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Financial Services and Markets

Alternative Investment Fund Managers Directive: Fundamental change for the fund industry - update

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In the last few days there have been significant developments in the legislative process for the Directive. The European finance ministers at the ECOFIN meeting approved a draft text to be negotiated on behalf of the Council. The ECON Committee of the European Parliament has also produced its own approved text, which includes amendments proposed by the JURI Committee. Thus there are now two "approved" texts of the draft Directive, there are many similarities between the two drafts, but also some very important material differences. The Council, the European Commission and the European Parliament will now work together to agree a compromise text, which is expected to be achieved by the end of July this year. This is known as "trialogue". If it is, the agreed text of the Directive will be adopted by the Parliament at its first reading (currently scheduled for 6 July) and approved by the Council. Following the summer break, the Commission will start work on the extensive secondary legislation that is required.

It seems likely that the outstanding issues will be resolved; the only area where compromise might be made difficult is that relating to third country issues, as the Parliament and Council positions are very far apart. If they cannot agree on third country provisions then those aspects might be sent back to the Commission for more work. But it does seem as if the rest of the text is likely to be agreed soon. There are still some very important points at stake, in addition to third country issues, and these will be won or lost in an intense, fast moving and largely invisible process over the coming weeks.

We describe below the state of play on the latest texts, highlighting the similarities and the key differences between the Council and the Parliament position. Where the positions are similar it seems unlikely that the final text will take an entirely new line. Thus those provisions described below as being ones where there is broad agreement are unlikely to change without good reason and a strong case being made for change. Having said that, past experience of the final stages of the development of directives shows that surprising new provisions can appear and others disappear.

Timing

It appears that the Directive could be made by the end of July 2010. Member States must implement it within 24 months of it being made, so it could be in force by the end of July 2012.

There remains little by way of transitional provision. Both versions require managers who are established and operating in the EU before the Member State implementation date to apply for authorisation under the Directive within one year of that date. The Council draft makes provision for a fund manager of a closed ended fund to wind the fund down without obtaining authorisation, provided that no new investments are made after the Member State implementation date and the winding down occurs within 12 months of that date.

There may be some transitional provisions in relation to third country funds (the Council text has a brief provision), but these must await the outcome of the discussion on fundamental principles.

Comment

Those who have been following the progress of the Directive are aware of how deeply unsatisfactory the entire process has been from the very beginning. The Directive, conceived at a political level as an attack on hedge funds and private equity funds, covers far more

than just those types of fund. It is deeply ironic that a directive, which purports to be aimed at ensuring market stability and integrity, containing systemic risk and strengthening the economies of Europe, is likely to have the opposite effect. Whilst lip service is paid to the fact that neither hedge funds nor private equity funds caused the financial crisis, there is no recognition of this in the actual provisions.

All players have recognised that the venture capital and private equity industry has much to offer the economies of Europe. Yet whilst the Parliament text grants a partial exemption for private equity funds from some of the provisions, unless changes are made the overall effect of both texts will be to make European private equity investors less attractive to investees than other sources of funding. An investee company is more likely to prefer investment from non-European or non-fund investors who are not subject to any disclosure or transparency requirements. The creation of a completely unlevel playing field for private equity investees is a very serious matter, certain types of private company are to be put at a major competitive disadvantage to other private companies, solely because of the nature of their owners.

There are many other extremely undesirable implications, particularly in the Parliament text. For example, the proposal by the Parliament that European professional investors should be banned from investing in third country funds which do not meet the requirements of the Directive, would, if implemented, be deeply damaging both in the short and the longer term. Major institutions like pension funds and insurance companies would have to reconfigure their existing portfolios and they might find it impossible to get the global exposure that they need because there will be many funds in other jurisdictions which will have no interest in meeting the European criteria. Thus, if adopted, the Parliament provision would reduce the scope and breadth of investment by European professional institutions, producing an ever more inward looking investment profile for European investors.

The creation of the Directive was a response to the concerns of some politicians. Given the current events in the debt markets, the attitude of politicians at the highest level has turned firmly against hedge and similar funds who are being blamed for the current crisis affecting some European Member States. Thus the Directive is being finalised against an ever hardening political attitude, no matter how unfair that is, and the industries affected have much work to do over the coming weeks in order to achieve a fair draft against this background.

The Directive will, once passed, represent one of the first European legislative measures to confer extensive powers and duties on ESMA, the new European Securities and Markets Authority. This centralises within ESMA matters which might previously have been within the jurisdiction of national Member State regulators operating through CESR. ESMA may issue guidelines to national regulators on how to monitor conformity with the Directive and settle disagreements between national regulators. This, together with the wide-ranging powers conferred on the Commission to make delegated legislation, shows that the European institutions are now, more than ever, the bodies which wield the power in relation to law-making in the financial services sector.

THE AIFMD - WHERE ARE WE NOW?
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Scope

The Directive will regulate fund managers who manage alternative investment funds, and will therefore indirectly regulate certain matters concerning the operation and constitution of a fund. It is therefore necessary to understand both the nature of the arrangements that will constitute an alternative investment fund and then know how to identify the entity that will be regarded as the "manager".

What is an alternative investment fund?

Although there are differences between the Council and the Parliament texts, it is clear that the scope of the Directive will be potentially much wider than the "fund" concept as currently understood in many Member States. It appears to cover a number of vehicles and arrangements which are not currently treated as "collective investment schemes" in the United Kingdom. The core concept of "collective investment undertaking" remains undefined. Certain types of structured product, investment trusts, venture capital trusts and some other corporate structures are likely to fall within the definition.

There are some important differences between the Council and the Parliamentary approach to the scope of the Directive.

Similarities between the texts

- The Directive will apply to all alternative investment fund managers who are established in the EU, whether they manage EU or third country funds
- An alternative investment fund ("AIF") may be open or closed ended, constituted as a company, a trust, under a contract, a statute, or in any other legal form.

Key differences between Council and Parliament

Definition

There are potentially important differences in the definition of an AIF.

The Council text provides that an AIF is:

> "Any collective investment undertaking including investment compartments 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."

The Parliament text:

- does not require "a number of investors" and indeed makes it clear that funds with only three investors are within scope
- makes no reference to a defined investment policy
- includes "leveraged managed accounts" within the definition of an AIF, which is defined as:

> "An investment account that is managed by a third party who has the authority to do transactions without prior approval from the holder and in respect of which leverage is used in connection with such transactions."

This appears to extend the requirements of the Directive to any accounts managed by a discretionary fund manager which may use leverage. No such provision appears in the Council draft and it must be hoped that this reference will not be in the final agreed text.

Exemptions

There is a fundamentally different approach to exemptions in the two versions. The Parliament draft has very few absolute exemptions, but incorporates the concept of partial exemption. The Council text has more absolute exemptions, but does not have the concept of partial exemptions. The table below summarises some of the important distinctions in the two texts. The Parliament text also makes certain specific provision for private equity funds.

