CLIFFORD CHANCE

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AIFMD: Key issues for Private Equity and Infrastructure Fund Managers

For the alternative investment fund industry, 22 July 2013 will mark the radical transformation of the EU regulatory landscape. The EU Alternative Investment Fund Managers Directive ("**AIFMD**") imposes a licensing and regulatory compliance framework on the managers of alternative investment funds other than retail funds regulated under the UCITS Directive (referred to as "**AIFMs**" and "**AIFs**", respectively in this briefing) which are managed or marketed in the EU. Its provisions will affect EU AIFMs managing and marketing AIFs in the EU, non-EU AIFMs managing EU AIFs and non-EU AIFMs marketing AIFs in the EU, and will therefore have significant implications for financial sponsors across the globe.

The first part of this briefing provides an overview of some of the key structuring issues for managers. The second part focuses on the impact of the AIFMD's transparency and asset stripping provisions for portfolio companies and looks in particular at some of the UK implementation issues. Finally, we consider the key issues relating to the remuneration provisions in the AIFMD.

Recent developments

There have been a number of recent developments relating to implementation of the AIFMD:

- On 14 November 2012, the FSA published its first consultation paper on the transposition of AIFMD into UK law, which will require changes to primary and secondary legislation and a re-write of some of the FSA Handbook.
- On 19 December 2012, the EU Commission's delegated regulation on AIFMD-implementing measures (the "**EU Regulation**") was adopted. The Commission believes that the EU Regulation will minimise the risk of divergent application across the EU, because it will have direct effect in Member States.
- Then, on 11 January 2013, HM Treasury published a consultation paper setting out the UK Government's proposed approach towards a number of the key policy decisions relating to the transposition of AIFMD into UK law and appending the draft Alternative Investment Fund Managers Regulations 2013 (the "**Regulations**").
- Finally, ESMA published its final guidelines on sound remuneration policies under the AIFMD on 11 February 2013.

What's next?

At European level, ESMA may decide to issue further guidance, depending on issues coming out of the EU Regulation. However, the clear focus has now shifted towards national implementation measures, providing the impetus for the necessary preparations at AIFM-level. From a domestic perspective, the remainder of AIFMD will be implemented through FCA rules and potentially via further implementing regulations, and additional FSA and HM Treasury consultation papers are expected soon.

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What are the key issues and considerations for fund managers?

Where are your investors based?

Managers of AIFs with EU investors are likely to benefit from the EU marketing passport of an AIFMD-authorised AIFM. Managers with no or very few EU investors are likely to find it difficult to see benefits from a passport so are likely to be reluctant about becoming authorised AIFMs. However, EU AIFMs will have to seek authorisation in the twelve months from 22 July 2013 irrespective of where their investors are based, and non-EU AIFMs will not be able to become authorised until July 2015 even if they want to.

What are your investors' views on AIFMD?

What benefits do they see from investing through an AIFMD-regulated structure (for example are the additional formalised protections offered by AIFM considered to be significant)? What are their views on the costs of regulation that will be borne by them, including for example depositary costs?

Have you considered your existing and future AIFs as a whole?

AIFMD focuses on managers rather than AIFs so an AIFM that becomes authorised for the purposes of its mandate for one AIF is likely to lead to all the other AIFs it manages becoming subject to AIFMD. Therefore, an AIFM that becomes authorised will need to assess the impact of the AIFMD compliance obligations on all of its AIFs. Even if an AIFM can structure future AIFs to reduce the indirect impact of AIFMD on those AIFs, the structures of its existing AIFs may bring the manager within AIFMD in any event. Equally, if an AIFM becomes an authorised AIFM in the future this is likely to bring its existing AIFs wholly or partially into the scope of AIFMD. Transitional provisions may serve to limit, but not extinguish, the impact of compliance obligations for existing funds.

Will it affect carried interest and other performance related arrangements?

