The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 28, NO. 2 • FEBRUARY 2021

AIFMD Revisited—Ten Years Later

By Stuart Fross

As we kick off 2021, we approach the 10th anniversary of the Alternative Investment Fund Managers Directive (AIFMD).[1] For US investment advisers, AIFMD has offered rich opportunities. Ten years on, change is afoot. Brexit has sundered Great Britain from the AIFMD market. The European Union is engaged in revisiting AIFMD.[2] This article reviews some of the changes to the AIFMD environment that US managers should have in mind as the year unfolds.

Background

First proposed in April 2009 in response to the 2008 financial crises and adopted effective June 2011, AIFMD has harmonized the EU regulatory framework for the supervision and operation of alternative investment fund managers (AIFMs) and the marketing of alternative investment funds (AIFs). AIFMD also had a complementary objective: The creation of a unified market for AIFs marketed to professional investors in the European Union. By any measure, AIFMD has been a remarkable success story. The European Commission has concluded that under AIFMD the market for AIFs grew from €2.3 trillion to €5.9 trillion, attributing the industry's growth to AIFMD's depositary regime, its rules on conflicts of interest, and requirements for disclosure and transparency that protect investor interests and built investor confidence in the AIF market.[3] Against this background of highly successful capital formation, changes are now underway that will affect US fund managers, and that will need to be accounted for in the near term. These changes constrict reverse solicitations, impose a new process to getting to a "first fund close," force all US sponsors into a hybrid approach to pan-European marketing, as the reality of Brexit has taken hold, and will require taking a stand on sustainability.[4]

Discussion

While the regulators fairly take credit for their contributions to the robust state of the EU marketplace, innovation in Ireland and Luxembourg has led the way to the success of the AIF marketplace.

Innovation

From the author's perspective, the Irish introduction of the Irish Collective Asset-management Vehicle (ICAV) under the 2015 ICAV Act[5] offers a purpose-built company law for AIFs that can be adapted flexibly to various investment strategies and tax considerations. Indeed, the ICAV (coupled with the US-Ireland double tax treaty), has been particularly useful for loan-origination funds[6], particularly closed-ended and certain kinds of limited liquidity funds.[7] For its part, the Irish Central Bank has adopted provisions in its rule-book for loan origination qualifying investment AIFs (L-QIAIFs) that have been introduced in stages, and have, over time, become quite flexible. L-QIAIFs are subject to

substantive regulation unique to their role as lenders. In particular L-QIAIFs may issue loans; participate in loans; invest in debt/credit instruments; participate in lending; and invest in equity securities of entities or groups to which the L-QIAIF lends or instruments that are held for treasury, cash management, or hedging purposes. The ICAV and L-QIAIF have led to a robust credit fund environment in Ireland.

Luxembourg also developed company laws and product laws exceptionally well adapted to AIFs. Today, industry makes frequent use of the common limited partnership (société en commandite simple) and special limited partnership (société en commandite spéciale) forms of organization introduced simultaneously with the implementation of AIFMD in Luxembourg. These forms have made it relatively easy to adapt US styles of institutional fund limited partnership agreements to Luxembourg law. In terms of product law, Luxembourg's Reserved Alternative Investment Funds (RAIF) law introduced the possibility for an unregulated fund to benefit from the pan-European passport provided that it qualifies as an AIF, appoints an authorized AIFM and opts for the RAIF regime. While the RAIF law introduces a mechanism for establishing sub-funds (or compartments) for different investment pools within an umbrella structure, the real innovation of the RAIF law is the fact that funds are not subject to regulatory approval or supervision (as the AIFM is required to be authorized within the European Union), offering flexibility in structuring funds and creating an environment quite well-suited to loan originating AIFs[8]. Of course, the purpose of these innovations in Luxembourg and Ireland is to facilitate capital formation in a regulated environment,[9] discussed below.

