Amendments Clog EU AIFM Directive Debate

The political backdrop is also evolving rapidly

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The Proposal for a European Directive on Alternative Investment Fund Managers (the "Directive") was published by the European Commission in April 2009 (the "Commission Proposal"). There have been various iterations of the Directive following the initial Commission Proposal. Last year a number of compromise drafts were issued by Sweden during its presidency of the European Council and a report was issued by the Parliamentary Rapporteur, Jean Paul Gauzes (the "Gauzes Report"). During its presidency, Spain has *(at the time of going to press)* published four drafts, the most recent dated 1 March 2010 (the "Spanish Compromise").

The positive news is that Spain has built on the basic framework developed by Sweden, which introduced a number of broadly positive changes culminating in a compromise draft of 15 December 2009 (the "Swedish Draft"). However, the Spanish Compromise contains a number of additional or re-opened provisions which are more onerous for the industry. Some of the key points are considered below.

The political context

The Spanish Compromise should be considered against the broader political process which is currently at a very active stage.

The Economic and Monetary Affairs Committee of the European Parliament ("ECON") has recently concluded its first formal discussions on the 1669 proposed amendments. These discussions are set to continue on 17 March with a committee vote expected on 12 April. A full Parliamentary vote is still proposed to occur in July, although many commentators are doubtful that this timetable will be met.

As the news filters out from the Parliamentary discussions, while there is agreement in some areas, it is becoming apparent that on other points opinions remain widely divided.

There is some consensus that there should be proportionality in the application of the Directive to certain types of alternative investment fund managers ("AIFM") and alternative investment funds ("AIF"). However, there is disagreement as to whether this should be by wholesale exemption for certain types (or sizes) of AIFM and AIF or by a more tailored application of the Directive to each relevant category. If a flexible approach is adopted, then a clear concept of proportionality in this context will be necessary to guard against implementation at Member State level in a manner not intended by the Directive.

There is also broad support for reshaping the proposed depositary model, amongst other things, so that the liability provisions are more in line with the UCITS model and to allow non-EU entities to act as depositaries. However, opinions remain strongly divided between those who would restrict EU marketing rights for non-EU AIF and those who think this approach would be protectionist.

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

Separately, the General Secretariat of the European Council has issued a report to the Permanent Representatives Committee ("Coreper") which consists of Member States' ambassadors to the EU. The report notes that there is, as yet, no qualified majority supporting an overall compromise on the Directive due, primarily, to disagreement on the key areas of scope, depositaries and third country issues. The report invites Coreper to agree and recommend to the Council a general approach on these points for negotiation with the Parliament with a view to reaching an agreement at the first reading of the Directive.

Marketing and management

Marketing

The Directive provides for a European "passport" allowing EU AIFM to market EU domiciled AIF throughout the EU. In addition, both the Gauzes Report and the Swedish Draft would have allowed Member States, if they wished, to permit private placements to professional investors subject to their national laws. This was an important inclusion as without it, access to the EU market would have been severely restricted for non-EU AIF and non-EU AIFM. It is clear from the ongoing debate in the Parliament that these provisions remain among the more controversial.

While the Gauzes Report and the Swedish Draft left some uncertainty as to the exact scope of private placements that would be permitted, the Spanish Compromise has now set out the requirements in more detail. However, the Spanish Compromise imposes additional minimum conditions for such private placements to be permitted.

There is now a requirement for "appropriate cooperation agreements" where a non-EU AIF is marketed into the EU. The most recent draft of the Spanish Compromise clarifies that these agreements are to be focussed on ensuring "efficient exchange of information" to enable competent authorities to carry out their duties under the Directive. However, as the Commission has the power to adopt implementing measures setting out specific requirements in relation to these cooperation agreements, there is still a risk that such requirements, if broadly drafted, could substantially limit the number of non-EU jurisdictions able to achieve such agreements.

For AIF already being marketed into the EU prior to the transposition date (the date on which the Directive is to be implemented into national law by Member states), the latest Spanish Compromise includes a three year transitional period during which Member States may relax the requirement for cooperation agreements in allowing private placements. In tandem with this, the Commission is required to issue the associated implementing measures within two years following the transposition date, leaving just one year for the agreements to be put in place.

While this helps to preserve the status quo for existing AIFM and AIF during the three year period, it does not address the position for non-EU AIF established after the transposition date. This also creates prolonged uncertainty as to whether an operable network of EU private placement regimes will be permitted.

There is reference in the Recitals to the Spanish Compromise to an intention that "cooperation agreements should not be used as a barrier to impede third country funds from being marketed in a Member State". The Spanish Compromise also states the intention that the "rules should not limit the choice of the European investors nor should they be used as a barrier to impede the marketing of those funds in a Member State or prevent the European Union to comply with WTO rules".

These statements of intention are welcomed. However, it is far from clear how the Directive will safeguard against its implementing measures being used to achieve precisely the opposite result. In addition, as the FSA itself has pointed out, by seeking to impose such requirements on matters of purely national regulation, the Spanish Compromise offends against the principle of subsidiarity which is supposed to be at the heart of European lawmaking.

