that are nebulously phrased, or that are received by the US AIFM months after a prospective investment

²⁴ *Autorité des Marchés Financiers*, Position Document DOC-2014-04, 'Guide to UCITS and AIF Marketing Regimes in France' (June 2014), at p 3.

relationship was initiated, are likely to pose particularly challenging compliance issues for the manager.²⁵

Private equity-related provisions

In addition to the basic AIFMD responsibilities imposed on a US AIFM, there are certain additional requirements that US AIFMs conducting a private equity business must satisfy. A complete discussion of the AIFMD's private equity-specific requirements is beyond the scope of this article, but in general the Directive creates additional disclosure obligations for US AIFMs in relation to AIFs that have holdings in portfolio companies with registered offices in the EU. The AIFMD's private equity provisions also prohibit the practice referred to as 'asset stripping'.

The disclosure obligations imposed on private equity AIFMs differ depending on whether the portfolio company has securities admitted to trade on a market within the European Economic Area (EEA).²⁶ The nature and scope of any disclosure obligations further depend on whether the AIF has acquired 'control' of the company, among other criteria.²⁷ For a company with securities trading on an EEA-regulated market, 'control' means that the AIF has acquired the number of securities that will require it to bid on the company under the EU Takeover Directive.²⁸ For a non-listed company, in comparison, 'control' is defined in the AIFMD as occurring when the AIF has acquired securities representing 'more than 50% of the voting rights of the company'.²⁹ Further, 'control' may be acquired by an AIF acting alone,

²⁵ Another factor that a US AIFM must consider is the extent to which its business, and specifically its capital-raising activities, are subject to the second Markets in Financial Instruments Directive (MiFID II), which entered into force in 2014 and will generally apply within the EU in January 2017. MiFID II includes a provision that permits reverse solicitation under circumstances potentially narrower than those permitted under the AIFMD. Accordingly, in developing a marketing policy that may target, directly or indirectly, prospective EU investors, a US AIFM must consider its duty to comply with both the relevant NPPR(s) and the relevant provisions of MiFID II, if applicable.

²⁶ The EEA comprises the EU's Member States and three of the four non-EU members of the European Free Trade Association: Iceland, Liechtenstein and Norway.

²⁷ For example, the disclosure obligations do not apply to 'small and medium-sized businesses' or special purpose vehicles formed to purchase real estate. AIFMD at Preamble, para 58, OJ L174/8. A 'small or medium-sized business' is one with less than 250 employees, and 'which [has] an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million'. European Commission, Annex to Commission Recommendation 2003/361/EC [May 2003] OJ L24, Art 2(1), OJ L124/39.

²⁸ This threshold is not uniform across the EU, and may be as high as 30 per cent of the voting rights for a particular class of stock.

²⁹ AIFMD Art 26(5), OJ L174/36.

or through two or more AIFs under common investment management authority, which enter into an agreement to acquire control of the company.

Assuming that an AIF has acquired control of an EU-based non-listed company, the US AIFM will be obligated to ensure that certain disclosures are made to the relevant regulator. This includes disclosing the identity of the AIF that has acquired control; the identity of the US AIFM that manages that AIF; the US AIFM's policy for preventing and managing conflicts of interest among the manager, the AIF, and the portfolio company; and the policy for communicating with employees of the portfolio company.³⁰

US AIFMs are also prohibited from engaging in any practices that could be characterised as 'asset stripping'. That term refers to the practice of managers utilising the assets of portfolio companies to secure debt financing the proceeds of which are distributed to the shareholders of the AIF. The specific concern posed by asset stripping, according to regulators, is that the practice leaves a portfolio company with a potentially unsustainable level of debt owed to third parties, while the shareholders of the AIF (and potentially the AIFM) are enriched.

The asset-stripping prohibitions take several forms. In brief, for two years from the date on which an AIF acquires control of a listed or non-listed company, the AIFMD's asset-stripping provisions prevent the US AIFM from causing the AIF to effect, directly or indirectly, any distribution or similar transaction, including through any reduction in share capital, through certain reductions in the portfolio company's net assets, or through a distribution to existing shareholders, in each case in an amount that is greater than the AIF's net profits from the most recent accounting year.³¹ These prohibitions would not prevent all payments to the AIF (or AIFs) that control the portfolio company during the two-year period; instead, profits could be paid to the owner(s) so long as the US AIFM could demonstrate that, after each payment, the portfolio company's net assets remained at or above the level of the company's subscribed capital. In sum, US AIFMs advising private equity AIFs, and investors in those AIFs, should remember that the asset-stripping provisions could prohibit a portfolio company from paying a dividend to its AIF owner under a wide variety of circumstances, irrespective of how the dividend is financed.

