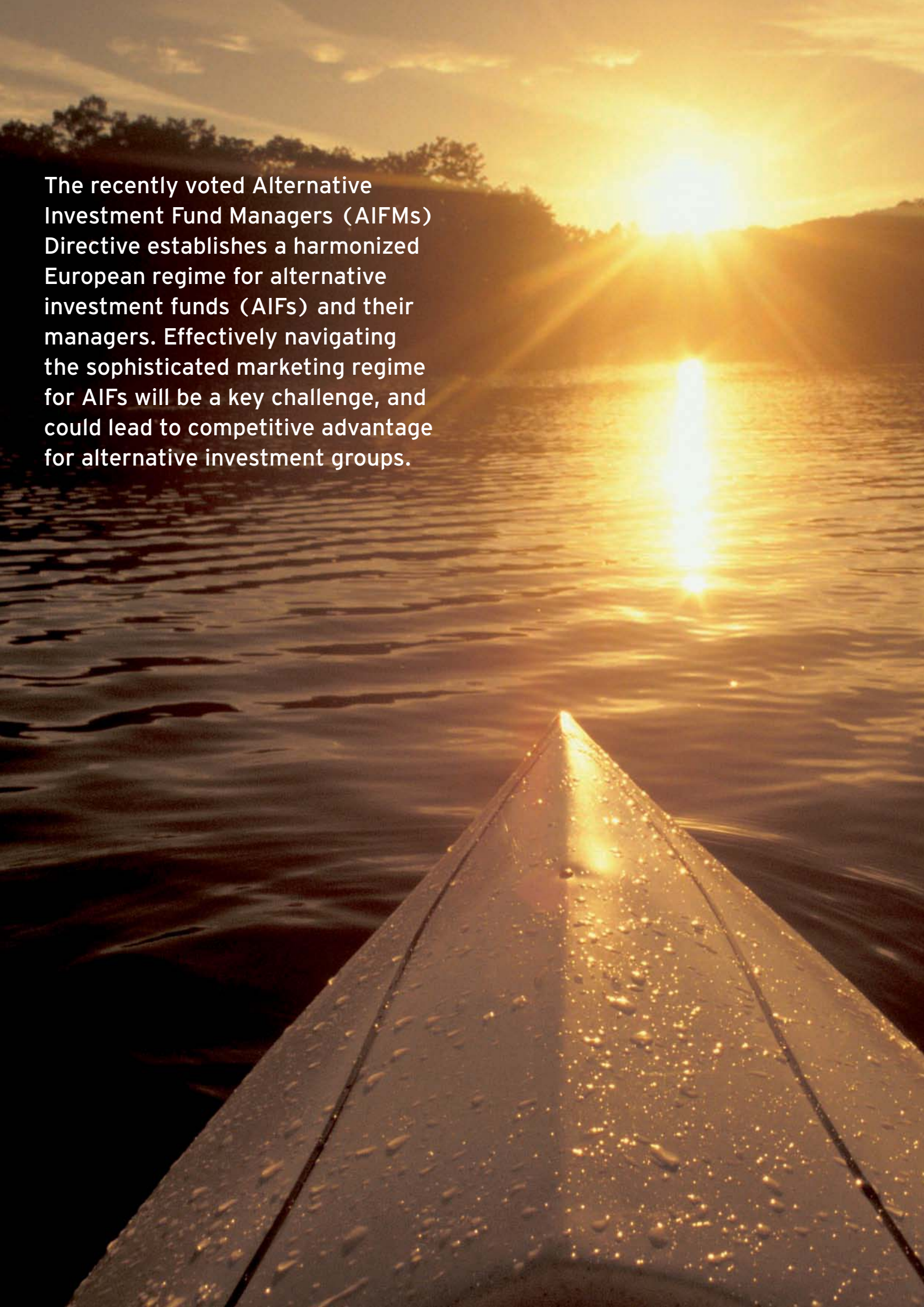


Marketing in Europe in the post-AIFM Directive era

Effectively navigating the regime

A photograph of a sunset over a body of water. The sun is low on the horizon, creating a bright, golden glow and a long, shimmering reflection on the water's surface. In the foreground, the white, pointed prow of a boat is visible, covered in numerous small water droplets that catch the light. The background shows a dark, silhouetted shoreline with trees under a cloudy sky.

