DechertOnPoint

August 2009 / Issue 9

A legal update from Dechert's Financial Services Group

European Commission Proposals on the Regulation of Alternative Investment Fund Managers

Introduction

The European Commission (the "Commission") has published proposals, in the form of a draft Directive on Alternative Investment Fund Managers, for the establishment of an authorisation and supervisory regime for alternative investment fund managers ("AIFM") in the European Union ("EU") in relation to their management of alternative investment funds ("AIF") domiciled both inside and outside of the EU.

The naming of the Directive belies its intended scope, which is ambitious, and has wide ranging potential impact on European investment managers. The Directive applies to asset managers in respect of their management of most if not all forms of collective investment undertaking, both closed and open ended, which are not UCITS qualifying.

It is therefore relevant not only to managers of hedge funds and private equity funds but also managers of all other non-UCITS strategies including property funds, commodities funds, long only funds and fund of funds, to name but a few.

This *DechertOnPoint*:

- considers the context of the Commission's proposals and the Commission's objectives in formulating them;
- takes a critical look at the scope and key elements of the draft Directive; and
- considers some likely implications for key categories of investment manager.

Context of the AIFM Directive Proposals

AIFM Activities Embed Significant Risks

The Commission's Explanatory Memorandum to the draft AIFM Directive states that the proposals form part of an ambitious Commission programme to extend "appropriate" regulation and oversight to all actors and activities that embed significant risks. The activities of AIFM are considered to embed significant risks.

The Explanatory Memorandum and the accompanying Commission Staff Working Document identify a selection of risks which, the Commission argues, the current financial crisis has shown AIFM to be vulnerable to. These risks, according to the Commission, are of direct concern not only to investors in AIF managed by AIFM but also present a threat to creditors, trading counterparties and to the stability and accountability of European financial markets. The risks identified by the Commission may be summarised as follows:

Category of Risk	Source of Risk
Macro-prudential (systemic) risk	■ Direct exposure of systemically important banks to the AIFM sector ■ Pro-cyclical impact of herding and risk concentrations in particular market segments and deleveraging on the liquidity and stability of financial markets
Micro-prudential risks	■ Weakness in internal risk management systems with respect to market risk, counterparty risks, funding liquidity risks and operational risks

Dechert LLP

Investor protection	■ Inadequate investor disclosures on investment policy, risk management, and internal processes ■ Conflicts of interest and failures in fund governance, in particular with respect to remuneration, valuation and administration
Market efficiency and integrity	■ Impact of dynamic trading and short selling techniques on market functioning ■ Potential for market abuse in connection with certain techniques, for example short-selling
Impact on market for corporate control	■ Lack of transparency when building stakes in listed companies (e.g. through use of stock borrowing, contracts for difference), or concerted action in "activist" strategies
Impact on companies controlled by AIFM	■ Potential for misalignment of incentives in management of portfolio companies, in particular in relation to the use of debt financing ■ Lack of transparency and public scrutiny of companies subject to buy-outs

The Commission is of the view that the nature and intensity of these risks varies between AIFM strategies. For example, the Commission argues that macro-prudential risks associated with the use of leverage relate primarily to the activities of hedge funds and commodity funds; whilst risks relating to governance of portfolio companies most closely relate to private equity funds. It nonetheless believes that risks relating to management of micro-prudential risks and to investor protection are common to all types of AIFM and not simply hedge funds, commodity funds and private equity funds.

Role of AIFM in Financial Crisis

Whilst the Commission accepts that AIFM were not the cause of the crisis, it believes that:

- hedge funds have contributed to asset price inflation and the rapid growth of structured credit markets; and the abrupt unwinding of large, leveraged positions in response to tightening credit conditions and investor redemption requests has had a pro-cyclical impact on declining markets and may have impaired market liquidity;
- fund of hedge funds have faced serious liquidity problems which have resulted in such funds limiting investor liquidity;
- commodity funds were implicated in the commodity price bubbles that developed in late 2007; and
- private equity funds have experienced challenges relating to the availability of credit and the financial health of their portfolio companies.

Inadequacy of Current Regulation of AIFM

The Commission acknowledges, both in the Explanatory Memorandum and the Commission Staff Working Document accompanying the draft Directive, that the activities of AIFM in the EU are currently regulated by a combination of national financial and company law regulations and the general provisions of community law; and that these rules are supplemented in some areas by industry developed standards.

However, the Commission argues that:

- The current fragmented national approaches do not constitute a robust and comprehensive response to risks in the AIFM sector;
- The current fragmentation of the regulatory environment may:
  - i. inhibit the effective regulation, supervision and macro prudential oversight of AIFM by failing to take account of the cross border dimension of their activities. This may result in incomplete or inconsistent monitoring and control of the macro- prudential and market efficiency risks and weaknesses in frameworks for ensuring investor protection; and
  - ii. impede market integration and the development of the single market by creating barriers to the efficient cross border distribution of AIFM products. This may prevent AIFM from achieving the available economies of scale and investors from diversifying their portfolios optimally.
- Effective management of the cross border nature of these risks demands:
  - i. a common understanding of the obligations of AIFM;
  - ii. a co-ordinated approach to the oversight of risk management processes, internal governance and transparency;

iii. clear arrangements to support supervisors in managing these risks, both at domestic level and through effective supervisory co-operation and information sharing at European level.

Objectives and Timetable for Adoption of AIFM Directive Proposals

Justification for EU Wide Response

In the Commission Staff Working Document the Commission express the view that:

- "Doing nothing" and persevering with a fragmented and incomplete EU regulatory and supervisory regime is not a viable option;
- Industry-developed standards may have a role to play in elaborating on legal norms and are sensitive to market developments but do not on their own provide a sufficient degree of assurance;
- Whilst member states could in principle upgrade their own regulatory and supervisory arrangements, a piecemeal response would risk failing to take account of the cross border nature of risks and the binding co-operation and information sharing arrangements may prove elusive.

The Commission believes that EU level action in the form of a draft Directive has clear advantages both in terms of effective risk monitoring and control and in providing a secure framework for pan European AIF distribution. The Commission states that this is the most appropriate approach for establishing regulatory and supervisory standards for hedge funds, private equity and other systemically important market players.

Commission Objectives in Formulating the AIFM Directive Proposals

It is clear from the Commission Staff Working Document that the Commission believes that a comprehensive response to the risks it has identified requires a clear and consistent regulatory and supervisory framework for AIFM.

The Commission identifies a number of objectives for such a framework which are reflected in the terms of the draft AIFM Directive proposals:

- **Appropriate authorisation and registration requirements** for all AIFM operating in the EU.

  Achieving this objective would require all AIFM to respect and satisfy a common set of requirements (minimum capital, fitness and properness, transparency, etc.) before operating across the EU.

- **Improved monitoring of macro-prudential risks** through the provisions of relevant information to prudential authorities.

  To take due account of the cross-border dimension of these risks, relevant information would need to be pooled at European or global level. At operational level, this objective would require the collection of relevant data on *inter alia* leverage, trading activity, risk concentrations and performance, and the establishment of appropriate information-sharing mechanisms.

- **Enhanced management of micro-prudential risks** through the imposition of strict risk management controls on market, liquidity, counterparty (credit and settlement, especially in case of short selling) and operational risks.

- **A common approach to protecting investors in AIFM-managed funds,** including improvements in investor disclosures to ensure that due diligence can be performed effectively.

  Ensuring the proper management of conflicts of interest and imposing independent controls and processes in key risk areas, in particular valuation and custody functions, would also help to achieve this specific objective.

- **Greater public accountability of AIFM investing in and managing companies,** so as to ensure that such activities are subject to an appropriate level of public scrutiny.

  The operational objective related to this is to impose additional transparency requirements on AIFM when they acquire controlling stakes in companies with the aim to actively engage in and influence these companies' future management.

- **The removal of barriers to the efficient cross-border distribution of AIF** to allow an internal market in AIF in the EU to develop which is grounded in a robust and consistent regulatory supervisory framework.

The International Dimension

In the Commission Staff Working Document the Commission acknowledges that there is a risk that the current AIFM Directive proposals would not take adequate account of the international dimension. Indeed, in the Explanatory Memorandum to the

draft Directive it acknowledges that while the enhancement of the regulatory and supervisory environment for AIFM at European level is important and necessary, it should—to be fully effective—be accompanied by parallel initiatives in other key jurisdictions.

However, it is of the view that international level agreements would be likely to take a considerable time to conclude and would be likely to be limited to broad principles. The development of a robust framework in Europe could nonetheless provide a good starting point for global discussion and sharing of information and effective co-operation will be essential for monitoring of those parts of the investment management industry located offshore.

The Commission also states that it will continue to work with its international partners, in particular the United States, to ensure regulatory and supervisory convergence of the rules applying to AIFM and avoid regulatory overlap.

Process and Timetable for Adoption

Co-Decision Procedure and Lamfalussy

The Directive proposals are proceeding under the co-decision procedure using the Lamfalussy approach. This approach is based on the recommendations of the Committee of "Wise Men", chaired by Baron Alexandre Lamfalussy.