Capital Formation

In terms of opportunities for capital formation, the European institutional marketplace that most US managers can access[10] now typically fits into one or more of three alternatives: (1) passporting—a regime for pan-European marketing to professional investors[11] of EU domiciled funds; (2) national private placements of non-EU funds, subject to standardized notification and transparency regimes, reserving to member states the option to impose country-specific rules (so called "gold plating")[12] and (3) reverse solicitation.

Reverse Solicitation

AIFMD does not restrict professional investors who wish to invest in AIFs on their own initiative. Many US fund sponsors may have taken the view that confirmation from the investor that the offering of the AIF was made at the investor's initiative may be sufficient to demonstrate reverse solicitation. Indeed, in practice a reverse solicitation can arise particularly as discussions reveal the investor's particular tax and regulatory requirements such that a "bespoke" solution as proposed by the investor proves to be in order. Change is afoot when it comes to reverse solicitation. The concept of the investor's "own initiative" however is about to become linked to a new regulation of "pre-marketing" just at the time when ESMA has made clear that managers may not be able to rely on the investor's contractual acknowledgements of a reverse solicitation.[13]

Pre-Marketing

AIFMD regulates "marketing" of AIFs in Europe. The definition of "marketing" is "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 [professional] investors domiciled in the European Union." Until 2019, neither the European Commission nor European Securities and Markets Authority (ESMA) had given context to the definition of "marketing," leading to country-specific interpretations. For example, the United Kingdom's Financial Conduct Authority defined marketing by focusing on the concept of the presentation of final fund documents that could lead to a contract.[14] This friendly view will not prevail within the European Union, however. Europe will

soon be following a new uniform interpretation of the limits on "pre-marketing" from no later than August 2021.[15] What this means is that US investment advisers may engage only in "pre-marketing" communications with potential EU investors limited to information relating to investment strategies or ideas to test interest in an AIF which *do "not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF or compartment."* Any communication of this type must be accompanied by certain legends, will trigger country specific notice requirements and, importantly, will preclude reliance on reverse solicitation of that AIF for a period of 18 months. It would appear that the definition of pre-marketing may narrow the window of opportunity for "reverse solicitations," and may well lead to further reliance on passporting and/or national private placements.

Passporting

Passporting allows authorized AIFMs to market EU domiciled AIFs to professional investors in Europe. Since pre-marketing will soon preclude delivery of a full set of fund documents sufficient for investor due diligence, a new premium may emerge on a process that permits fund sponsors to move quickly from pre-marketing to marketing, making "passporting" a compelling option. The way passporting works in practice is that the AIFM notifies its home country regulator (including copies of the fund constitutive documents) that the AIFM intends to market an AIF in another EU member state, then (once satisfied that the AIFM's request is in good order) the home country regulator notifies the host regulator within 20 business days and marketing may commence. This process is by now highly predictable and straight-forward. Passporting is exclusively available to AIFMs and AIFs domiciled in Europe. (AIFMD by its terms provides for the possibility that "third country" AIFMs (for example, investment advisers based in the United States) could become authorized AIFMs and could access the passporting regime, upon meeting a number of conditions, including becoming regulated by a European fund regulator.[16] However, the process of implementing the third country regime (which progressed as far as a report from ESMA in 2015) has stalled out. Thus, in practice for US registered investment advisers, the route to "passporting" means becoming a "delegate" of an EU authorized AIFM. (It would appear that UK-based fund managers post-Brexit are now similarly situated to US investment advisers when seeking access to the European Union).

Prior to Brexit, AIFMD offered a passport route to marketing in the United Kingdom. For new AIFs, the passport regime has come to an end. However, the United Kingdom has established a temporary marketing permissions regime for AIFs passported into the United Kingdom that elected to participate in the temporary marketing permissions regime (TMPR), an option whose filing date lapsed December 30, 2020. The TMPR applies to new subfunds of umbrella funds that have opted into the TMPR. The Financial Conduct Authority (FCA) has indicated that the TMPR may be extended from year to year indefinitely.