The recently voted Alternative Investment Fund Managers (AIFMs) Directive establishes a harmonized European regime for alternative investment funds (AIFs) and their managers. Effectively navigating the sophisticated marketing regime for AIFs will be a key challenge, and could lead to competitive advantage for alternative investment groups.

Introduction

Voted by the European Parliament in November 2010, the AIFM Directive covers all alternative sectors such as hedge funds, real estate and private equity, as well as traditional sectors where the fund products are not registered as UCITS.¹

AIF products are generally reserved for professional investors, but may also be marketed to retail investors. Today, investors access alternative investment products primarily through national private placement channels; for European investors and products, the AIFM marketing regime will replace these.

The AIFM marketing regime is a complex set of rules covering the marketing of AIFs to EU investors by, or on behalf of, EU and non-EU AIFMs.

Following the transposition of the AIFM Directive into national legislation in 2013, EU AIFMs will benefit from a “passport” enabling them to market their EU AIFs to EU professional investors in their home Member State or cross-border following a notification.

For non-EU AIFMs and non-EU AIFs, the situation is more complex. Following a transitional period, non-EU AIFMs and non-EU AIFs should benefit from the same rights and same obligations as EU AIFMs with EU AIFs; marketing into the EU with a passport may become available to non-EU AIFMs and non-EU AIFs from 2015 onward.

We believe that alternative investment groups should – on a case-by-case basis, and particularly in light of the AIFM marketing regime – conduct a strategic review of their fund ranges and also their operating models before focusing on achieving compliance with the requirements of the Directive.

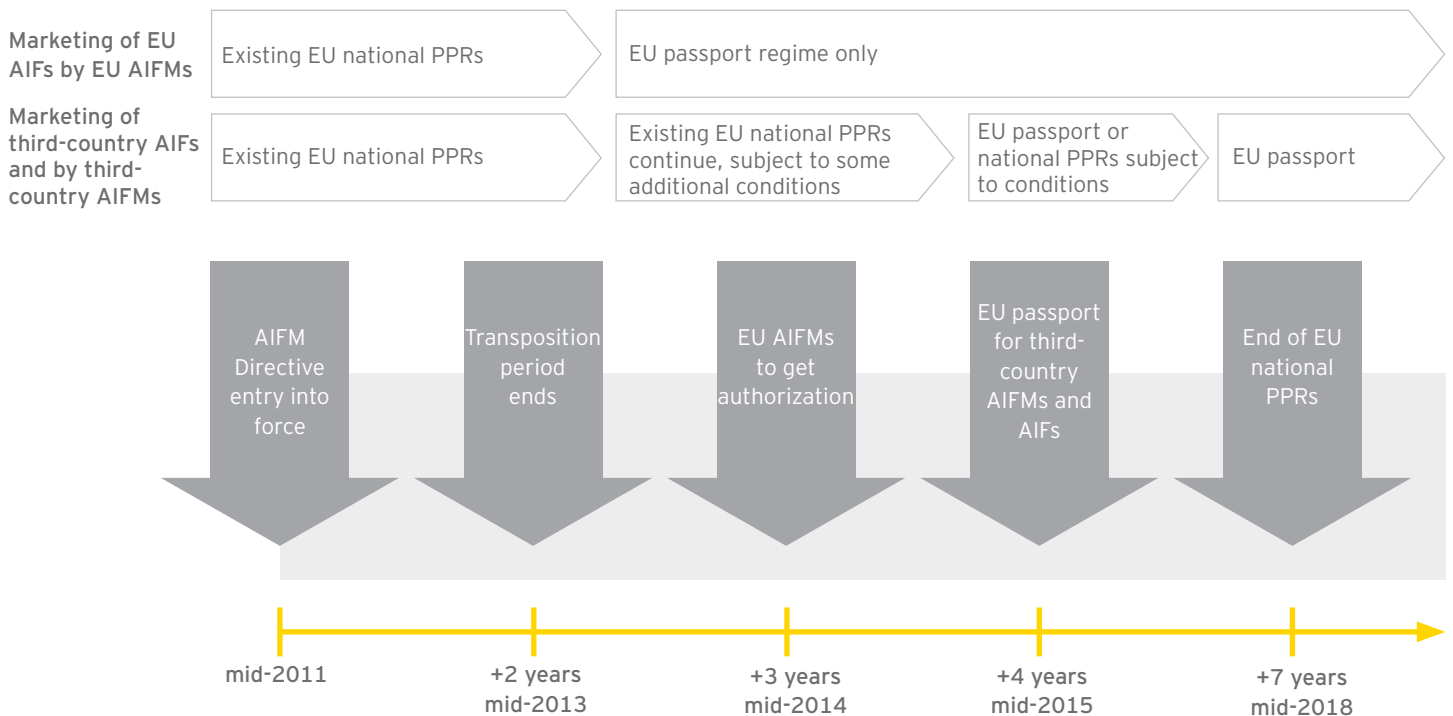
The objective of this publication is to provide an introduction to the AIFM marketing regime. It complements our simple guide to the complex AIFM Directive entitled *A new dawn for alternative investments: Navigating the challenges and opportunities of the AIFM Directive*.