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

Similarly, non-EU AIFM marketing AIF in the EU are required to comply with Articles 19 (Annual Reports), 20 (Disclosure to Investors), 21 (Reporting Obligations to Competent Authorities) and also the disclosure obligations arising on acquisition of a controlling interest in a non-listed company. As the drafting simply states the requirement for "compliance with" the relevant provisions of the Directive, there is considerable legal uncertainty as to how these would apply to a non-EU AIFM. On the basis of the current drafting, it is conceivable that a non-EU AIFM would need to make detailed disclosures to the authorities in each Member State in which it proposes to market. In addition, the drafting would seem to suggest that a non-EU AIF marketed into the EU by a non-EU AIFM would be required to have its accounts audited by an EU qualified or recognised auditor.

These requirements merely set out the minimum conditions for private placements to be permitted by Member States which may, of course, impose more extensive requirements or not permit private placements at all.

A separate area of uncertainty is the reference in Recital 19(a) to the proposed review of relevant legislation in relation to "institutional" investors to assess the need for "tighter requirements and more transparency" where institutional investors invest in AIF managed by non-EU AIFM. This potentially refers to a European Parliament Resolution of 23 September 2008 on Transparency of Institutional Investors (2007/2239(INI)) although it is unclear what impact such review may have on the scope of, or conditions for, private placement exemptions for non-EU AIF and non-EU AIFM.

The Spanish Compromise is a firm step backwards for the industry in relation to marketing, with the door ajar for protectionism to return. In addition, the Spanish Compromise would lead to a lengthy period of uncertainty, potentially for several years, which in many ways would be just as damaging as the imagined worse case scenario.

Management

The Swedish Draft set out conditions for an EU AIFM to be permitted to manage a non-EU AIF. These conditions were: (i) that the legislation in the domicile of the AIF was to be in line with standards set by international organisations (such as IOSCO); and (ii) that an appropriate cooperation agreement be in place with the third country authorities. In the Spanish Compromise, the first requirement is replaced with a requirement for compliance with all but certain sections of the Directive. Even if the non-EU AIF is not marketed in the EU, all of the requirements of the Directive would apply with the exception of Articles 17 (Depositaries) and 19 (Annual Reports) and Chapter VI (Rights to Manage and Market in the Community). In addition, the requirement for an "appropriate cooperation agreement" would remain. Such requirements are arguably more onerous than the Swedish Draft intended.

As with the marketing provisions above, there is a transitional period during which Member States may relax the requirement for a cooperation agreement. Likewise, although the draft gives some clarification as to the scope of the cooperation agreements, it would breed uncertainty which will continue for several years until the implementing measures are introduced.

Finally, the EU passport for AIFM to provide management services in other Member States now specifically extends to the other activities for which the AIFM has been authorised under the Directive.

Depositaries

The Directive requires AIFM managing EU AIF to ensure a depositary is appointed for those AIF. The Commission Proposal, the Swedish Draft and the Gauzes Report each imposed liability on the depositary for loss of financial instruments but allowed depositaries to disclaim this liability where a sub-custodian was appointed. The Spanish Compromise retains this derogation but is now conditional on such discharge being "reasonable", whereas before all that was required was an "objective reason" for the discharge. It is unclear how this reasonableness requirement would be interpreted in practice creating legal uncertainty for would-be depositaries.

The liability provisions will most likely reduce the number of depositaries willing to act, which would further increase the likelihood of concentration among a small number of depositaries. This would increase, not reduce, systemic risk. At the same time, the additional cost (in the form of increased liability insurance and capital requirements) will ultimately be passed on to end investors. As most depositaries service a wide range of asset managers, the cost will likely be passed on to investors far beyond the "alternative" vehicles targeted by the Directive. The requirement that the depositary should be established in the home Member State of the AIF was in square brackets in the Swedish Draft, suggesting that this position was provisional. However, the requirement has been retained in the Spanish Compromise (albeit after a four year transitional period). This seems arbitrary and likely to reduce choice and further increase potential for systemic risk due to the concentration of fund exposure among the relevant Member State depositaries.

A requirement in the latest version of the Spanish Compromise is that AIFM are to receive prior notice of the appointment of any sub-custodian.

Valuations

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

Where an external valuer is used, the valuer will now have liability to the AIFM, the AIF and investors for any loss resulting from failure to perform the valuation. In addition, the valuer must be subject to mandatory professional registration, provide professional guarantees and maintain professional indemnity insurance.

These provisions are inconsistent with the way the industry operates and, as it appears that the use of an external valuer is not mandatory, would seem to be a disincentive to using an external valuer. In addition, many valuers would be reluctant to assume these liabilities without substantially increasing their fees.

Conclusion

At one level, the Spanish Compromise is positive as it builds on the Swedish framework and includes some useful clarifications. However, in certain respects the Spanish Compromise is a backwards step. There is still uncertainty as to whether an effective private placement regime will be possible and the delays associated with cooperation agreements look set to prolong that uncertainty. The Parliamentary discussions on this point appear to remain very much in the balance. In addition, the liability provisions for valuers and depositories will increase cost, reduce flexibility and may actually increase, rather than decrease, systemic risk.

It seems clear that the final text of the Directive is still some way off and as such it is impossible to predict exactly how it will impact. Combined with this, the vagaries of the political process and delays associated with the implementing provisions are damaging for the industry and seem set to continue for some time.