The remuneration rules in AIFMD may lead to restrictions on the functioning of performance related schemes: see the third part of our briefing below. Carried interest partnerships (and co-investment partnerships) may potentially be AIFs and therefore subject to the same AIFMD analysis (for example in relation to marketing and compliance) as any other fund vehicle.

When will you become subject to AIFMD?

When will you become subject to AIFMD authorisation requirements?

AIFMD comes into effect on 22 July 2013 and transitional provisions allow a one year period for EU AIFMs that manage AIFs prior to this date to apply to obtain authorisation as an AIFM. Non-EU AIFMs of EU AIFs must comply with AIFMD by July 2015 (or replace the non-EU AIFM with an authorised EU AIFM) even if they are not marketing in the EU and do not require an AIFMD passport. Non-EU AIFMs of non-EU AIFs have a greater number of options available to them including becoming authorised in 2015, becoming authorised only from 2018 or staying outside the scope of AIFMD by not marketing in the EU. In all cases, AIFMD will affect how funds are marketed from mid-2013 due to its impact on national private placement regimes (i.e. giving national authorities the opportunity to consider limiting their private placement exemptions). Furthermore, an AIFM will need to become an authorised AIFM by 2018 if it wishes to market in the EU after this date. If eventual full AIFMD compliance is unavoidable for a particular AIFM, it should assess whether it has any scope to move the compliance date forwards or backwards by using a mix of onshore and offshore vehicles.

When will the FCA start authorising UK AIFMs?

The FSA has indicated that the FCA will not accept applications for AIFMs to become authorised until after 22 July 2013, and it will take up to three months (which may be subject to a further three month extension) to authorise an AIFM from the date of its application. The transitional provisions in AIFMD provide a one year period for an AIFM managing an AIF prior to July 2013 to apply to become authorised. Prior to becoming authorised an AIFM does not need to comply with AIFMD, although an AIFM relying on the twelve month grace period does need to be compliant with AIFMD by July 2014, even if it is not yet authorised as an AIFM. Whilst this one year transitional period is likely to be of benefit to EU managers seeking to postpone full compliance with AIFMD, there is significant uncertainty over the ability of a UK AIFM to market in the EU if it has not received AIFM authorisation from the FCA. This could serve to restrict UK AIFMs marketing in the EU in the second half of 2013, particularly in jurisdictions where existing private placement regimes are being restricted. This is an area that should be monitored by AIFMs over the coming months, particularly due to the fact that certain other EU countries will enable authorisation with effect from July 2013 (as they are making the application forms available from March and accepting applications before 22 July 2013).

What are the structuring implications of AIFMD?

Which combinations of EU and non-EU AIFs and manager structures are available?

A fund can be structured as (1) a non-EU AIF with a non-EU AIFM, (2) an EU AIF with a non-EU AIFM, (3) a non-EU AIF with an EU AIFM, or (4) an EU AIF with an EU AIFM. In practice, other structuring considerations will mean that few managers will have all of these options available to them. Each of these structures has different consequences from an AIFMD perspective depending on whether AIFs are being marketed in the EU or not. These consequences relate to the time at which the manager is required to become an authorised AIFM, how the AIFM is able to market the fund, and the extent to which the compliance obligations in AIFMD apply in full, in part or not at all.

Have you considered onshore/offshore structuring issues as a whole?

Any structure optimised from an AIFMD perspective must also work from a tax perspective. In many cases the tax analysis and the AIFMD analysis will oppose each other to one extent or another, and it is therefore important that all structuring issues are considered in the round. Other corporate and partnership law considerations (such as limited liability issues and confidentiality) may also impact on whether and if so which combination of onshore and offshore vehicles is used.

Where are your management operations currently based?

In general, AIFMD takes account of substance over form. If a manager's operations are based in the EU it is likely to be difficult to avoid the impact of AIFMD unless it transfers a very significant part of its organisation to a non-EU jurisdiction or is prepared to take advantage of a substantial existing non-EU presence. Longer term, a non-EU AIFM will need to become an authorised AIFM by 2015 if it manages EU AIFs and by 2018 if it manages non-EU AIFs that are marketed in the EU. It is possible for an EU entity to act as an advisor to a non-EU AIFM (or vice versa) but the AIFMD delegation rules and the focus on substance may mean this is impractical in many circumstances. Restrictions on "letter box" entities may cause a delegate to be treated as the AIFM where there is delegation of the majority of investment management functions.