The Lamfalussy approach provides for the implementation of Directives at four levels:

- **Level 1:** Framework legislation (the Directive), voted on by the Council of Ministers and Parliament;
- **Level 2:** Implementing measures for the Level 1 Directive, led by the Commission;
- **Level 3:** Supervisory Committees facilitating the convergence of regulatory outcomes; and
- **Level 4:** Enforcement of all EU measures, led by the Commission.

Under the Lamfalussy arrangements, the Commission proposes framework legislation and it is adopted under the "co decision" procedure. This involves both the Council of Ministers and the European Parliament (Level 1). It is supplemented at Level 2 by more detailed implementing measures, adopted by the Commission and endorsed by a qualified majority of member states. The Commission considers that this is the most efficient approach to ensure that the new rules benefit from the input and experience of the national supervisors. It will also allow for regular update of these technical requirements as they will not have to be adopted through the co-decision procedure (i.e. by the European Parliament and Council). This is particularly sensitive in relation to the current proposals which set out general principles in many areas whilst granting the Commission powers to adopt more detailed rules.

The Level 2 legislation is prepared by the Commission on the basis of advice provided by the representatives of national supervisory authorities, acting through the Level 3 Committees. These include CESR. In finalising their advice, the Level 3 Committees also aim to foster supervisory convergence and best practice, principally through the creation of non legally binding guidance. Finally, at Level 4, the Commission ensures that member states are complying with applicable legislation and it pursues enforcement action where relevant.

Adoption Timetable

The Commission states that if political approval of the Directive is reached by the end of 2009, the Directive could come into force in 2011. As an exception, certain important provisions regarding third countries (discussed in more detail in this Article) are intended only to come into force in 2014 after a transitional period of 3 years.

Under the Lamfalussy arrangements, the proposals have now been sent to the European Parliament (the "Parliament") and the Council of Ministers (the "Council") under the co-decision procedure. The Commission proposal has now been assigned to a Parliamentary committee in this case, the Committee on Economic and Monetary Affairs, which will appoint one of its members as rapporteur to draft an opinion on the proposals together with any amendments. As a general rule of thumb, this stage lasts on average four to eight months, but can be much longer depending on the technical and political complexity involved.

Each proposed amendment is voted on by the responsible committee on the basis of a simple majority, and it is consolidated in a legislative resolution that is submitted to the Parliament's plenary session for approval. According to the Legislative Observatory procedure file for the proposals, the indicative date for the Parliament plenary sitting is 24 November 2009.

Additional amendments can be tabled by political groups or at least 40 members at this time. The Commission has the opportunity to explain its

position on the amendments tabled. A simple majority is required for adopting amendments, the Commission's proposal as amended and the legislative resolution. It is possible that if the Commission's proposal as amended fails to secure a majority of the votes cast, then the President of the Parliament requests that the Commission withdraws its proposal. In cases where the Commission refuses to do this, then the matter is sent back to the committee. It is possible that the Parliament may adopt a position containing amendments that make the Commission's proposals null and void, in this case it is likely that the Commission may submit an amended proposal.

The opinion (including any amendments the Parliament suggests to the proposals) will be sent to the Council. The Council will then finalise its position on the basis of the Commission's proposal, and the Parliament's first reading and amendments. The Council will either: (i) accept the Commission's proposal if there are no amendments from the Parliament, and the act can be adopted; (ii) accept all the Parliament's amendments as incorporated by the Commission into its amended proposal, and the act can be adopted; or (iii) the Council adopts a common position in all other cases, and thus the proposal is referred to the second reading in both Council and the Parliament.

The key point to note is that Council decisions in this case are on the basis of qualified majority voting. Essentially this means that a two thirds majority vote must be achieved and there must be a minimum of 255 votes in favour. Thus in order for a member state to block the proposal, it must either avoid a majority vote or achieve a blocking minority of votes.

The current votes per member state are set out below:	
Germany, France, Italy, United Kingdom	29
Spain, Poland	27
Romania	14
Netherlands	13
Belgium, Czech Republic, Greece, Hungary, Portugal	12
Austria, Bulgaria, Sweden	10
Denmark, Ireland, Lithuania, Slovakia, Finland	7
Cyprus, Estonia, Latvia, Luxembourg, Slovenia	7
Malta	3
Total	345

Subject Matter of the AIFM Directive

In response to the Commission's objectives, the draft AIFM Directive lays down the rules for the authorisation, ongoing operation and transparency of the managers (AIFM) of Alternative Investment Funds (AIF).

These are considered below under the following sections:

- Role of AIFM and Scope of Directive;
- Authorisation of AIFM;
- AIFM Capital Requirements;
- Operating Conditions and Capital Adequacy of AIFM;
- Organisational Requirements Imposed on AIF Managed by AIFM;
- Transparency Requirements Applicable to all AIF;
- Additional Obligations on AIFM Managing Specific Types of AIF;
- Marketing Passport for AIF Managed by AIFM;
- Passporting of Management Services by AIFM;
- Specific Rules Relating to Third Countries.
- Overview and Conclusions.

Role of the AIFM and Scope of Directive

The Role of the AIFM

The draft Directive is designed to seek to regulate AIFM as opposed to the AIF which they manage. This is deliberate as the Commission believe that the risks associated with the management of an AIF rest almost exclusively at the level of the AIFM. The Commission Staff Working Document identifies the

AIFM as responsible for almost all decision making in relation to the management of AIF, such as:

- Investment decisions, including trading and the use of leverage;
- The development and maintenance of the governance structure and internal systems for risk management and the avoidance of conflicts of interest;
- The management of relationships with investors, counterparties and regulators, including the provision of information; and
- The organisation of administrative functions (including valuation), safekeeping of assets and audit, even if these functions are delegated to third parties, e.g., the AIF's administrator, custodian, prime broker and auditor.

The decision to seek to regulate AIFM as opposed to the AIF which they manage does mean that the Directive does not impose registration requirements on AIF themselves. Indeed, the Commission believes that a registration process would carry a degree of moral hazard with investors relying on regulators rather than their own due diligence. The Commission also states that the Directive does not seek to restrict investment policies of AIF. It believes this would be unnecessarily restrictive given the professional nature of the investor base and would in its view be impractical to implement given the diversity of business models in the industry.

There is however a major flaw in the manner in which the Commission (and hence the Directive) views role of AIFM in the context of the operation of the AIF they manage. As indicated above, the Commission attributes responsibility for the organisation of administrative functions, safe keeping and audit to the AIFM. This clearly demonstrates that the Commission is approaching the framework of the Directive from the perspective that managers are responsible for all key operational functions in relation to collective investment undertakings which themselves have a limited independent role in corporate governance. This is a theme which can be seen throughout the provisions of the Directive. The Commission staff working document actually states in this regard that: "... the AIF is merely a legal structure for the pooling of assets and has no economic life of its own".

Whilst this may to a limited extent be the case with some contractual fund structures such as unit trusts and FCPs which are operated by their management companies and are common structures for retail based funds, it clearly does not sit well with the corporate governance practices and requirements which apply in the case of many corporate AIF in which professional investors invest. This is particularly the case with closed ended AIF listed and traded on recognised Stock Exchanges. Nor does this approach fully recognise the reality that key service providers to the AIF, such as the administrator and custodian, are directly appointed by, and accountable to, the AIF and not the AIFM.

Scope of Directive

The scope of the Directive is comprehensive in nature and applies to all AIFM established in the Community which provide "management services" to collective investment undertakings whose object is the collective investment in assets and which do not require authorisation under the UCITS Directive. These collective investment undertakings are termed Alternative Investment Funds (AIF).

The term AIFM itself is defined to mean any legal or natural person whose regular business is to manage one or more AIF.

Consequently the potential impact of the Directive on the European investment management industry is wide ranging and comprehensive: the Directive is capable of applying to AIFM which provide management services to all categories of non UCITS collective investment undertaking whether domiciled inside or outside of the EU and regardless of the characteristics of the assets managed. This includes AIFM managing AIF:

i. investing in financial assets such as hedge funds, private equity funds, commodity funds and securities funds;

ii. investing in real property;

iii. investing in unusual asset classes such as, for example, art or wine;

iv. which are open ended; or

v. which are closed ended, including investment companies listed on a recognised Stock Exchange (for example investment companies and investment trusts listed on AIM and the London Stock Exchange).

The Directive will also apply, for example, to AIF that are already permitted to be marketed to retail investors in particular member states, e.g., Non UCITS Retail Schemes (NURS) in both the United Kingdom and the Republic of Ireland.

The Definition of Management Services

As indicated above, the AIFM Directive only applies to AIFM which provide management services to AIF. The term "management services" covers the "activities" of "managing and administering" one or more AIF "on behalf of one or more investors".

This suggests that the Directive is only intended to apply to investment managers which fulfil the role of an operator of a collective investment undertaking as opposed to investment managers undertaking a pure investment management function.

This interpretation is not inconsistent with the views expressed by the Commission (mentioned above) as to the role of the AIFM in the organisation of administrative functions (including valuation), safekeeping of assets and audit, even if these functions are delegated to third parties.

Collective Investment Undertakings

Collective investment undertakings are not defined in the Directive but are stated in the Recitals to the Directive as being undertakings which raise capital from a number of investors with a view to investing in accordance with a defined investment policy on the principle of risk spreading for the benefit of those investors. Accordingly, a fund for a single investor, or a fund which does not operate on the principle of risk spreading, could well be outside of the scope of the Directive.