¹ Undertakings for Collective Investment in Transferable Securities, subject to the UCITS Directive (Directive 2009/65/EC)

Summary and timing

- ▶ Authorized EU AIFMs have a **passport** to market EU AIFs to professional investors in their home Member State and in other Member States from the date of transposition (mid-2013). They will no longer be allowed to use national private placement regimes (PPRs).
- ▶ For **non-EU AIFs managed by EU AIFMs** and **non-EU AIFMs marketing EU and non-EU AIFs**, two regimes will coexist for marketing:
 - ▶ Continuation of **national PPRs**, which may be phased out in 2018
 - ▶ A passport regime, which may be phased in from 2015 upon an opinion and advice to be issued by the newly created European Securities and Markets Authority (ESMA) and the adoption of “delegated acts.”²
- ▶ Non-EU AIFMs intending to market AIFs they manage in the EU with a passport must acquire prior authorization from their **Member State of reference**.
- ▶ All marketing with a passport of EU and non-EU AIFs to **professional investors** by EU and non-EU AIFMs in home Member State/Member State of reference or another Member State is subject to a **notification procedure**.
- ▶ Member States may permit marketing of EU or non-EU AIFs by AIFMs to **retail investors** on their territory – stricter requirements may be applied.

The following indicative timeline shows the key milestones following the entry into force of the Directive, expected in June 2011.



² The AIFM Directive Level 2 measures will be adopted according to the new Treaty of Lisbon procedure. To improve the efficiency of EU decision-making, the Treaty has created a new category of Level 2 measures: delegated acts whereby the EU legislator (the Parliament and the Council) delegates the power to adopt acts amending *non-essential elements* of a legislative act to the Commission under strict limits. For example, in the AIFM Directive the Commission is required to adopt a delegated act specifying how to calculate the de minimis thresholds (see page 10).

What is marketing under the AIFM Directive?

Marketing under the AIFM Directive covers any “direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled in the EU.” An AIF is defined as a collective investment undertaking, or compartment thereof, which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which is not covered by the UCITS Directive.

The marketing provisions of the Directive do not apply to passive marketing; therefore the Directive should not affect the status quo, whereby an EU professional investor may invest, on its own initiative, in AIFs anywhere in the world. However, passive marketing is not yet defined in the Directive.


