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Financial Services and Markets

Fundamental change for the fund industry - the AIFMD saga continues

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The legislative process on the Alternative Investment Fund Managers Directive (as with any instrument of this kind) is deeply political and is now potentially fast moving. The picture could change often and very quickly in the first half of this year. It is more than unfortunate that a piece of legislation with such significant implications for the future of Europe as a global fund centre should become such a political football. In the first part of this note we outline the legislative process and where we currently are in that process. In the second part of this note we describe the latest draft European Council compromise published by the Swedish Presidency, highlighting the key elements which have changed from the original proposal and certain material differences between the compromise text and the position currently being taken by the European Parliament.

Part I: Where we are and how we got here

Legislative process

Procedure

In April 2009 the European Commission published its proposal for a directive on Alternative Investment Fund Managers (http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf). To become law, the Directive has to be adopted by both the European Parliament and the European Council. This means that the original Commission proposal is considered, amended and voted upon at a political level between Member State governments in the European Council whilst at the same time it is subject to consideration, amendment and voting by the European Parliament. Therefore, different versions of the draft Directive will be circulating at the same time. As the discussions proceed the Council, the Commission and the European Parliament liaise to see to what extent there can be common agreement on the draft as a whole. If any differences can be reconciled, the Directive will be in an agreed form and ready to become EU law. If there are substantive differences between the requirements of the European Parliament and the position reached in Council then the Directive has to move to a second reading in Parliament and further reconciliation meetings between the Council and the Parliament will be necessary in order to create a joint agreed text. The timing of adoption depends on how quickly differences between them can be resolved.

'Progress' in Council

Until the end of 2009 the Directive proceeded within the European Council under the Swedish Presidency. The initial optimism expressed by the Swedish Presidency, that there could be political agreement on a near final draft of the Directive by the year end, has proved unfounded. Whilst at various points over the last few months there has appeared to be progress on a number of fronts, there was ultimately little political agreement on significant elements and the Directive will now be taken forward by the Spanish Presidency and may well still be open when the Belgian Presidency starts in July 2010.

The Swedish Presidency produced a handover note (http://register.consilium.europa.eu/pdf/en/09/st17/st17329.en09.pdf) and also published the latest compromise proposal (http://register.consilium.europa.eu/pdf/en/09/st17/st17330.en09.pdf).

Despite the statements in the Presidency "progress report" that there are four key outstanding issues being:

- Depositary provisions
- Valuation provisions
- Remuneration provisions
- Third country issues

there are a number of other important open issues. It remains to be seen whether the Swedish Presidency's view that these "can be resolved by further technical drafting" is again unduly optimistic.

There is an unfortunate tendency on the part of the European authorities and Member States to label major substantive issues as "technical", such as matters relating to the scope of the Directive.

European Parliament

Jean-Paul Gauzès was appointed as the Rapporteur in the European Parliament and he issued his draft report at the end of November 2009 (" the Gauzès Report") (http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-430.709+01+DOC+PDF+V0//EN&language=EN). Amendments can be tabled in Parliament up to the 21 January 2010 and will be debated in February and March. There is due to be an ECON Committee vote on 12 April 2010 and a European Parliament plenary vote is scheduled for July 2010. By that time there will have been negotiations between the Council, the European Parliament and the Commission during which it will have become clearer whether or not a common approach to the Directive appears likely at that stage.

To some extent the final draft produced by the Swedish Presidency reflected amendments tabled by Gauzès. Where there are important differences between Gauzès Report position and the compromise text we have noted these at the end of each relevant section of this note. However, it must be borne in mind that the Gauzès Report is a preliminary report and there is considerable scope for many more amendments to be tabled to the draft.

Timing

The Commission's intention that the Directive should be finalised by the end of 2009 was never likely to be met. The earliest date on which this could now occur is July 2010. Member States must implement the Directive within 24 months of it being made.

There is little by way of transitional provision. Fund managers operating in the Community before the Member State implementation date must apply for authorisation under the Directive within one year of that date. There may be an exemption for closed-ended funds which make investments for only a limited period after the Directive comes into force.

Impact Studies

Over the last few months a number of studies have been published on the impact of the proposal. These include:

