AIFMD and Channel Island AIFMs: The private placement regime - obligations and opportunities

The Alternative Investment Fund Managers Directive (the "Directive") was published in July 2011. It seeks to regulate alternative investment fund managers ("AIFMs") managing or marketing alternative investment funds ("AIFs") in the European Union.

Background
Our briefing entitled "The AIFM Directive - the Channel Islands’ perspective", which was published in August 2011, gave an overview of the implications of the Directive for those AIFs with a Channel Islands connection. More recently, on 19 December 2012, the European Commission published the so-called level 2 implementing regulations ("Level 2 Measures"), comprising guidelines on a number of aspects of the Directive. As a result, there is now sufficient clarity on the scope and application of the Directive for consideration to be given to the on-going structuring and operation of AIFs and AIFMs, although some areas remain subject to further guidance. This briefing focuses on Jersey and Guernsey AIFMs and the operating regimes available to them under the Directive.

How does the Directive affect Channel Island AIFMs?
This briefing addresses the situation of managers who are established in the Channel Islands and who either manage EU AIFs; or market EU or non-EU AIFs to investors in the EU.

AIFMs established in the Channel Islands who are managing an EU AIF, or who are marketing an EU or non-EU AIF in the EU, will be subject to the provisions of the Directive applying to non-EU AIFMs with effect from 22 July 2013, which is the date on which the Directive must be implemented by all EU Member States (the "Implementation Date"). However, AIFMs of an AIF established in the Channel Islands will not be impacted by the Directive if no marketing of interests in that AIF is carried on within the EU after 22 July 2013.

There are certain exemptions from the requirements of the Directive. For example, AIFMs who manage AIFs whose aggregate assets under management fall below certain thresholds, UCITS funds, pension funds, employee schemes, holding companies and family offices are not caught by the requirements of the Directive. Furthermore, the Directive does not apply to closed-ended funds which are fully invested at the Implementation Date or which are closed for subscription at the Implementation Date and whose term expires no later than 2016.

The Directive also permits the marketing of AIFs into the EU by way of "reverse solicitation", i.e. passive marketing which is not instigated by the AIFM but where the investor itself has approached the AIFM.
Establishing which entity is the AIFM

Another important question is who is the AIFM, bearing in mind that the AIFM for the purposes of the Directive may not be the entity which is the "manager" of the AIF according to the AIF's constitution and that an AIF may, in fact, be "internally managed", i.e. no third party is appointed to manage the AIF so that the AIF itself will be the AIFM. Certain listed funds and issuers may fall into the internally managed category.

The Directive provides that the AIFM is the entity which manages the AIF, i.e. which performs at least investment management functions, namely, portfolio or risk management. An AIFM may, in addition, perform other functions (e.g. administration, registrar, compliance or distribution functions), but it must at least perform either portfolio or risk management in order to be treated as the AIFM.

The Directive restricts the delegation of the AIFM's duties to third parties to situations where, among other conditions, the delegate has sufficient resources to perform the delegated tasks, the AIFM is able to effectively supervise the delegate and, where portfolio or risk management functions are delegated to non-EU entities, that delegate is authorised and subject to supervision by the competent authority of its country of registration.

Since the publication of the Directive, a key issue for Jersey and Guernsey has been the extent to which an AIFM can delegate its functions. The Level 2 Measures provide that the delegation must not allow the circumvention of the AIFM's responsibilities or liability, nor must its obligations towards the AIF and its investors be altered as a result of the delegation. To ensure investor protection, the delegation must not only increase the efficiency of the AIFM's business but be based on objective reasons. It is also a requirement that the AIFM retains the necessary expertise and resources to supervise the delegated tasks and has the power to take decisions in key areas which fall under the responsibility of the AIFM (in particular in relation to the implementation of the investment policy and strategy of the AIF). Should the delegation arrangements not fulfil these criteria, there is a risk that the AIFM will be deemed to be a 'letter box entity', thereby no longer being regarded as the manager of the relevant AIF. This conclusion will be reached where the AIFM "delegates the performance of investment management functions to an extent that exceeds by a substantial margin the investment management functions performed by the AIFM itself".

Offshore structures typically involve a delegation of functions, to varying degrees, on the part of the AIFM. External AIFMs as well as internally-managed AIFs should review their fund structures and existing delegation arrangements with a view to establishing whether any modifications are necessary in light of the Level 2 Measures. If the delegation arrangements do not work in line with the Directive and Level 2 Measures, it is likely that the relevant authorities will "look through" the arrangements and conclude that the delegate is, in fact, the AIFM. It would appear that the private equity advisory model (i.e. onshore adviser, offshore general partner) should survive the application of the Directive's delegation provisions.