EU AIFMs and non-EU AIFMs

EU AIFM

The regime for marketing of EU and non-EU domiciled AIFs by, or on behalf of, EU AIFMs to EU and non-EU investors is summarized in the following table:

Domiciles		Any EU investor?	Is AIFM Directive applicable?	AIFM marketing regimes	Requirements applicable to AIFM and AIF	Requirements applicable to third-country domiciles
AIFM	AIF					
EU	EU	Yes	Yes	Passport (from 2013)	Full Directive	None
EU	EU	No	Yes	None	Full Directive	None
EU	Non-EU	Yes	Yes	PPRs (2013 to at least 2018)	Full Directive except provisions on depositary, but an entity needs to be appointed to execute depositary functions	Cooperation arrangements (1) AML requirements (2)
				Passport (expected from 2015 onward)	Full Directive	Cooperation arrangements (1) AML requirements (2) Tax agreements (3)
EU	Non-EU	No	Yes	None	Full Directive except provisions on depositary and annual report	Cooperation arrangements (1)

- (1) Cooperation arrangements between the competent authorities of the AIFM home Member State and the supervisory authorities of the AIF third country
- (2) The AIF third country must not be listed as a non-cooperative country and territory (NCCT) by the Financial Action Task Force (FATF), an intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing
- (3) OECD Model Article 26 compliant tax convention information sharing agreement between non-EU AIF third country, AIFM home Member State and each other Member State in which the non-EU AIF is proposed to be marketed



EU AIFMs marketing non-EU AIFs to EU investors will have to comply with almost all obligations under the AIFM Directive from 2013 onward, but will not benefit from the EU passport before the implementation of the passport for non-EU AIFs (expected in 2015). In addition to national PPR rules, the non-EU AIF's jurisdiction will need to meet new requirements (on cooperation arrangements and anti-money laundering and terrorist financing) for the AIF to be marketed in the EU. To benefit from the passport, conditions related to tax cooperation agreements will also need to be fulfilled by the AIF's jurisdiction.

Non-EU AIFM

The AIFM Directive applies to non-EU AIFMs only to the extent that they manage EU AIFs or market AIFs (EU or non-EU) to EU investors. The regime for marketing EU and non-EU domiciled AIFs by, or on behalf of, non-EU AIFMs to EU and non-EU investors is summarized in the following table:

Domiciles		Any EU investor?	Is AIFM Directive applicable?	AIFM marketing regimes	Requirements applicable to AIFM and AIF	Requirements applicable to third-country domiciles
AIFM	AIF					
Non-EU	EU	Yes	Yes	PPRs (2013 to at least 2018)	Provisions on transparency (1), and major holdings and control (if applicable)	Cooperation arrangements (2) AML requirements (3)
				Passport (expected from 2015 onwards)	Full Directive (4); Member State of reference authorization (5) to manage EU AIFs or market AIFs in EU	None
Non-EU	EU	No	Yes	None	Full Directive (4); Member State of reference authorization (5) to manage EU AIFs	None
Non-EU	Non-EU	Yes	Yes	PPRs (2013 to at least 2018)	Provisions on transparency (1), and major holdings and control (if applicable)	Cooperation arrangements (2) AML requirements (3)
				Passport (expected from 2015 onward)	Full Directive (4); Member State of reference authorization (5) to market non-EU AIFs in EU	Cooperation arrangements (2) AML requirements (3) Tax agreements (6)
Non-EU	Non-EU	No	No	None	None	

(1) Annual report, disclosure to investors and reporting to competent authorities

(2) Cooperation arrangements between the competent authorities in each Member State where the AIF is marketed and the AIF's Member State (or the AIF's country of establishment supervisory authorities for non-EU AIF) and the supervisory authorities of the AIFM third country of establishment

(3) The third country where the AIFM (and the AIF for non-EU AIF) is established must not be listed as a NCCT by the FATF

(4) Or equivalent rules

(5) See page 8

(6) OECD Model Article 26 compliant tax convention information sharing agreement between non-EU AIF third country, AIFM home Member State and each other Member State in which the non-EU AIF is proposed to be marketed



Between transposition of the Directive and the implementation of their passport, non-EU AIFMs may manage EU AIFs if permitted by national regimes in the EU. They may use national PPRs for marketing to EU investors, subject to additional conditions.

Between the implementation of the passport for non-EU AIFMs and the withdrawal of national PPRs in the EU, non-EU AIFMs³ may be allowed to register under the Directive via the Member State of reference procedure to manage EU AIFs and to market AIFs (EU and non-EU) in the EU under the passport. They may also choose to continue to market AIFs in the EU under national PPRs, provided that the new additional conditions are met.