- The Charles River Associates Report commissioned by the Financial Services Authority to assess the impact of the Directive on investors, financial markets and enterprise across the EU (http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf). The resulting report is detailed and covers a wide range of funds. . The overall conclusion is that the Directive will have significant impact in terms of reduced investor choice and substantial compliance costs for the fund industry (which will be passed on to investors, ultimately resulting in lower returns). They state that "the universal application of one set of rules on such different types of fund results in compliance costs which are significant. The Directive will cause a fundamental reorganisation in the business model of global fund managers (with significant one-off costs) and may lead to costly changes of legal structures and domiciles. It also brings costs associated to valuators and depositories which do not seem to be matched with benefits for at least some of the fund types considered."
- Impact Assessment Studies commissioned by the European Parliament (http://www.eer.co.uk/download/2009shortAIFMdirective.pdf). The European Parliament commissioned Europe Economics to conduct a quantitative assessment of the costs and benefits.. One of the key conclusions is that the Directive would create a more level EU playing field, but at the expense of material falls in competition and innovation in the AIFM sector, driven particularly by deglobalisation, leading to materially higher costs for investors, reduced efficiency in financial markets, less investment to innovative businesses, and less efficient restructuring of businesses in financial distress. They also conclude that it is likely that some fund managers would exit the EU market as a result of limitations on the use of leverage and the additional cost of compliance. They accept there is a case for regulating the fund rather than the fund manager (a route favoured by some MEPs) but consider that the arguments in favour of regulating the fund manager far outweigh the considerations which would favour regulating the fund.
- The opinion of the European Central Bank (http://www.ecb.int/ecb/legal/pdf/en_con_2009_81_f_sign.pdf). This makes a number of interesting comments, including:
    - it recognises that there are risks of regulatory arbitrage and evasion given the highly international nature of the industry, unless the Commission has a successful dialogue with international partners, in particular the United States;
    - it suggests that the Directive could be tailored in a way that better reflects the fundamental differences between different types of fund;
    - it expresses level playing field concerns in two areas. The first concerns the risk of regulatory arbitrage between AIFMs, insurance companies and credit institutions. The second concerns the fact that many of the provisions, including those related to short-selling, securitisation and the acquisition of a controlling influence in companies, cover issues that concern all market participants. The ECB suggests that these provisions should only be introduced by means of legislation that is applicable across all sectors and not just the AIFM sector;
    - as might be expected, the ECB welcomes the increased emphasis on the provision of information to supervisory authorities. It also suggests that there should be more standardisation of information provision across the EU.

Comment

While the intervening months have seen some improvements in the draft (both within Council and as proposed by Gauzès) there have also been new developments which are unwelcome, such as detailed provisions on remuneration policies. All of the provisions which provided a special marketing regime for third country funds have been removed. There remains significant concern that the final form of the Directive will represent the result of political "horse trading" of issues (including of issues not related to alternative investment funds at all) and as a result will do a grave disservice to the fund industry and to the future of Europe as a global financial services centre. The simple fact is that many of those who will have a real influence on the final shape of the legislation have no idea of the range of funds affected or of the implications of what they propose. The fund industry has begun a massive education process, but whether it will be sufficient remains to be seen.

The Directive, whilst it contains some detailed provisions, is in many senses only a framework piece of legislation. The Level 2 legislation will comprise further detailed technical rules. The example of MiFID demonstrates that there can be considerable substantive provisions introduced at Level 2, which are not foreshadowed in the framework Directive, but which merely build on "principles" enshrined in it. This however is a battle for the future, the development of the Level 2 legislation is unlikely to commence until there is greater certainty as to the shape of the final Directive.

Part II: The Swedish compromise text and the Gauzès report

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1. Scope

The original draft Directive was produced in haste, without proper prior consultation and there was considerable uncertainty as to the entities which would fall within its scope. Since publication of the draft there have been discussions between Member States and with the Commission with a view to clarifying the scope issue. In this note we set out our current understanding of the position from the latest draft, although we are still "seeing through a glass darkly".

Alternative investment funds ("AIF")

The scope of the Directive is, if anything, wider than the previous draft even though some very specific exemptions have been introduced.

An AIF may be open or closed ended, listed or unlisted, be constituted as a company, a trust, under a contract, a statute, or in any other legal form.

An AIF is now defined as:

"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".

Key changes:

- A recital in the original draft included the condition that an AIF's investment policy should be "on the principle of risk spreading". There seems to have been a conscious decision to remove this concept completely. As a result, unless an exemption applies, vehicles established to hold a single asset will be in scope, including closed ended companies. This is certainly not an improvement in terms of certainty as to the scope.
- New exemptions have been included for employee participation schemes, funds whose only investors are group companies (which are not themselves funds) and for holding companies in respect of their shareholdings in subsidiaries. The very thought that such an exemption is necessary illustrates the intended breadth of the AIF concept.
- There is a new exemption for securitisation special purpose entities, but these are very narrowly defined.
- The previous exemption for "actively managed investments in the form of securities, certificates, managed futures or index linked bonds" has been deleted. Thus various forms of structured product may well fall within the AIF definition.

The core concept of a "collective investment undertaking" remains undefined.

The definition therefore includes co-investment and carried interest schemes, investment trusts, VCTs and all non-UCITS investment funds (no matter where established). It may also cover a number of vehicles and arrangements which have not until now been treated as "collective investment schemes" in the United Kingdom.

The exemptions for the management of pension funds and for managers of non-pooled investments "such as endowments and sovereign wealth funds" remain.

Alternative investment fund managers ("AIFM")

There have been some significant changes to the draft in relation to identifying the entity which is to be regarded as the alternative investment fund manager.

Key Changes:

- It has been made clear that each AIF can have only one AIFM.
- The previous draft defined the AIFM in the context of management, marketing and administration of a fund and appeared to exclude firms who only managed the assets of a fund (such as MiFID investment managers). This has now changed and the AIFM is the person appointed by or on behalf of the fund to be responsible for managing the portfolio of the AIF. In this context "managing the portfolio" means the provision of portfolio management and risk management services. An 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 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 new recital states that an AIFM which has been appointed to provide management functions to 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.
- The AIFM is responsible for ensuring compliance with the Directive, even if certain requirements are outside its power to control. This provision 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.

- The exemption for EU banks and insurance companies has been removed so they will be subject to the Directive's provisions if they provide management services to AIF.