What if your fund comprises a mix of onshore and offshore entities?

In structures with a mix of onshore and offshore management entities it is important to identify which entity is the AIFM of each AIF comprising the fund. This can be problematic in situations where there are separate general partner and investment management or advisory entities, and the portfolio and risk management functions appear to be carried out by a combination of the two.

Can you use a parallel or feeder structure to limit the impact of AIFMD?

It may be possible to use parallel structures to reduce the impact of AIFMD but a substantial degree of separation (and genuine substance in the managers of both parts of the parallel structure) is likely to be required to avoid tainting any structure that is being kept outside of AIFMD and this may be unattractive from an operational and investment decision making perspective. In some cases it may be possible to create EU parallel structures that fall within the small manager exemption (see below). Feeder structures are less likely to provide a route around AIFMD as AIFMD focuses on the master fund so the AIFMD treatment of the master fund will influence the treatment of the feeder.

Does AIFMD apply if you are a small fund manager?

If an AIFM has assets under management of less than €500 million, and all its AIFs are both unleveraged and do not permit redemption in the first five years following the initial investment in the AIF, the AIFM can register with the FCA as a small AIFM which will, at least in the case of the unregulated collective investment schemes typically used for private equity funds, mean the AIFM will be subject to only a few of the AIFMD's provisions. If some of the AIFs fail to meet either the leverage or redemption restrictions, the small AIFM threshold falls to €100 million of assets under management. These thresholds are aggregated across all AIFs managed by an AIFM, so an AIFM with multiple small AIFs could breach this threshold.

What are the marketing implications?

Where is your investor base and when will you be marketing in the EU?

If an AIFM has an EU investor base, the benefits of an EU marketing passport may compensate for the burdens of AIFMD regulation. If an AIFM has a wholly non-EU investor base, it will not get any marketing benefits from an AIFMD passport. Due to variations between national private placement regimes, the AIFM should also consider which EU Member States the manager will market in and how much investor money is anticipated to come from each EU jurisdiction.

Are you overly reliant on national private placement regimes?

Some EU jurisdictions (such as Germany) are considering restricting their national private placement exemptions, often significantly. In light of this, and the need for co-operation agreements (see below) some existing national private placement regimes will generally be harder to use than they are at the moment. Therefore, if the AIFM will be marketing in the EU, there are significant benefits in becoming an authorised AIFM that can market to professional investors, using a passport.

Are there any other requirements that must be satisfied to take advantage of national private placement regimes?

In structures with a non-EU AIF or a non-EU AIFM, if the AIF is being marketed in the EU under national private placement regimes, AIFMs will need to ensure that appropriate co-operation agreements are in place between the EU jurisdictions in which marketing will take place (as negotiated by ESMA on behalf of the 27 members of the EU) and the relevant non-EU jurisdictions. It is also important to ensure that the home regulatory status of any non-EU AIFM is such that it can take advantage of the regulatory co-operation agreements. It will not be possible to market AIFs from countries treated as non-compliant by FATF in the EU or for AIFMs from non-compliant jurisdictions to market their AIFs in the EU. It should also be noted that a non-EU AIFM that markets an AIF in the EU must still comply with some provisions of AIFMD, including its transparency and reporting requirements and asset stripping provisions, even if it is not an authorised AIFM.

Can reverse solicitation be used?

Reverse solicitation does not constitute marketing for the purposes of AIFMD. However, it is likely that national regulators will take a narrow interpretation of reverse solicitation, meaning that it must genuinely be an approach taken at the investor's initiative.

What are the compliance obligations?

Which entities must comply with AIFMD?