Acting as a Delegate

Delegation to US registered investment advisers is also by now a well-worn path, subject to reasonable supervision of the US investment adviser by the AIFM.[17] Indeed, a number of AIFMs offer platforms and offer to sponsor funds for US investment advisers.[18] Currently, the EU-based AIFM retains a meaningful proportion of the portfolio and risk management functions, but the US investment adviser can be granted investment discretion to invest the AIF's assets day to day, so long as the AIFM does not become a "letter box" entity.[19]

Meanwhile, Europe is rethinking delegation—a review triggered by ESMA in 2017 in anticipation of Brexit.[20] ESMA's 2017 opinion expressed the view that AIFMs need to be involved in the delegate's investment process beyond mere prospectus compliance, noting that "it is not sufficient if

[the AIFMs] only carry out formal assessments in the sense that they only check whether the investment proposed by the investment advisers would breach investment restrictions." Moreover, ESMA opined that to demonstrate sufficient "substance" the AIFM must retain more of the investment functions than it delegates. Similarly, the Central Bank of Ireland has issued a "Dear Chair" letter in which it notes that fund management companies (that is, AIFMs) should be in a position to engage in "ongoing independent challenge" of their delegates.[21] The renewed focus on delegation is to be expected, given the proliferation of delegates over time, and the anticipated surge of delegation arrangements involving UK managers due to Brexit. US managers should expect when acting as a delegate that the AIFM will need a level of involvement as part of the entire investment process that rises well above post-trade compliance.

Among the challenges of being a delegate, US managers need to navigate the regulation of their compensation practices.[22] AIFMD imposes on EU AIFMs, in respect of their delegates' compensation, regulation having two components: procedural rules and pay out process rules (that is, how and when identified staff are paid). Most US managers take no issue with procedural rules, and focus tends to be on pay out process, since on their face, they are designed to defer compensation so that payment to identified staff does not put the firm at risk, or incentivize excessive risk taking. In certain circumstances, it may be appropriate for the EU AIFM to "dis-apply" the pay-out process rules in respect of their US investment adviser delegates where their application to the US investment adviser would be "disproportionate." ESMA issued detailed guidance on remuneration practices in 2013 that specified that AIFMs should assure (in respect of US investment advisers) that their delegates are subject to contractual arrangements addressing remuneration of the delegate's "identified staff as compensation for the performance of portfolio or risk management activities on behalf of the AIFM." Therefore, the remuneration rules applicable to a particular AIF can be ring-fenced within the US manager to a sub-set of personnel that are working on a particular AIF. Further, the question of whether the characteristics of a particular AIF warrants disapplication of some or all of the pay-out process rules is primarily "the responsibility of the AIFM to assess its own characteristics and to develop and implement remuneration policies and practices which appropriately align the risks faced and provide adequate and effective incentives to its staff."[23] While ESMA's guidance is too detailed for the scope of this article, the author has found that registered investment adviser compensation policies formulated without regard to ESMA's guidance nonetheless tend to align payments to the firm with payments to identified staff, such that compliance with AIFMD's pay-out process rules proves to be less arduous than it might first appear.

National Private Placements and Brexit

National private placements (NPPRs) are an alternative method to accessing individual member states in Europe, and the NPPR route takes on a new urgency post-Brexit, where it has become the future route for US managers as a practical matter to raise capital by marketing in the United Kingdom. For US registered investment advisers, AIFMD permits member states to authorize private placements of non-EU funds at the option of the member state, with Article 42 of AIFMD providing a minimum framework for private placements, with each member state invited to introduce (or gold plate) AIFMD with its own additional requirements. National private placements require the filing of the AIF's offering documents before marketing commences and that those documents comply with AIFMD's disclosure and reporting requirements. In the main, offering memoranda designed for the US institutional markets are not likely to contain all of the disclosures required by AIFMD Article 23 (offering memorandum) and will need to be supplemented before filing with the local regulators. For example, US PPMs

typically reserve flexibility on the use of leverage as defined by the fund sponsor, while AIFMD mandates that the AIF sets a policy limiting its leverage. Furthermore, the fund's annual accounts will need to be amended to company with AIFMD's Article 22 and the adviser will also have to make arrangements to comply with Article 24 (filing reports annually with the regulator in each member state in which the AIF is marketed). In most member states, regulatory sign-off is required before marketing can commence.