Thus we consider that the impact of the latest draft 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, unless one of the limited exemptions applies. This is regardless of where the fund is established but there are restrictions on the third country funds that can be managed (see the end of this section).

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.

The exemptions for managers of smaller funds remain as in the original draft, being for:

(a) managers where the fund portfolios under management do not in total exceed €500million, provided that those funds are not leveraged and that investors have no redemption rights for five years from initial investment in each fund; and

(b) managers where the fund portfolios under management do not in total exceed €100million (including assets acquired through the use of leverage).

The Commission is granted powers to clarify in Level 2 legislation what is meant by "leverage" and how to treat managers whose fund assets fluctuate above and below the exemption levels. It is still not clear whether portfolio size is to be calculated on a gross or net basis and on a committed capital or NAV basis.

Managers of smaller funds will be permitted to "opt in" so that they can have the passport, but they must then comply with the requirements of the Directive.

However there is considerable uncertainty (see "Gauzès Report" below) as to whether the exemptions for managers of smaller funds will survive. In any event the Directive states that AIFM which are exempt should be subject to registration in their Home Member State, which seems to require all Member States to introduce some form of licensing regime for all fund managers. This is not new in the U.K., but is for some other Member States.

Management of third country funds

An EU established manager is only permitted to manage an AIF established in a third country (i.e. a country outside the EU) if:

(a) the relevant law in that third country is in line with standards set by international organisations (e.g. IOSCO) or the AIFM can demonstrate that the fund complies with such standards; and

(b) there are cooperation arrangements in place between the regulator in the AIFM's Member State and the supervisory authority in the third country where the fund is established.

This is so even if the fund is not marketed in Europe, which removes an exemption in the original draft and seems an unnecessary own goal for Europe as a financial centre. In managing the fund he will still have to comply with the Directive, except for the provisions relating to depositaries if the fund is not marketed in the EU the Annual Report provision is also disapplied.

British Crown dependencies such as Jersey, Guernsey and the Isle of Man are outside the EU.

Non EU managers

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

Self managed funds

The revised text clarifies that a "self-managed" fund will nevertheless fall within the scope of the Directive. The Directive draws a distinction between:

(a) an external manager – which is a legal person appointed by or on behalf of a fund to be responsible for managing the portfolio; 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, carry on activities related to the underlying assets of the fund and issue and redeem units/shares.

Gauzès Report

- Would remove the exemption for managers of smaller funds on the basis that the provisions of the Directive should maintain a level playing field and apply a 'proportionality principle' to manage differences between funds of different size.

Restrictions on AIFM activities

The compromise text introduces an entirely new provision, based on a similar concept in the UCITS Directive, which places significant limitations on the activities that can be carried on by an AIFM. There is a real risk that the final text will restrict the activities that can be carried on by an AIFM and this may force firms to restructure. It certainly seems clear that no fund manager will be allowed to carry on a proprietary dealing activity.

As is often the case with the development of the Directive, this provision was inserted by one or two Member States during the debates in Council, and very rapidly the question has become not whether such a provision is desirable, but what it should say. Whilst there may be political and regulatory reasons for imposing limits on the activities of a manager of a fund principally destined for the retail market, there is not necessarily any similar justification across the entire range of alternative investment funds. The objective is to limit the possibility of conflicts of interest arising from a fund manager carrying out other activities.

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 (this should allow private equity fund managers to carry on their activities with their investee companies as they do now, although the drafting is not perfect);
- the issue and redemption of units in 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. If they do they may also permit it to provide investment advice, and custody "in relation to units of collective investment undertakings," if these activities are ancillary to the discretionary management. In such a case the AIFM will be subject to certain MiFID provisions, though not actually authorised under MiFID. An AIFM will not be able to carry on any other activities/services as a MiFID investment firm such as the receipt and transmission of orders, investment advice, execution of orders or underwriting and placing activities (apart from marketing its funds).

The present draft is highly restrictive, may well lead to fund managers having to undertake significant reorganisation of their activities and also reveals a lack of agreement between Member States as to the interpretation of current MiFID activities. For example, it has generally been considered that the manager of a discretionary portfolio may well carry on the activity of execution of orders in the course of his management activity. It is therefore inexplicable as to why this is not listed as an activity that he may provide in connection with such management.

2. Marketing the alternative investment fund

Definition of marketing

The revised definition of marketing refers to offerings and placements "at the initiative of or on behalf of the AIFM". The Commission is to make rules clarifying what this means. It appears therefore that it is intended that, subject to national private placement rules, an investor may be able at its own initiative to invest in any funds, whether based in the EEA or a third country (i.e. there is an exclusion for so-called "passive marketing"). Whilst the change in the definition is welcome, it cannot be assumed that the current draft will remain.

EU established funds

A fund is "established" in the EU if it is either authorised or registered under applicable national law in a Member State, or, if not so authorised or registered it has its registered and/or head office in a Member State. Thus, for example, a limited partnership registered under the Scottish or English Limited Partnerships Act will be established in the EU.

An EU established fund that is managed by an AIFM authorised under the Directive can be marketed in EU Member States to professional investors by the AIFM.

An EU established fund that is not managed by an AIFM authorised under the Directive (e.g. an English limited partnership with a Guernsey manager) cannot be marketed in EU Member States except, it appears, to the extent permitted by the national laws of the relevant Member State (i.e. national private placement regimes).