AIFMD is a manager focused directive and the AIFMD status of the manager should always be the key consideration. However, in practice certain obligations are more relevant to a manager and others are more relevant to its funds. All these compliance obligations should be assessed in the context of a specific AIF and a specific AIFM as the burden will vary on a case by case basis depending, for example, on the investment strategy of the AIF and the internal operations of an AIFM.

What are the main compliance obligations on an AIFM that affect the internal operation of the AIFM?

Obligations affecting the internal operation of the AIFM include capital adequacy requirements, remuneration restrictions (which may impact on carried interest), delegation restrictions, the need to comply with principles of conduct, the requirements regarding risk and conflict management arrangements, and the need for sound valuation processes. As well as being licensed as an AIFM, an AIFM will be permitted to conduct a very limited range of other licensable activities. For example, an AIFM could not also be a bank, but could act as a manager of accounts or as an investment adviser. As a result some managers are considering separating their AIFM and non-AIFM functions into separate entities.

What are the main compliance obligations on an AIFM that affect the operation of its AIFs?

Each AIFM must ensure that each AIF it manages complies with certain obligations. An AIF must have a depositary although EU AIFMs of non-EU AIFs are subject to relaxed depositary requirements up to 2015. In addition, UK private equity AIFs are likely to benefit from less onerous depositary requirements although there remains a lack of clarity over the entities that will act as this type of depositary and the requirements to which they will be subject. Asset stripping and notification requirements exist in relation to certain EU companies and the impact of these is discussed in more detail below. There are extensive transparency and reporting requirements including preparing an annual report, wide-ranging disclosures to investors including on "preferential treatment" (which would extend to side letters), and various disclosures to be made to regulators. Furthermore, regulators such as the FCA have the power to limit leverage at the level of the AIF (but importantly not at portfolio company level).

Who bears the costs of AIFMD compliance?

The question of who bears what AIFMD related costs is a matter of some debate amongst managers and investors. In general there is a tendency for AIFMD costs to be treated like any other costs and for a distinction to be made between those that are closer to overheads of the manager (for example AIFM costs of the AIFM itself) which would be borne by the manager, and those that are more similar to fund expenses (such as depositary costs) which are typically borne by the fund itself.

How will this affect fund documentation?

Fund documentation is evolving to facilitate compliance with AIFMD. Potential areas of development will be in relation to PPMs and other marketing materials which may require notification and potentially the approval of the regulator that authorises the AIFM (e.g. the FCA) and the requirement to pre-notify investors of changes in fund terms. These are likely to lead to changes in how fundraising processes are managed.

Depositary services will also be governed by a depositary services agreement, and amendment of fund administration agreements is likely to be required.

What is the impact of the AIFMD at a portfolio company level?

The AIFMD, through Member State implementation, imposes significant additional disclosure obligations on AIFMs and also imposes restrictions on "asset stripping" from portfolio companies up to an AIF shareholder. The disclosure and asset stripping provisions relate to acquisitions of certain shares or voting rights in EU portfolio companies, subject to a 'de minimis' exemption where the company employs fewer than 250 people in the EU and has an annual net turnover not exceeding €50 million or a balance sheet not exceeding €43 million. The Regulations apply these provisions to relevant acquisitions by relevant AIFMs (FCA-authorised AIFMs and non-EU AIFMs in relation to AIFs authorised by the FCA to be marketed in the UK via private placement). The FCA will be required to supervise compliance by relevant AIFMs regardless of the EU jurisdiction in which the target is incorporated.

Transitional provisions

For some UK AIFMs, these restrictions will apply to relevant acquisitions on or after 22 July 2013. However, many other UK AIFMs will make full use of the transitional arrangements in the Regulations, which give them until 22 July 2014 (or the date on which the AIFM becomes FCA-authorised, if that is sooner) to comply with these requirements in relation to AIFs managed by them immediately prior to 22 July 2013. In addition, UK AIFMs managing only closed-ended AIFs immediately prior to 22 July 2013 which make no additional investments after that date will not have to comply with the disclosure and asset stripping provisions at all (unless and until the AIFM becomes FCA-authorised).