Entity	Council	Parliament
Institutions for occupational retirement provision	Exempt	Exempt
Credit institutions, insurers, other regulated institutions investing for own account	No express provision	Exempt
AIFM which manage smaller funds	Optional exemption (exercised at Member State level) for: AIFM of funds that do not in total exceed €500 million, provided fund is not leveraged and no redemption rights for first 5 years; AIFM of funds that do not in total exceed €100 million (including assets acquired through leverage)	Partial exemption for: AIFM of portfolios that are not leveraged and where each fund's assets do not exceed €100 million and total portfolios do not exceed €250 million, with no redemption rights for first 5 years.
AIFM which manage funds with only group companies as investors	Exempt	Partial exemption
Securitisation SPVs	Exempt	No provision
AIFM with only 3 professional investors	No provision – likely to be within scope	Partial exemption
Investment trusts traded on an EU regulated market with no investor redemption or repurchase rights, which invest mainly in transferable securities	No provision	Partial exemption
Employee participation or savings schemes	Exempt	Partial exemption for employee participation schemes

Partial exemption for AIFM of private equity funds

The Parliament version defines a private equity fund as: "a fund whose investment policy is to invest in equity and equity related securities of, principally, private companies and businesses in order to finance venture capital, growth plans and buy-outs". It appears that a private equity fund could be either open or closed ended.

The Parliament draft provides that only certain provisions apply to the AIFM of a private equity fund. The provisions requiring the appointment of a depositary do not apply, nor do the capital requirements for a fund manager. The position in relation to a valuer is not entirely clear, save that the frequency of valuation should be in compliance with the rules of the fund and whenever shares in the fund are issued or redeemed. A private equity fund manager would however remain subject to the various transparency requirements and remuneration provisions. Whilst these points are relatively clear, the exact scope of the exemptions for a private equity fund manager is not completely clear from the text.

There is no exemption for AIFM of private equity funds in the Council version. The irony is that, overall, the Parliament version of the Directive is far more onerous and damaging for private equity funds, despite the apparent generosity of the exemption.

Partial exemption for AIFM of real estate funds

Real estate funds are defined as: "a fund whose investment policy is to invest in real estate or assets linked to real estate". Under the Parliament draft, AIFM of real estate funds are not required to comply with the depositary provisions, and are only required to carry out valuations at frequencies required by the rules of the fund. There is no such provision in the Council draft.

Partial exemption for smaller fund managers

As will be seen from the table above, the Council and Parliament take a different approach towards smaller fund managers. The Parliament draft defines smaller fund managers as: "non-systemically relevant AIFM". These AIFM have to comply with some rules (including remuneration and capital rules) but do not have to comply with a number of other requirements including those that relate to valuations and depositaries.

Who is the AIFM?

Self managed funds

A "self-managed" fund will fall within the scope of the Directive. The Directive draws a distinction between:

(a) an external manager and

(b) "internally managed AIF", i.e. where a fund's governing body does not appoint an external AIFM. The fund itself will be authorised as the AIFM. Thus, for example, investment trusts which have not appointed an external manager will themselves become the AIFM under the Directive. They are only permitted to manage their own assets, administer and market their own funds and carry on activities related to the underlying assets of the fund.

External managers

- An AIF can have only one AIFM. Identifying who is the AIFM, for example, in a context where there may be a manager offshore and an onshore delegate, is not always simple, although as noted below, if the Council text prevails on this, the position will be reasonably clear.

- The Council text states that, where an AIF is not self-managed, the AIFM is the person appointed by or on behalf of the fund to be responsible for managing the AIF. In this context "managing the portfolio" means the provision of portfolio management and risk management services. The AIFM may perform certain other functions listed in the Directive, being marketing and some administrative functions.

  Therefore firms which have risk and portfolio management responsibilities will have to consider if they are "appointed by or on behalf of the fund". If they are, then they will be the AIFM. However if they are only a delegate of the person so appointed then they will not be the AIFM.

  This distinction will be particularly important for UK "managers" of third country funds. There will be some, particularly in the hedge fund community, who are truly delegates of a third country global manager and they will not be within the scope of the Directive. There will be other managers who will need to look carefully at the fund constitutional documents in order to ascertain their status.

  This may produce an important change in the position of some firms who are currently treated, in the U.K. at least, as being investment managers within the scope of MiFID. At present a firm which is only appointed by the fund to provide investment management services is likely to be a MiFID investment manager. As a result of the Directive this will no longer be the case. A recital states that an AIFM which has been appointed to manage an AIF is not to be deemed to be providing MiFID portfolio management, but instead collective portfolio management under the AIFM Directive. This may mean that some managers will no longer be MiFID firms. Managers who are delegates of the appointed manager will remain as MiFID firms and not fall within the AIFM Directive.

- It is not clear if the Parliament text produces a different result. It simply defines the AIFM as being "the person whose business is to manage AIF, that is responsible for the compliance with the requirements of the Directive".

  We think it would reach the same result as described above, but the drafting is not as clear.

- On either text the AIFM, once identified, is responsible for ensuring compliance with the Directive, even if certain requirements are outside its power to control. This recognises that fund structures differ and that, for example, the power of appointment of a depositary will not necessarily be with the AIFM. The AIFM must inform its regulator if at any time there is non-compliance with the Directive and unless the AIFM is able to procure compliance it will be required to resign and the fund may no longer be marketed in the Community.

Thus we consider that the impact of the latest drafts is as follows:

EU-based managers

The only entity in the EU permitted to manage an AIF is a manager whose head and registered office are both in the same EU Member State and who is authorised under the Directive. This is regardless of where the fund is established but there are restrictions on the third country funds that can be managed (see below).

An AIFM authorised in one EU State is able to provide management services to an AIF established in another EU State by using a passport under the Directive. It can provide the services either from its home State or by establishing a branch in the EU State in which the fund is domiciled.

Non EU managers

A non EU manager cannot be an AIFM authorised under the Directive.

Limits on AIFM activities

Both texts place significant limitations on the activities that can be carried on by an AIFM, which may force some firms to restructure. It certainly seems clear that no fund manager will be allowed to carry on a proprietary dealing activity.

Thus (subject to the one exception below), an AIFM will only be able to engage in:

- the management, administration and marketing of funds in accordance with the Directive
- activities relating to the underlying assets of the fund
- the management of UCITS funds.

Allowing an AIFM to carry on "activities relating to the underlying assets" should allow private equity and real estate fund managers to carry on their activities with their investees as they do now. A recital indicates that this provision is, amongst other things, to allow AIFM to perform services necessary to meet their fiduciary duties, such as facilities management, real estate administration, corporate, financial and investment strategy advice and other services connected to industrial activities undertaken by the AIFM as part of its management of the AIF and the companies and other assets it has invested in.

Member States may authorise an external AIFM also to:

- be a discretionary portfolio manager. In such a case the AIFM will be subject to certain MiFID provisions, though not actually authorised under MiFID
- provide investment advice
- provide custody in relation to units of collective investment undertakings
- receive and transmit orders (arrange deals). (NB this activity does not appear in the Parliament text).

It is not clear to what extent, if at all, the AIFM will be permitted to operate an advisory, arranging or custody activity that is separate from discretionary or fund management, as these are described as "non-core" activities. An AIFM will not be able to carry on any other activities/services such as the execution of orders or underwriting and placing activities (apart from marketing its funds).