Non-EU funds

Those parts of the original Directive which made provision (albeit onerous) for marketing non-EU funds have all been deleted. It looks as if there will be no passport for marketing such funds, whether they are managed by an EU or a non –EU manager.

Member States may allow an authorised AIFM which manages a non-EU fund to market that fund to local professional investors under their national private placement regime. It appears that this will also be the case for non-EU funds managed by non-EU managers. Such funds will therefore be in the same position as all non-UCITS funds today, that is, they can be marketed in a Member State to the extent that the laws of the Member State so permit, but there is no European regime or passport. However this remains a deeply political debate and there can be no certainty yet as to the outcome.

Feeder funds

There are special rules for marketing feeder funds. There is no right under the Directive, even for an authorised AIFM, to market a feeder fund managed by it unless it invests in a master fund which is established in a Member State and managed by an AIFM authorised under the Directive. Member States may allow an AIFM which manages a feeder fund which invests in non EU Master funds to market that fund to local professional investors but there is no passport.

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 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.

The Directive has been changed to make it clear that 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. This is a welcome clarification.

Home State and Cross-border Marketing

Before an AIFM can market an EU fund it manages to professional investors in its own EU State it must first provide its regulator with certain information about each fund that it intends to market. The original provision which allowed the regulator to impose restrictions or conditions on the marketing has been deleted. The manager's regulator must inform the manager within ten working days 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 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. 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.

Any material change to the particulars that have been provided must be described 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.

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

The original draft appeared to place restrictions on the ability of EU based advisers and others to provide investment services to third country funds. These were potentially severe and damaging to European financial markets and fortunately do not appear in the revised draft.

Gauzès Report

This is more restrictive in relation to marketing:

- It permits marketing of third country funds under national private placement regimes but either the fund manager must be domiciled in the Community or there must be cooperation and information exchange agreements in place with/between the various regulators;
- Professional investors can invest in third country AIF only if the fund is managed by an AIFM authorised under the Directive or the third country where the fund has its registered office has signed an information sharing cooperation agreement (the drafting is unclear as to who the agreement is with);
- Would not allow Member States to permit marketing to retail investors of a fund which invests more than 30% in other funds which do not benefit from the European passport.

3. Authorisation and Capital Requirements

Authorisation Procedure

The provisions relating to the grant of authorisation have been amended, broadly to 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. The draft appears to indicate that even if authorisation is granted the activities may not commence earlier than one month after submission of the required information including the final fund documents.

Capital requirements

There have been some changes to the proposed capital requirements.

- An external fund manager will have to maintain initial capital of EUR 125000 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 alternative investment fund portfolios under management exceeds €250 million, subject to a cap of EUR 10 million. (The cap is new, but similar to that applying to UCITS managers).

  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.

- If a manager of smaller funds opts in to the Directive, it will be required to have only an initial capital of EUR 50000, 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.
- There is no capital requirement for an externally managed fund but an internally managed fund must have an initial capital of at least EUR 300000.

As with the current FSA regulatory capital rules applicable to investment managers, the requirement is not to hold money in a bank account, but rather that capital should be retained in the fund manager. Capital essentially means "shareholder funds" (after deducting any losses and intangible assets such as goodwill). LLPs may treat capital contributions as own funds if the LLP agreement imposes significant restrictions on withdrawal and repayment of capital.

Gauzès Report

- 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 funds raised from initial capital and own funds as working capital. Until now this type of requirement has been limited to banks and insurers; neither UCITS firms nor investment firms subject to MiFID have this kind of requirement.
- Requires professional indemnity insurance against professional negligence. It is not clear if this is a stand alone requirement or an optional substitute for capital but it appears to be an additional requirement.

4. Conduct of business requirements: general principles

The revised draft expands the general principles 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 require the manager to:

(a) act honestly in the best interests of the fund, or the investors in the fund and the integrity of the market;

(b) act with due skill, care and diligence;

(c) have and employ effectively the resources and procedures necessary for the proper performance of its business activities;

(d) try to avoid conflicts of interests and, when they cannot be avoided, ensure that the funds it manages are fairly treated;

(e) comply with all regulatory requirements applicable so as to promote the best interests of the fund or the investors of the fund and the integrity of the market; and

(f) treat all investors fairly.

5. Conflicts of Interest

Only minor changes have been made, mainly to the range of conflicts that must be identified.

The AIFM must take all reasonable steps to identify conflicts of interest:

(a) between it (including its employees and controllers) and the fund or fund investors;

(b) between one fund and another; and

(c) between the fund or fund investors and another client of the AIFM (e.g. a discretionary management client).

The AIFM must 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.

6. Risk management

This has been improved by the insertion of a proportionality concept, although this is balanced by an obligation on the Commission to adopt measures which specify how this principle applies.

The AIFM is required to:

(a) separate tasks and responsibilities for risk management and for portfolio management so far as is appropriate and proportionate in view of the nature, scale and complexity of the business;

(b) 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 each investment; and

(c) follow a documented and regularly updated due diligence process for investment.

7. Short selling

The provisions in the original draft which effectively prohibited naked short sales have been removed. Whilst AIFM may be asked to provide information on short selling, more drastic measures are not proposed.