Finally, UK AIFMs managing only closed-ended AIFs immediately prior to 22 July 2013 which closed to new investors before that date and which will terminate by 22 July 2016 will still need to comply with the disclosure and asset stripping provisions.

When is an FCA notification obligation triggered?

When an AIF acquires, disposes of or holds shares in a non-listed company, its AIFM must notify the FCA when the proportion of voting rights held reaches, exceeds or falls below the thresholds of 10, 20, 30, 50 and 75 per cent.

This obligation is most likely to be triggered where the percentage of voting rights held by the AIF reaches or crosses a relevant threshold as a result of the acquisition or disposal of a corresponding number of shares, but could also be triggered as a result of the acquisition or disposal by the AIF of voting rights which do not correlate to the number of shares acquired or disposed of or as a result of events changing the breakdown of the company's total voting rights in issue, without any acquisition or disposal of shares or voting rights by the AIF.

The current draft of the Regulations applies the FCA notification obligation to individual and joint holdings between relevant AIFs (whether managed by the same AIFM or different AIFMs), whereas the AIFMD only applies this on a single entity basis. At this stage, it is not clear whether HM Treasury in fact intends this obligation to attach to voting rights held individually and jointly, which trip the relevant thresholds. The aggregation of interests across parallel fund entities and potentially across consortia fund entities would give rise to an increased level of notifications, given that the obligation applies to each AIF once a threshold is reached or there is movement through a threshold. If the drafting remains, the UK regime may be more administratively burdensome than in other Member States who adopt a straightforward "copy-out" approach to implementation of this obligation.

What additional disclosure obligations are triggered on the acquisition of control?

When an AIF (individually or jointly) acquires control (i.e. more than 50 per cent. of the voting rights) of a non-listed company, its AIFM must:

- notify the company, its shareholders and the FCA of that control and provide them with prescribed information relating to it, and ask the company's board of directors to inform/make the relevant information available (and use its best efforts to ensure that the board does so inform/make the relevant information available) to the company's employee representatives without undue delay (the "**best efforts employee notification obligation**");
- provide the company, its shareholders and the FCA with information about the AIFM, its conflicts management policy and its "policy for external and internal communication relating to the company, in particular as regards its employees" and comply with the best efforts employee notification obligation with regard to that information without undue delay. This obligation also applies when an AIF (individually or jointly) acquires control over an issuer with a registered office in the EU whose shares are admitted to trading on an EU regulated market. For portfolio companies with their registered office in the UK, the control threshold is 30 per cent., but the percentage ranges from 30–33 per cent. across the EU;
- inform the company and its shareholders of 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" and comply with the best efforts employee notification obligation in relation to that information without undue delay;
- provide the FCA and the AIF's investors with information relating to the financing of the acquisition; and
- either (i) if the company is required by the law in its relevant Member State to draw up an annual report
(a) ensure that the company's annual report contains "a fair review of the development of the company's business" during the financial year, refers to any important events that have occurred since the end of the financial year, addresses "the company's likely future development" and includes specified information concerning acquisitions of the company's own shares **and**
(b) comply with the best efforts employee notification obligation in relation to that information (and make that information available to the AIF's investors) or (ii) include the prescribed information in the AIF's annual report and comply with the best efforts employee notification obligation in relation to that information.

How burdensome are these obligations?

Clearly, the precise extent of these new information disclosure obligations will initially represent an area of uncertainty for AIFMs and their advisers. Since 2006, on an acquisition of a public company in the UK, a bidder has had to disclose its intentions with regard to, among other things, the future business of the target company and the likely repercussions on employment, and it may therefore be possible to draw some broad parallels with developing practice in a public M&A context. Disclosures around employment issues will be particularly acute where there is a specific intention to close target premises or make a number of the target workforce redundant, but could also apply to more generic synergies, depending on the extent to which specific intentions have been formulated at the relevant time.