Marketing the alternative investment fund

Definition of marketing

The Council definition of marketing refers to "any direct or indirect offering or placement at the initiative of or on behalf of the AIFM". It appears that the Council intends that an investor may be able at its own initiative to invest in other third country funds (although if the fund is marketed in Europe it could only be so marketed in accordance with the requirements described below).

Parliament defines marketing as "an offering or placement at the initiative of the AIFM or of an intermediary responsible for distribution" and, as will be seen below, severely restricts the range of third country funds that an investor can invest in of his own volition.

Marketing to retail investors

Each Member State can decide if it permits marketing to retail investors and impose conditions if it does, there is no passport for marketing to them. However a recital in the Council draft states that if a Member State allows such marketing of certain types of AIF, then it should assess, on a case by case basis, if a specific AIF is of the type that may be marketed to retail investors. This suggests that funds will need individual approval for marketing to retail investors, an unwelcome burden for AIFM, and also more work for regulators.

If a Member State allows certain types of fund to be marketed to retail investors, then it cannot discriminate between funds established in that Member State and those established in other Member States. The Parliament text would require Member States to ban the marketing of any fund to retail investors if more than 30% is invested in funds that cannot be marketed in the Community.

Home State and cross-border marketing

Before an AIFM can market an EU fund it manages to professional investors in its own EU Member State it must first provide its regulator with certain information about each fund that it intends to market. The Parliament draft allows the regulator to impose restrictions or conditions on the marketing. The manager's regulator must inform the manager within ten working days (twenty days in the Parliament draft) whether it may commence its activities.

The AIFM must notify its regulator of its intention to market an EU fund to professional investors in other Member States, together with certain documents and details about the fund. The regulator must transmit this within ten working days (twenty days in the Parliament draft) of receipt to the relevant authorities of the Member State where the fund will be marketed and notify the AIFM that it has done so. The AIFM can only market cross-border from the date it receives this notification.

Any material change to the particulars must be provided to the manager's own regulator at least one month before implementing the change. Since this would include changes to documents such as the PPM, this does not fit with the established approach to private placement.

Thus there has been no improvement to the marketing provisions, and they simply do not reflect the practicalities of the marketing process for most funds.

Provision of services in respect of alternative investment funds by third parties

The Parliament text, but not the Council text, retains the recital from the original draft of the Directive which appears to place restrictions on the ability of EU based advisers and others to provide investment services to third country funds. The position is therefore now uncertain as to what is intended and will doubtless be one of the issues for clarification and agreement over the next few weeks. If the provision is not removed it will produce confusion and is likely to be very damaging.

Authorisation and capital requirements

Authorisation procedure

The provisions relating to the grant of authorisation broadly reflect the MiFID provisions which require assessment of the suitability of the persons who conduct the business, the suitability of the controllers and the close links.

The authorisation procedure requires the fund rules to be submitted to the regulator but if these are not submitted until near the end of the application process there may be a delay before the fund manager can start its management activities.

Capital requirements

Under both texts, managers will be required to have a minimum amount of "initial capital" and/or "own funds". These definitions are derived from the Capital Requirements Directive ("CRD"), where they are used to determine the regulatory capital which needs to be held by banks and investment banks. "Initial capital" and "own funds" are two ways of measuring what are essentially "shareholder funds" (after deducting any losses and intangible assets such as goodwill). Certain types of preference shares and subordinated debt can be counted towards "own funds" at present, but this part of the CRD may well be amended before the AIFM Directive comes into force. LLPs may treat capital contributions as own funds if the LLP agreement imposes significant restrictions on withdrawal and payment of capital.

Under both texts:

- An external fund manager will have to maintain initial capital of €125,000 and a minimum level of own funds. It is likely that amounts which are eligible for initial capital will also count towards own funds.

  The requirement is that own funds must be the higher of:

  (a) one-quarter of fixed annual overheads, including salaries, guaranteed bonuses and rent and

  (b) €125,000 plus 0.02% of the amount by which the total value of portfolios under management exceeds €250 million, subject to a cap of €10 million.

  The requirement under (b) may be reduced by up to 50% if a bank or insurer has guaranteed the balance. It is difficult to see that this is of any significant use.

- An internally managed fund (i.e. where the AIFM is the AIF) has an initial capital requirement of €300,000 but has no own funds requirement. There is no capital requirement for an externally managed fund.

Under the Council text, if a manager of smaller funds opts in to the Directive, it will be required to have only an initial capital of €50,000, provided that its funds are not leveraged, there are no redemption rights for five years and the fund is an investing rather than a trading fund. This may be helpful to some venture capital managers.

The Council text does not impose any restrictions on the way in which initial capital or own funds can be invested; these amounts do not need to be held in cash or liquid assets.

The Parliament text, however, has other onerous provisions:

- it requires own funds to be invested in liquid assets or assets readily convertible to cash in the short term. This is a significant development which would prevent firms using own funds as working capital. This goes considerably beyond the UK's liquidity regime for BIPRU investment firms (subject to CRD). Until now this type of requirement has been limited to banks, investment banks and insurers in the UK
- it requires professional indemnity insurance against professional negligence
- it requires the AIFM to invest in each fund it manages, so that on an annual basis the AIFM holds a net economic exposure superior or equal to a specified percentage of the total amount invested by the other investors. The Commission will determine the specified percentage.

Conduct of business requirements: general principles

Certain general principles are applicable to the fund manager. They may seem relatively innocuous, but similar provisions in MiFID have provided the basis for detailed regulation in Level 2 legislation. The principles include requirements to:

- act in the best interests of the fund, the investors in the fund and the integrity of the market
- act with due skill, care and diligence
- treat all investors fairly.

Conflicts of interest

The Council and Parliament texts are similar so it would appear that the final text will require the AIFM to take all reasonable steps to identify conflicts of interest:

- between it (including its employees and controllers) and the fund or fund investors
- between one fund and another and
- between the fund or fund investors and another client of the AIFM (e.g. a discretionary management client).

The AIFM will have to operate effective systems and controls designed to prevent conflicts from adversely affecting the interests of the fund and investors and disclose the general nature and sources of conflicts of interest to investors if those arrangements are not sufficient for it to be confident that risks of damage to investors' interests will be prevented.

Risk management

The AIFM is required to:

- functionally separate tasks and responsibilities for risk management and for portfolio management. The Council text recognises that this may not be proportionate in view of the nature, scale and complexity of the business of some AIFM, in which case its regulator may grant it a derogation from this requirement
- implement adequate risk management systems to measure and monitor the risks associated with each fund investment strategy and to which each fund is exposed and stress test the risks associated with investments
- follow a documented and regularly updated due diligence process for investment.

In addition the Parliament text provides that AIFM who use prime brokers must enter into contracts with the prime broker and notify the contracts to the depositary. Investors must be informed about the liability provisions including in case of loss of financial instruments.

Short selling

The Parliament text contains specific provisions on short selling which require AIFMs who engage in short selling on behalf of the fund:

- to have agreed to borrow the relevant securities at the time they submit the short sale order

- to have a risk management procedure to manage the risks associated with delivery of short sold securities
- to regularly disclose information on significant short positions to the regulator.

The competent authorities are required to provide to ESMA the information they receive on short selling so that ESMA may, in exceptional circumstances, take the decision to restrict short selling activities.