Thankfully, in light of Brexit the United Kingdom has adopted a robust (and not gold plated) NPPR online filing mechanism. At the heart of the UK process each manager utilizing the UK Article 42 process must self-certify that the AIF complies with the relevant conditions in the UK AIFM Regulations. Note that the UK requires most US investment advisers (that is, those that are not "sub-threshold") to report to the FCA quarterly. Sub-threshold AIFMs are managers of unlevered closed end funds with assets less than €500 million (or other funds with less than €100 million).

SFDR

Meanwhile, the EU evolution of funds in Europe continues apace, in ways beyond the scope of this article. For example, US managers evaluating AIFMD will want to take note of the sustainability related disclosure regime (SFDR), that will come into effect on March 10, 2021.[24] In summary, the SFDR related disclosures relate mainly to sustainability risk policies, the investment decisionmaking process, the potential for adverse sustainability impacts and the remuneration policies of the AIFM.

Conclusion

Over nearly 10 years, the EU marketplace for AIFs has become robust, benefiting from regulation that has earned investor confidence and that has allowed for innovation. On the horizon, pending regulation will tilt the market away from reverse solicitations, will constrain pre-marketing, and will soon impose sustainability disclosure transparency. The substance of AIFMs will become more closely scrutinized post Brexit, and in consequence US investment advisers to passported AIFs will be obliged to work closely with their third party AIFMs on the investment process. Lastly, post-Brexit, accessing the United Kingdom via a passport will only work so long as the AIF has availed itself of the TMPR. Otherwise, new AIFs will be obliged to utilize the NPPR route in the United Kingdom, even if otherwise relying on their passports in the European Union.

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NOTES

1 European Parliament and Council Directive (EU) 2011/61/EU of 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 105/2010.

2 The European Commission's Public Consultation on the Review of the Alternative Investment Fund Managers Directive (AIFMD) dated October 22, 2020. See also the European Securities and Markets Authority (ESMA) letter to the European Commission dated August 18, 2020.

3 See, Report from the Commission to the European Parliament and the Counsel assessing the application and scope of Directive 2011/61/EU of the European Parliament and Counsel on Alternative Investment Fund Managers, October 6, 2020 (the 2020 AIFMD Report). The 2020 AIFMD Report

notes that AIFMD has encouraged particularly non-bank lending, concerns about this development may lead to the EC adopting common standards for loan-originating funds.

4 *See*, *esma34-32-551 esma_letter_on_aifmd_review (10).pdf* (oglobal.net) (January 13, 2020) (ESMA notes that "with the end of the UK transition period on December 31, 2020, some questionable practices by firms around reverse solicitation have emerged." Further, ESMA underlined that any promotion precludes reverse solicitation, contractual clauses notwithstanding).

5 Irish Collective Asset-management Vehicles Act, 2015.

6 ICAVs afford the opportunity for US investment advisers engaged in US loan origination to access the US-Ireland double tax treaty, offering the potential for a globally distributed loan origination fund tax efficient for non-US investors not resident in either the United States or Ireland.

7 *See*, ESMA Opinion – Key Principles for a European framework on loan origination by funds (April 11, 2016) (acknowledging that AIFs may originate loans, UCITS may not, and that AIFs should not transform liquidity).

8 The Luxembourg regulatory approach to loan origination is principles-based. *See*, Luxembourg Law of 12 July 2013 on alternative investment fund managers FAQ–FAQ 22.

9 *See, e.g.*, CSSF Circular 18/698 (August 23, 2018).