³⁰ *Ibid* Art 28(2)(a)–(c), OJ L174/37.

³¹ *Ibid* Art 30, OJ L174/38. The redemption of debt, on the other hand, would seem not to be prohibited, given that Art 30 refers only to the redemption of shares.

Enforcement/sanctions

The AIFMD itself does not impose an enforcement or sanctions regime that would apply to US AIFMs that do not comply with the requirements of the Directive. Instead, the AIFMD requires each Member State to ensure that its securities regulator is empowered to penalise or sanction, through ‘effective, proportionate and dissuasive administrative measures’, violations of the local law implementing the AIFMD.³² These measures are in addition to any criminal sanctions that would already be available under local law, including any applicable anti-fraud regulations. As an example, in the UK, the FCA is authorised to enforce the regulations adopted to implement the provisions of the AIFMD in the UK through a wide range of sanctions, including public censures, potentially unlimited financial penalties, and restricting, suspending or cancelling a registrant’s licences or approvals.

Marketing passport initiative

As described above, the AIFMD permits an EU AIFM managing an EU AIF to market the fund in any Member State as long as the manager has satisfied the requirements for marketing the AIF in another Member State; no authorisation from the second Member State’s regulator must be obtained before the EU AIFM may market that AIF to investors in the second Member State. Currently, this cross-border marketing ‘passport’ is available only to an EU AIFM that is marketing an EU AIF to investors domiciled in the EU. In contrast, there is no passport for use by a non-EU AIFM, including a US AIFM; instead, to market a non-EU AIF or an EU AIF in more than one Member State, the US AIFM must comply with the requirements of the NPPR for each jurisdiction in which the manager seeks to market the AIF, including, among other requirements, satisfying any registration and disclosure obligations applicable to the US AIFM.

When the Directive was drafted, it was contemplated that there could be conditions under which the marketing passport would be available to all AIFMs, and not only to EU AIFMs. Article 67(1) of the AIFMD obligated ESMA to provide advice by July 2015 to the EU Parliament, Council and Commission regarding whether the passport should be extended to non-EU AIFMs marketing EU and non-EU AIFs to EU investors. Under Article 67(4), if ESMA communicated ‘positive advice’ that there were ‘no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risks’ in relation to the marketing to EU investors of non-EU AIFs by EU AIFMs and non-EU AIFMs,

³² *Ibid* Preamble, para 75, OJ L174/11.

then the European Commission would be authorised to adopt legislation fixing a date by which the marketing passport would be extended to non-EU AIFMs and non-EU AIFs.

On 30 July 2015, ESMA published its advice and opinion to the EU Parliament, Council and Commission.³³ As the regulator explained, in the period between adoption of the AIFMD and the July 2015 deadline, ESMA identified 22 jurisdictions as relevant to its ‘country-by-country analysis’ of non-EU alternative investment fund and private placement regulations.³⁴ The regulator further explained that its assessment covered topics such as measures intended to protect investors, protections against market disruptions, investment risk management requirements, the extent to which non-EU AIFMs from the jurisdiction under review had conducted business in one or more Member States in the past, the extent and nature of any interactions between non-EU AIFMs from that jurisdiction and Member State securities regulators and any barriers to or limits on cooperation and access to information between the relevant non-EU securities regulator and Member State regulators.³⁵

ESMA additionally reported that it focused its analysis on, and was providing legal advice about, the alternative investment fund regulations and securities laws of only six of the 22 non-EU jurisdictions covered by its report: Guernsey, Hong Kong, Jersey, Singapore, Switzerland and the US. Of these six, ESMA stated that it had reached definitive conclusions only with respect to three jurisdictions. In relation to Guernsey and Jersey, ESMA reported that it had not identified any relevant regulatory ‘gaps’ or instances of substantive non-equivalence between their respective legal requirements and corresponding concepts under the AIFMD. ESMA also concluded that the requirements of Switzerland’s private placement regime overall would be similar to those of the AIFMD, if that country’s government adopted certain supplemental legislation that it was considering at the time ESMA issued its opinion.³⁶

But ESMA deferred completing its analysis of the other three jurisdictions: Hong Kong, Singapore and the US. The regulator rationalised that, among other problems encountered in conducting its review, it required additional information to assess particular local law requirements, or was concerned

33 European Securities and Markets Authority, ESMA 2015/1236, ‘ESMA’s Advice to the European Parliament, the Council and the Commission on the Application of the AIFMD Passport to non-E.U. AIFMs and AIFs’ (30 July 2015) (‘ESMA Advice’).