Gauzès Report

- Would retain the original provisions and imposes an obligation to disclose information about short selling to regulators with the possibility that ESMA (the new European Securities Markets Authority) could in exceptional circumstances restrict short selling activities.

8. Liquidity management

These provisions have been changed so they do not apply to unleveraged closed-ended funds. When they do apply the manager must:

(a) adopt appropriate liquidity management procedures to ensure that the liquidity profile of investments complies with the fund's "underlying obligations";

(b) regularly conduct stress tests and monitor the fund's liquidity risk; and

(c) ensure that each fund has a consistent investment strategy, redemption policy and liquidity profile.

The requirement that the Commission specify the minimum liquidity requirements for funds which redeem their units or shares more often than half-yearly has been removed.

9. Investing in securitised investments

There has been no change to this provision, nor was there a comment in the Gauzès Report. It may well therefore remain unchanged.

If so there will be restrictions on investment in securitisations by AIFM. The Commission is 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.

The Commission will impose additional requirements on funds which invest in these securities. These are likely to reflect the due diligence and risk assessment requirements which will be imposed on EU credit institutions through the new Article 122a to the Banking Consolidation Directive (2006/48/EC) introduced by amending Directive 2009/111/EC from 31 December 2010..

10. Appointment of an independent valuator

The original draft required a "valuator", independent of the manager, responsible for valuing fund assets and fund units. This was extremely controversial and for a time it looked as if there would be a more satisfactory outcome as the negotiations progressed in the Council. However in its handover note the Swedish Presidency highlighted the valuation provisions as being one of the key outstanding areas. They noted continuing disagreement on the use of different types of valuer for different business models, on frequencies of valuations, on the independence of the valuer and on liability issues.

Therefore whilst the latest draft is a significant improvement on the original there can be no certainty that it will remain in this form. The draft would enable an AIFM to choose to carry out valuations itself rather than appoint an external valuer, subject to ensuring functional independence of the valuation and portfolio management functions and the ability of the Home Member State of the AIFM to require verification of valuation procedures /valuations by an auditor or external valuer. The requirements in the original draft as to the appointment of valuers established in third countries have been deleted.

Gauzès Report

- Would require the valuator to be authorised and supervised by a Member State regulator although under certain conditions could be in a third country. Seems to allow AIFM to be valuator subject to independence of valuation processes.
- Provides that the valuator requirement should not apply to a private equity fund as it invests in equity securities that are not publicly traded and is inappropriate for the business model and the expectations of investors.

11. Appointment of an independent depositary

Overview

The requirements in the original draft for an independent depositary were controversial, not only because they failed to reflect the reality and practicalities of custody business, but also because they were unsuitable for many types of fund. Unfortunately these provisions have not improved at all: indeed they are worse. The provisions are one of the principal items noted by the Swedish Presidency as outstanding, for example there is no political agreement as to the type of entity eligible to be a depositary other than an EU bank or investment firm and no agreement on the liability profile of the depositary.

An AIFM cannot be a depositary. It must ensure that a depositary is appointed in respect of each EU established fund managed by it to fulfil a number of functions including:

- the safe-keeping of financial instruments;

- the verification of whether the fund holds an ownership interest in the assets invested in by the fund which are not financial instruments. The scope of the Directive is extremely wide, and this obligation could extend, for example, to trees, ostriches, paintings – all of which are non financial instruments capable of being invested in by a fund.

Key elements of the provisions relating to depositaries are:

- the imposition of statutory liabilities, including liability for sub-custodians.
- limitations on the entity which can act as a depositary, regardless of the type of investments made by the fund or the nature of the fund investors;
- regulatory approval of the appointment of a depositary. This requirement adds add another time constraint to the establishment of funds, imposes a further burden on regulators and seems particularly inappropriate given the proposed restrictions on the identity of a depositary;
- there will be detailed provisions which will affect the operational aspects of being a depositary as well as the legal responsibilities. For example, implementing measures will specify 'the modalities for the segregation of financial instruments in different accounts'.

The provisions in the compromise text do not apply to third country funds managed in the EU, but Gauzès would require a third country fund managed in the Community to have a depositary with a registered office in the Community unless certain conditions are met, including cooperation agreements between regulators.

"Financial instruments that can be kept"

This new concept is important as there is 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", it seems less likely that it could refer to dematerialised or other securities where evidence of title is obtained through registration in the books of an issuer or central securities depositary. However the depositary provisions are confusing, and do not properly reflect the complexities of custody operations and methods of holding securities.

Liability of depositary

The provisions for liability of a depositary remain onerous. It is currently common practice for a custodian to accept responsibility for negligence etc of a sub-custodian appointed by it, and for its own negligence if it does not take proper care in selecting and supervising the sub-custodian. However the draft imposes far greater liabilities as follows:

- if "financial instruments that can be kept" are lost, the depositary is obliged to return identical financial instruments of the corresponding amount to the fund without delay, even where it has delegated the safe-keeping to a sub-custodian unless it has contracted out of liability for instruments lost by a sub-custodian. 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; and
  - there must be "an objective reason" for such a discharge of liability. This concept is undefined and the Commission is required to adopt implementing measures which specify what it means. It would seem an unnecessary addition to the requirement that the depositary is in compliance with its obligations under the Directive;
- the depositary is liable to the AIFM, the fund and the investors for "any other losses" suffered by them as the 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 the liability provisions which would limit any other contractual provision. If 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" then the liability for loss of financial instruments or any other losses will not apply.

