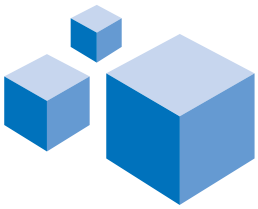

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Current UK legal and regulatory issues for US managers – part 2

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Current UK legal and regulatory issues for US managers – part 2

This is the second part of our two-part series dealing with the impact of MiFID II and AIFMD on US managers. This second and final part will provide a brief overview of the key issues raised by the AIFMD for US managers wishing to market their funds in the UK and to what extent the UK's domestic legislation will also impact any such marketing activities.

What is the AIFMD?

The Alternative Investment Fund Managers Directive (AIFMD) came into force on 22 July 2013. As a result, all alternative investment fund managers (AIFMs) must (subject to quite limited exemptions) be appropriately authorised to manage and/or market an alternative investment fund (AIF) in the EU.

An AIFM is anyone who, at a minimum, either performs portfolio management or risk management services for an AIF and an AIF means virtually any fund, regardless of structure, jurisdiction or investment strategy, other than a UCITS fund.

While the requirements of AIFMD were initially viewed with caution, increased familiarity with them and the potential ease with which they may be complied with has led an increasing number of US and other non-EEA AIFMs to add investors in the UK into their marketing campaign.

The AIFMD's EU passport

The AIFMD introduced a European passport under which full-scope AIFMs can manage and market AIFs throughout the EU. However, the EU passport is not yet available for non-EU AIFMs marketing a non-EU AIF and is subject to the European Securities and Markets Authority (ESMA) recommending that the passport is made available to them.

Until such time as the EU passport is available, US AIFMs are required to market their AIFs in the UK in accordance with the UK's national private placement regime (NPPR).

The below summarises the conditions which must be met by US AIFMs marketing non-EU AIFs into the UK. Firstly, however, we will touch briefly upon the definition of marketing under the AIFMD and reverse solicitation or passive marketing, which continues to be permitted under the AIFMD.

What are "marketing" and "reverse solicitation"?

Marketing for AIFMD purposes, means any offering or placement of shares/units in AIFs at the initiative of the AIFM or on behalf of the AIFM to or with EU investors.

The use of third party marketing agents will not circumvent the provisions of the AIFMD. By including "on behalf of the AIFM" within the definition, the AIFMD will capture marketing by third party distribution or placement agents and an AIFM will therefore be subject to the AIFMD marketing rules. Furthermore, the AIFM will effectively be responsible for compliance with the AIFMD by such distribution or placement agents.

The above definition does indicate, however, that passive marketing, or reverse solicitation, is not considered "marketing" under the AIFMD i.e. if an investor approaches the AIFM about investing in an AIF without prior solicitation, then on that basis the AIFM would seemingly not need to comply with the AIFMD as such marketing would not be at the initiative of the AIFM.

The most important point to note is that there is little firm guidance as to what constitutes reverse solicitation. According to PERG 8.37.11 of the FCA Handbook, if the AIFM can show evidence of confirmation that the offering or placement as made at the investor's initiative, the investor being a professional investor, this should

normally be sufficient to demonstrate that this is the case, provided that the confirmation is obtained before the offer or placement takes place. An AIFM intending to rely on reverse solicitation will therefore need to ensure that procedures and policies are put in place to clearly demonstrate that a particular EU investor invested in the AIF on this basis. It will also need to ensure that follow up communications with such an investor do not result in active marketing, for example, of another AIF. Please note, however, that reverse solicitation can not be relied upon if it is used to circumvent the AIFMD and it may be difficult to prove that this is not the case.

It is also important to note that reverse solicitation is construed tightly by the UK's FCA. For example, according to FCA guidance, documentation available on a publicly accessible website is not considered to be sent at the initiative of an investor; thus, open websites with free access to application forms and offering documents may prejudice reliance on the passive marketing exemption. The same applies to documentation left on stands or the like at conferences. The FCA has said that in supervising this area, it will take account of any evidence suggesting that marketing activity has been going on.

If an AIFM is unwilling to rely on reverse solicitation, then the only alternative at present for US AIFMs is to market within the EU in accordance with the national private placement regime ("NPPR") applicable in each relevant jurisdiction.

Marketing in the UK under the UK's NPPR

The AIFMD imposes a number of conditions upon private placement regimes, which must be met for a non-EU AIFM to be able to market its AIFs in the EU. These are as follows:

(i) there must be a co-operation agreement/ memorandum of understanding ("MoU") in place between the relevant Member State and the regulator of the AIF's jurisdiction;

(ii) the AIF's jurisdiction must not be designated as non-cooperative by the Financial Action Task Force ("FATF"); and

(iii) the AIFM must comply with certain requirements of the AIFMD, namely the disclosure obligations (to investors), transparency requirements (to regulators) and the annual reporting obligations of the AIF (please see below for more detailed information on each of these requirements).