34 ESMA included these jurisdictions within the scope of its review after collecting survey information on non-EU AIFs previously marketed in at least one Member State by a non-EU AIFM. ESMA Advice at Section 2.2(32), pp 14–15.

35 *Ibid* Section 2.1(16)–(21), pp 8–11.

36 *Ibid* Section 2.7(118), p 43.

that certain provisions of local law might not adequately provide important investor and other safeguards, or that the local legal and regulatory regime posed difficulties for EU AIFMs attempting to market EU AIFs in that market. With respect to the last point, ESMA articulated a specific concern that permitting a non-EU AIFM to make use of the AIFMD marketing passport when that manager's own domestic market had erected direct or indirect barriers against entry by EU AIFMs, would result in 'an unlevel playing field between E.U. and non-E.U. AIFMs'.³⁷ In relation to the latter three jurisdictions, therefore, as well as the remaining 16 nations, ESMA stated that it would need additional time to analyse these non-EU private placement regimes relative to the AIFMD's requirements.³⁸

For US AIFMs, ESMA's report indicates that the passport will not be extended to non-EU AIFMs anytime in the near future. Instead, the regulator will continue to conduct its assessment of the relevant components of the US private placement and securities regulatory regime, while also conducting further country-by-country analyses relative to the AIFMD's requirements.³⁹ Importantly, however, there is no concrete indication as to when this analytical work will be completed, and reported to the EU Parliament, Council and Commission as advice or opinions.

Practical considerations for US AIFMs

The AIFMD, as mentioned, is complex legislation, and it has yet to be fully implemented. Moreover, there is a limited enforcement record that would provide guidance to US AIFMs regarding how critical components of the AIFMD may be interpreted by Member State regulators. What current considerations, therefore, should a US AIFM have in mind when seeking to raise investor capital in one or more Member States? One option is for

³⁷ *Ibid* Section 2.3(65), p 22.

³⁸ For example, in relation to Hong Kong's private placement regime, ESMA explained that it had not yet received certain information regarding the scope of an AIFM's obligations under local law, and therefore was not in a position to complete its analysis. Additionally, ESMA stated that it had not yet reached a conclusion regarding the adequacy of the Singapore regulator's approach to monitoring systemic risk. In assessing the relevant US laws, ESMA stated that there were potentially significant differences between the AIFMD requirements and US private placement laws, including with respect to the custody of AIF assets, the absence of regulation regarding remuneration of senior investment and other US AIFM staff, and certain regulatory obligations imposed by US law that could possibly function as constructive barriers to entry for an EU AIFM to the US market. As the report notes, 'it remains generally more difficult to market foreign funds in [the US], especially to retail investors'. *Ibid* Section 2.3(62), p 21.

³⁹ In October 2015, as part of this effort, ESMA announced that it had begun to assess the alternative investment fund and private placement regulations of a second set of non-EU jurisdictions: Australia, Canada, Japan, the Cayman Islands, the Isle of Man and Bermuda.

the US AIFM to satisfy the requirements of the NPPR of each jurisdiction in which it expects to manage and market an EU AIF or non-EU AIF, with the understanding that fulfilling these criteria may involve relatively significant legal and other expenses and fees, and potential delays as the relevant regulator(s) completes its review of any required filings.

A third option is to position the US AIFM's business to accept investor capital only through a reverse solicitation, where such a policy may be reliably implemented. A US AIFM that adopts this approach must also develop and utilise appropriate processes to assure that a robust written audit trail is created to support its judgment that, in a particular instance, the manager did not engage in marketing, and that a specific investor relationship was the product of the investor initiating substantive communications with the US AIFM, and not in response to communications from the investment adviser.

A second option is for the US AIFM to obtain a passport to market EU AIFs on a pan-European basis. As mentioned above, because the marketing passport currently is available only to EU AIFMs managing EU AIFs, a US AIFM seeking to pursue this option would be required to establish an EU AIFM, which would then need to be managed in compliance with the full set of AIFMD obligations, rather than the 'AIFMD lite' programme to which US AIFMs may otherwise be subject. If a US AIFM sought to implement this plan, it could use an affiliate that is already regulated, or which could be registered, in the UK or another Member State, and then establish an EU AIF as its investment vehicle for marketing to investors. Alternatively, a US AIFM could create a self-managed AIF in a Member State, or engage a local investment management company in Ireland, Luxembourg, or another Member State in which there are well-developed laws on the operation and management of these structures. If the US AIFM pursued either of these alternatives, it would have to be prepared to invest in developing (or enhancing) its regulatory compliance infrastructure so that the manager would avoid violating the additional substantial obligations it would face, and would mitigate the potentially significant financial and reputational risks it would accept, by obtaining the right to market the AIF across Member State borders. Depending on the business model and operations of the US AIFM and its affiliate, this could mean hiring more, and more experienced, staff; acquiring, developing and implementing additional technology; and introducing new or expanded operational and reporting processes, including in relation to position and portfolio valuation, AIF investment and liquidity risk management, and reporting to investors and Member State regulators.