The Parliament text therefore effectively prevents "naked short selling", a very topical issue at present. This contrasts with the approach in the Council text which simply requires fund managers to provide information to their regulator on short selling, and for this then to be used for identifying systemic risk.

The Parliament text also amends the Market Abuse Directive in relation to short selling, inter alia, to prohibit naked short selling of equities.

Liquidity management

The Council and Parliament texts are similar save that the Council excludes unleveraged closed-ended funds. When the provisions apply the manager must:

- adopt appropriate liquidity management procedures to ensure that the liquidity profile of investments complies with the fund's "underlying obligations"
- regularly conduct stress tests and monitor the fund's liquidity risk
- ensure that each fund has a consistent investment strategy, redemption policy and liquidity profile.

Investing in securitised investments

There will be restrictions on investment in securitisations by AIFM. The Commission will be obliged to lay down requirements which must be met by originators before the manager of an alternative investment fund can invest the fund in a securitisation. This will include a requirement that the originator retain at least a 5% net economic interest.

Remuneration

Probably the most controversial and significant element after the third country provisions is the inclusion of extensive provisions relating to remuneration. As is well known, remuneration in the financial sector is a hot political topic at present. Both texts include an extensive annex concerning the remuneration policies that an AIFM must have for all its staff whose professional activities have a material impact on the risk profile of the AIFM or of the funds that it manages. Key aspects are:

- AIFM will be required to have remuneration policies and practices for staff, including senior management, whose professional activities have a material impact on the risk profile of the AIFM or of the funds which are managed. The policies and practices must be comprehensive and proportionate to the nature, scale and complexity of the AIFM's activities and to the funds it manages.
- The provisions in the annex to both drafts set out an extensive list of considerations to be taken into account in formulating the remuneration policies (although the Parliament draft seems to require all the provisions of the Annex to be complied with). For example, there are requirements in relation to performance related remuneration (so that, for example, the assessment of performance is set in a multi-year framework appropriate to the life cycle of the fund) and guaranteed bonuses must be exceptional and occur only in the context of hiring staff in their first year. There are also restrictions on the amount of the bonus that can be paid without deferral.
- The position in relation to carried interest is not clear on either draft. The Council draft provides that the remuneration principles do not apply to returns paid in connection with the liquidation of funds, or when investors have been reimbursed the amounts invested in the funds. This may indicate that carried interest arrangements are intended to be excluded by the Council. However, the Parliament text is far more ambiguous, it is poorly drafted but it does appear to say that the remuneration principles apply to returns to employees from their investments in the fund. Those industries that award employees with carried interest still need to win the argument that carried interest arrangements are not remuneration and should not be caught by remuneration policy requirements.
- AIFM that are significant in terms of their size or the size of the firms they manage, will be required to have a remuneration committee which is chaired by a non-executive member of the management body. There are many firms at present that have no such non-executive presence.
- In addition the Commission (or possibly CESR/ESMA) will be producing guidelines on sound remuneration policies.

Remuneration rules are here to stay.

Valuations

Both drafts contain valuation requirements (in the case of the Parliament text, there are some minor modifications for private equity and real estate fund managers - see "Scope" above).

Similarities between the Council and the Parliament position

- The assets of the fund and the shares/units must be valued at least once a year and whenever required to enable the redemption or issuance of units
- Valuation may be by either an external party, or by the AIFM itself
- If carried out by the AIFM, the valuation function must have independence. The Council draft requires an independent valuation function (whether internal or external) if the AIFM receives fees or other payments which are directly or indirectly linked to the performance of the fund, but in all other cases permits the AIFM to take account of the nature, scale and complexity of the fund when putting in place procedures to ensure the independence of the valuation function
- If an external valuer is used the AIFM has to be able to demonstrate that the third party is qualified, was selected with due care and is monitored by it
- Member States can require an AIFM which carries out its own valuations to have them and/or its valuation procedures verified by an external valuer or, where appropriate, an auditor.

Differences between the drafts

- Depositary liability. The Parliament draft requires the depositary to be responsible for verifying the conditions under which valuation, calculation and publication is done and requires all valuations, whether by the AIFM or by an external valuer to be subject to oversight and monitoring by the depositary. There is no such provision in the Council draft
- Publicity. The Parliament draft requires AIFMs to publish regularly the methodologies used for the valuation of illiquid assets. The Council draft envisages that the net asset value should be published at least once a year, except for closed ended funds traded on regulated markets and funds where publication is excluded by the constitution of the fund. There is no further indication of what is meant by "publication". As other parts of the drafts require the information to be provided to investors in any event, these provisions are either unnecessary or suggest a wider publication
- The Council draft has more extensive provisions on valuation, in particular:
    - it makes express provision for an external valuer to be liable to the AIFM, the fund and investors for losses suffered as a result of a failure to perform the valuation
    - it requires an external valuer to be subject to mandatory professional registration/rules of professional conduct, to furnish sufficient professional guarantees and to have professional indemnity insurance. The Commission is to specify the exact criteria for the guarantees and insurance.

Delegation

There are many similarities in the texts on delegation, key points and differences are:

- there are restrictions on the ability of the AIFM to delegate one or more of its functions
- advance notification of any proposed delegation to the AIFM's competent authority. The Parliament text gives the competent authorities a month to reject any proposed delegation, whereas the Council text seems only to require prior notification
- delegation does not affect the liability of the AIFM
- the AIFM cannot delegate functions so that in essence it is no longer the manager, i.e. it becomes a "letterbox entity"
- delegation of portfolio or risk management to an entity (EU or third country) that is not supervised for asset management will not be possible (although if the Council text prevails it will be possible with the prior consent of the Home Member State authorities). The Parliament text seems to allow delegation of portfolio, risk or liquidity management only to another AIFM that is authorised to manage a fund of the same type. The Council text permits delegation of portfolio or risk management to a third country undertaking provided that there are arrangements for co-operation between the competent authorities of the AIFM and the supervisor of the third country undertaking

- the Parliament draft prohibits any third party from delegating functions that are delegated to it. The Council draft permits a third party to sub-delegate so long as it meets the conditions that would apply to the AIFM on delegation and notifies the AIFM of the sub-delegation
- the Parliament text retains extensive restrictions on delegating administrative, valuation and depositary functions to third country entities
- the Council draft prohibits delegation of portfolio or risk management to the depositary or a delegate of the depositary, or to any other entity which may have interests which may conflict with the AIFM or the investors unless those conflicts can be managed. The Parliament draft also prohibits delegation to the depositary, the valuator or any other undertaking which may have interests that conflict with those of the fund or investors.

Appointment of an independent depositary

Whilst there are important differences between the Council and the Parliament approach, the depositary concept looks set to be imposed and it alone will bring about the need for significant restructuring of many funds. The provisions are complex and lack clarity, it is not at all clear how the depositary concept links to the one of multiple prime brokers. However it ends up, the Directive represents a major challenge for those firms who provide custody services to funds.

When do the depositary requirements apply?

The Council and Parliament texts differ as to when the depositary requirements apply.

Council text

In the Council text, an AIFM must ensure that a depositary is appointed for each EU established fund it manages.