For Jersey and Guernsey, the Directive's delegation requirements could also create opportunities. Many managers already operate staffed offices in the Islands, such that it should be a straightforward matter to demonstrate substance offshore. In addition, for those who do not have a presence in the Islands, the "managed entity" model which has successfully operated on a regulated basis for a number of years, together with the availability of a highly skilled workforce, mean that arrangements can be put in place to ensure that an AIFM can provide the requisite functions from the Islands.

It should be noted that the European Commission will monitor and conduct a review of the delegation provisions two years following the implementation of the Level 2 Measures, taking into account market developments and the application of the letter box provisions and may, if appropriate, specify further conditions under which the AIFM shall be considered to have delegated its functions to the extent that it becomes a letter box entity. A further review of delegation arrangements may, therefore, be required following this assessment.

The marketing regimes available to Channel Island AIFMs and Key Dates

From 22 July 2013, whilst AIFMs established in the EU will be subject to the full impact of the Directive, in return for which they will be able to market AIFs into the EU with the benefit of an EU-wide marketing “passport”, Channel Island AIFMs will be subject to only certain of the Directive’s requirements but will not
benefit from a passport. Non-EU AIFMs will be subject to EU Member States’ national private placement rules (the rules applicable during this period, referred to as the “Private Placement Rules”). EU-wide marketing passports will not be available to non-EU AIFMs until 2015 at the earliest, when the European Securities and Markets Authority ("ESMA") is due to conduct a review of the passporting regime with a view to recommending that it be extended to non-EU AIFMs. In any event, the Directive anticipates that, even if non-EU AIFMs are able to benefit from an EU-wide passport from 2005, they will continue to be able to market AIFs under the Private Placement Rules until at least 2018.

In summary, the significant dates referred to above in relation to marketing are:

- **22 July 2013**: Implementation Date (the Directive becomes law in all EU Member States); non-EU AIFMs can market AIFs into the EU under Member States’ national Private Placement Rules
- **July 2015**: EU-wide marketing passports potentially to become available to non-EU AIFMs and marketing under EU Member States’ Private Placement Rules continues to be available
- **During 2018**: Marketing under EU Member States’ national Private Placement Rules likely to come to an end. Non-EU AIFMs will then be subject to the full impact of the Directive.

A summary of the requirements for Channel Island AIFMs under the Private Placement Rules, that is, from the Implementation Date until at least 2018, is set out below.

**The Private Placement Rules**

**The conditions**

The Directive provides that marketing under Member States’ national Private Placement Rules will be available to a non-EU AIFM, subject to the third country in which that AIFM is established complying with the following three criteria:

- co-operation agreements are in place between the competent authorities of the EU Member State into which the AIF is to be marketed and the supervisory authority of the third country (in the case of Jersey that authority is the JFSC and in the case of Guernsey the GFSC). The governments of both Jersey and Guernsey are constructively engaged with ESMA for the purpose of agreeing the form of these co-operation agreements prior to July 2013. And, unlike certain other non-EU and offshore jurisdictions, Jersey and Guernsey have no difficulty in signing agreements which enable EU regulators to access information and carry out on-site inspections as is required by the co-operation agreements;
- the third country is not listed as a non-cooperative country and territory by the Financial Action Task Force on anti-money laundering and financing of terrorism (neither Jersey nor Guernsey are listed as non-cooperative by FATF); and
- of particular significance to private equity funds, the transparency, reporting and acquisition of control (including asset stripping) provisions of the Directive, apply to non-EU AIFMs as for EU AIFMs.

It should be noted that the Directive allows EU Member States discretion to impose stricter conditions on non-EU AIFMs wishing to market AIFs in that Member State and, as a result, the three above conditions may not be exhaustive. However, the Channel Islands are encouraged by the approach taken by the UK regulator (the Financial Services Authority) and the Dutch regulator (the Netherlands Authority for the Financial Markets), both of which have indicated that they intend to adopt the criteria set out above with no further amendments to "gold plate" their private placement regimes. In addition, the proposed new AIF regulations in Jersey and Guernsey, which will implement the applicable provisions of the Directive, are being drafted sufficiently widely to enable any additional requirements which an EU Member State may impose to be dealt with.