The Recitals make it clear in this regard that the Directive should not apply to the management of pension funds, non pooled investments such as endowments, sovereign wealth funds or assets held on own account by credit institutions, insurance or reinsurance entities. As indicated under the **Exemptions** section below, the potential exemption of "own account" insurance and banking products is a potential concern for the European asset management industry.

Exemptions

The draft Directive allows for AIFM to be exempted from the application of the Directive in a number of circumstances:

- AIFM which directly or indirectly manage portfolios of AIF whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of:

  i. €100 million; or

  ii. €500 million when the portfolios of AIF consists of AIF that are not leveraged and have no redemption rights exercisable during a period of 5 years following the date of constitution of each AIF.

  The Commission believes that the management of portfolios of less than €100 million is unlikely to pose significant risks to financial stability and market efficiency. As a point to note, this threshold was reduced from €250 million in an earlier draft of the proposals following intensive lobbying from European Socialists.

  According to the Commission the €100 million threshold ensures that roughly 30 percent of hedge fund managers managing almost 90 percent of EU-domiciled hedge funds are brought within the Directive. This allows supervisory attention to be focused on this market segment and also allows managers of niche businesses for whom the new requirements would be overly burdensome to operate outside of the Directive.

  The higher threshold of €500 million euros for unleveraged funds (intended to apply to certain private equity funds) is justified by the Commission on the grounds that unleveraged funds are not likely to cause systemic risks.

  It should be noted that the definition of leverage in the Directive is widely drawn and, in certain circumstances may well catch legitimate macro or micro hedging arrangements.

  It should also be noted that the Directive nonetheless permits AIFM which do not exceed the threshold exemptions to opt into regulation under the Directive in order to obtain access to the cross border passport provisions of the Directive (see below).

- AIFM established in the Community which do not provide management services to AIF domiciled in the community and do not market AIF in the Community.

  The value of this exemption is unclear not least given the wide definition of "marketing" in the Directive, which covers both solicited and unsolicited offers and placings. Accordingly AIFM wishing to avail themselves of the exemption would be likely to need to

establish marketing operations which are legally separate from their activities.

- UCITS or their management companies authorised under the UCITS Directive.

  This is logical given that the Directive is not directed at AIFM of UCITS qualified AIF.

- Credit institutions, various types of insurance companies and supranational institutions such as the World Bank.

  Given the size of the banking and insurance industries and their major role in managed financial products, both unitised and non unitised, the investment management industry will need to look carefully at the intended extent and scope of the exemptions afforded to these competitors.

Authorisation of AIFM

The General Prohibition and Requirement for Authorisation

The Directive seeks to restrict AIFM covered by the scope of the Directive from:

i. providing "management services" to any AIF; or

ii. marketing shares or units thereof,

without prior authorisation from their home member state regulator.

As indicated above, the definition of "management services" appears to encapsulate the activities of managing and administering which may be an operator as opposed to a mere investment management function. If this is the case, an AIFM may not be required to be regulated under the Directive for providing mere investment management services or marketing services to an AIF but would presumably still be required to be regulated under MiFID for these activities.

This distinction may in part explain the approach taken in the Recitals to the Directive in relation to the potential overlap between the Directive provisions and MiFID. Recital 5 of the Directive states that:

> *"... Investment firms authorised under Directive 2004/39/EC on Markets in Financial Instruments should not be required to obtain an authorisation under this Directive in order to provide investment services in respect of AIF. Investment firms can however only provide investment services in respect of AIF, if and to the extent the units or shares thereof can be marketed in accordance with this Directive."*

Unfortunately, the wording of the Recital strongly suggests that such MiFID firms can only provide investment services to AIF which receive management services from AIFM authorised under the Directive i.e. have an EU based operator (and are therefore capable of being marketed under the Directive). The only potential relaxation in relation to this is that, following a three-year transitional period, AIFM domiciled outside of the EU may apply on a member state by member state basis to market AIF that they manage in the EU subject to meeting certain minimum requirements. This may enable AIFM operating in a member state in which an overseas AIFM has successfully passported the relevant AIF, to provide services to the AIF concerned under MiFID.

It also raises a number of additional possible spectres:

- Since non-EEA AIF cannot be marketed under the Directive until three years after implementation, will MiFID investment firms be prohibited from providing investment services to them at all in this period?

- Since MiFID investment services include more than just portfolio management e.g. order execution and reception, transmission of orders and investment advice, will MiFID investment firms other than portfolio managers, including brokers, dealers, advisers and distributors, also be prohibited from providing any MiFID investment services to AIF which do not receive management services from AIFM authorised under the Directive?

The Directive also contains a provision stating that entities which are neither authorised under the Directive nor (in the case of AIFM not covered by the Directive), in accordance with the national law of a member state, are not permitted to provide "management services" to AIF or market units or shares of such AIF, in the Community.

This provision would effectively appear to mean that in order to market AIF in any member state of the EU a person or entity must either be regulated as an AIFM under the Directive or authorised under national law. If this is the intention of the provision, it clearly has potential implications for non-EU based AIFM or promoters wishing to market their AIF products in the EU under existing private

placement regimes. These AIFM and promoters would be forced to seek specific authorisation for such marketing activities under Article 39 of the Directive (see below).

Procedure for Authorisation

AIFM must seek authorisation to provide management services to either all or certain types of AIF. The authorisation is required to cover any delegation arrangements made by the AIFM with third parties.

The authorisation is sought from the AIFM's home state regulator.

In order to apply for authorisation AIFMs must provide substantial information to their home state regulator as part of the authorisation procedure. This includes:

- information on the AIFM shareholders or members;
- a programme of its activities including how the AIFM intends to comply with its obligations under the Directive;
- detailed information about each AIF it intends to manage, where they are domiciled, their fund rules or instruments of incorporation;
- information on arrangements made for delegation to third parties of management service arrangements; and
- depositary arrangements (including delegation).

Note that there is no specific reference to the role of an administrator. This would appear to be encapsulated in the role of the AIFM in providing management services to the AIF and therefore captured by the third party delegation arrangements.

The Directive provides that the home member state regulator may only grant authorisation if it is satisfied that AIFM will be able to fulfil the conditions of the Directive.

Timetable and Conditions of Authorisation

The home member state regulator is required to inform the applicant within two months of the submission of the application whether or not the authorisation has been granted and must give reasons for any refusal or for any special conditions attached. The AIFM may only start providing management services in the home member state covered by the authorisation following such authorisation.

AIFM are required to notify the home state regulator of any change in the information provided in their initial application that may substantially affect the conditions under which the authorisation has been granted. These include in particular changes of investment strategy and policy of AIF which they manage, of the rules or instruments of incorporation and the identity of any further AIF the AIFM intends to manage. The home state regulator must, within one month of notification, either approve, impose restrictions or reject those changes.

In certain circumstances, the home state regulator may withdraw the AIFM's authorisation.

General Observations on Authorisation Model

Given the wide ranging conditions imposed by the Directive, the approval process is likely to be no less substantive than the current FSA authorisation model and much more orientated towards the procedures and capabilities of AIFM relative to the AIF which they manage.

It remains unclear whether the form of authorization is intended to require an AIFM to obtain authorization for managing AIFs on a fund by fund basis (micro level) or on the basis of broad "types" of AIF (macro level). The Directive suggests both approaches. For example, Article 6(3) enables a home state regulator to restrict the scope of authorization, in particular as regards the "type" of AIF an AIFM may manage. On the other hand, Article 7 (which deals with changes in the scope of authorization) suggests that changes in investment strategy and policy of any AIF, their constitutional documents and any further AIF intended to be managed must be notified before "implementation" and the regulator may either approve, reject or restrict these changes.

If it is intended that the model will be a fund by fund approval process and changes to fund terms require to be "approved" before implementation, then clearly the timing and cost implications for launching and operating AIF will be significant. Indeed, the challenge for home state regulators would be equally significant in that they would be required to approve changes relating to funds potentially established in other jurisdictions. Thus, for example, the FSA might look very closely at the decisions made by other regulators; for example, the CSSF in Luxembourg and the Financial Regulator in Ireland, in relation to their fund

products and could reject matters which they had already opined on. Clearly a potential challenge for the regulatory approval process in these jurisdictions.

If, on the other hand, it is only intended to be a macro authorization model by AIF type with a filing requirement for changes (presumably to the information notified), then the procedure envisaged under the Directive may be more workable. However, the retention of the effective one month "wait and see" period would still be an unwelcome hindrance to economic activity in the professional fund sector.

Operating Conditions of AIFM

Conduct of Business

The Directive specifies some minimum conduct of business principles which an AIFM should comply with in its management of AIF:

a. a duty to act honestly, with due skill, care and diligence;

b. a duty to act in the best interests of the AIF, its investors and the integrity of the market;

c. a duty to ensure all investors are treated fairly;

d. duties in relation to identifying, preventing, managing and disclosing conflicts of interest;

e. duties in relation to risk management and liquidity management;

f. restrictions on investments in certain types of securitisation issue (which are significant).