Once the national PPRs in the EU are withdrawn, non-EU AIFMs will only be able to market EU AIFs to EU investors if they are duly authorized under the AIFM Directive.

³ From jurisdictions meeting the requirements applicable to third-country domiciles



The “Member State of reference” authorization process

Non-EU AIFMs intending to market AIFs they manage in the EU with a passport once it is available (expected in 2015), or to manage EU AIFs, must receive a prior authorization from the competent authorities of their EU Member State of reference. To obtain such authorization, they must comply with the requirements of the Directive or equivalent rules.

The Member State of reference is determined in accordance with a complex series of rules; in summary, it is generally the Member State where the applicant AIFM carries out most management or marketing.

The following conditions must also be met:

- ▶ The non-EU AIFM must appoint a legal representative in the Member State of reference, which will, alongside the AIFM itself, have the role of a contact person for investors and EU authorities. The legal representative shall also jointly perform with the AIFM the compliance functions relating to the management and marketing activities of the AIFM under the Directive.
- ▶ There must be appropriate cooperation arrangements between the Member State of reference competent authorities, EU AIF competent authorities (if relevant) and the non-EU AIFM supervisory authorities at least for efficient exchange of information.
- ▶ The non-EU AIFM country must not be listed as an NCCT by the FATF.
- ▶ The non-EU AIFM country must have signed an OECD Model Article 26 compliant tax convention with AIFM Member State of reference, and any other Member State in which the non-EU AIF will be marketed.
- ▶ The effective exercise by the competent authorities of their supervisory functions must neither be prevented by laws, regulations or administrative provisions of the third country governing the AIFM, nor by limits on the supervisory and investigatory powers of the third-country regulator.

The notification procedure

Before authorized EU AIFMs or non-EU AIFMs benefiting from the passport (once it is phased in for third countries) start marketing their AIFs in an EU Member State, they must notify the competent authority in their respective home Member State or Member State of reference for each AIF.

The notification must include:

- ▶ A notification letter, identifying the AIF which the AIFM intends to market and information on where it is established
- ▶ The AIF rules or instruments of incorporation
- ▶ The identity of the depositary for each AIF
- ▶ A description of, or information on, the AIF available to investors, as well as information that must be provided to them before they invest
- ▶ Information on the master AIF, if the AIF is a feeder
- ▶ The identification of the Member State (s) in which it intends to market the AIF
- ▶ Measures to prevent the fund from being marketed to retail investors (if relevant)
- ▶ Information on arrangements made for marketing the AIF in "host" (as well as home) Member State

For marketing in the AIFM's home Member State or Member State of reference, provided that the provisions of the AIFM Directive are met, the competent authority shall inform the AIFM within 20 days of notification that it may start marketing the AIF.

For cross-border marketing (marketing in Member States other than the AIFM's home Member State or Member State of reference), the competent authority of the AIFM's home Member State or Member State of reference is required to transmit, within 20 days, the complete documentation to the competent authorities of each host Member State, together with an attestation that the AIFM is authorized to manage AIFs with that particular investment strategy. Upon transmission, the competent authority of the AIFM notifies the AIFM of the transmission. The AIFM may start marketing the AIF in the host Member State (s) as of the date of notification. Arrangements made for marketing the AIF and measures to prevent the fund from being marketed to retail investors (if prohibited) in the host Member State are subject to the laws and supervision of the host Member State.

The requirement to present the competent authorities with final fund documentation prior to starting marketing under the passport regime may raise practical issues for funds. Negotiations of fund terms between parties often span several months, and can result in a number of amendments to the fund documentation before it reaches its final form. The Directive requires that any material change in the information provided shall be submitted to the competent authorities at least one month in advance, except for unplanned changes. The implementing measures should clarify how this will work in practice.

Transitional provisions and special situations

Until the AIFM Directive is transposed into EU Member States' national laws (mid-2013), national private placement rules will continue to apply to the marketing of both EU and non-EU AIFs, be it by EU or non-EU AIFMs. Nothing in the Directive prevents Member States from imposing stricter requirements on marketing to investors on their territory.

