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A legal update from Dechert's Financial Services Group

Spain Issues Compromise Draft Proposal for a European Directive on Alternative Investment Fund Managers

The Proposal for a European Directive on Alternative Investment Fund Managers (the "Directive") has met with much controversy since it was first proposed in April 2009 (the "Commission Proposal"). Various revised proposals were published last year during the course of the Swedish presidency. A short period into its term as President of the European Council, Spain then published a compromise draft of the Directive and two weeks later a further revised compromise draft of the Directive (the "Spanish Compromise").

At the same time, there have been a number of other developments in relation to the Directive.

The European Parliament is now reviewing in excess of a reported 2,200 proposed amendments to the Commission Proposal. Although a vote in committee is proposed to occur in early April and a full vote is proposed to occur in July, many commentators are doubtful that this timetable will be met.

In addition, while Parliamentary responsibility for the Directive originally rested with the Economic and Monetary Affairs Committee ("ECON"), it has now been agreed that certain aspects of the Directive will fall within the competence of the Legal Affairs Committee ("JURI"). JURI has recommended a number of fundamental changes including: direct regulation of alternative investment funds ("AIF") in addition to alternative investment fund managers ("AIFM"); transfer of regulatory authority to the European Securities Monitoring Authority ("ESMA") if an AIFM markets its AIF into more than three EU jurisdictions; mandatory fixed leverage limits; capital requirements equivalent to those of credit institutions; and a prohibition on delegation by depositaries. The Parliamentary rules of procedure state that in these circumstances, one committee will accept without vote the amendments agreed to be within the competence of the associated committee. As such, it can be expected that ECON will not seek to amend the JURI proposals, although it would seem likely that there would be some modification of the proposals given that they are significantly at odds with the development of the Directive to date and far outstrip JURI's original mandate of providing a legal opinion on the Directive.

With regard to the Spanish Compromise, the positive news is that the Spain has built on the basic framework developed by Sweden who, during their presidency, introduced a number of broadly positive changes from the perspective of the industry culminating in a compromise draft of 15 December 2009 (the "Swedish Draft"). However, the Spanish Compromise contains a number of additional provisions, or provisions carried across from the report of the Parliament's Rapporteur, Jean Paul Gauzes (the "Gauzes Report"), which are more onerous for the industry. These changes are considered below.

Marketing and Management

Marketing

The Directive provides for a European "passport" allowing EU AIFM to market EU domiciled AIF throughout the EU. In addition, both the Gauzes Report and the Swedish Draft would have allowed Member States, if they wished, to permit private placements to professional investors subject to national law. This was an important inclusion as without it, access to the EU market would have been severely restricted for non-EU AIF and non-EU AIFM.

While the Gauzes Report and the Swedish Draft left some uncertainty as to the exact

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scope of private placements permitted under the Directive, the Spanish Compromise has now set out the requirements in more detail. However, the Spanish Compromise imposes additional minimum conditions for such private placements to be permitted as set out in Articles 34b and 35 of the Spanish Compromise.

There is now a requirement for "appropriate cooperation agreements" where a non-EU AIF is marketed into the EU. If the AIFM is established in the EU, the agreements are required to be entered into between the authorities in the AIFM's home Member State and the authorities in the third country of the AIF it is marketing. For non-EU AIFM, the agreements are required to be entered into between the authorities in each Member State in which the AIF is marketed and the authorities in the AIFM's country of establishment. The Commission may adopt implementing measures setting out the requirements in relation to these cooperation agreements. As such, it is not clear how extensive they will need to be. It is conceivable that the requirements could substantially limit the number of non-EU jurisdictions able to achieve such agreements and there will inevitably be delays until a substantive network of agreements can be signed between the key Member States and the various third countries.

Article 34b now requires that where an EU AIFM markets a non-EU AIF in the EU, the AIFM must comply with all of the requirements of the Directive with the exception that the requirement to have an EU depositary is relaxed provided that one or more entities are appointed to fulfil the substantive depositary functions.