There are some notable features of the proposed requirements in this regard:

- The Directive reserves power to the Commission to adopt implementing measures specifying the criteria to be used by competent authorities for assessing whether an AIFM has complied with the matters outlined in (a), (b) and (c) above. This is an interesting development given that there is clearly an assumption that the AIFM must take into account the interests of third-party investors in the AIF with whom it may have no relationship.
- The duty to ensure that all investors are treated fairly places a somewhat unfair onus on the AIFM in that it assumes the AIFM has the power to impose this requirement on AIF it manages directly or through a delegation. In the case of corporate AIFs (including those listed on recognised exchanges), these duties rest with the directors of the AIF and it is not possible, or indeed necessarily appropriate or desirable, for an AIFM to undermine this segregation of roles.

  In the case of AIFM managing portfolios under delegation from other AIFM, particularly AIFM operating outside of the EU, this is clearly an impossible standard. Indeed it would be likely to deter non-EU fund platforms from appointing EU based managers.
- The duties in relation to risk management include:

  i. a requirement that risk management and portfolio management be separated and subject to regular reviews. This is clearly a challenge for small investment management businesses with assets under management of greater than the €100/€500 million exemption thresholds;

  ii. provisions which appear to be designed to prevent naked shorting.
- The provisions on liquidity management place an obligation on the AIFM to adopt measures to ensure the liquidity profile of an AIFs investments complies with its obligations; and to ensure that the AIF has a redemption policy which is appropriate to the liquidity profile of the AIF.

It is unclear how an AIFM can impose requirements such as these on an independent AIF or, in respect of AIF portfolios an AIFM is managing under delegation, do so without deterring the appointment by non-EU fund platforms of EU managers.

Capital Requirements

The Directive also specifies certain minimum capital requirements in respect of AIFM subject to the Directive.

These are broadly as follows:

i. AIFM are required to have own funds of at least €125,000;

ii. where the value of the portfolios of all AIF managed by the AIFM exceeds €250 million, the AIFM is required to provide additional own funds equal to 0.02 percent. of the value in excess of €250 million;

iii. irrespective of (i) and (ii), the AIFM's own funds must not be less than one quarter of its annual fixed overheads (*i.e.* the amount required under Art. 21 of the re-cast Capital Adequacy Directive (No. 2006/49/EC)).

In calculating these capital requirements, the AIFM is required to count the value of directly managed AIF portfolios as well as the value of AIF portfolios in respect of which it has delegated any of its functions or which it manages under delegation.

Whilst the capital requirement is broadly equivalent to that imposed on management companies of UCITS funds, it is somewhat more onerous in that there is no maximum cap on the amount of capital required. However, the absence of a cap at the UCITS level of €10 million is unlikely to affect small to medium sized investment management groups, since that cap would only be reached on assets under management of €49.625 billion.

Moreover, many AIFM may find that the level of own funds required under the AIFM Directive is no more than that required under MiFID. This would be true where the asset-based own funds requirement under (i) and (ii) above is less than the fixed overheads requirement under (iii) above. For example, the asset-based regulatory capital requirement of an AIFM with €1 billion under management would only be £275,000, which may be less than one quarter of such an AIFM's annual fixed overheads.

Delegation

The Directive as currently configured requires AIFM to obtain the prior authorisation of their home state regulator for each delegation to third parties of any of their functions.

There is no definition per se of "third" parties which would therefore potentially include affiliates. Nor are there any qualitative or materiality based exemptions.

It is hard to imagine that a delegation by delegation approval process would be welcomed by either home member state regulators or the industry as being either practicable or credible and one would hope that this requirement will be amended with a more principles based approach.

The Directive also prescribes a number of principle based conditions to delegation. Many of these appear both appropriate and sensible. For example:

- a third-party delegatee must be creditworthy and the persons who effectively conduct the business must be of sufficient good repute and experience;
- the third party delegatee must be qualified and capable of carrying out the functions in question, must be selected by the AIFM with due care and the AIFM must be in a position to effectively monitor the delegated activity, give instructions and withdraw the delegation with immediate effect. There are also provisions preventing delegations to depositaries, valuators and other persons whose interests may conflict with those of the AIF and investors.

However there are a number of troublesome conditions and related aspects.

First, where the delegation involves portfolio management or risk management, the third party must be authorised as an AIFM to manage an AIF of the same type.

Whilst on the face of it this may appear a reasonable proposal, it prevents entirely delegation to non-EU based investment managers including offices of AIFM based in centres outside of the EU. The proposal is therefore unworkable, would undermine EU manager competitiveness and will be viewed negatively by non-EU based regulators.

Secondly, the assumption by the Commission that the role of the AIFM covers both management and administration clearly places too much of a burden on the AIFM in terms of supervising the delegation of matters outside of the normal competence of a portfolio manager. Portfolio managers cannot be required to be the "guarantors" or "keepers" of the fund administration industry.

Organisational Requirements Imposed on AIF Managed by AIFM

The assumption by the Commission that an AIFM has the power to impose requirements on the AIF it manages is also evident in certain organisational requirements imposed by the Directive affecting the operation of AIF managed by AIFM.

Valuators

The Directive requires an AIFM to ensure that for each AIF it manages a valuator independent of the AIFM is appointed to value the assets of an AIF and its shares or units. The AIFM must also ensure the valuator has appropriate and consistent procedures in place to value the assets of an AIF. These procedures must comply with existing applicable

valuation standards and rules. These rules are required to be laid down in the law of the country where the AIF is domiciled or in the AIF's rules or instruments of incorporation. The valuator must ensure that the assets, shares and units are valued at least once a year and each time shares or units of the AIF are issued or redeemed, if this is more frequent.

The Commission is to be empowered to adopt implementing measures further specifying the criteria under which a valuator can be considered to be independent. It is assumed that similar principles in this regard will be adopted to those which apply in relation to the independence of administrators and depositaries under the UCITS Directive, although we cannot be sure that this will be the case. Nor can we be sure what actual role in valuations the AIFM will be permitted to continue to have.

Depositaries

The Directive also requires an AIFM to ensure that for each AIF it manages a depositary is appointed to fulfill various safekeeping responsibilities in relation to the AIF. These responsibilities include the receipt of all payments made by investors when subscribing units or shares of an AIF managed by AIFM and booking them in a segregated account, safe keeping of assets belonging to the AIF and verification as to whether the AIF has obtained ownership of the assets it invests in. The depositary is required to act independently and solely in the interests of AIF investors. It must also be an authorised credit institution having its registered office in the EU.

The Directive provides for the assumption of a high level of liability on the part of the depositary to both the AIFM and investors for any losses suffered as a result of its failure to perform its obligations under the Directive. In terms of the safe keeping of financial assets, there is strict liability for the depositary unless it can show it could not have avoided the loss. The Directive also provides for a direct right on the part of investors against the depositary.

This requirement is unlikely to be acceptable to custodians either at all or in sufficient numbers to support a viable and competitive EU based non UCITS fund industry.

General Comments

As with the concerns expressed in relation to certain aspects of the proposals on conduct of business, it is clearly inappropriate and impracticable for an AIFM to be in the position where it, as opposed to the AIF, has the responsibility to ensure the appointment of a valuator and a depositary.

Indeed, this requirement is likely to cause difficulties in relation to the take on by EU based AIFM of mandates from non-EU based AIFM or AIF platforms, particularly where the AIFM is one of a number of other investment managers.

Transparency Requirements Applicable to all AIF

Disclosure to Investors in AIF

The Directive places significant obligations on AIFM as to the disclosures which should be made to investors in AIF that they manage:

- An obligation to make available an annual report for each financial year.

  This again looks very much like the type of "operator" function undertaken by the manager of a unit trust or an FCP and does not reflect the independent role of the Directors of corporate AIF particularly those listed on a recognised stock exchange.

- An obligation to ensure that AIF investors receive some minimum disclosures before they invest in the AIF managed by an AIFM. Broadly these cover:

  i. Detailed disclosures as to investment and borrowing powers (including leverage) and procedures for implementing changes;

  ii. the identity of service providers, their duties and the rights of investors should failures arise;

  iii. a description of any delegated management or depositary function and the identity of delegatees;

  iv. a description of the AIF's valuation procedure and, where applicable, of the pricing models for valuing assets, including the methods used in valuing hard to value assets;

  v. a description of the AIF's liquidity risk management, including the redemption rights both in normal and exceptional circumstances, existing redemption arrangements with investors, and how the

AIFM ensures a fair treatment of investors;

vi. a description of all fees, charges and expenses and of the maximum amounts thereof which are directly or indirectly borne by investors;

vii. a disclosure of any preferential treatment obtained by an investor and a disclosure as to the identity of the investor.

Whilst most of these "point of sale" disclosure requirements are consistent with current best practice, they will raise the importance of detailed disclosure in AIF offering documents and inevitably, standards of disclosure across Europe. This will be beneficial to the industry.

Although it is hard to object to the principle of a disclosure of preferential treatment given to investors, this is perhaps too broad a concept as currently drafted given the different classes of share which sophisticated funds issue and the nature of transparency reporting to institutional investors. Clearly these investors would not wish to have their identities disclosed. To avoid deterring investors the Commission should consider a more sophisticated approach perhaps based on the FSA/AIMA approach to the disclosure of material side letter terms.

- A periodic disclosure requirement on the AIFM in respect of each AIF it manages as to the percentage of AIF assets which are subject to special arrangements arising from their illiquid nature, any new arrangements for managing the liquidity of AIF and the current risk profile of the AIF and the risk management systems employed to manage this risk.