Limits on delegation

The depositary is permitted to delegate the tasks of safe-keeping financial instruments and verifying whether an ownership interest is held in any other assets.

The depositary can only delegate the safekeeping of "financial instruments that can be kept" if it can demonstrate that there is an objective reason for the delegation. The meaning of "an objective reason" is also to be elaborated in implementing measures made by the Commission. It is difficult to see what this can mean. A custodian generally uses a sub-custodian either because there is no other legal means of holding the particular financial instrument or because it does not have its own branches in a particular jurisdiction. Are these both "objective reasons"? The limitation is superfluous given the provisions relating to liability for sub-custodians.

Even if delegation of safekeeping of "financial instruments that can be kept" is permitted, the sub-custodian must meet a number of conditions, including that:

- it is subject to supervision and periodic audit in the jurisdiction concerned;
- it segregates the instruments and other securities from its own assets.

There may well be jurisdictions where the applicable law or market practice means that some or all of these conditions may not be capable of being met. Indeed current regulatory rules (including those made under MiFID) recognise that in some instances instruments may have to be registered in the name of the sub-custodian and require clients to be notified if this is the case.

Identity of depositary

A depositary must be:

- an EU credit institution or investment firm; or

- a legal person authorised in a Member State to act as depositary which furnishes "sufficient financial and professional guarantees"; or
- in the case of a fund which has no financial instruments which can be safe-kept or which are derivatives, an entity which carries out depositary functions as part of professional or business activities in respect which it is subject to mandatory professional registration or to legal or regulatory provisions or rules of professional conduct and which furnishes sufficient financial and professional guarantees.

Implementing measures will specify what amounts to a sufficient financial and professional guarantee.

It also appears (the provision is in square brackets) that there may be a requirement that the depositary has to be established in the Home Member State of the fund. So on the one hand the Directive is biased against the use of sub-custodians (implying a branch network of an EU institution is preferred), whilst on the other hand a provision of this kind would require separate subsidiaries in each Member State where services are provided to funds.

Comment

Whilst the Commission is required to adopt implementing measures which specify "when instruments are subject to trading", this concept does not appear in the main text and therefore there is no provision which recognises the substantive legal and risk differences between custody of unquoted investments and investments that are regularly traded. If this is continued it will impose unnecessary costs on venture capital and private equity funds.

Unless the fund industry and custodians rapidly educate and convince politicians and regulators that these provisions are impracticable and have significant downsides, they are likely to remain, at best, deeply unsatisfactory.

There must be a real chance that, whilst some of the drafting may be refined, these core concepts will remain both in the final version of the AIFM Directive and be carried through to other Directives (UCITS and MiFID). There are a number of Member States which have very strong views on the need to tighten up (as they see it) depositary issues generally. Custodians have to date successfully stayed out of mainstream EU regulation (excepting UCITS), but the custody industry may now be subject to radical and onerous change, the knock on effects for investors may well be to increase cost and reduce choice.

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- Wants the final AIFM and UCITS depositary provisions to be aligned.
- Depositary should have its registered office in the same Member State as the fund and no passport for depositaries.
- Provides for the depositary to be jointly responsible with the AIFM for the proper valuation of AIF assets as well as for the calculation of NAV.
- Requires a third country fund managed in the Community to have a depositary with a registered office in the Community unless certain conditions are met including cooperation agreements between regulators, that the Commission has decided that the prudential regulation and supervision and anti-money laundering standards are equivalent and there is an OECD agreement for exchange of information on tax matters.
- Provides that if as a result of a local law, a depositary has to use a third party sub-custodian, then the depositary's liability may be shifted to the third party if there is a contract to that effect between the AIFM, the depositary, the third party and the investor.

12. Delegation by the fund manager

There have been some important and constructive changes as follows:

- The original draft required the AIFM to obtain prior authorisation from its regulator for each delegation by it of its functions, e.g. the appointment of third party administrators. This has improved so that the general requirement is for prior notice to the regulator. The manager's liability will not be affected by delegation.
- There are the following additional restrictions on delegation of portfolio management or risk management:
    - if delegated to an entity which is not authorised and supervised for asset management, prior approval from the regulator is required.
    - delegation to a third country entity is only permitted if there is a co-operation agreement between its regulator and the AIFM's regulator.
    - no delegation to the depositary or a delegate of the depositary.
- A delegate may sub-delegate, provided that it complies with the same conditions as apply to the AIFM in doing so.
- The provisions in the original draft imposing further restrictions on delegation to an entity based outside the EU have been deleted. However this is probably only as part of the wider debate on third country issues, so there may be a risk that they could be reinstated.

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- Requires delegation to be notified in advance and for regulators to have one month in which to reject the proposed delegation.

13. Transparency requirements – disclosure to investors and regulators

The transparency requirements are divided into: (a) the requirement for an annual report; (b) investor reporting; and (c) reporting to regulators.

Annual report

The important change is that the new draft imposes requirements relating to remuneration disclosure. Apart from the fact that this is objectionable on a number of grounds, the requirement appears to mean that an AIFM must disclose its full remuneration structure to investors in all AIFs managed by it. The requirement is to disclose:

- total remuneration for financial year, split into fixed and variable (bonus) paid by the AIFM , the number of "beneficiaries", and the "carried interests paid by the AIF"
- the aggregate remuneration broken down by senior management and members of staff whose actions have a material impact of the risk profile of the AIF.