It seems, though the Council text is unclear on this point, that a depositary must also be appointed before an AIFM can market a non-EU fund to professional investors in the EU. However, the detailed Directive provisions on depositary liability, delegation and who can be a depositary do not apply in such cases.

Parliamentary text

The Parliamentary text requires an AIFM to ensure a depositary is appointed for EU and non-EU funds managed by it, except where the fund is a real estate or private equity fund or where the AIFM is "non-systemically relevant".

"Non-systemically relevant" AIFM are those managing unleveraged fund portfolios which in total do not exceed €250million (€100 million for any one fund) and whose investors have no redemption rights for five years from the constitution of the fund.

Who can be a depositary?

Similarities

The Council and the Parliament agree that an AIFM cannot be a depositary.

They also agree that a depositary may be an EU credit institution or MiFID investment firm, though the Council text requires depositaries that are MiFID investment firms to be subject to capital requirements.

Differences

The Council text allows the following additional categories of depositary:

- institutions subject to prudential regulation and supervision and which are eligible depositaries for UCITS funds under the UCITS IV directive
- for unleveraged funds whose investors have no redemption rights for five years from the date of their initial investment, an entity which carries out depositary functions as part of professional or business activities in respect of which it is subject to mandatory professional registration recognised by law or to legal or regulatory provisions or rules of professional conduct and which can furnish sufficient financial and professional guarantees.

It also makes the appointment of a depositary subject to competent authority approval.

The Parliamentary text permits as a depositary a legal person who is:

- authorised by the AIFM's home Member State competent authority
- subject to prudential regulation and supervision equivalent to that for EU credit institutions and

- able to provide sufficient financial and professional guarantees.

Location of depositary

Council text

The Council text only applies full depositary requirements in respect of EU funds. The depositary must therefore be established in the fund's home Member State (being the Member State where the fund is authorised or registered or, if it is not authorised or registered, where it has its registered and/or head office).

The fund's home Member State competent authorities will have discretion, for a period of up to four years from implementation of the Directive, to allow a depositary that is an EU credit institution to be established in another Member State. If the fund is unregulated, this discretion will lie with the competent authority in the Member State where the AIFM has its registered office.

Parliamentary text

The Parliamentary text applies the depositary requirements in respect of EU and non-EU funds managed by an EU AIFM. For EU funds, the depositary must have its registered office in the Member State where the fund is domiciled. The depositary of a non-EU fund must also have its registered office in the EU unless:

- co-operation and information exchange agreements (including in relation to tax matters) are in place between the AIFM's competent authority and those in the country where the fund is domiciled
- the Commission has deemed the country where the fund is domiciled to have prudential regulation and supervision and anti-money laundering standards equivalent to those in the EU
- the depositary is a bank or other entity equivalent to a credit institution or investment firm that is subject to prudential regulation and supervision equivalent to that for EU credit institutions and can provide sufficient financial and professional guarantees
- the depositary has agreed to:
    - accept liability to the AIFM and fund investors on the basis the Directive provides (see below) and
    - comply with the Directive requirements relating to delegation by depositaries.

Depositary functions and duties

Similarities

The Council and Parliamentary texts are closely aligned on the functions a depositary is appointed to fulfil. Both require the depositary to:

- ensure investor subscription payments are booked in segregated accounts
- safe-keep financial instruments belonging to the fund
- ensure financial instruments cannot be re-used without the AIFM's prior written consent
- verify whether the fund (or the AIFM on its behalf) holds an ownership interest in investments that are not financial instruments
- ensure transactions in fund units/shares are carried out in accordance with applicable national law and the fund rules
- ensure timely remittance of consideration for transactions in fund assets
- not carry out the AIFM's instructions, unless they conflict with applicable national law or the relevant fund rules
- ensure fund income is applied in accordance with applicable national law and the fund rules.

Differences

The Parliamentary text additionally requires depositaries to maintain records evidencing ownership of fund assets that are not financial instruments or investor subscription payments.

The texts also differ further, as follows:

- The Parliamentary text requires the depositary to receive investor subscription payments, whilst the Council simply requires the depositary to ensure these (as well as redemption proceeds) are correctly booked in segregated accounts

- The Parliamentary text requires the depositary to ensure the valuation of the fund's units/shares is carried out in accordance with applicable national law and the fund rules. In the Council text, the depositary must ensure the fund's assets are valued and NAV calculated in accordance with the valuation requirements in the Directive
- The Parliamentary text also expressly states that:
  - all valuations are subject to oversight and monitoring by the depositary; and
  - the depositary is responsible for verifying the conditions under which fund assets are valued and NAV is calculated and published.
- Whilst the Parliamentary text requires depositaries to act independently and in the interest of fund investors, the Council text additionally requires them to act honestly, fairly and professionally.

Limits on delegation

Similarities

Both the Parliamentary and Council texts allow depositaries to delegate, and require depositaries to exercise due skill, care and diligence in the selection, appointment and periodic review of their delegates.

Differences

The Council text permits delegation of the following tasks only:

- safe-keeping of financial instruments belonging to the fund
- verifying whether the fund (or the AIFM on its behalf) holds an ownership interest in all other fund investments.

A depositary may only delegate custody of "financial instruments that can be kept" if it can demonstrate an objective reason for the delegation and it ensures the sub-custodian fulfils a number of conditions relating to supervision, systems and controls, audit and the segregation and re-use of assets.

The Parliamentary text does not restrict the tasks that can be delegated, except that a depositary must not delegate its oversight of sub-custodians and may not delegate to such an extent that it becomes a "letter-box entity". However, there is provision for the Commission to impose restrictions in future by specifying the circumstances under which a depositary may delegate.

The recitals to the Parliamentary text indicate that, for third country funds, tasks can be delegated to a depositary in that third country provided that its legislation protects investors to a standard equivalent to that in the EU. It is not clear where, if anywhere, this point is addressed in the main text.

Liability of depositary

Council text

If "financial instruments that can be kept" are lost, the depositary is obliged to return identical financial instruments or the corresponding amount to the fund or its investors without undue delay. This applies even where the depositary has delegated custody to a sub-custodian unless it has contracted out of liability for instruments lost by sub-custodians. In order to rely on a contractual opt-out the depositary must prove that:

- it has met all of its obligations under the Directive in relation to the delegation
- it is reasonable for it to opt-out of liability. (The Commission is required to adopt measures specifying the circumstances in which it may be reasonable.)

The depositary is liable to the AIFM, the fund and the investors for "any other losses" suffered by them as a result of its failure to perform its obligations and this liability is not affected by any permitted delegation.

There is a limited 'force majeure' exemption from liability for losses (including loss of financial instruments) if those losses arise "in cases of unforeseeable circumstances beyond the control of the [depositary], the consequences of which would have been unavoidable despite all efforts to the contrary".

Parliamentary text

Except in cases of force majeure, the depositary is liable to the AIFM and fund investors for any losses they suffer as a result of its "intentional or negligent" failure to perform or improper performance of its obligations under the Directive.

The recitals to the Parliamentary text define 'force majeure' as applying in the case of an external event:

- that is unforeseeable
- that causes losses beyond the depositary's control
- whose consequences could not have been avoided in spite of proper adherence to the due diligence requirements in the Directive.