A fourth option for a US AIFM to consider is providing investment services through a programme or 'platform' hosted by a third-party manager. This approach would obviate the need for the US AIFM to operate through

a subsidiary or affiliate organised in the EU. A platform structure would have the additional advantage of shifting to the platform sponsor the duty to comply with the NPPR of each Member State in which the AIF will be marketed (a requirement that the platform sponsor may have already satisfied when launching its business, before seeking to retain the services of the US AIFM). In particular, the use of a platform structure would allow the US AIFM to avoid having to address potentially challenging questions regarding whether a particular investor subscription in the AIF was obtained through marketing or reverse solicitation.

In brief, to implement the platform offering, the sponsor would form an EU AIF, and register that entity with a Member State regulator. That registration status would allow the EU AIF to be marketed to prospective investors in other Member States on the basis of the AIFMD passport. The sponsor would then create one or more sub-funds under the EU AIF, each of which could be managed by a US AIFM. The US AIFM would be considered the portfolio manager of the sub-fund, and not the manager of the EU AIF itself. This would potentially position the US AIFM-sub-advised AIF to be marketed, without further Member State registrations, on a cross-border basis in the EU.

A platform structure, however, is not without potentially significant regulatory risks or administrative burdens and expenses for a US AIFM. In structuring the platform relationship, it is important for the EU AIFM to avoid becoming a 'letter-box entity': an entity that is legally an EU AIFM, and therefore subject to the requirements of the relevant NPPR, but which has delegated so many functions to the sub-fund's US (or other non-EU) portfolio manager that it no longer complies with the AIFMD and the relevant NPPR.⁴⁰ If the EU AIFM, for example, delegated so much authority to the US portfolio manager that the former no longer had the contractual authority or practical ability to make decisions regarding trading, investment risk management, or other essential duties allocated to the EU AIFM under the AIFMD, then the EU AIFM would be at risk of being considered a 'letter-box entity'.

As a portfolio manager to an EU AIF sub-fund on a platform, rather than as the manager of the EU AIF itself, the US AIFM would also continue to be obligated to provide sufficient information to the EU AIFM to support the latter's ability to fulfil its investor and regulatory reporting and other obligations under the AIFMD. For example, the US AIFM could be required to provide the EU AIFM with information regarding its investment risk management practices, valuation processes and conclusions, and potentially

⁴⁰ AIFMD at Preamble, para 83, OJ L174/12.

other information that the EU AIFM would need to prepare its own reports about the business covered by its registration. Hence any initial cost savings from joining the platform could potentially be negated by the EU AIFM requiring that the US portfolio manager invest in developing and implementing processes to create, track and report significant amounts of data to the EU AIFM. In addition, the compensation arrangements of a US AIFM serving as a platform portfolio manager could become subject to the EU AIFM's bonus retention, clawback and related remuneration policies.

Conclusion

Beyond simply developing AIFMD-compliant marketing strategies that target EU-domiciled investors, US AIFMs should be vigilant regarding how additional, non-marketing obligations under the AIFMD may develop over time. ESMA continues to collect information regarding how the Directive has been transposed into Member States' laws, and in relation to Member States' experience in interpreting and enforcing their respective NPPRs. In addition, ESMA is required to continue to report on the use of the AIFMD's marketing passport, and, in 2018, to provide the EU Parliament, Council and Commission with an opinion on, among other topics, the use of the passport by non-EU AIFMs. Depending on the content of that opinion, the EU could conclude that Member State NPPRs should be phased out entirely. If those private placement regimes were abolished, possibly through the adoption of a pan-EU regulation, the ability of a US AIFM to rely on having to satisfy only minimal registration requirements in a particular Member State, or on an exemption from registration entirely, might be eliminated. With this outcome, a US AIFM would have little choice but to register in a Member State, and comply with all AIF- and AIFM-related obligations under that jurisdiction's laws, to support any marketing of an AIF's securities to an EU investor. Until that time, however, and unless and until the benefits of the marketing passport are extended to include US AIFMs, these investment advisers will be required to comply with the NPPR for each of the Member States in which the US AIFM seeks to raise new or additional investor capital.