Although information relating to the "financing of the acquisition" will only have to be provided to the FCA and the AIF's investors (as contrasted with the similar requirement, under the UK Takeover Code, to disclose the principal terms to shareholders and put the relevant documents on display), this concept is not defined by the AIFMD (or the Regulations) and could, depending on the confidentiality controls imposed, ultimately result in commercially sensitive information becoming widely available.

The directors' report for a company incorporated in the UK is already required to include a business review comprising a fair review of the company's business and a description of the principal risks and uncertainties facing the company. Qualifying UK portfolio companies of FSA-authorised AIFMs will already be familiar with the requirement, pursuant to the Guidelines on Disclosure and Transparency in Private Equity, to report in compliance with the enhanced business review requirements under the Companies Act 2006, which are otherwise only applicable to quoted companies. This requires the inclusion of specific information relating to the future development, performance and position of the company's business. Although applicable to a much broader group under the AIFMD, the Guidelines Monitoring Group's annual reports on disclosure and transparency in private equity may provide some useful practical guidance on compliance with the new reporting requirements.

The best efforts employee notification obligation will be overridden if the communication "would seriously harm the functioning of the company or would be seriously prejudicial to it" and can be made subject to confidentiality obligations in relevant circumstances.

What does this mean for transaction documents?

It will be prudent to include contractual undertakings from the managers of relevant portfolio companies in equity documentation going forward, in order to support the AIFM's compliance with these disclosure obligations, particularly the best efforts employee notification obligations, and to support the prescribed additional content of the annual report and authorise relevant information to be disseminated.

What is prohibited by the "anti-asset stripping" rules?

Where an AIF (individually or jointly) acquires control of a non-listed company or an issuer, for the next 2 years the AIFM must not facilitate, instruct or vote for, and must use its best efforts to prevent, the relevant company/issuer effecting distributions, capital reductions, share redemptions or acquisitions of own shares, subject to certain limited carve-outs. Under the AIFMD, the anti-asset stripping restrictions attach to the target company which has been the subject of the change of control. Voting rights in the target held by intermediate undertakings controlled by the AIF or by persons acting on its behalf are attributed to the AIF.

It is important that the anti-asset stripping provisions are not inadvertently triggered, for example as a result of the acquisition (even if only temporary) by the AIF of additional voting rights or where the AIF's voting rights fluctuate.

Distributions

The Regulations prohibit distributions which reduce net assets below the level of subscribed capital plus undistributable reserves or which exceed distributable profits, in each case as determined by reference to the company's annual accounts "on the closing date of the last financial year". This suggests that distributions will not be permitted even if they can be justified by reference to interim accounts, if the most recent audited accounts do not show sufficient surplus net assets or distributable profits.

The net assets restriction broadly correlates to the existing restriction on distributions by public companies under the Companies Act 2006 and the distributable profits restriction broadly reflects the existing requirement under the Companies Act 2006, that distributions may only be made out of profits available for the purpose.

Capital reductions

As drafted, the Regulations appear to prohibit *any* capital reduction by a relevant portfolio company during the 2 year period, other than one whose purpose is to offset losses incurred or to credit an amount (being not more than 10 per cent. of the reduced subscribed capital) to a non-distributable reserve of the company. This would mean that capital reductions not involving any integral distribution to or for the benefit of the AIF shareholder (for example, to create a reserve to improve the relevant company's balance sheet) would also be subject to the prohibition.

Own share purchases and share redemptions

The Regulations prohibit acquisitions of own shares which reduce net assets below the prescribed level, again as determined by reference to the company's annual accounts. This broadly reflects the existing restriction on acquisitions of own shares out of capital by public companies under the Companies Act 2006. The effect would therefore be to extend the restriction to private AIF-backed portfolio companies (whereas non-AIF backed private companies incorporated in the UK are also permitted to buy their shares back out of capital).

Finally, whilst conceptually it would make sense for share redemptions to be prohibited or permitted in the same circumstances as acquisitions of own shares, the Regulations appear to impose a blanket prohibition on all share redemptions for the 2 year period. However, in practice, redeemable shares could be bought back in the manner described above, albeit potentially giving rise to a stamp duty liability.