**Operational requirements - what are a non-EU AIFM’s obligations when marketing under the Private Placement Rules?**

The Directive, supplemented by the Level 2 Measures, sets out the detailed requirements of the provisions which will apply to non-EU AIFMs from July 2013. These are:

1. **Transparency**
   
   a) **Annual Report**: For each EU AIF it manages and each AIF it markets in the EU, the AIFM shall make available to investors an annual report for each financial year containing, in relation to that financial year, a balance sheet or a statement of assets and liabilities, an income and expenditure account, a report on activities, any material changes in the information disclosed to investors, the total amount of remuneration paid by the AIFM to its staff and, where relevant, carried interest paid by the AIF. The annual
AIFMs of AIFs which employ leverage shall disclose on a regular basis to investors:
– any changes to the maximum amount of leverage which the AIFM may employ on behalf of the AIF as well as any right of the reuse of collateral or any guarantee granted under the leverage arrangements; and
– the total amount of leverage employed by that AIF.

c) Reporting obligations to competent authorities: The Directive requires AIFMs to regularly report (using a set template) to the competent authority of the Member States into which the AIF is marketed. In respect of private equity funds, the requirement is not particularly onerous as such reporting is only required to be carried out on an annual basis. Half-yearly or quarterly reporting is required, however, in relation to other AIFs depending on the amount of their assets under management, or if the competent authority of the EU Member State into which the AIF is marketed so requires.

The report shall include the following details:
– the percentage of the AIF’s assets which are subject to special arrangements arising from their illiquid nature;
– any new arrangements for managing the liquidity of the AIF;
– the current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk;
– information on the main categories of assets in which the AIF is invested; and
– the results of the stress tests on liquidity risk performed periodically by the AIFM in accordance with the Directive.

The AIFM may in addition be requested to provide the following documents to an EU Member State’s competent authority:
– an annual report of each EU AIF it manages and each AIF marketed by it in the EU for each financial year; and

In addition, where relevant:
AIFMs shall periodically disclose to investors:
– the percentage of the AIF’s assets which are subject to special arrangements arising from their illiquid nature;
– any new arrangements for managing the liquidity of an AIF; and
– the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks; and

b) Disclosure to Investors: The AIFM shall make certain specified information available to investors before they invest in the AIF (as well as any material changes to such information), including: the investment strategy and objectives of the AIF, any applicable investment restrictions, information regarding the use, types and maximum levels of leverage permitted to be used by the AIF, the identity of the AIFM and any other service providers and a description of their duties and the investors’ rights, a description of any delegated management function, identification of the delegate and any conflicts of interest that may arise from such delegation, a description of the AIF’s valuation procedure, a description of the AIF’s liquidity risk management including the redemption rights, a description of all fees, charges and expenses borne by investors, the latest annual report, the procedure and conditions for the issue and sale of units or shares and the latest net asset value or the latest market price of the AIF.

These requirements are not overly onerous and, in most cases, it is expected that offering documents may be amended quite easily to provide for any additional disclosures.

In addition, where relevant:
AIFMs shall periodically disclose to investors:
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– any new arrangements for managing the liquidity of an AIF; and
– the current risk profile of the AIF and the risk management systems employed by the AIFM to manage those risks; and

report must be subject to an audit meeting international audit requirements in force in the country where the AIF is established.

It is anticipated that most annual reports currently produced in relation to AIFs should largely comply with these requirements.
– for the end of each quarter a detailed list of all AIFs which the AIFM manages.

Additional disclosures are required to be made by AIFMs of AIFs which employ leverage on a "substantial basis".

2. Private equity funds only - Acquisition of Control of non-listed companies and issuers
   a) Obligations for AIFMs which acquire control of non-listed companies and issuers
      These obligations apply to:
      – AIFMs managing one or more AIFs which either individually or jointly acquire control of a non-listed company; and
      – AIFMs cooperating with one or more AIFMs in order that the AIFs managed by those AIFMs jointly acquire control of a non-listed company.

      The obligations do not apply in respect of:
      – the acquisition of non-listed companies which are established outside the EU;
      – small and medium-sized enterprises (broadly meaning enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million); and
      – special purpose vehicles with the purpose of purchasing, holding or administering real estate.

      EU Member States may apply stricter rules with respect to the acquisition of holdings in issuers and non-listed companies in their territories.

   b) Notification of acquisition of major holdings and control of non-listed companies
      An AIFM is required to report to the competent authorities of the EU Member States where the AIF is marketed, within 10 working days, when its shareholding or control in the non-listed entity reaches, exceeds or falls below 10%, 20%, 30%, 50% and 75%.