It is important to note that private placement regimes vary and Member States have the ability to impose stricter conditions on their private placement regimes or to ban private placements altogether at any time.

The UK has left its own private placement regime unchanged, however, with one exception, namely notification to the FCA (see "***Notification to the FCA***" below).

The FCA has currently signed MoUs with more than 50 non-EEA authorities, including, for example, with those in the US (namely, the SEC, CFTC and the Board of Governors of the Federal Reserve System), FINMA (Switzerland), the Cayman Islands, Bermuda, the British Virgin Islands, Jersey, Guernsey and the Isle of Man. For the complete list, which may be updated from time to time, please see the FCA website at: https://www.fca.org.uk/firms/nppr/supervisory-co-operation-arrangements-mous.

If the first two conditions are satisfied, and the US does meet both (i) and (ii), then the US AIFM must then ensure that it complies with paragraph (iii) above, as follows:

Disclosures to investors

The AIFM is required to make initial and on-going disclosures to investors. These disclosures deal with issues such as full disclosure of all fees, charges and expenses directly or indirectly borne by investors (as well as maximum amounts), details of service providers, use of leverage and details of any preferential treatment provided to an investor or any special arrangements, such as side pockets. This will mean that

offering documents will be required to contain certain obligatory disclosures and AIFMs will need to make a checklist of AIFMD disclosure requirements and update offering memoranda and all marketing documentation where appropriate.

Transparency requirements

A US AIFM marketing its AIF in the UK must make an annual report available for each AIF it markets within six months following the end of the financial year, The annual report must be provided to investors on request and must also be made available to the FCA. The annual report must include a balance sheet or a statement of assets and liabilities, an income and expenditure account for the financial year, a report on the activities of the financial year and disclosures in relation to the remuneration and management fees paid by the AIFM to its staff (including the total amount of carried interest payments made). The aggregate amount of remuneration must be broken down by senior management and members of staff whose actions have a material impact on the risk profile of the AIF. These rules are set out in the FCA Handbook at FUND 3.3.5.

Reporting obligations to the FCA

The AIFM is required to report regularly and at least on an annual basis to the FCA in the form of Annex IV reporting. The relevant information which must be disclosed is set out in the FCA Handbook and in the following chapters in particular: SUP 16.18, FUND 3.4 and FUND 10.5. The information required is set out in two forms, AIF001 which relates to the AIFM and AIF002 which relates to the AIF, and includes information relating to the main categories of assets in which the AIF is invested, the risk profile of the AIF and risk management systems employed, the results of stress tests required by the AIFMD in respect of investment risk and liquidity risk and new arrangements for managing the liquidity of the AIF.

For US AIFMs, the reporting requirements are similar to Form PF, but it will not be possible merely to lift all the necessary information from one report into another, as the valuation and leverage calculations differ under the AIFMD.

With reporting already having been completed since the introduction of the AIFMD, the procedure is becoming better understood and somewhat smoother than at the start.

The reporting obligation starts from the date the US AIFM notifies the FCA that it intends to market its AIF in the UK.

The FCA has provided guidance on Annex IV reporting, for both small and above-threshold non-EEA AIFMs, which can be found at the following link: www.fca.org.uk/publication/info-reporting-annex%20-iv-small.pdf.

Disclosure obligations on acquiring control of a company

There are additional disclosure obligations for above-threshold non-EEA AIFMs marketing a non-leveraged (private equity) AIF in the UK in the event of the following:

(i) the acquisition of major holdings, starting at 10% in non-listed EU companies; or

(ii) the acquisition of control (as defined below) of a listed or unlisted EU company.

There are also requirements designed to prevent so called asset stripping (see further below) of EU companies upon acquiring control.

Small non-EEA AIFMs are not subject to these rules.

Control: the test for control depends on whether the company is a non-listed company or an issuer. For non-listed companies, control means control of more than 50% of the voting rights. For an issuer, control refers to the threshold for a mandatory bid under the Takeover Directive, which varies between Member States - in the UK, this is 30% of the voting rights.

With regard to (i), a US AIFM must notify its regulator when an AIF's interest in the voting rights of a non-listed EU company reaches, exceeds or falls below 10%, 20%, 30%, 50% or 75%, specifying what the precise voting interest is.

With regard to (ii), in the event that an AIF acquires control of a listed or unlisted EU company, the AIFM is required to provide certain information to its own regulator, the relevant company and its shareholders (whose details are accessible to the AIFM). This information includes:

(i) what voting rights the AIFM has;

(ii) the conditions under which control has been obtained, including the identity of the shareholders involved and persons entitled to exercise voting rights on their behalf;

(iii) the chain of undertakings through which voting rights are held, if applicable;

(iv) the date on which control was reached;

(v) the AIFM's intentions as to the company's future business (company and shareholders only); and

(vi) information on how the acquisition has been financed (regulator and AIF investors only).

