

THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

THE UK'S PROPOSED REGIME FOR SUB-THRESHOLD PRIVATE EQUITY, REAL ESTATE AND HEDGE FUND MANAGERS

The Alternative Investment Fund Managers Directive (AIFMD) will, subject to certain transitional provisions, come into force in the UK, and across the EU, on 22 July 2013. It applies certain rules to managers that manage Alternative Investment Funds (AIFs), which are, broadly, AIFs that are not regulated UCITS funds.

Unless they choose to fully opt-in to the AIFMD in order to benefit from the EU-wide marketing passport, managers that manage AIFs (AIFMs) whose assets under management (AUM) are "sub-threshold" (i.e. they do not meet the size criteria set out in the AIFMD) will not be subject to the full requirements of the AIFMD, or the accompanying Level 2 implementing regulation (the Level 2 Regulation).

Sub-threshold AIFMs will still need to meet certain minimum requirements set out in the AIFMD and EU Member States may apply more stringent requirements to them, if they so choose. The Financial Conduct Authority (FCA) and Her Majesty's Treasury (HM Treasury) have consulted on the regime for UK sub-threshold AIFMs which manage unregulated collective investment schemes (such as private equity, real estate or hedge fund managers¹). Following the consultation HM Treasury has produced The Alternative Investment Fund Managers Regulations 2013 (Regulations).

AIFMD EXEMPTION THRESHOLD

An AIFM will be sub-threshold if it either directly or indirectly (through a company with which it is linked by common management or control, or by a substantive direct or indirect holding) manages portfolios of AIFs whose aggregate AUM:

- ♦ do not exceed €100m (including any assets acquired through the use of leverage); or
- ♦ do not exceed €500m where the portfolio of AIFs consist of AIFs that are unleveraged and do not give their investors a right of redemption within five years of initial investment in each AIF.

WHAT IS LEVERAGE?

The AIFMD defines "leverage" as "any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means". This also captures any leverage contained in structures underneath the AIF which were established in order to increase an AIF's exposure.

As per the Level 2 Regulation, an AIF's leverage should be expressed as the ratio between its exposure and its net asset value, and an AIFM must calculate an AIF's exposure in accordance with two types of prescribed methodology, called the "commitment method" and the "gross method".

It appears from the Level 2 Regulation that the following types of borrowing will not be "leverage" for the purposes of the AIFMD:

- ♦ if the AIF in question has a core investment policy focused on acquiring non-listed portfolio companies, any leverage at portfolio company level (provided that the AIF does not have to bear potential losses beyond its investment in the portfolio company);
- ♦ borrowings which are "temporary" in nature and are fully covered by capital commitments, such as capital call bridging facilities (although there is currently no definition of what "temporary" means in this context, a revolving credit facility will not be considered temporary and so would count as leverage); and
- ♦ any currency hedging which does not add any incremental leverage or exposure or other risk on the AIF.

It is still not clear if other common forms of financing when backed by a commensurate amount of undrawn commitments (such as guarantees from an AIF to a subsidiary) would constitute "leverage" in an AIF, forcing an AIFM to consider the lower €100m threshold rather than the €500m threshold. In addition, there is no de minimis amount of leverage that can be ignored for these purposes. Any amount of relevant leverage will therefore trigger the lower threshold.

CALCULATING AN AIFM'S AUM

The Level 2 Regulation gives details on how AIFMs should calculate AUM for determining their thresholds. AIFMs must identify all the AIFs for which they are the AIFM and, for each such AIF, determine the value of assets under management in that AIF (including any assets acquired through leverage). This determination must follow the valuation rules in each AIF's constitutional documents, save that derivative instruments must be converted into the value of the underlying asset following a particular conversion method set out in the Level 2 Regulation². Given that an AIFM must ensure that AUM reflects capital draw downs and distributions, it is implicit that undrawn commitments can be excluded from the calculation³.

¹ These types of managers are termed "small authorised UK AIFMs" in the Draft Regulations.

² See articles 2(3) and 10 of the Level 2 Regulation.

³ See article 3 of the Level 2 Regulation.