Disclosure to Competent Authorities

The Directive provides for a regular reporting regime to the AIFM's home member state regulator in connection with the principal markets and instruments on which it trades on behalf of AIF it manages. These disclosures are to be made on an aggregated basis and include principal exposures and concentrations.

There is also a requirement to submit periodic reports covering, *inter alia*:

i. The percentage of an AIF's assets which are subject to special arrangements arising from their illiquid nature (this would presumably cover both side pockets and other liquidity management tools);

ii. any new arrangements for managing liquidity;

iii. the risk profile of AIF managed by the AIFM and the risk management tools employed to manage this risk;

iv. the main categories of assets in which the AIF is invested;

v. any use of short selling.

An AIFM is also required to file with its home member state regulator the annual report of each AIF managed and, quarterly, a list of all AIF managed.

Additional Obligations on AIFM Managing Specific Types of AIF

The Directive imposes specific requirements on AIFM of AIF, which employ high levels of leverage or acquiring controlling influences in underlying companies.

These targeted provisions are specifically aimed at hedge funds and private equity funds but may have application to funds employing other strategies involving the use of leverage. For example, leveraged long only funds, property funds, leveraged fund of funds and, indeed, funds adopting activist strategies.

AIFM Managing Leveraged AIF

The Directive imposes specific requirements on AIFM of AIF which employ high levels of leverage on a systematic basis. The Directive provides that an AIF will be deemed to employ high levels of leverage on this basis where the combined leverage from all sources exceeds the equity capital of the AIF in two of the past four quarters.

"Leverage" is widely defined under the Directive to cover any method by which an AIFM and AIF increases the exposure of an AIF it manages through borrowing of cash and securities, leverage embedded in derivative positions or by any other means. In relation to the use of derivatives, it is unclear whether AIFM will be entitled to "net" exposures for the purposes of determining whether the leverage threshold is exceeded. It would be sensible for the Commission to issue some guidelines in this regard particularly in relation to currency hedging transactions.

An AIFM is required to assess whether any of its AIF meet this definition on a quarterly basis and to inform the relevant home state regulator.

It is also required to make the following additional disclosures to its home member state regulator and to investors:

- Additional Disclosures to Regulators

  i. regularly provide to the home member state regulator information about the overall level of leverage employed by each AIF it manages and a breakdown between the leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives;

  ii. disclose the identity of the five largest sources of borrowed cash or securities for each AIF managed and the amounts of leverage received from each of those sources by each AIF.

- Additional Disclosures to Investors

  i. disclose to investors the maximum level of leverage which the AIFM may employ on behalf of the relevant AIF as well as a right to re-use collateral or any guarantee granted under the leveraging arrangements; and

  ii. disclose on a quarterly basis to investors the amount of leverage employed by each AIF in the preceding quarter.

It should be noted that whilst the additional disclosure requirements only apply to AIF managed by the AIFM which meet the high level of leverage test, the regular reporting requirements to home state regulators outlined above apply in respect of all AIF managed by the AIFM provided it manages one AIF which meets the high level of leverage test.

The Directive includes additional obligations and powers relating to the need for home member state regulators to make available information disclosed to regulators throughout the EU in order to ensure systemic and other risks are properly monitored.

However, the most significant interventionary power granted under the Directive is the power granted to the Commission to adopt measures setting limits to the leverage AIFM in the EU may employ in any fund or strategy. Whilst these limits are expressed to need to take into account the type of AIF, strategy and the source of their leverage, it clearly means that the Commission can set limits to overall leverage which may be employed by different strategies. The Recitals to the Directive give some inkling as to the nature of these restrictions. It suggests that the limits to leverage could, for example, either consist of a threshold that should not be breached at any point in time or a limit on the leverage employed during a given period (e.g. monthly or quarterly).

In addition, the Directive empowers home member state regulators to impose additional temporary limits on the leverage AIFM can employ in exceptional circumstances where this is required to ensure the stability and integrity of the financial system.

AIFM Managing AIF Acquiring Controlling Influences in Companies

The specific provisions of the Directive in this regard apply to AIFM managing one or more AIF which individually or in aggregation acquire 30 percent (a "controlling influence") or more of the voting rights of an issuer or of a non listed company domiciled in the EU. They also apply where the AIFM have concluded agreements with one or more other AIFM which allow AIF which they manage to achieve this level of influence.

These provisions do not apply where the issuer or non listed company is a small or medium sized enterprise employing fewer than 250 persons, having an annual turnover not exceeding €50 million and/or an annual balance sheet not exceeding €43 million. It is unclear whether these exemptions operate in the alternative or not.

Where the Directive provisions apply, an AIFM has the following obligations in relation to non listed companies and issuers in which it acquires the necessary controlling influence:

- Non listed Companies

  Not later than four trading days of it achieving a relevant controlling influence in a non listed company, the AIFM is required to notify the non listed company and all other shareholders as to its voting rights, when the controlling influence was acquired and the conditions under which it was acquired (including the identity of other concert parties);

  In addition, the AIFM is required to make available to the non listed company, its shareholders and the representatives of the employees, details of the identity of the AIFM, the development plan for the non listed company, the policy for preventing and

managing conflicts of interest particularly between the AIFM and the non listed company and the policy for external and internal communications, in particular as regards employees.

- Issuers

  The AIFM is required to make available to the issuer, its shareholders and the representatives of the employees information as to its policy on preventing conflicts of interest, in particular between the AIFM and the issuer, and its policy for external and internal communications, in particular as regard employees.

In addition, there are detailed requirements for the disclosure of operational and other financial information in relation to any such issuers and non listed companies in the AIFM annual reports required to be produced for each AIF under the Directive. The information includes information as to employment matters and significant divestment of assets. The report needs to be made available to all representatives of the employees of the issuer or the non listed company.

Marketing Passport for AIF Managed by AIFM

The Directive contains important provisions permitting AIFM authorized pursuant to the Directive to market units of AIF which they manage in other member states of the EU under an approved private placement regime.

These provisions, and the extent to which these offer real benefits to AIFM authorized under the Directive, are considered below.

AIFM Marketing AIF in Home State

The Directive provides that an AIFM may market shares or units of AIF to professional investors **in its home member state** once it has complied with the notification and filing requirements laid down in the Directive.

The notification and filing requirements are relatively straight forward and include information as to the AIF which are intended to be marketed pursuant to the Directive, details as to each such AIF including its constitutional documentation and information on the arrangements established to prevent units or shares from being marketed to retail investors. Given that the AIFM will already have submitted detailed information on AIF managed by it as part of its application for authorization (see above), this would not of itself appear a particularly onerous notification regime.

Within 10 working days of receipt of the notification, the home member state regulatory authorities are required to inform the AIFM whether it can start marketing the AIF concerned. The Directive enables member states to impose restrictions or conditions on marketing. Details of the types of restriction which may be imposed will be specified in measures to be adopted by the Commission. It is unclear how onerous these may be and whether different home state regulators will in this regard impose different de facto standards. The 10-day period may be extended in relation to non-EU domiciled AIF.

The Directive does permit home member states to allow marketing of AIF to retail investors in their territory in relation to which they may impose stricter requirements than those which apply under the Directive.

AIFM Marketing AIF Cross Border in other Member States

The Directive also permits an AIFM to market AIF which it manages to professional investors in other member states subject to completing a similar notification process to that referred to in the section above with its home member state regulator. This filing must in addition include a programme of operations identifying the AIF it intends to market in other member states and the member states in which the marketing is proposed.

The home member state is required no later than 10 working days after receipt of the complete application to transmit the relevant documentation

to the competent authorities in the other member states in which the marketing is to be conducted together with certification that the AIFM is authorized. The marketing may commence on the date of notification by the home member state.

Extent of the Professional Investor Passport

There are a number of important observations which may be made in relation to the extent of the professional investor marketing passport:

- A professional investor is defined as any investor within the meaning of Annex II of the MiFid Directive.

This is a somewhat opaque definition in that Annex II of MiFid defines a professional client and not an investor. However, on the assumption the Commission will address the technical drafting, the intent of the MiFid definition is clearly to identify "investors" who possess the experience, knowledge and expertise to make their own investment decisions and properly assess the risks that the investment incurs.

Part I of Annex II makes it clear that the following should be regarded as professionals:

i. entities which are required to be authorized or regulated to operate in a financial market (e.g. credit institutions, investment firms, other authorized or regulated financial institutions, insurance companies, pension funds, commodity and commodity derivative dealers, locals and other institutional investors);

ii. large undertakings meeting two of the following size requirements: a balance sheet total of €20 million, net turn over of €40 million and own funds of €2 million;

iii. national and regional governments, public bodies, central banks, international and super national institutions such as the world bank, the IMF, the ECB, the EIB and other similar international organizations;

iv. other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitization of assets or other financing transactions.

It should be noted that Part I does not include high net worth individuals unless they are individually authorized or regulated. That said, Part II of the definition does potentially introduce the concept of "elective" professional investors which could include high net worth individuals. In order for an investor to fall within this category the AIFM would need to make an assessment as to the expertise, experience and knowledge of the investor and the investor must elect to be treated as such. In addition the potential investor, as a minimum, should satisfy at least two of the following criteria:

i. The potential investor has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters;

ii. the potential investor's financial instrument portfolio (defined as including cash and financial instruments) exceeds €500,000; and

iii. the potential investor works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

Accordingly, the number of high net worth individuals which fall within the definition is likely to be limited.