An annual report on each fund must be made available to investors (on request) and to regulators within four months of the end of the financial year.

The annual report must include a balance sheet or statement of assets and liabilities, a detailed income and expenditure account and a report on activities.

The requirement to provide information to employee representatives has been removed. The annual report published by the manager of the relevant fund(s) must contain further information in relation to each unlisted company in which the fund has a controlling interest. This information must include:

(a) operational and financial developments;

(b) a presentation of revenue and earnings;

(c) a description of and key factors relating to the nature of the company's main categories of products sold and/or services performed and, to the extent that the development of new products or services has been publicly disclosed, the status of development .

The requirements in the original draft to disclose financial risks associated with the capital structure have been removed.

If the AIFM manages a fund which is not established or marketed in the EU it is still required to prepare a document containing at least this information and make it available to his regulator and to investors on request. Quite why there should be any such requirement in respect of a fund that is not marketed to European investors is not at all clear, and if retained the provisions will merely be yet another discincentive to use Europe as a global base for fund management.

The accounting information must be audited by an EU auditor. A welcome change is that if the AIF vehicle is established in a third country, Member States may permit an audit meeting international accounting standards in the country where the AIF is established.

Disclosure to investors

The AIFM must make available to investors certain information prior to their investment and regularly update it. There have been no major changes to this section. Most of the information is probably not exceptional, although note the following requirements to:

(a) describe all risks associated with the fund's assets and investment techniques;

(b) describe the main legal implications of the contract of investment, including information about jurisdiction, applicable law and the existence (or not) of laws providing for the recognition and enforcement of judgments in the jurisdiction in which the fund is established;

(c) for AIF which employ leverage on a systematic basis, disclose the maximum level of leverage which the AIFM may use as well as any right of re-use of collateral or any guarantee granted under the leveraging arrangement and disclose periodically the total amount of leverage employed by the fund

(d) describe the fund's valuation procedure including the methods used in valuing hard-to-value assets;

(e) describe all fees, charges and expenses and the maximum amounts of them which are directly or indirectly borne by investors;

(f) describe the nature of any preferential treatment granted to any investor e.g. through side letters or side pocket arrangements (the requirement to identify the investor has been deleted);

(g) describe any arrangements under which the depositary limits its liability and inform investors without delay of any changes to depositary liability.

Reporting to competent authorities

Overall there have been no major substantive changes. The manager will be obliged to report to its regulator:

(a) the principal markets and instruments on and in which it trades;

(b) the principal exposures and most important concentrations of each of the funds it manages;

(c) a list of its funds; and

(d) a copy of the annual report on each fund.

The AIFM must also, on request, provide other information to its regulator including:

(e) the main categories of assets in which the funds are invested;

(f) the use of short selling;

(g) the actual risk profile of the AIF and the risk management tools employed by the AIFM to manage market risk, liquidity risk, counterparty risk and other risks including operational risk;

(h) the results of the stress tests required by the Directive in respect of position risk and liquidity risk management.

Also see section 14 below concerning leverage reporting.

14. Requirements on managers of leveraged funds

Generally the changes to these provisions are an improvement. The focus is on providing information to regulators for systemic risk purposes. The provision which required the Commission to set limits on the level of leverage funds could employ has been removed and replaced by a more specific power for use in specific cases (see below). It is also clear that the provisions are directed at leverage at the level of the fund.

The concept of "high levels of leverage" has disappeared and instead the provisions refer to "AIFM managing funds which employ leverage on a systematic basis". The Commission is required to make implementing measures which specify when leverage is employed on a systematic basis and how it is to be calculated.

“Leverage” is defined as “any method by which the manager 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”.

Fund managers who manage such funds are required to make available to their regulator:

(a) information about the overall level of leverage employed by each fund, with a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, and the extent to which their assets have been rehypothecated (this last requirement may be taxing, funds who had assets with Lehman were not easily aware of the extent to which at any particular time their assets had been rehypothecated); and

(b) the five largest sources of borrowed cash or securities for each of the funds and the amounts of leverage received from each of those sources for each of the funds managed by the manager.

The AIFM's regulator is required to make the information it receives available to other EU regulators and the ESRB. It is also required to notify other regulators if an AIFM under its responsibility or funds managed by it could potentially constitute an important source of counterparty risk to a bank or other systemically relevant institution in other Member States.

The information provided to the regulator is intended to assist it in identifying the extent to which leverage contributes either to the build up of systemic risk or to the risk of disorderly markets.

The regulator in each Member State is required to asses the risks that the use of leverage by an AIFM could entail, and, if necessary to ensure the stability and integrity of the financial system, it is required to impose limits on the level of leverage that the AIFM can employ or place other restrictions on the management of the fund. The Commission is required to make implementing measures setting out principles to help define the circumstances under which these powers would be exercised.

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- Suggests that the AIFM should define in advance the leverage limits it will use for each fund and inform the supervisor of the limits.
- In exceptional circumstances the European Securities and Markets Authority ("ESMA") may, on the basis of information from regulators, determine that the leverage employed by an AIFM poses a substantial risk to the stability and integrity of the financial system and if it does, the Commission may set limits of a temporary nature to the level of leverage AIFM can employ.