Similarly, if financial instruments are lost, the depositary is obliged to return them to the fund without undue delay (again, including where it has delegated custody to a sub-custodian) unless it can prove that the loss was caused by an external event, was not foreseeable and that it could not have avoided the loss.

Where a depositary has delegated to a sub-custodian, it can transfer liability to that sub-custodian (but not to the sub-custodian's delegates) if:

- it can prove that it has complied with the Directive's due diligence requirements
- it cannot itself carry out custody functions:
    - because it is legally prevented from doing so by the law of a country where the AIFM invests for the fund (e.g. because a local custodian is required) or
    - due to an unforeseeable external event and
- it has a written contract with the sub-custodian details of which must be disclosed to the AIFM before it is concluded and to fund investors before they invest.

Where a depositary has delegated to a sub-custodian or prime broker, it can transfer liability to that sub-custodian or prime broker if:

- its contract with the sub-custodian or prime broker allows the transfer and re-use of fund assets in accordance with the fund rules
- it can prove that it has complied with the Directive's due diligence requirements and
- details of the transfer of liability are disclosed to the AIFM before the contract is concluded and to fund investors before they invest.

Other matters

Financial instruments that can be kept

This concept is contained in the Council text, and is important as the Council makes specific provision concerning liability for loss of and delegation of safekeeping for such instruments. It is not clear what is intended by this phrase, indeed it is so uncertain that the Commission is required to adopt implementing measures specifying how to determine when a financial instrument "can be kept". The concept could be a reference to bearer securities. It certainly seems to relate to an instrument that can be held in custody, and seems less likely to refer to dematerialised or other securities where evidence of title is obtained through registration in the books of an issuer or central securities depositary.

Prime brokerage arrangements

The Parliamentary text explicitly addresses prime brokerage arrangements. It requires an AIFM who uses prime brokers to enter into a contract with the prime broker which deals with the possibility of fund assets being transferred or re-used (to the extent permitted by the fund rules). Details of the contract are to be provided to the depositary and, before they invest, to fund investors.

Alignment with UCITS IV

The Council has expressly acknowledged the differing investment strategies and investor bases of AIF and UCITS. The Council text does not therefore contemplate future alignment of the roles and responsibilities of AIF and UCITS depositaries.

By contrast, the Parliamentary text provides for the Commission to put forward a legislative proposal covering the responsibilities and liabilities of depositaries as well as passporting rights. This would replace the depositary provisions of the AIFMD and would also apply to UCITS depositaries.

Annual report

General requirements

The Council and the Parliament position is very similar and is described below.

- the AIFM must prepare an annual report in respect of each fund it manages no later than six months following the end of the financial year. (The Parliament text provides for a four months limit, except where information is required from third parties, when a six months limit is applied)
- the annual report has to be provided to:
  - investors (the Council draft provides for investors to receive it on request)
  - the competent authorities of the Home Member State of the fund and of the AIFM

The annual report has to include:

- the balance sheet or statement of assets and liabilities
- an income and expenditure account
- a report on activities
- the total remuneration for the financial year split into fixed and variable remuneration paid by the AIFM. Both drafts seem to require details of carried interest. The Council text, in addition, requires the aggregate amount of remuneration broken down by senior management and members of staff whose actions have a material impact on the risk profile of the fund. This remuneration disclosure, which is objectionable in principle, seems to require a fund manager who manages a number of funds to disclose its full remuneration structure to investors in all funds managed by it
- the accounting information must be audited by an EU auditor
- the Commission has the power to make further legislation specifying the content of the annual report. It is therefore entirely possible that the final report will be subject to many more detailed requirements.

Additional requirements where the fund has a controlling interest in a company

- As explained below, the Directive will impose a number of requirements on AIFM who manage funds which take a "controlling" interest in companies. The Parliament and the Council differ as to the point at which a controlling influence is reached, and the Parliament text extends to interests in listed as well as unlisted companies. These provisions are directed at private equity activity although are likely to have even wider implications
- AIFM must disclose certain information in the annual report about each company in which the fund has a controlling influence (which, at best, will be investees where the fund owns 50% of the voting shares). The additional information required is significant, and the Parliament draft in particular would result in the disclosure of a considerable amount of information that would otherwise be regarded as confidential to either or both of the fund and the investee company
- Both drafts would require the disclosure of:
  - operational and financial developments
  - a presentation of revenue and earnings, capital structure
  - a statement on any significant divestment of assets
  - the number of employees and material changes in such numbers.

The Council text also requires details of the main categories of products sold and services provided, indications of significant new products and services and the status of development of new products or services (but only to the extent that such development has been publicly disclosed).

The Parliament draft also requires the disclosure of:

- financial risks associated with the capital structure
- research and development efforts
- remuneration policy and conditions of employment
- environment policy
- management compensation packages
- the resale price and profit on any sale.

The Parliament text would require this additional information to be provided to employee representatives of the company concerned, to the AIFM's regulator and to the competent authority in the Member State where the investee is established.

There is therefore considerable difference between the drafts as to the level of detail required in an annual report in respect of an investee where the fund has control. However, given that the Commission has the power to specify further details that must be included in annual reports, it will be difficult to know how material these differences are, until we see the next level of legislation.

Disclosure to investors

Both drafts make provision for disclosure to investors, both prior to their investment and at regular intervals thereafter. Most of the information is probably not exceptional and there are many similarities between the Parliament and the Council text. Both texts would require the disclosure of:

- the investment strategy and objectives of the fund, the type of assets it can invest in and the techniques it may employ
- a description of all associated risks
- details of any arrangements for rehypothecation of assets
- details of custody arrangements
- applicable investment restrictions, the circumstances in which the fund may use leverage, the types and sources of leverage permitted, the maximum level of leverage and the associated risks
- a description of the main legal implications of the contractual relationship, including information on jurisdiction, applicable law and the existence (or not) of laws providing for the recognition and enforcement of judgments in the territory where the fund is established
- the valuation procedures, including the methods used in valuing hard to value assets
- the liquidity risk management arrangements
- all fees, charges and expenses and the maximum amounts thereof which may be borne directly or indirectly by investors
- description of any preferential treatment given to an investor and the description of that treatment (Parliament also requires the identity of the investor to be disclosed)
- the percentage of the assets which are subject to special arrangements because they are illiquid
- description of arrangements under which the depositary limits its liability
- periodic disclosure of the total amount of leverage employed.

The Parliament has imposed some additional disclosure requirements which include:

- information about the correlation of the applied investment approach vis à vis traditional investment strategies (such as stocks or bonds)
- the maximum level of leverage
- a detailed description of the source, maturity and amount of funds raised, including the share directly or indirectly contributed by the AIFM and its representatives, directors and employees.