Under Article 35, non-EU AIFM marketing AIF in the EU are required to comply with Articles 19 (*Annual Reports*), 20 (*Disclosure to Investors*), 21 (*Reporting Obligations to Competent Authorities*) and also the disclosure obligations arising on acquisition of a controlling interest in a non-listed company. As the drafting simply states the requirement for "compliance with" the relevant provisions of the Directive, there is considerable legal uncertainty as to how these would apply to a non-EU AIFM. On the basis of the current drafting, it is conceivable that a non-EU AIFM would need to make detailed disclosures to the authorities in each Member State in which it proposes to market, not just for the AIF it markets but for all AIF managed by it (irrespective of whether they are marketed in the EU). In addition, the application of Article 19 on annual reports would seem to suggest that a non-EU AIF marketed into the EU by a non-EU AIFM would be required to have its accounts audited by an EU qualified or recognised auditor.

These requirements merely set out the minimum conditions for private placements by Member States. It is of course possible that individual Member States may choose to impose more extensive requirements or not permit private placements at all.

A separate area of uncertainty is the reference in new Recital 19(a) to the need for a review of relevant legislation in relation to "institutional" investors to assess the need for "tighter requirements and more transparency" where institutional investors invest in AIF managed by non-EU AIFM. This potentially refers to a European Parliament Resolution of 23 September 2008 on Transparency of Institutional Investors (2010/C 8 E/07) although it is unclear what impact such review may have on the scope of, or conditions for, private placement exemptions for non-EU AIF and non-EU AIFM.

The result is continued uncertainty as to the scope of permitted private placements. In addition, there are likely to be delays before the conditions for private placements can be satisfied, particularly as the Committee of European Securities Regulators (CESR) is required to develop guidelines for the implementing measures.

Management

The Swedish Draft set out conditions for an EU AIFM to be permitted to manage a non-EU AIF. These conditions were: (i) that the legislation in the domicile of the AIF was to be in line with standards set by international organisations (such as IOSCO); and (ii) that an appropriate cooperation agreement be in place with the third country authorities.

In the Spanish Compromise, Article 34a now replaces the first requirement with a requirement for compliance with all but certain sections of the Directive. Provided the non-EU AIF is not marketed in the EU, all of the requirements of the Directive would apply with the exception of Articles 17 (*Depositaries*) and 19 (*Annual Reports*) and Chapter VI (*Rights to Manage and Market in the Community*). In addition, the requirement for an "appropriate cooperation agreement" would remain. Where the AIF is also marketed into the EU, the more extensive requirements in Article 34b (which relax only Article 17) would apply, as discussed above.

Therefore, in the case of management of a non-EU AIF, the Spanish Compromise now provides a greater degree of clarity as to the applicable requirements compared to the somewhat uncertain requirement for compliance with standards set by international organisations. However, such requirements are arguably more onerous than the Swedish draft intended.

Depositary

The Directive requires AIFM managing EU AIF to ensure a depositary is appointed for those AIF.

The Commission Proposal, the Swedish Draft and the Gauzes Report each imposed liability on the depositary arising from the loss of financial instruments.

The earlier drafts of the Directive allowed depositaries to contract out of this liability where a sub-custodian was appointed. This ability is retained in the Spanish Compromise but is now conditional on such discharge being “reasonable”, whereas before all that was required was an “objective reason” for the discharge. It is unclear how this reasonableness requirement would be interpreted in practice and this creates legal uncertainty for would-be depositaries.

In addition, the Spanish Compromise requires the relevant sub-delegation contract to establish the “parties assuming the liability and the conditions under which liability is assumed”. While the drafting is not clear, the consistent use of the term “liability”, first used in the context of liability to return assets to the AIF or investors, and the reference to “assumption” of the liability, suggests that the Directive contemplates an assumption of liability to the AIF and investors under the Directive rather than the liability simply being disclaimed.

The liability provisions will most likely reduce the number of depositaries willing to act which in turn would further increase the likelihood of concentration among a small number of depositaries. This would increase, not reduce, systemic risk. At the same time, the additional cost (in the form of increased liability insurance and capital requirements) will ultimately be passed on to end investors. As most depositaries service assets for a wide range of asset managers, the cost will likely be passed on to investors far beyond the “alternative” vehicles that the Directive seeks to regulate.

The requirement that the depositary should be established in the home Member State of the AIF was in square brackets in the Swedish Draft, suggesting that this position was provisional. However, the requirement has been retained in the Spanish Compromise. This seems arbitrary and likely to reduce choice and further increase potential for systemic risk due to the concentration of fund and depositary exposure within the relevant Member State.