- For a number of jurisdictions the permitted category of investor to which an AIF may be marketed under the Directive is narrower than the existing private placement regimes which apply. Examples in this regard include the UK where high net worth individuals may be assessed by an authorized person as being sufficiently experienced to receive promotional material in respect of an unregulated fund. It remains unclear as to the extent to which the current private placement regimes will continue to be available to AIF and their AIFM following the adoption of the Directive.

  On the other hand, in relation to other EU jurisdictions which do not the permit the solicitation of unregulated funds at all, the passport under the Directive is more permissive.

- The ability of home member states to permit the promotion of AIF to retail (i.e. non professional) investors subject to more restrictive conditions is clearly important. A number of jurisdictions, such as the UK and Ireland, permit non UCITS qualifying AIF to be authorized for wider sale within their territories subject to compliance with strict regulatory standards. Examples in this regard include UK based non UCITS retail funds, which may be marketed to retail investors in the UK, and qualifying investor schemes regulated and authorized by the FSA which may be marketed to wider categories of investor than would fall within the current Directive definition of a professional investor.

Additional Restrictions in relation to Non-EU Domiciled Funds

Unfortunately, the Directive imposes additional requirements and restrictions on the marketing of AIF domiciled in non-EU jurisdictions. This would cover, for example, AIF domiciled in the United

States, Hong Kong, Australia, Canada, Cayman Islands, the Channel Islands, the Isle of Man, to name but a few.

These requirements, which are one of a number of unfortunate protectionist measures under the Directive, are worthy of close scrutiny and may be summarised as follows:

- While such funds may be marketed under the Directive in the home member state of the AIFM from the date the Directive comes into force, they are not permitted to be marketed under the passport provisions of the Directive to professional investors in other member states for a period of 3 years from the date of adoption of the Directive. This clearly introduces less than a level playing field for investment management groups managing non-EU based funds.
- From a date commencing three years after the coming into force of the Directive, the AIFM may only market non-EU domiciled AIF in their home member state if the third country has signed an agreement with the member state which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information on tax matters. This requirement also applies in circumstances where AIFM seek to market non-EU domiciled AIF in member states other than its home member state pursuant to the Directive passport after the three year period.

Passporting of Management Services by AIFM

The Directive contains important provisions permitting AIFM authorized pursuant to the Directive to provide management services in relation to an AIF domiciled in another member state either directly or via the establishment of a branch provided that the AIFM is authorised to manage that type of AIF.

The process of passporting under the Directive would appear relatively straightforward. The AIFM is required to notify its home member state regulator as to whether it intends to provide management services directly to the relevant EU domiciled AIF or indirectly via a branch. It must also notify a programme of operations stating in particular the services which it intends to perform and identify the AIF it intends to manage. Where the AIFM intends to establish a branch, it must also provide the organisational structure of the branch and certain other information.

The home member state regulator must then within 10 working days notify the competent authority in the relevant host member state and the AIFM may start to provide its services in the host member state upon notification. The host member state may not impose any additional requirements on the AIFM in respect of the matters covered by the Directive.

There are a few issues relating to the management services passport which are worthy of comment:

- For AIFM providing management services to EU domiciled AIF there is clearly a requirement to passport under the Directive.
- As indicated above, the AIFM Directive only applies to AIFM which provide management services to AIF. The term “management services” covers the “activities” of “managing and administering” one or more AIF “on behalf of one or more investors”. This suggests that the Directive, as currently configured, is only intended to apply to investment managers which fulfil the role of an operator of a collective investment undertaking as opposed to investment managers undertaking a pure investment management function. If this is the intention, then the Directive would permit, for example, a UK based AIFM to act as the “operator” or management company of an Irish or Luxembourg domiciled unit trust or FCP. It would also permit an Irish or Luxembourg management company to act as the operator of a UK domiciled non UCITS retail scheme or qualifying investor scheme.

  Whilst this form of passporting is perhaps achievable in terms of a UCITS scheme under the UCITS IV Directive, there must be some doubt as to whether this is workable in the context of the AIFM Directive which applies to a broad range of unregulated schemes and structures.
- The Directive states that no additional requirements may be imposed in respect of matters covered by the Directive. Given the wide definition of management services to cover managing and administering one would assume there are few, if any, areas which are not covered. However, we would expect a number of the more protectionist EU jurisdictions may seek to achieve a non level playing field relative to other jurisdictions.

Specific Rules Relating to Third Countries

In addition to the troublesome provisions of the Directive relating to the marketing of AIF domiciled

in non-EU jurisdictions, there are additional provisions relating to non-EU jurisdictions which are also a source of considerable concern.

These provisions come into force from a date commencing three years after the coming into force of the Directive.

Delegation by AIFM to Non-EU Entities

As indicated above, the Directive effectively prevents the delegation of AIFM activities involving portfolio management or risk management outside of the EU. The Directive provides that delegatees in respect of these services must be authorised as an AIFM. This is particularly troublesome for large asset management groups which would not be able to delegate investment management activities to their offices outside of the EU or, indeed, appoint third party investment or risk managers outside of the EU.

In addition, from a date commencing three years after the coming into force of the Directive, AIFM may only delegate administrative services to entities established in a third country provided that:

i. The general requirements as to delegations by AIFM under the Directive are met (i.e. prior authorisation on a case by case basis);

ii. the entity is authorised to provide the administration services or is registered in the third country and is subject to prudential supervision; and

iii. there is an appropriate co-operation agreement in place between the third country and the home state regulator of the AIFM.

Due to the wide ranging definition of management services under the Directive, it is unclear whether this provision is intended to attach to the outsourcing of middle office administration of the AIFM's investment management function or the outsourcing of administration services relating to the AIF itself. This further highlights the somewhat unsatisfactory definition of management services and the confusion as to the intentions of the Commission in this regard.

Non-EU Domiciled Valuators

As indicated above, the Directive requires an AIFM to ensure that for each AIF it manages a valuator independent of the AIFM is appointed to value the assets of an AIF and its shares or units. The AIFM must also ensure the valuator has appropriate and consistent procedures in place to value the assets of an AIF.

The Directive also imposes restrictions on the appointment of a valuator outside of the EU. The Directive provides in this respect that, from a date commencing three years after the coming into force of the Directive, member states may only allow the appointment of a valuator established in a non-EU country provided that the country is approved by the Commission as having valuation standards and rules used by valuators in the territory which are equivalent to those applicable in the EU. The Commission is required to adopt implementing measures specifying the criteria for assessing the equivalence in this regard.

It is not altogether clear how the Commission proposes to enforce this requirement which as drafted would appear to extend the jurisdiction of the Directive to AIF established outside of the EU. However, following the three-year transitional period clearly prevents AIFM from providing management services to non compliant AIF and would appear to restrict the ability of AIFM in the EU to provide management services to AIF which may use non-EU based administrators.

Conceivably, this would also present a difficulty for a number of administrators in jurisdictions such as Ireland, for example, which use non-EU based group companies to provide services in respect of their clients.

Non-EU Based Depositary Services

As discussed above, the AIFM is required to ensure that a depositary is appointed to fulfill various safekeeping responsibilities in relation to the AIF.

The AIFM is also required to ensure that the depositary is an authorised credit institution having its registered office in the EU. This taken together with the requirement that depositaries may delegate to other depositaries restricts the appointment of non-EU based sub custodians to AIF managed by AIFM from the date the Directive comes into force.

Clearly, this is totally unworkable for an international investment fund investing in non-EU markets. Perhaps in recognition of this Directive provides in Article 38 for the appointment of sub depositaries domiciled outside of the EU. However, this provision is flawed in a number of respects:

- The permission only comes into force from a date commencing three years after the coming into force of the Directive;

- The provisions only apply in relation to non-EU domiciled AIF, which is clearly not helpful at all to EU domiciled AIF;
- the permission only extends to sub depositaries appointed in the same jurisdiction as the non-EU domiciled AIF which does not address at all the requirements of an international investment fund with sub custodians in non-EU jurisdictions in which the AIF invests;
- the delegation may only be effected if:
  - i. the third country is approved by the Commission as having effective prudential regulation and supervision equivalent to the provisions laid down in the community law;
  - ii. co-operation between the home member state and the relevant authorities of the third country is sufficiently ensured; and
  - iii. the third country is subject to a decision by the Commission that the standards to prevent money laundering and terrorist financing are equivalent to those laid down in Community law.

Clearly, an emerging market fund (and indeed funds investing in certain developed markets) may have difficulty satisfying these criteria. Indeed, the requirement that the depositary's liability towards investors is not affected by reason of the delegation to a third country depositary of all or part of its tasks, is unlikely to encourage depositaries to agree to provide services to AIF which invest in these markets.

Authorisation of AIFM Established in Third Countries

The Directive applies to AIFM established in the Community which provide management services to AIF domiciled both in and outside the EU.

Although the Directive as currently drafted prevents the delegation of AIFM activities involving portfolio management or risk management outside of the EU, it does not prevent AIFM established outside of the EU from providing investment services to AIF domiciled in the EU.