Reporting to regulators

Both the Council and Parliament texts require reports to be made by the AIFM to the regulator in its Home Member State. They are broadly similar and it appears as if AIFM will be obliged to report:

- the principal markets and instruments on and in which it trades
- the principal exposures and most important concentrations of each of the funds it manages
- a list of its funds
- a copy of the annual report on each fund
- the percentage of assets in each fund which are subject to special arrangements because they are illiquid (e.g. side pocket arrangements)

- the risk profile of the fund and the risk management tools employed to manage market risk, liquidity risk, counterparty risk and other risks including operational risks
- the results of the stress tests required by the Directive in respect of position risk and liquidity risk management
- the use of short selling during the reporting period
- the overall level of leverage employed by each fund it manages, with a breakdown between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives and the extent to which each fund's assets have been re-used under leveraging arrangements. The information must include the identity of the five largest sources of borrowed cash or securities for each of the funds managed by the AIFM, and the amount of leverage received from each of those entities for each of the funds managed. (In the Council text this only applies to AIFM who "employ leverage on a systematic basis".)

The Parliament draft requires certain additional information, being:

- the structure of fees and the amounts paid to AIFM
- performance data for the fund, including asset valuations.

The Parliament draft also envisages that ESMA may impose additional reporting requirements in exceptional circumstances.

Leverage

General

Leverage is a matter of intense interest on the international stage and it is therefore inevitable that there will be some provisions on leverage in the Directive. The Parliament text contains more extensive and intrusive provisions and in particular includes a worrying development from a private equity perspective. It is unusual for a private equity fund itself to be leveraged, although it will make investments in companies which are leveraged.

There is no clarity on the exact scope of the "leverage" concept but a critical difference is that the Parliament text treats private equity funds as employing leverage when an investee company is leveraged. The result will be that all of the provisions in the Directive which refer to leverage would apply to private equity funds, including, most importantly, those summarised below.

The Parliament draft defines leverage as:

> "Any method by which the AIFM increases the exposure of a fund it manages to particular investments whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means, including leverage used by funds or other legal entities controlled by the AIF, alone or jointly with other AIF and which increases the financial debt supported by the AIF."

The Council definition is simpler and provides that leverage means:

> "Any method by which the AIFM increases the exposure of a fund it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means."

As a general comment, much of the language used lacks precision, however, the Commission is likely to have delegated powers to set further criteria for implementing those provisions.

Council position

The Council draft requires each Member State regulator to use the leverage information provided to it by the AIFM (see above under "Reporting to regulators") to assess the risks that the use of leverage by an AIFM could entail and, if it considers it necessary in order to ensure stability and integrity of the financial system, the Home State regulator may impose limits on the level of leverage that the AIFM may employ or impose other restrictions on the management of the fund.

Parliament position

The Parliament text takes a different approach and requires Member States to ensure that AIFM set leverage limits in respect of each fund that they manage. The Parliament specifies the matters which must be taken into account by the AIFM when setting leverage limits. These include:

- the need to limit the exposure to any one counterparty
- the extent to which the leverage is collateralised
- the scale of any asset/liability mismatch.

The Parliament text requires regulators to ensure that the leverage limits set by an AIFM are reasonable, taking into account:

- the extent to which limits do not increase systemic risk
- the exposure of counterparties
- the likely impact on markets on which the AIFM concerned operates
- the limits observed in other jurisdictions for similar types of fund.

It requires a Member State to take into account, when assessing leverage limits for a private equity fund, the ratio of financial debt used for an acquisition to earnings before interest, taxes, depreciation and amortisation. The implication is that these leverage limits must at least be applied to any acquisition of a controlling interest.

The Home State regulator must provide ESMA with the leverage information that is provided to it - under the requirements on AIFMs to make disclosures to regulators. ESMA has the power to determine that the leverage employed by an AIFM, or by a group of AIFM, poses a substantial risk to the stability and integrity of the financial system. If ESMA makes such a determination then it can specify remedial measures, which may include imposing limits on the level of leverage which that AIFM can employ.

Requirements on managers who acquire control of companies

Both texts impose disclosure and other obligations on fund managers who manage funds which acquire a controlling influence in companies domiciled in the EU. The provisions apply:

- when a single AIFM manages funds which either individually or in aggregate acquire "control"
- when two or more AIFMs agree with each other so that the funds managed by them together acquire "control".

These will have a particular impact on private equity funds and their investee companies. There are similarities between the texts but also some important points of difference.

Scope

Once an AIFM's holdings in a company bring it within the scope of the provisions, it will have a number of disclosure obligations relating to the investment. There are differences in the texts on the issue of scope, described below:

- the Council test for control requires the acquisition of more than 50% of the voting rights of an unlisted company. The Council text does not apply to holdings in EU listed companies, with the exception of one leverage disclosure obligation (see below). The Parliament text applies to unlisted companies and EU companies whose shares are traded on an EU regulated market and appears to apply when 10%, 20%, 30% or 50% of the voting rights are acquired
- the Council text exempts investees which are small and medium-size enterprises. (These meet two of the following tests: they employ fewer than 250 people in the Community, have an annual net turnover not exceeding €50 million, have a balance sheet total not exceeding €43 million.) The Parliament text only excludes companies where the total group employs less than 50 people
- the Council text exempts special purpose unlisted companies established to buy, hold or administer real estate. There is no such exclusion in the Parliament text.

Once control is reached, what information is required?

Once the AIFM reaches a position to exercise control (whether acting alone or in concert with other AIFM), it is required to provide certain information.

Initial disclosure

Both drafts require the AIFM to notify the company and the other shareholders of:

- the voting rights situation
- the conditions under which the control has been reached, the identity of the different shareholders involved and persons entitled to exercise voting rights on their behalf
- the chain of undertakings through which voting rights are effectively held.

The Parliament draft also requires this notification to be given, each time a threshold (10%, 20%, 30% or 50%) is passed, to:

- employee representatives or, where there are no such representatives, the employees themselves

- the competent authority of the fund manager and the competent authority of the Member State where the investee is established.

Additional information

In addition, both drafts require the following to be provided to the investee, other shareholders and employee representatives (or employees where there are no representatives):

- the identity of the fund manager(s) which have reached control
- the policy for preventing and managing conflicts of interest, in particular between the fund manager and the company. We have previously noted that this is a worrying provision, because it would not normally be considered that an investor owes duties to an investee of the kind that could produce legal conflicts of interest
- the policy for external and internal communication of the company, in particular as regards employees.

The Parliament draft imposes more extensive disclosure obligations, including details of:

- planned significant divestments of assets
- the persons who are authorised to conclude legally binding agreements relating to business strategy and employment policy

and also requires all disclosures also to be made to the AIFM's regulator and the competent authority of the Member State where the investee is established.

The Parliament draft additionally requires the target company to inform employee representatives (or employees where there are no representatives) comprehensively and in due time, of all the documentation referred to in the Takeover Directive. The only exception is to the extent that such disclosure would jeopardise the conduct of business. The Takeover Directive requires the board of the target company to draw up a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the target company and their likely repercussions on employment and the locations of the company's places of business.

Leverage disclosure

The Council text requires an AIFM which acquires control (50% of voting rights) of an unlisted or a listed EU company to provide both its Home State regulator and fund investors with information on the debt supported directly or indirectly by the investee company:

- directly before control is reached
- immediately after control is reached
- whenever material changes occur thereafter (with no time limit on this requirement).

Public to private transactions

The Parliament text alone requires a company that has been taken private to continue to comply with the obligations applicable to a listed company under the "Transparency Directive" for one year from the date it is withdrawn from the regulated market.