AIFMs may also exclude any of the following when calculating AUM:

- ◆ UCITS for which the AIFM acts as the designated management company;
- ◆ AIFs that the AIFM is managing under delegation from a third party manager (but not any AIFs for which the AIFM is the manager but has itself delegated some of its functions);
- ◆ investments made by an AIF in other AIFs managed by the same externally appointed AIFM or investments made by one compartment of an AIF into another compartment of that AIF;
- ◆ the AUM of any closed-ended AIFs managed by the AIFM, if such AIFs do not make additional investments after 22 July 2013. A limited amount of “follow on” investment by an AIF will not breach this condition, provided that such “follow on” investment arises out of an existing commitment, represents a “negligible percentage” of the AIF’s portfolio and is only aimed at maintaining the value of the portfolio⁴; and
- ◆ the AUM of any close-ended AIFs managed by the AIFM, if such AIFs have both closed their subscription period to new investors before 22 July 2013 and will terminate by 21 July 2016. The common view is that the existing projected end date of a fund should be used for this purpose, rather than any end date after 21 July 2016 which might apply following optional term extensions.

For a number of private fund managers, the last two exclusions will be particularly helpful, as this will substantially reduce AUM.

FREQUENCY OF AUM CALCULATIONS

AIFMs must calculate AUM at least annually, using the latest available asset value for each AIF to check they are still sub-threshold. The latest asset value for each AIF will need to have been produced no more than 12 months prior to the AUM calculation. AIFMs that are close to their relevant exemption threshold or anticipate subscription or redemption activity that may take them over their AUM threshold should undertake more frequent AUM calculations.

BREACHING AN EXEMPTION THRESHOLD

If an AIFM’s AUM goes over its relevant threshold and the AIFM considers it likely that the breach will last longer than three months, it must notify the FCA and apply for full authorisation as an AIFM under the AIFMD within 30 days of the breach. If, however, the breach is unlikely to last longer than three months, the AIFM must notify the FCA of the breach and provide its reasons for why the situation is temporary. At the end of the three month period, the AUM must be recalculated to see whether or not full authorisation as an AIFM is required.

REQUIREMENTS FOR UK SUB-THRESHOLD AIFMS

The Regulations provide for two types of sub-threshold AIFM:

- ◆ A Small Authorised UK AIFM – this is an AIFM which is sub-threshold, which is FCA authorised and which has not opted in to the AIFMD. This will be the relevant categorisation for most small private fund managers.
- ◆ A Small Registered UK AIFM – this is an AIFM which is sub-threshold and either:
 - is an internal AIFM of a corporate body, such as an investment trust;
 - is the unauthorised manager of property funds which are operated by an FCA authorised operator; or
 - is a fund manager which has applied for registration under the European Venture Capital Funds Regulation (see below) or the European Social Entrepreneurship Funds Regulation.

Small Authorised UK AIFMs

In line with HM Treasury’s proposed objective of increasing the UK’s competitiveness as a fund domicile, the UK will not be “gold plating” the requirements set out in the AIFMD or the Level 2 Regulation for Small Authorised UK AIFMs. Small Authorised UK AIFMs will therefore continue to be subject to their current regulatory regime under the FCA Handbook, and in particular:

- ◆ a Small Authorised UK AIFM will continue to operate under the same regulatory capital obligations as before. In particular, a private equity manager which is sub-threshold should be able to retain its existing £5,000 “own funds” regulatory capital treatment; and
- ◆ the SYSC and COBS rules in the FCA Handbook will continue to apply, save that for some managers who are

⁴ According to the European Commission’s Q&A document on the AIFMD (ref: 1188).

currently MiFID firms, some of the rules in SYSC will now be applied as less stringent guidance.

The FCA is introducing a new Part 4A permission of “managing an AIF” which is expected to be added to the scope of permission for both Small Authorised UK AIFMs and AIFMs who comply in full with the AIFMD. The FCA has not yet confirmed whether this update to a firm’s scope of permission will happen automatically or if Small Authorised UK AIFMs need to apply for a variation of permission. Given that full-scope AIFMs have a year’s transitional period to comply in full with the AIFMD, it is likely that Small Authorised UK AIFMs will also be given up until 21 July 2014 to make any changes to their regulatory scope of permission.

Small Registered UK AIFMs

The FCA is required to maintain a register of Small Registered UK AIFMs. Small Registered UK AIFMs will need to apply to the FCA for entry on to the register. It would appear that registration is required, notwithstanding that in the UK, a Small Registered UK AIFM applying for registration under the European Venture Capital Funds Regulation will already be authorised by the FCA. It is expected that registration will be determined within three months of receipt of a complete application by the FCA.