10 This article does not discuss the "AIFMD-lite" regime for "sub-threshold managers," those with no more than a maximum of EUR 500 million of assets or, where leveraged, a maximum of EUR 100 million of assets.

11 AIFMD applies to marketing of AIFs, permitting marketing by means of a passport to "professional investors." Under the AIFMD, a "'professional investor' means an investor which is considered to be a professional client or may, on request, be treated as a professional client within the meaning of Annex II to Directive 2014/65/EU (relating to markets in financial instruments) (the MIFID Directive). A professional client under MIFID generally covers professionals in the finance industry, large corporate undertakings, government bodies and those that are eligible to elect to be considered a professional client.

12 *See*, Stuart Fross and Michael Rohr, "AIFMD Implementing Regulations Update: ESMA's Final Report and Impacts for US Managers," *The Investment Lawyer*, Vol.19, No.2, Feb. 2012 (AIFMD Implementing Regulations Update). In our last article, six key themes were identified for US money managers seeking to adopt their current operations to AIFMD, focusing on (1) the AIFMD's "transparency" requirements for alternative investment funds (AIFs) organized outside the EU that will market in the EU on a national, private placement basis, and (2) certain of the AIFMD's most onerous requirements for US money manager.

13 *See*, ESMA "Reminds Firms of the MIFID II Rules on Reverse Solicitation (January 13, 2021) *https://www.esma.europa.eu/press-news/esma-news/esma-reminds-firms-mifid-ii-rules-reverse-solicitation* (contractual provisions from the investor do not cure promotion).

14 Financial Conduct Authority, PERG 8.37.6, AIFMD Marketing (addressing communications with investors in relation to draft documents).

15 Cross-border Distribution Directive EU/2019/1160 (CBDD) and Cross-border Distribution Regulation EU/2019/1156 (CBDR) "'Pre-marketing' means provision of information or communication, direct or indirect, on investment strategies or investment ideas by an EU AIFM or on its behalf, to potential professional investors domiciled or with a registered office in the Union in order to test their interest in an AIF or a compartment which is not yet established, or which is established, but not yet notified for marketing in accordance with Article 31 or 32 [of AIFMD], in that Member State where the potential investors are domiciled or have their registered office."

16 *See*, Stuart Fross and Michael Rohr, "Authorization for US Managers under AFMD," *The Investment Lawyer*, Vol.19, No.4, April 2012.

[17] Commission Delegated Regulation (EU) 231/2013, Article 78.

[18] *See*, ESMA, Review of the Alternative Investment Fund Managers Directive (August 18, 2020) (recommending more regulatory granularity on delegation potentially specific requirements for "White Label" service providers).

[19] AIFMD, Article 20(3) "The AIFM's liability towards the AIF and its investors shall not be affected by the fact that the AIFM has delegated functions to a third party, or by any further sub-delegation, nor shall the AIFM delegate its functions to the extent that, in essence, it can no longer be considered to be the manager of the AIF and to the extent that it becomes a letter-box entity."

[20] European Securities Markets Authority Opinion of 13 July 2017 to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union, paragraph 40.

[21] Letter of Gerry Cross, the Interim Director of the Asset Management Division of the Central Bank of Ireland, addressed to the Chair, entitled "Thematic review of fund management companies' governance, management and effectiveness," October 20, 2020.

[22] Remuneration and risk management are central tenets of the AIFMD, which contemplates controls applicable to remuneration paid to senior management, risk takers and control functions. *See*, Stuart Fross and Philip Morgan, "The Advent of Investment Adviser Remuneration Regulation, *The Investment Lawyer*, Vol.18, No.2, Feb. 2011. exploring regulation of compensation and the potential for disapplication of certain pay-out process rules due to disproportionality.

[23] ESMA Guidance on Sound Remuneration Policies Under AIFMD, July 3, 2013, paragraph 28.

[24] *See*, REGULATION (EU) 2019/2088 on sustainability-related disclosures in the financial services sector.