Asset Stripping

Acquiring control also triggers further obligations, which are designed to prevent so called 'asset stripping' of EU companies controlled by AIFs. Thus, when an AIF individually or jointly acquires control of an issuer or non-listed company, for a period of 24 months following the acquisition or control, the AIFM must use its best efforts to prevent (and is prohibited from voting in favour of or otherwise facilitating or supporting) certain prohibited transactions as set out in Article 30 of the AIFMD. Please note that there are a number of limited exemptions for acquisitions of own shares and capital reductions. These restrictions appear to be triggered on first acquisition and not when moving through a higher control threshold.

Notification to the FCA

The FCA notification requires confirmation from the AIFM that the management of the AIF complies with the relevant conditions set out in the Alternative Investment Fund Managers Regulations 2013, the regulations implementing the AIFMD into UK law.

These conditions vary depending on whether or not the AIFM is a 'small' AIFM i.e. broadly an AIFM who manages leveraged assets of below €100m (such as a small hedge fund) or who manages unleveraged assets of below €500m where there are no redemption rights within five years of initial investment in the AIFs (for instance, a typical private equity fund).

The two registers relevant to US AIFMs are therefore:

(i) the Article 42 Register – for non-EU AIFMs that are not small AIFMs managing AIFs; and

(ii) the Small Third Country AIFM Register – for non-EU AIFMs that are small AIFMs managing AIFs.

These forms can be found under Forms in the AIFMD section of the FCA website at: https://www.fca.org.uk/firms/nppr.

Further details regarding the FCA's private placement regime can be found in the FUND sourcebook of the FCA Handbook at FUND 10.5.

Financial promotion

It is important to note, however, that in addition to the NPPR above, the AIFM marketing the AIF in the UK will be subject to the FCA financial promotion rules, namely that the AIF can only be offered to certain types of investors, such as investment professionals and high net worth and sophisticated investors.

Regulated activity – advising and arranging

In addition to the restriction on financial promotion, an AIFM will not be permitted to carry out any regulated activity in the UK without authorisation unless it falls within an exemption. For marketing, the relevant regulated activities are usually advising and arranging. If the AIFM is arranging deals in the UK, it will either need to be authorised or fall within an exemption. Dealing with an application by an investor in the AIF would usually amount to arranging for FCA purposes.

Only regulated activities carried on in the UK will fall within the scope of the Financial Services and Markets Act 2000 ("FSMA") and while it is often clear where an activity is being carried on, activities with a cross-border element usually require further analysis. Although FSMA and the FCA rules do not specify where particular regulated activities are regarded as carried on, it is commonly considered that investment advice is given where it is received and arrangements relating to investments are normally carried on at the place where the arranger is when the arrangements are made.

Thus, if it is the case that all arrangements for raising funds from the UK investor take place outside of the UK, then the activity could be deemed to fall outside the territorial scope of FSMA. If this is not clear cut, however, and an element (or elements) of the activity are carried on within the UK, then an AIFM will need to consider whether any exemption applies, either generally or specifically, to a regulated activity.

The overseas person exemptions

As regards general exclusions, the overseas person exclusion under Article 72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("RAO") may be applicable to US AIFMs. Article 72 RAO will apply to an overseas person which carries on certain regulated activities (including advising and arranging) but which does not do so, or offer to do so, from a permanent place of business in the UK, subject to the condition that the arranging is carried on as a result of a "legitimate approach". This means that the approach made by the overseas person does not breach the FCA financial promotion rules.

How to use the AIFMD to your advantage

To discuss the points discussed in this paper and how you might make use of the AIFMD to develop your business in the UK, please contact Claire Cummings at claire.cummings@cummingslaw.com.

How can we help?

US managers wishing to market their funds in the UK need to take three steps. These are:

(i) to ensure that the fund prospectus and other marketing documentation contain the relevant obligatory disclosures for investors required under the AIFMD and the UK's own regulatory regime;

(ii) to notify the FCA of their intention to market the fund using the correct form and supplying the correct information; and

(iii) to ensure compliance with the UK's regulatory regime, which may be via an exemption.

We are able to assist US managers to review their offering documents and carry out a gap analysis relating to AIFMD disclosures and to help re-draft or prepare supplemental documentation accordingly. We can also advise on the required UK regulatory compliance.

If you would like our assistance in this respect or in respect of MiFID II, the subject of the first part of this two-part series, please contact Claire Cummings at claire.cummings@cummingslaw.com.

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