Key issues – Portfolio level

- AIFMD imposes significant additional disclosure obligations on relevant AIFMs and also imposes restrictions on "asset stripping" from portfolio companies
- Distributions, capital reductions, share redemptions and acquisitions of own shares by some portfolio companies will be restricted for 24 months, subject to limited carve-outs
- AIFMs will need to consider the potential impact of this restricted flexibility carefully when considering portfolio investments
- For some EU AIFMs, these obligations and restrictions will apply from 22 July 2013 whereas, for others, they will only apply with effect from 22 July 2014

What does this mean for transaction documents? Other practical steps

As a practical matter, any changes to the share capital of the relevant company will require the active involvement of the AIFM (and, in the vast majority of cases, also the AIFM's consent). As belt and braces, it may also be appropriate to insert relevant undertakings from the managers of portfolio companies and from co-investors in equity documentation going forward, in order to support the AIFM's compliance with the restrictions.

Going forward, due diligence will need to be conducted to identify excess distributable cash in the target group. Pre-completion re-organisations may be required to extract that cash and adjust the price accordingly, as the flexibility to distribute such cash post-completion will be more limited.

Over-funding by way of equity will need to be avoided - this occasionally happens on all-equity deals that are subsequently re-financed. Similarly, equity funding for bolt-ons will need to be carefully assessed, as the extraction of any excess equity will be subject to the restrictions on capital reductions and distributions within the first 2 years.

It is likely (as is currently the case) that most equity funding will be by way of shareholder loan, to ensure maximum flexibility.

What is the impact of the AIFMD on remuneration?

The European Securities and Markets Authority ("**ESMA**") published its final guidelines on sound remuneration policies (the "**ESMA Guidelines**") on 11 February 2013. It is understood that the draft AIFM Remuneration Code ("**AIFM Code**") issued by the FSA in November 2012 will be amended to reflect these ESMA Guidelines. The ESMA Guidelines themselves are not binding on individual AIFMs, but they should inform the approach that the FCA will take to operating the AIFM Code.

The final AIFM Code will require AIFMs to put policies in place for certain categories of their staff that comply with the remuneration provisions in the AIFMD. As financial sponsors consider the need to comply with AIFMD generally, they will need to review their remuneration structures in light of the final AIFM Code. At the time of writing we still await clarity about when the Code will become relevant to particular AIFMs as the FSA/FCA's approach to transitional arrangements remains outstanding.

The ESMA Guidelines confirm that staff who need to be covered by the AIFM Code should include executive and non executive directors, senior management, risk takers, control functions and employees receiving total remuneration which takes them into the same remuneration bracket as senior management and who have a material impact on the AIFM's risk profile or on an AIF it manages ("**AIFM Code Staff**").

The ESMA Guidelines do not provide for the AIFM Code to limit how much AIFM Code Staff are paid, but do regulate the structure and the timing of payment. The ESMA Guidelines also contain provisions on how remuneration is overseen and monitored.

ESMA indicates which of its Guidelines it expects to be applied AIFM-wide and those that are confined to AIFM Code Staff; the FCA is likely to follow this approach.

Whose remuneration may need to be considered?

As noted above, the ESMA Guidelines provide that executive and non-executive members of the governing body, senior management, control functions and staff responsible for heading the portfolio management, administration, marketing and human resources, and other risk takers are all presumed to be Code Staff ("Identified Staff" in the Guidelines). But the Guidelines also recognise that this may not be appropriate if such a person has no material impact on the AIFM's risk profile or that of an AIF it manages.

Financial sponsors who will become subject to the Code will need to go through an iterative process of identifying relevant staff. If an AIFM already produces a list of Remuneration Code staff for the FSA these staff are also likely to feature on the AIFMD Remuneration Code Staff list. However, additional staff are also likely to be classified as AIFMD Code Staff who would not be regarded as Remuneration Code Staff.

How is carried interest impacted?