Additional conditions (Sections 5. *EU managers* and 6. *Non-EU managers*) will apply to marketing of non-EU funds by EU AIFMs and to marketing of any AIF by non-EU AIFMs on top of existing national PPR rules from the date of transposition and until the potential phase out of these regimes.

Managers of some closed-ended AIFs existing at the final date of transposition may benefit from grandfathering clauses, namely:

- ▶ Managers of closed-ended AIFs "which do not make any additional investments" after mid-2013 may continue to manage such AIFs without authorization under the AIFM Directive.
- ▶ Managers of fully subscribed closed-ended AIFs which had their final close prior to mid-2011 (the date of the AIFM Directive's expected "entry into force") and are constituted with a maximum life that requires them to be liquidated by mid-2016 at the latest, may continue to manage such AIFs without complying with most of the AIFM Directive, except for:
 - ▶ The provisions on application for authorization and on production of annual reports
 - ▶ The obligations relating to the acquisition of major holdings and controlling interests in EU portfolio companies, if applicable.

It is worth mentioning, however, that this may prove useless to most closed-ended funds whose investment period is generally five years, i.e., most of them would not have time to exit all their investments by the 2016 deadline.

In addition, the marketing provisions of the AIFM Directive do not apply to the marketing of AIF's shares or units that are subject to a current offer to the public on an EU-regulated stock exchange under a prospectus that has been drawn up and published in accordance with the Prospectus Directive (Directive 2003/71/EC) before mid-2013, as long as this prospectus is still valid.

Small and mid-sized AIFMs falling below the *de minimis* thresholds⁴ are expected to be allowed to continue marketing cross-border in the EU under national PPRs, subject to additional conditions set by the Directive. This may continue to be the case after the potential phasing out of national PPRs. However, such funds may decide to opt in under the AIFM Directive, but they will then be bound by the entire provisions of the AIFM Directive in the absence of a lighter regime for small and mid-sized funds wishing to use the passport.

In the case of master-feeder AIFs,⁵ in order to benefit from the passport regime from mid-2013, an EU feeder AIF must have an EU master AIF managed by an authorized EU AIFM. An EU feeder AIF that does not invest into an EU master AIF managed by an authorized EU AIFM may be marketed in the EU on the same basis as a third-country AIF.

In the case of fund of funds (FoF), managers will find themselves in the position of AIFM as well as investor.

Non-EU AIFMs that neither market their AIFs to EU investors after the 2013 transposition deadline nor manage EU AIFs under the passport when it becomes available (expected 2015) are not impacted by the AIFM Directive.

⁴ De minimis thresholds: AIFMs that "manage portfolios of AIFs whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of €100 million" or "manage portfolios of AIFs whose assets under management in total do not exceed a threshold of €500 million when the portfolio of AIFs consists of AIFs that are not leveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF" will be exempt from part of the Directive. However, they will need to register with their home Member State regulator and will be subject to certain regulatory reporting requirements.

⁵ A feeder AIF is defined as an AIF that i) invests at least 85% of its assets in shares or units of another AIF (the master AIF); ii) invests at least 85% of its assets in more than one master AIF where those master AIF have identical investment strategies; or iii) has otherwise an exposure of at least 85% of its assets to one or more such master AIFs.

Impact

The AIFM Directive's geographic impact will stretch beyond the EU; for example, due to the additional eligibility conditions for third-country AIF jurisdictions. Third-country jurisdictions wishing to ensure that their alternative funds can be actively marketed in the EU will need to carefully review their legal and regulatory framework in relation to AIFM supervision and be prepared to implement international cooperation arrangements for the purpose of systemic risk oversight and tax cooperation with relevant EU Member States.

Most of the new costs related to the implementation of the AIFM Directive will be borne by the alternative investment industry and the AIF investors. The initial cost of restructuring is likely to be borne by the alternative investment groups and managers, while the additional ongoing compliance costs are likely to be borne by the alternative investment funds, and thus the investors themselves. Service providers will represent a substantial portion of the compliance costs.