"Asset stripping"

The Parliament text also contains a provision which is directed at so-called "asset stripping". The intention appears to be to require investee companies to meet certain net asset criteria, being those set out in the capital adequacy regimes in the Second Company Law Directive. This would subject private companies to a public company regime and will, if adopted, place investees, whose shareholders are funds, in a detrimental position compared to companies whose owners are not funds. The exact scope of the requirement is unclear and it is critical that it is clarified. Whilst it is objectionable in principle, it will be important that if the concept survives the trialogue process it is clarified, so that it applies to investee companies those provisions which the European Parliament stated in its justification for imposing the requirement. These were the provisions which provide that:

- except for reductions of capital, no distributions may be made by a company where net assets are or would become lower than (i) the amount of the subscribed capital plus (ii) undistributable reserves
- a company may not acquire its own shares if this has the effect of reducing its net assets below the limits referred to above
- shares which have been repurchased and not sold within three years must be cancelled and capital reduced accordingly.

Third country issues

The most significant differences between the Council text and the Parliament text relate to issues concerning third country managers, and the marketing of third country funds (whether by an EU AIFM or a third country manager). The debate on third country issues has provoked significant international activity, with letters being written to the European authorities, in particular from U.S. Treasury Secretary, Tim Geithner.

In broad outline the differences between the approaches are as follows:

Council text and third country issues

Managing a third country fund

The Council text provides that an EU established manager cannot be the AIFM of a third country fund even if that fund is not marketed in Europe unless:

- the AIFM complies with the Directive except for the requirements in relation to annual reports and depositaries
- there are cooperation arrangements in place between the AIFM's regulator and the supervisor of the third country where the fund is established.

This seems to be a huge own goal, for which there is no policy justification as it reduces the attractiveness of Europe as a whole as a global asset management centre. It does not apply to a European discretionary asset manager who is a delegated manager of a third country AIFM.

Marketing third country funds by an EU AIFM

These provisions could affect, for example, the UK manager of a Guernsey fund.

Key points on the Council text are:

- there is no marketing passport for a third country fund, whether managed by an EU AIFM or a third country manager
- if an EU AIFM wishes to market to professional investors a third country fund that it manages:
    - the AIFM must comply with all the requirements in the Directive with the exception of the depositary requirement
    - it must ensure that there is a depositary entrusted with the functions that a depositary must carry out under the Directive (it cannot be the depositary)
    - there must be cooperation arrangements in place between the competent authorities of the AIFM and the supervisory authority in the third country where the fund is established.

Marketing third country funds by a third country AIFM

A Member State will only be able to permit a third country manager to market its fund in the Member State to professional investors if:

- the third country fund manager complies with the Directive requirements in relation to the annual report, disclosures to investors and the provisions which apply when a controlling influence over an EU company is acquired. The annual report and investor disclosures apply in respect of investors in the Member State
- there are co-operation arrangements between the competent authorities of the Member State where the fund is marketed and the competent authorities of the third country fund manager.

There is therefore no provision for marketing under a passport system or for there to be a "lead" regulator. The impact will be to require third country fund managers to interact with a range of regulators across Europe. In addition, if the fund manager itself has no regulator, then it would appear that it will be unable to market its fund.

The approach is deeply objectionable. In particular it infringes the principle of subsidiarity because it dictates to a Member State the kind of activity that may be permitted by that Member State on its own territory when that activity has no cross-border impact. It removes from Member States the power to determine the scope of their own domestic private placing regime.

Parliament text and third country issues

The Parliament text in relation to third countries is both more onerous in the requirements which it imposes but more permissive in that, if those requirements are met, it envisages the possibility of a passport for the marketing of third country funds. However, the requirements are so restrictive that there must be a significant doubt as to whether they are practicable and therefore desirable.

Basic conditions for marketing

The Parliament text imposes the same basic conditions on the promotion of a third country fund, whether it is managed by an EU fund manager, or by a third country fund manager. Thus a third country fund may only be marketed to professional investors in a Member State if all the following conditions are satisfied:

- there is a co-operation agreement between the competent authorities of the Member State where the (prospective) investors are domiciled and the supervisor of the fund
- the Commission has decided that the third country has standards which meet EU standards on the prevention of money laundering and terrorist financing
- the third country has an agreement with each Member State in which the fund is to be marketed, which complies with the standards in the OECD Model Tax Convention to ensure an effective exchange of information in tax matters (and also where there is an EU AIFM such an agreement exists between its Home Member State and the third country)
- the Commission has decided that the third country grants Community AIFM effective market access comparable to that granted by the Community to fund managers from that third country.

The approach requires a Member State by Member State analysis.

Additional conditions for third country fund managers

A third country fund manager can only market a third country fund to professional investors if the third country in which the AIFM is domiciled meets the basic conditions (see above) and the following requirements are satisfied:

- the AIFM enters into an agreement with ESMA to comply with the Directive (subject to necessary changes to take account of domicile in a third country)
- ESMA has an agreement with the competent authority in the third country which:
    - delegates ESMA's powers under the Directive to the competent authority of the third country
    - the competent authority of the third country agrees to exercise those powers of ESMA in relation to the fund manager
    - the fund manager agrees to submit to the jurisdiction of European courts in relation to any matter arising under the Directive.

If the third country fund manager wishes to market a fund that is domiciled in another third country then the basic conditions must be satisfied in relation to that third country as well. Thus, if a United States fund manager with a Cayman fund wished to market that fund in Europe, all of the basic conditions must be met by both the United States and the Cayman Islands.

If all of these conditions are met then the third country fund manager has a version of a "passport", in that if ESMA has entered into the agreements described above, the third country fund manager can market its fund in any Member State where the "basic conditions" are satisfied.

Third country managers providing management services in the EU

The Parliament text envisages that a third country fund manager can provide management services (for example, by establishing a branch) in a Member State if:

(a) the basic conditions are satisfied in relation to the third country in which the AIFM is domiciled

(b) the AIFM agrees with ESMA to comply with the Directive (subject to necessary changes to take account of third country domicile)

(c) there is an agreement between ESMA and the competent authority of the third country which meets the conditions referred to above.

Delegation

The Parliament text retains the very restrictive provisions on the ability of EU fund managers to delegate administrative services, valuation or depositary tasks to entities established in third countries.

Restrictions on EU professional investors

The Parliament text provides that professional investors who are domiciled in Member States can only invest in third country funds if all of the basic conditions are met. They are expressly prohibited from investing in any other third country fund.

Such a provision, if implemented in the final text, would have a devastating impact on major institutions across the Community. There is no transitional or grandfathering provision, so the inference is that they would have to examine their existing portfolios and dispose of any fund investments which did not meet the criteria. It would seem likely that there will be a vast number of such investments and that such disposals would themselves be disruptive and damaging both to the investor and potentially to the wider financial markets. Looking ahead, such a provision will place a significant restraint on the ability of EU professional investors to invest their funds in the best available location. It will starve European professional investors of legitimate investment opportunities, and is only likely to encourage the major institutions to establish off-shore locations from which they invest.

If you would like further information or advice on these matters, please contact Margaret Chamberlain, Jane Tuckley or Tim Lewis in the Financial Services and Markets Department or your usual contact at Travers Smith.

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