15. Requirements on managers who acquire control of companies

There have been some significant changes to the disclosure provisions which are directed at funds such as private equity funds, which acquire significant stakes in Community domiciled companies, as follows:

- the provisions no longer apply to holdings in EU listed companies, although one new disclosure obligation does (see below);
- the provisions only apply once a "control" position is reached in relation to an EU non-listed company, defined as acquiring more than 50% (rather than 30%) of the voting rights;
- unfortunately the limitation of the provisions to investees domiciled in the EU seems to have disappeared, but this may be a redrafting oversight. If it is not then the provisions will catch holdings in non-EU companies, including those whose securities are admitted to trading on markets outside the EU, which we doubt is intended;
- the exception for investees which are small and medium enterprises has been retained. (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 requirement in the original draft to disclose the development plan for the unlisted company and the policy for its communications with stakeholders has been removed. The manager is still required to provide the following information to unlisted companies, their shareholders and employee representatives:

  (a) the identity of the fund manager(s) which have acquired control, and

  (b) the policy for preventing and managing conflicts, in particular between the fund manager and the unlisted company. The retention of this reference remains concerning. It implies that AIFM owe obligations to companies in which their funds invest.

A new recital is also included which recognises that the imposition of these provisions only on AIFM would not produce a level of playing field with other entities which acquire control of companies. It requires the Commission to conduct a review of relevant legislation in the first three years that the Directive is in force with a view to imposing equivalent requirements on others. So it will be some time before there is a level playing field. These disclosure provisions in the Directive ought to be suspended until all investors are subject to the same rules.

Disclosure of leverage in relation to control of non-listed and listed companies

A new provision has been inserted which will require a fund manager which acquires control of an unlisted or a listed EU company to provide both its Home State regulator and its fund investors with information on the debt supported directly or indirectly by the company:

- before control is reached;
- immediately after control is reached;
- 6 months and12 months after acquiring control.

Confidentiality

The sections concerning control of non-listed companies and issuers are stated to apply subject to the restrictions on confidential information in the employee consultation Directive. This states that employee representatives are not authorised to reveal to employees or third parties any information which an undertaking has expressly provided to them in confidence. It also enables Member States to provide that an employer is not obliged to communicate information when the nature of that information is such that it would seriously harm the functioning of the undertaking or would be prejudicial to it. Whilst the drafting is not clear, it would appear that the inclusion of a reference to the employee consultation Directive is some recognition of the fact that, to the extent the Directive requires information to be provided to employees or their representatives, it may in effect be a conduit for publication to the world. The application of this provision seeks to impose a duty of confidentiality on the recipient. It is therefore a welcome development, though whether it would be effective may be another issue.

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- Also concerned by the level playing field issues in relation to investors in companies and wants the Commission to have conducted a review of relevant law by the time the Directive comes into force and make necessary changes.
- Keeps the provisions so that they apply to holdings in EU listed companies and retains much of original text on disclosure, e.g. of development plan for the investee.

16. Public to private transactions

The requirements in the original draft which required an issuer which is delisted to continue to fulfil certain requirements applicable to a listed company for another two years have been removed.

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- Keeps the original requirement (if a 'controlling influence' acquired) but limited to compliance for one year, on the basis that this is necessary for transparency purposes.

17. Remuneration

Probably the most controversial and significant development in the Council draft 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. The compromise draft includes 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.

The provisions are based on similar provisions which appear in draft revisions to the Capital Requirements Directive ("CRD3") (http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf), which, when adopted, will apply to all European banks and most investment firms, subject only to a "proportionality override". This override is also reflected in the AIFM Directive and provides that AIFM are to comply with the remuneration principles:

"in a way and to the extent that is appropriate to their size and the size of the fund they manage, their internal organisation and the nature, the scope and the complexity of their activities".

The underlying purpose of this requirement is to have, across the financial sector, remuneration policies that are consistent with effective risk management. To that end there are requirements in relation to performance related remuneration (so that, for example, the assessment of performance is set in a multiyear framework appropriate to the life cycle of the fund), and guaranteed bonuses must be exceptional and occur only in the context of hiring new staff in their first year. There are also restrictions on the amount of a bonus that can be paid without deferral and the basing of vesting for a bonus.

As remuneration policy principles look likely to be applied to portfolio managers subject to MiFID (via CRD3) it seems highly likely that fund managers will also be brought within scope.

A particular concern relates to whether the provisions will cover carried interest arrangements, which are not remuneration paid by the manager, but which represent capital gains to employees from their investments in a fund. There is no logical reason why they should be caught.

It seems likely that, subject to the debate on carried interest which is a fund specific matter, the shape of the final provisions may well be dictated by whatever happens in CRD3. CESR (the Committee of European Securities Regulators) will be required to ensure the existence of guidelines of sound remuneration policies in the AIFM sector and the Committee of European Banking Supervisors will assist. Given that the European Parliament also wants remuneration rules, they are unlikely to disappear.

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- Requires AIFM to be subject to same remuneration rules as credit institutions and investment firms-wants alignment with principles developed by the Financial Stability Board for Sound Compensation Practices.
- Requires remuneration policies consistent with effective risk management, which counter short-term profit motives and are in line with business objectives and the long term interests of the AIFM and investors

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