The level of costs will vary substantially between the alternative industry segments, and also between individual managers in each segment. It will also depend on the marketing route used by the AIFMs (passport or PPR), especially for non-EU AIFMs. The one-off and ongoing compliance costs for non-EU AIFMs using the PPR route will be much lower than those of non-EU AIFMs using the passporting route and for EU AIFMs, whatever the route. The costs therefore need to be carefully analyzed on a case-by-case basis.

Investors in existing funds at the final date of transposition or in funds to be launched afterwards will therefore need to get a clear picture of the route used by a given AIFM when marketing an AIF, as well as understand whether some grandfathering or special exemptions may apply to the AIF in which they intend to invest.

As an answer to investors and in order to accommodate their particular needs in a flexible and efficient way, managers may need to consider different paths. Marketing rules in the post-AIFM Directive era could therefore impact fund structuring and lead to an increased level of complexity.



What's next?

Following the vote of the EU Parliament plenary session of 11 November 2010, and without formally waiting for the entry into force of the Directive expected for mid-2011, work on the implementation phase has started. This work will span more than two years, and will consist of two main pillars: Member States will draft their implementing legislation while the Commission and ESMA (former CESR)⁶ will work on so-called "Level 2" measures or technical and regulatory guidelines for implementation.

Following a provisional request for assistance from the Commission, CESR/ESMA issued a call for evidence on implementing measures on the AIFM Directive on 3 December 2010 whereby it invites "*all interested parties to submit their views on what CESR should consider in its advice to the Commission.*" The purpose of the advice to be delivered by CESR/ESMA to the Commission is to enable the latter to deliver the full package of implementing legislation at the latest one year before the end of the two-year transitional period, i.e., around June/July 2012. Therefore, CESR/ESMA has been asked to provide its advice by November 2011. This is an ambitious and challenging mandate. An extensive set of technical standards and guidelines need to be issued in order to bring the necessary clarifications to the current framework. The

Directive also covers new issues such as the passport for third-country managers that have so far never been in the scope of CESR/ESMA's work. In this context, the process should be seen as still very much open ended and thus as an opportunity for the alternative investment industry to fully engage with ESMA and the European Commission so as to translate the current framework into sensible and appropriate measures whenever possible.

Nearly 40 implementing measures, technical standards and guidelines concern third-country AIFs or AIFMs. A particular focus of CESR/ESMA's call for evidence is placed on objectives, parties and scope of cooperation arrangements to be put in place between the EU and the non-EU supervisory authorities "as from the first day the national laws transposing the AIFM Directive take effect in 2013"⁷ in the framework of the new rules covering national PPRs. The aim of these arrangements is to ensure the efficient cooperation between supervisors – mainly for the purpose of systemic risk oversight and monitoring – and the effective supervision of the third-country AIFM and AIF. ESMA is also requested to advise the Commission on the procedure to be followed when determining the Member State of reference in cases where there could be several.

⁶ CESR: Committee of European Securities Regulators which became ESMA (European Securities and Markets Authority) on 1 January 2011

⁷ CESR Call for evidence 3 December 2010 – ref CESR/10-1459 – Part IV: Supervision

How Ernst & Young can help

Although the Directive is in place to regulate managers, all major stakeholders will be affected: managers, investors and service providers.

Ernst & Young has built a dedicated multidisciplinary team of high-caliber experienced professionals to support all major stakeholders in the alternative investment industry value chain throughout the cycle of work in light of the Directive. As a first step, Ernst & Young's diagnostic tool can be used to help assess your readiness for the Directive, and to obtain an overview of the options available and the amount of work associated with each.

We can then provide strategic review (products, distribution and organization), restructuring and compliance support as well as ongoing compliance review.

Conclusion

The AIFM Directive foresees a pan-European marketing regime that will become available to EU managers with EU funds in 2013, and may be available to non-EU managers and non-EU funds from 2015. Meanwhile, and for the upcoming seven years at least, national PPRs will remain available for the distribution in Europe of non-EU funds and to non-EU managers. However, individual Member States may impose stricter rules. Mapping existing AIFs and their AIFMs and getting a good understanding of new EU fundraising rules in the post-AIFM Directive era to strategically adapt fund structures should be started without delay and will constitute a real competitive advantage in the near future.

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