The substantive provisions of the Directive do not extend the marketing passport under the Directive to non-EU established AIFM. However, the Directive permits a derogation from this requirement. Member states are permitted, from a date commencing three years after the coming into force of the Directive, to authorise non-EU AIFM to market units under the Directive to professional investors in the member state subject to certain strict pre conditions:-

- i. the AIFM's country of domicile is approved by the Commission as having prudential regulation and ongoing supervision equivalent to the Directive;
- ii. the third country domicile is approved by the Commission as granting Community AIFM effective market access comparable to that granted by the Community to AIFM from that third country;
- iii. the AIFM provides to the relevant member state equivalent information as for an authorisation and marketing passport application by an EU based AIFM;
- iv. a cooperation agreement exists between the competent authority of the member state and the supervisor of the AIFM which ensures an efficient exchange of information relevant for monitoring the activities of the AIFM to ensure that stability and the orderly functioning of markets;
- v. the third country has signed an agreement with the member state which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention and ensures an effective exchange of information on tax matters.

It would appear that the permission to market AIF by a non-EU AIFM must be applied for on a member state by member state basis. It is unclear what timetable applies to this and it is unclear how easy in practice this provision will be to invoke.

Indeed, in circumstances where the AIFM are managing non-EU domiciled AIF, the provision may be of little practical assistance if the AIF themselves are not permitted to be marketed under the Directive for a period of three years after the implementation of the Directive.

Overview and Some Conclusions

The draft AIFM Directive is one of the most significant, possibly the most significant, proposal for regulating the European financial services industry in the history of the European Union. It is ambitious and potentially wide ranging in its impact in the sense that it seeks to improve a regulatory and supervisory structure affecting the management and marketing within the EU of all forms of non-UCITS funds.

A number of general observations can be made as to the current structure of the Directive proposals and their potential impact on the financial services industry in the EU.

Targeting the AIFM and not the AIF

There is considerable merit in the views expressed by the Commission that the Directive should focus on regulating EU domiciled AIFM in their management of AIF and should not seek to impose a registration requirement on the AIF themselves. A registration regime for AIF would be unworkable and would unnecessarily affect the efficiency and competitiveness of European investment managers.

Scope of Directive

The Directive will affect the management by AIFM of all types of non-UCITS AIF and not just hedge funds and private equity funds.

If such a proposal is to be workable, then it needs to be more sensitive than the current proposals to the particular needs of managers of all types of investment strategy extending through hedge funds, private equity funds, commodity funds, property funds, long only funds and closed ended listed funds, to name but a few.

Exemptions from the Directive

The exemptions from the application of the Directive are limited in scope and it is arguable they should be extended to increase the monetary thresholds below which AIFM are not required to seek regulation under the Directive. The €100 million threshold in particular would appear unnecessarily low particularly given the administrative and cost burden likely to be imposed on small managers under the Directive.

Whilst the Commission has provided a means whereby AIFM may opt into the Directive to access the passporting provisions relating to AIF, there is an argument that such managers should in any event be able to access the marketing passport without being subject to the substantive provisions of the Directive.

Finally, the Commission does urgently need to clarify the intended scope of the exemption from the Directive made available to credit institutions and insurance institutions in relation to their "own account" business. It would be unfair to the investment management industry if these key players in relation to managed products are able to operate outside of an equivalent regime to the Directive in respect of their competing financial products.

The AIFM Authorisation Requirement

It is unclear whether the Directive is intended to regulate AIFM providing management and administration services to AIF (i.e. "operators") or to regulate both pure investment managers and pure administrators.

The key here is the definition of "management services" which appears to apply to the activity of managing and administering as opposed to pure investment management or administration. The Directive therefore looks like a Directive for operators and not for investment managers.

This is problematic for a number of reasons:

i. The Directive does not adequately address the overlap between authorisation under the Directive and MiFID. On the one hand it suggests that MiFID managers do not require authorisation in respect of their provision of investment services to AIF. On the other there is a suggestion that this exemption only applies if, in effect, an AIF has appointed a regulated AIFM (and is therefore capable of being marketed under the Directive);

ii. the current provisions of the Directive would appear to prevent a MiFID firm from providing any investment services to non-EU AIF during the three year transitional period; and

iii. by focusing on the concept of managing and administering, the Directive anticipates that the AIFM is responsible for operational matters relating to the administration of the AIF which truly rest with the AIF governing entity and, by delegation from the AIF, with depositaries and administrators. This is a key weakness in the current structure of the Directive which needs to be urgently addressed.

The Authorisation Model

Aside from the concerns as to the nature of the activities of an AIFM to which the Directive relates and the lack of clarity in relation to the overlap with MiFID, the process of authorisation appears workable subject to one important and critical caveat.

It is not clear whether the Directive is intended to operate as an authorisation model permitting AIFM

to manage "types" of AIF supplemented by filing requirements; or an authorisation model which requires an AIFM to obtain approval for each AIF it manages and for significant changes to such AIF. Whilst it is assumed that the Commission intends the former given its rejection of an AIF registration model, this point does require further clarification.

In addition, the one month wait and see period before changes to AIF managed by AIFM can be implemented would appear unnecessarily restrictive.

We wait to see how these points are addressed going forward.

Operating Conditions of AIFM

In general terms the conduct of business requirements imposed by the Directive on AIFM in relation to pure investment management duties would appear sensible and workable. The main difficulty for small managers is the requirement to segregate risk and portfolio management and this should be addressed in the Directive in a fairer way.

In addition, the capital requirements are unlikely to be unduly onerous provided that they are brought into line with the comparable requirements relating to UCITS funds.

The provisions in relation to delegation of duties of AIFM suffer from some fundamental difficulties:

i. it is clearly impracticable for an AIFM to obtain authorisation for each delegation. This should be replaced with a principle based approach to delegation which the AIFM is required to comply with;

ii. the prohibition on delegation of portfolio management and risk management to AIFM which are not authorised under the Directive is clearly unworkable both in terms of the legitimate requirement of AIFM to delegate to group companies outside of the EU and appropriately authorised non-EU managers. A more UCITS style approach permitting delegation to suitably authorised overseas entities should be adopted;

iii. the imposition on AIFM of responsibility for effectively supervising the delegation of administrative tasks should be removed. This goes beyond the competence of most AIFM and is most appropriately regulated at the administrator level.

Organisation of Requirements Imposed on AIF

Although the Directive is not intended to be a model for registering or directly regulating AIF managed by AIFM, it does seek to impose a number of minimum requirements relating to the organisation and operation of AIF.

Unfortunately a number of these requirements do not sit easily with the relationship between AIFM and the AIF which they manage. These particular difficulties relate to both open and closed ended AIF.

For example, the duty on the AIFM to ensure that all investors are treated fairly fails to recognise the reality that many corporate AIF, particularly listed open and closed ended corporate AIF, have active governing bodies which an AIFM may not be able to influence. Indeed, from a pure corporate governance perspective hitherto perceived wisdom has been that an AIFM should not unduly influence these matters.

This principle also applies to a number of other provisions of the Directive which seek to impose responsibility on AIFM in relation to the liquidity and redemption policy adopted by an AIF as well as the appointment of a depositary and valuator. It should be possible to find a way under the Directive to ensure these investor protection issues are dealt with in a way which preserves this division of responsibilities whilst achieving the aim of the Directive to enhance investor protection.

Depositaries

The proposals in the Directive relating to depositaries are of considerable concern.

Seeking to impose additional liabilities on depositaries relative to, inter alia, investors will result in depositaries either not being prepared to provide their services to AIF managed by AIFM established in the EU or only being prepared to do so at prohibitive fee rates. This would clearly be a disaster for the European financial services industry.

Secondly, the provisions preventing depositaries delegating custody to sub depositaries outside of the EU will make it impossible for AIFM in the EU to manage anything other than investment funds investing in the EU. Whilst this may be an error in the drafting of the Directive, it is nonetheless consistent with the approach currently underpinning a number of important aspects of the structure of the Directive.

Administrator and Valuator

The responsibilities imposed on the AIFM in relation to the appointment of a Valuator responsible for the valuation of assets and the pricing of shares and units of an AIF are consistent with the general assumption under the Directive that the AIFM has control over the operational administration of the AIF.

Given that this is not a universal practice within the investment management industry, it would be better if the Commission provided an exemption from these requirements in circumstances where the AIF itself appoints the administrator or Valuator.

Disclosure

There are widespread concerns within the industry as to the extent of the disclosure requirements placed on AIFM in relation to disclosures to home state regulators.

In addition, it is not altogether clear how an AIFM can ensure that an AIF will make the disclosures required under the Directive to investors at the "point of sale" and periodically. This is particularly the case where an AIFM is appointed by a non-EU based fund promoter. Such promoters may not take kindly to an EU based AIFM seeking to impose point of sale disclosure requirements on their AIF structures. Indeed, one can see real difficulties arising where an EU AIFM is one of a number of managers some of which may not be based in the EU.

The Marketing Passport

The passport provisions under the Directive are in many ways to be welcomed although many EU jurisdictions do of course already have private placement regimes in place.

To avoid unduly restricting current EU national private placement regimes, the Directive provisions should not prevent individual EU states from operating more permissive regimes if they so wish. This is particularly important in relation to jurisdictions, such as the UK, which permit the distribution of non UCITS AIF more widely than the current Directive provisions.