The AIFM Code will apply to any type of remuneration paid to AIFM Code Staff and carried interest is specifically included. Thought will need to be given to the extent to which the ESMA Guidelines permit a simplified application to carried interest schemes of the detailed principles relating to alignment of variable remuneration with risk and performance, award and pay out processes.

Control Functions

Although Control Function staff are AIFM Code Staff, the ESMA Guidelines make it clear that slightly different rules apply to them, compared to other AIFM Code staff and AIFMs will need to factor these differences into any necessary review of remuneration structures.

Are co-investment schemes caught?

The ESMA Guidelines exclude from the concept of variable remuneration pro-rata returns from co-investment schemes where there is an actual disbursement made by the staff member. Provided that any loans made are reimbursed by the time that the return is paid, the return on the co-investment will not be classified as variable remuneration. As part of assessing their structures, AIFMs should consider their co-investment schemes to establish how well they sit within this part of the ESMA Guidelines.

How will the proportionality principle be applied?

The ESMA Guidelines permit the FCA to apply a proportionality principle to the AIFM Code with the effect that if the size, scope and structure of the AIFM so merits the AIFM has the scope to disapply the rules on: (i) paying variable remuneration in instruments; (ii) retention; (iii) deferral; (iv) risk adjustment; and (v) having a remuneration committee. It is anticipated that the FSA will issue guidance on how it/the FCA will apply the proportionality principle shortly.

Fixed v variable remuneration

Fixed and variable remuneration need to be appropriately balanced. Fixed remuneration should be a high enough proportion of overall remuneration to allow the AIFM to operate a fully flexible variable remuneration policy, including the possibility of paying no variable remuneration.

Deferral

At least 40 per cent. of variable remuneration (and up to 60 per cent. depending on the impact of the staff member on the risk profile of the AIF) needs to be deferred. The deferral period depends on the particular AIF, but must be at least 3 to 5 years unless the lifecycle of the AIF is shorter.

Remuneration in units/shares

At least 50 per cent. of variable remuneration is to be paid in units or shares of the AIF, equivalent ownership interests, unit linked instruments (for AIFs issuing only units), share linked or equivalent non cash instruments unless: (i) this would give rise to a conflict of interest with the AIFM Code Staff's duty to perform their function independently, or (ii) the management of the AIF accounts for less than 50 per cent. of the total portfolio managed by the AIFM. The non cash instruments must be subject to a retention policy.

What performance is taken into account?

There is scope within the ESMA Guidelines to take into account a combination of individual and business unit performance and the overall results of the AIFM as a whole, as appropriate to the role of the individual, when determining the level of variable remuneration.

Clawback/Malus

Remuneration structures should, where appropriate, allow for "malus" (adjustment of variable remuneration before it vests) and "clawback" (repayment after ownership has passed/vesting). It may be necessary to review long term arrangements including carry arrangements to consider the inclusion of clawback. The drafting of clawback provisions should be done carefully to reduce the risk of them being considered a penalty and to find an appropriate "home" for any clawed back awards.

When are guarantees permitted?

The draft AIFM Code provides that multi-year guarantees are not permitted. Guarantees are permitted only where exceptional, in the context of hiring new staff and are limited to the first year of performance. This is not expected to change as a consequence of the ESMA Guidelines.

Is there an overlap with the Remuneration Code?

Some limited parts of fund AIFMs are already subject to the FSA's Remuneration Code ("**Remuneration Code**"). The draft AIFM Code provides that for such AIFMs if they have complied with its provisions then the AIFM will not need to demonstrate compliance with the Remuneration Code. However, ESMA declined to include a provision in its Guidelines that an AIFM will be deemed compliant with the ESMA Guidelines if it is compliant with the CEBS Remuneration Guidelines (which the Remuneration Code implement) issued in respect of the Capital Requirements Directive.

Conclusions

22 July 2013 is fast approaching, providing the impetus for AIFMs' implementation planning.

We would be very happy to advise in more detail on any of the aspects covered in this briefing or relating to implementation of AIFMD more generally. For specific, tailored advice, please contact your usual Clifford Chance contact in the first instance.

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