Small Registered UK AIFMs will also be expected to:

- ♦ provide information to the FCA on the investment strategies of the AIFs they manage; and
- ♦ regularly provide information to the FCA on the main instruments in which they are trading and on the principal exposures and most important concentrations of the AIFs that they manage,

in order to enable the FCA to monitor systemic risk effectively.

MARKETING REQUIREMENTS FOR SUB-THRESHOLD UK AIFMS

A UK sub-threshold AIFM cannot benefit from the EU marketing passport under the AIFMD. This means that any marketing in the EU will need to comply with local private placement regimes (as is the case now). HM Treasury has confirmed that no changes are proposed to the UK’s regime for private placement (both for UK and non-UK AIFMs) but other EU jurisdictions may amend their rules in light of the AIFMD coming into force. At the date of writing, France, Luxembourg, Sweden, Finland, Denmark and the Netherlands do not propose significant changes to their private placement rules, whereas Germany may curtail private placement regimes

for non-German sub-threshold AIFMs (although their initial proposals look likely to be watered down). A number of other jurisdictions, including Italy and Spain, have not yet published any proposals on this topic.

In addition to the extent that a UK adviser operates with a non-EU AIFM/AIF model then the AIFMD provisions that would otherwise apply to a non-EU AIFM when marketing in the UK (i.e. disclosure and reporting requirements) seem to be disapplied if the non-EU AIFM is below the threshold.

The European Commission proposes to review the whole system of national private placement regimes in 2018, and may decide to prohibit private placement of AIFs outside of the AIFMD. This would force non-EU fund managers to comply with the full provisions of the AIFMD before marketing in the EU. However, the consequences of this are not yet clear for sub-threshold firms.

THE EUROPEAN VENTURE CAPITAL FUNDS REGULATION

Some sub-threshold managers may wish to benefit from the provisions of the European Venture Capital Funds Regulation (the VC Regulation). This EU legislation was approved by the EU’s Council of Ministers in March 2013 and is due to come into effect at the same time as the AIFMD.

The VC Regulation provides EU venture capital funds that invest predominantly (being at least 70 per cent of a fund’s assets) in the equity or “quasi-equity” of small and medium sized enterprises (SMEs)⁵ with an EU wide marketing passport, provided that they also label their fund a “European Venture Capital Fund” (EuVECA), and market it as such. The VC Regulation allows managers to market to both (i) MiFID professional clients; and (ii) retail investors who can demonstrate their investment sophistication and high-net-worth.

The VC Regulation is not compulsory, but managers will only be able to benefit from its provisions if they are sub-threshold for the purposes of the AIFMD. Managers who want to utilise the EuVECA passport will also need to comply with the VC Regulation’s restrictions on leverage, the rules on governance and delegation provisions. These rules reflect the AIFMD to some degree, but helpfully, most of the more onerous AIFMD provisions have not been copied across. In particular, the regulatory capital obligation will be only to maintain a sufficient level of own funds, there are no particular remuneration rules

⁵ SMEs have a particular definition under EU law, being an undertaking which employs fewer than 250 persons and either has an annual turnover of less than €50m or a balance sheet of less than €43m.

and there is no depositary requirement for the fund itself (although the VC Regulation does contain rules on how ownership of assets should be regularly confirmed).

PRACTICAL CHECKLIST FOR POTENTIAL SUB-THRESHOLD UK AIFMS

AIFMs that consider themselves to be sub-threshold should:

- ◆ identify which AIFs are in scope for calculating AUM, including any AIFs managed by a linked or commonly controlled company;
- ◆ assess which AIFs (if any) use leverage and have limited redemption rights;
- ◆ if leverage is used by their AIFs, consider whether existing leverage arrangements need to be changed or amended;
- ◆ identify, based on the above analysis, whether the €100m or €500m threshold is the relevant one for them;
- ◆ take care on introducing any new leverage into their AIFs and investment structures, as this can affect whether the AIFM needs to comply with the €100m or €500m threshold;
- ◆ consider how frequently AUM should be calculated, given the nature of the AIFs in question, and establish a procedure for guarding against accidental breaches of the AUM threshold;
- ◆ establish regular AUM calculations and checks;

- ◆ Small Authorised UK AIFMs should keep monitoring publications and press releases from HM Treasury and the FCA, in order to determine when any applicable updates to the AIFM's Part 4A scope of permission should be made in readiness for compliance with the AIFMD; and
- ◆ Small Registered UK AIFMs should update their compliance procedures and compliance manuals, to reflect the new reporting requirements (including the regular reporting to the FCA described above).

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