The real difficulty with the passport proposal however is the exclusion of non-EU domiciled AIF from the pan member state passport provisions for a three year "wait and see" period. This is grossly unfair to well established jurisdictions such as the Channel Islands, the Isle of Man and the Cayman Islands and will also be viewed negatively by other non-EU jurisdictions.

The Management Services Passport

It is logical to include a provision permitting AIFM established in a member state to passport and provide management services to EU domiciled AIF.

However, it is unclear how this will work in practice. For example, is it intended that a UK based ACD should be capable of acting as the manager of an Irish unit trust or the manager of a Luxembourg FCP? Or indeed that a Luxembourg AIFM should be capable of acting as an ACD or manager of a UK based NURS? It will be interesting to see the views of individual member states on this proposal.

The Non-EU Dimension

The provisions relating to non-EU based AIFM and AIF are particularly unattractive and could be deeply damaging to the European financial services industry in terms of its business activities outside of the EU and with non-EU institutions and promoters.

As already highlighted, the Directive imposes wide ranging restrictions on delegation to non-EU based AIFM, on the appointment of non-EU-based administrators and valuators and on the appointment of non-EU based depositaries. The Directive also appears to prohibit non-EU based promoters from marketing AIF in the EU at all during the three year period after adoption of the Directive and, following this period, only permits marketing on a restricted basis subject to detailed approvals on a member state by a member state basis.

All of these provisions are potentially deeply damaging to the relationship between Europe and other parts of the world and are likely to severely affect the European asset management industry.

Impact on Particular Management Strategies

Finally, it is appropriate to briefly consider the potential impact of the proposals on particular parts of the European investment management industry.

Hedge Funds

If the Directive is implemented in its current form, AIFM managing AIF utilising hedge fund strategies will face many of the same cost and organisational challenges faced by managers of other types of open ended AIF.

Given that many of the entrants into the industry are initially small enterprises, the Directive provisions will present a number of challenges to these smaller managers. Most of these are cost based and relate to the additional operational requirements under the Directive which they will need to make provision for. A particular challenge in this regard will be the need to segregate portfolio management and risk management functions and for these to be subject to regular review. Further challenges may be faced if the Commission's intention is that AIFM should assume broader "operator" functions relative to the AIF managed.

In addition, the particular requirements imposed on AIF employing high levels of leverage on a systematic basis are likely to be relevant to most hedge fund strategies. Clearly hedge funds will be sensitive to the level at which leverage will be permitted and the restrictions which may be imposed under the Directive. Given that the detail of these proposals is yet to be determined, there is no current transparency on the likely regulatory outcome in this regard.

There are a number of additional points raised by the Directive which will be of relevance to hedge fund managers:

i. The Directive effectively bans naked shorting;

ii. AIFM will need to ensure that the liquidity profile of the AIF complies with its underlying obligations. These are not purely obligations to investors (relating to redemption policies) but will also include responsibilities to counterparties in the market;

iii. the requirement that an AIFM must ensure that the AIF's redemption policy is appropriate to the liquidity profile of the AIF will inevitably mean that AIFM will wish to see AIF which they manage adopt appropriate liquidity management powers. These will include powers to side pocket and apply gates. It will also mean that the power to suspend should be more obviously drafted as a bona fide liquidity management tool;

iv. the requirements as to "point of sale" and "ongoing disclosures" to investors will inevitably lead to more detailed and sophisticated offering memoranda and annual report and accounts. It may also lead to more detailed "verification" of offering memoranda disclosures;

v. the enhanced duties in relation to risk management including the conduct of due diligence in relation to underlying investments and counterparties will result in enhanced operational due diligence by hedge fund managers;

vi. the greater transparency in relation to the disclosure of preferential treatment granted to investors (including the identity of the investors concerned) will inevitably have an impact on AIF and AIFM material side letter policies. This is equally challenging both for AIF which operate side letter policies and those which issue multiple classes of shares with different terms.

Finally, the proposals may well have implications for the relationship between an AIF and its prime broker. The requirements in relation to the role to be taken by the depositary will inevitably mean that it will need to appoint the prime broker custodian as a sub custodian which will mean that prime brokers will need to ensure that these sub custodians are set up as credit institutions. It will also mean that rehypothecation arrangements will need to be agreed directly with the depositary and whilst the Directive does not ban rehypothecation it will have implications as to the manner in which it is documented.

Fund of (Hedge) Funds

The enhanced requirements as to the conduct of due diligence in relation to underlying investments and counterparties underline the need for AIFM of fund of funds (and in particular AIFM of fund of hedge funds) to conduct detailed and thorough due diligence of underlying funds and their service providers.

That said, in one sense, the Directive does assist fund of fund managers relative to the managers in which they invest. It should be possible for fund of fund managers to appoint a depositary in the EU pursuant to the Directive responsible for the safe custody of interests held in underlying funds. There is, however, no requirement under the Directive that the service providers to these funds, their administrators or custodians should themselves comply with the requirements of the Directive (assuming they are domiciled outside of the EU).

Private Equity Funds

The potential impact on AIFM managing private equity AIF is of a different nature to that faced by AIFM of other more open ended strategies. Private equity AIFM are less exposed to the liquidity management implications of the Directive and, given the nature of the role of general partners in private

equity limited partnership structures, potentially less sensitive to the Directive's current blurring of the division of responsibilities between the governing body of the AIF and the AIFM.

On the other hand, the enhanced disclosure regime under the Directive at the point of sale is likely to move private equity fund offerings towards utilising more formalised offering memoranda than can sometimes be the case at present. In addition, the disclosure requirements under the Directive in relation to the acquisition of controlling influences in issuers and non listed companies, as well as in relation to other matters, are disproportionate when compared with the disclosure required of other private investors. Such requirements may put private equity funds at a competitive disadvantage in relation to other private equity buyers.

The requirements concerning disclosure of preferential treatment given to investors will force a re-think of the way that some fund sponsors work their side letter and most favoured nation processes.

Finally, the requirement to use a "depository" seems to achieve little in the context of many private equity fund structures (other than imposing an additional layer of cost).

Closed-Ended Funds

The provisions of the Directive will be of particular concern to AIFM managing closed-ended AIF listed on recognised stock exchanges. Particular categories of AIF in this respect include UK listed investment trusts and investment companies.

The Directive does not address the fact that many of these types of AIF already enjoy wide-ranging passport rights under the Prospectus Directive. In these circumstances the passport provisions under the Directive are of little benefit.

In addition, closed-ended AIF listed on recognised stock exchanges, as is also true of open-ended listed AIF, are required to maintain the distinction between the governing body of the AIF and the AIFM and many of the proposals under the Directive are inconsistent with this important principle of corporate governance. Further, the Directive ignores one fact that closed-ended AIF traded on regulated markets are already subject to the Transparency Directive.

Property Fund Managers

Property fund managers manage a variety of different types of AIF. For example, some property funds follow the private equity model, some follow the more open-ended model (for example, APUT type structures) and others the closed ended listed model. As a result, AIFM managing property AIF will be particularly sensitive to the implications of the Directive for all these forms of AIF.

In addition, the Directive may well mean that pure property advisers which are not currently regulated (by reason of the fact that they provide pure property advice to AIF managed offshore) will need to establish regulated AIFM within the EU in order to effectively market their products in the EU.

AIFM managing property AIF may also be sensitive to the provisions of the Directive relating to leverage, given the use of leverage in property fund structures.

■ ■ ■

This update was authored by Stuart Martin (+44 20 7184 7542; stuart.martin@dechert.com) and is based on an article previously published on *Complinet* (www.complinet.com).

Practice group contacts

For more information, please contact one of the lawyers listed, or the Dechert lawyer with whom you regularly work. Visit us at www.dechert.com/financialservices.

Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

Peter D. Astleford
London
+44 20 7184 7860
peter.astleford@dechert.com

Gus Black
London
+44 20 7184 7380
gus.black@dechert.com

Peter Draper
London
+44 20 7184 7614
peter.draper@dechert.com

Richard Frase
London
+44 20 7184 7692
richard.frase@dechert.com

John Gordon
London
+44 20 7184 7524
john.gordon@dechert.com

Andrew Hougie
London
+44 20 7184 7373
andrew.hougie@dechert.com

Angelo Lercara
Munich
+49 89 21 21 63 22
angelo.lercara@dechert.com

Angelyn Lim
Hong Kong
+852 3518 4718
angelyn.lim@dechert.com

Stuart Martin
London
+44 20 7184 7542
stuart.martin@dechert.com

Antonios Nezeritis
Luxembourg
+352 45 62 62 27
antonios.nezeritis@dechert.com

Keith T. Robinson
Hong Kong
+852 3518 4705
keith.robinson@dechert.com

Marc Seimetz
Luxembourg
+352 45 62 62 23
marc.seimetz@dechert.com

Jennifer O. Wood
London
+44 20 7184 7403
jennifer.wood@dechert.com

Dechert LLP

www.dechert.com

EUROPE Brussels • London • Luxembourg • Moscow • Munich • Paris • **U.S.** Austin Boston • Charlotte • Hartford • Newport Beach • New York • Philadelphia • Princeton San Francisco • Silicon Valley • Washington, D.C. • **ASIA** Beijing • Hong Kong