Leverage

The Spanish Compromise has made a seemingly minor change to the power of the Commission to adopt implementing measures in relation to leverage limits. The passage now reads “The Commission shall adopt implementing measures setting out principles clarifying the circumstances in which competent authorities *shall* exercise the provisions in paragraph 3a...” (emphasis added). Read literally, this could suggest that the implementing measures may actually require Member States to impose leverage limits and other restrictions (rather than the decision to take action vesting with Member States). There is an argument that the actual measures taken (such as determining the actual level of leverage imposed) would remain in the discretion of the Member States. However, it is difficult to predict how far the implementing measures might seek to go in this respect.

Risk Management

In the Swedish Draft there was a requirement to ensure that an AIFM’s portfolio management and risk management functions were separated within the AIFM. To allow for the practical difficulties that very small managers may encounter in achieving such separation, the requirement only applied in so far as it was “appropriate and proportionate” in view of the nature and complexity of the AIFM and the AIF it managed.

The Spanish Compromise has now recast this qualification so that the nature and complexity of the AIF, not the AIFM, is the sole factor in determining whether the requirement to segregate may be relaxed.

This could result in a small manager without the personnel or resources to achieve segregation nonetheless being required to do so.

Valuations

The Spanish Compromise now requires that the valuation function be "independent" in circumstances where the AIFM receives a fee linked to the performance of the AIF. Previously, the requirement had been "where appropriate, to ensure functional independence" of the valuation function and the portfolio management function. The wording makes clear that independence can be achieved when valuation is performed by the AIFM. However, the result is uncertainty as to whether independence has been achieved in any particular case.

Where an external valuer is used, additional conditions will now apply including that the valuer: be subject to mandatory professional registration; provide professional guarantees; and maintain professional indemnity insurance.

In addition, the Spanish Compromise now proposes that the external valuer will have liability to the AIFM, the AIF and investors for any loss resulting from failure to perform the valuation. This is inconsistent with the way the industry operates and would also seem to have some unintended consequences. As it appears that the use of an external valuer is not mandatory, the provision would actually be a disincentive to using an external valuer, who would be reluctant to assume the associated liability without a substantial increase in their fees.

The Spanish Compromise also requires that the AIFM must "ensure that the net asset value" of AIF can be calculated and published in accordance with the Directive. While it may not be the intention, the effect of the drafting would create potential liability for AIFM where valuations cannot be produced due to market events or suspension of trading. The formulation adopted for the establishment of valuation procedures would be more appropriate here.

Exemptions

The Spanish Compromise includes a new Article 2b which now contains the de-minimus exemptions for AIFM whose aggregate assets under management do not exceed €100 million (or in the case of unleveraged closed-end funds, €500 million). These exemptions may now be imposed at the option of individual Member States. While in the Swedish Draft there was a general exemption for AIFM falling within this category together with the ability for the AIFM to opt-in to regulation under the Directive, under the Spanish Compromise Member States have the power to choose dis-apply the Directive "or parts thereof" for such AIFM. Article 2b makes clear that if Member States choose to dis-apply the Directive in whole or in part for an AIFM, such AIFM cannot benefit from the marketing passport under the Directive.

Pensions

New Article 9.1(a) in the Spanish Compromise provides that AIFM who manage pension portfolios will be subject to the EU Directive on investor compensation schemes. However, at this stage there is no detail as to how and to what extent this cuts across the existing exemptions under the Directive on investor compensation schemes in respect of professional and institutional investors (given the Directive is focused primarily on professionals).

Conclusion

At one level, the Spanish Compromise is positive in that it has largely built on the framework established by Sweden during its presidency and there are some useful clarifications in the new draft. However, there are particular areas where the Spanish Compromise is a backwards step for the industry. There is still no certainty as to whether an effective private placement regime will be possible. In addition, the liability provisions for valuers and depositories will increase cost, reduce flexibility and may actually increase, rather than decrease, systemic risk.

It seems clear that the final text of the Directive is still some way off and as such it is impossible to predict exactly how it will impact. In addition, the implementing measures have the potential to have a significant impact on some key areas. This uncertainty is damaging for the industry and seems set to continue for some time.

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