      Upon acquisition of control, the AIFM managing the relevant AIF is required to notify the following, within 10 working days:
      – the non-listed company (with a request to the board of directors of that company to inform the employees or their representatives of the acquisition of control by the AIF);
      – its shareholders; and
      – the EU Member States where the AIF is marketed, of:
         – the resulting situation regarding voting rights;
         – the conditions under which the control was acquired and the date on which control was acquired;
         – the identity of the AIFMs which either individually or together with other AIFMs manage the AIFs that have acquired control;
         – the policy for preventing and managing conflicts of interest; and
         – the policy for external and internal communication relating to the company in particular as regards employees.

      The AIFM of that AIF shall also disclose to the company and its shareholders its intentions with regard to the future business of the company and the likely repercussions on employment, including any material change in the conditions of employment.

      EU Member States may apply stricter rules with respect to the acquisition of holdings in issuers and non-listed companies in their territories.

   c) Specific provisions regarding the annual report of AIFs exercising control of non-listed companies
      When an AIF acquires control of a non-listed company, the AIFM managing such AIF shall either:
      – request and use its best efforts to ensure that the annual report of the non-listed company is made available by the board of directors to the employees or their representatives within the period such annual report has to be prepared in accordance with the applicable national law; or

      "The AIFM of that AIF shall also disclose to the company and its shareholders its intentions with regard to the future business of the company and the likely repercussions on employment, including any material change in the conditions of employment."
– include in its annual report and make available to investors of the AIF, no later than the date on which the annual report of the non-listed company is drawn up in accordance with applicable national law, at least a fair review of the development of the company’s business representing the situation at the end of the period covered by the annual report, an indication of any important events that have occurred since the end of the financial year, the company’s likely future developments and information concerning any acquisition of own shares by the company.

d) Asset stripping
The Directive provides that EU Member States shall require that, when an AIF acquires control of a non-listed company or issuer, the AIFM managing such AIF shall, for a period of 24 months following the acquisition:

(i) not be allowed to facilitate, support or instruct;

(ii) in so far as the AIFM is authorised to vote on behalf of the AIF at meetings of the governing bodies of the company, not vote in favour of; and

(ii) use its best effort to prevent, any distribution, capital reduction, share redemption and/or acquisition of own shares by the company relating, broadly, to:

(i) any distribution to shareholders (including the payment of dividends and interest relating to shares), when on the closing date of the last financial year the net assets were, or following such distribution would become, lower than the subscribed and paid up capital plus any statutory reserves;

(ii) any distribution to shareholders the amount of which would exceed the amount of the profits at the end of the last financial year plus any profits brought forward, less any losses brought forward; and

(iii) any permitted acquisition of own shares by the company which would have the effect of reducing the assets below the level mentioned in (i) above.

Conclusion
While the obligations set out in the Directive impose additional burden on AIFMs, the burden for non-EU AIFMs will, when marketing in accordance with the Private Placement Rules, be significantly reduced. Certain AIFs may require restructuring to ensure that the appropriate entity is, in fact, the AIFM and that any functions of the AIFM are delegated appropriately. In terms of the transparency and acquisition of control obligations, it is perceived that these will necessitate some additional procedures being put in place. Compared with the full EU-wide passporting alternative, however, the Private Placement Rules allow continued flexibility until at least 2018. The Channel Islands are well positioned to offer this flexibility.

Looking ahead, during 2015, assuming ESMA’s report on the functioning of the passporting system applicable to EU AIFMs is favourable, it is expected that the passporting system will be extended to allow non-EU AIFMs to passport non-EU AIFs throughout the EU. Third countries will need to comply with the three conditions described above in the case of private placement and, in addition, to have entered into Tax Information Exchange Agreements (TIEAs) with relevant EU Member States. Jersey and Guernsey already have a wide network of TIEAs with EU Member States and are working on signing additional TIEAs where necessary.

In order to benefit from the passporting system, a non-EU AIFM will be required to obtain authorisation under the Directive from the regulatory authorities of its EU Member State of reference and will then be subject to the full rigours of the Directive. Importantly, both Channel Islands intend to introduce regulatory regimes which will comply fully with the Directive from as early as July 2013 and will operate a dual regime (i.e. a lighter regulatory regime for private placement purposes and for those who do not require a fully compliant fund, and a fully compliant regime under the Directive for passporting purposes and for those who wish to be fully compliant earlier than 2018).

Finally, for those managers who operate entirely outside the EU space and who do not intend or wish to raise capital in the EU, the current regulatory regimes in Jersey and Guernsey will continue to offer a further choice outside the scope of the Directive.
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