

AIFMD Technical Update

22 February 2010

What's happening to the Alternative Investment Fund Managers Directive (AIFMD)?

Current state of play

The Alternative Investment Fund Managers Directive was proposed without any significant prior consultation in April 2009 and has been subject to endless comment and proposed amendment since then. The Swedish Presidency endeavoured to reach agreement between Member States on the Working Group reporting to the Council of Ministers but failed to reach agreement on several key issues before handing over the Presidency to Spain on 1 January 2010. The Spanish Presidency's work programme for 2010 identifies the AIFMD (along with capital strengthening, remuneration policies, joint crisis management and revised supervisory architecture) as one of the key topics it is aiming to progress in the financial sector. This priority is borne out by the Spanish Presidency's publication first of an [Issues Paper](#) in January identifying key discrepancies between the last [Swedish Compromise Proposal](#) and the [draft report](#) of the Parliamentary Rapporteur, Jean Paul Gauzes, and then, on 1 and 15 February 2010, of two further compromise proposals building on the work done under the Swedish Presidency and making the additional changes summarised below. The 15 February version is referred to below as the "[Spanish Proposal](#)".

The other key component in the European process is the amendments being tabled by MEPs, all of which relate to the original draft AIFMD, not to the various Presidency Compromise Proposals. The European Parliament was in recess over the holiday season but MEPS had to submit all their proposed amendments by 21 January 2010. The unprecedented level of amendments (1669, running to some 700 pages: [139 - 309](#); [310 - 507](#); [508 - 699](#); [700 - 979](#); [980 - 1183](#); [1184 - 1432](#); [1433 - 1669](#)) has resulted in considerable delay in their publication. The way in which the rapporteur Jean-Paul Gauzes and the key Parliamentary Committee on Economic and Financial Affairs ("ECON") react to these amendments remains to be seen - ECON is due to start discussing them on 23 February. However it is clear that there are strongly divergent political views on the AIFMD, including some believing (contrary to almost all analysis and reports into the financial crisis) that AIF played a significant part in causing that crisis and that all AIF and all AIFM should be much more strictly regulated than even the original Commission draft of April 2009 proposed. A flavour of some of these political views can be seen in a draft opinion produced for the Parliamentary Committee on Legal Affairs ("[JURI](#)") which is also summarised below.

Despite the uncertainty described above and the volume of amendments proposed it is understood that there is still a political drive for the Parliamentary ECON Committee to agree a text in April which can be discussed in "trilogues" between the Commission, Council and Parliament throughout May with a view to a common approach being reached in June and a Parliamentary plenary vote in July, with a view to implementation in 2012. Michel Barnier, the new EU Commissioner for the Internal Market and Services, in his first speech to the Ecofin Council on 16 February identified as part of his first and most immediate priority *"effective regulation of alternative investment funds... We will have to work together, and quickly, in order to find an agreement on this [AIFMD] text and I am convinced that we have the means to put in place appropriate and effective rules."*

This update does not summarise the whole Directive or proposed amendments to it but just outlines the new proposals made in either the JURI Opinion or the Spanish Proposal.

What changes are proposed in the draft JURI Opinion?

The draft JURI Opinion makes a number of sweeping allegations about funds and their managers (for example stating that there is no balance between risk and responsibility and that it was a "significant loophole" in the Directive that managers of foreign funds who are not EU nationals "would be able to invest in the EU without being registered or supervised.") It suggests various unwelcome amendments to the original draft of the directive, notably:

- a proposal that the Directive should expressly cover AIF as well as AIFM (as opposed to only doing so indirectly) and that thresholds should be removed
- direct regulation by the new European Securities Authority, rather than national regulators, whenever an AIFM markets AIF in more than 3 EU Member States
- a central EU public register of all AIF and their AIFM, depositaries and valuers
- adding to the requirements for an independent external valuator for every AIF a requirement that it should be EU certified and apply statutory valuation guidelines which should be uniform across the EU
- a ban on any delegation by depositaries
- disclosure to investors before investment of the AIFM's remuneration strategy
- additional risk disclosures to pension fund investors and, more importantly, an obligation to make available to pension rights holders, their representatives and advisers the disclosure information given to the pension fund investors themselves. This

is clearly with a view to employee and union involvement but effectively means that all such information would become public

- funds to be regarded as employing high leverage on a systematic basis and be subject to further restrictions if leverage exceeds the value of equity capital on more than three trading days in two preceding quarters
- own capital requirements for AIF which are no lower than those applicable to banks and an absolute leverage cap (within which the Commission could set lower limits) of 5 times own capital
- a trigger of only 25% of the voting rights before additional disclosure (including to employees) and other obligations apply in relation to investee companies, the application of those obligations even in relation to holdings in SMEs and new requirements for:
 - disclosure of those authorised to conclude agreements on business strategy and employment; and
 - treating fund acquisitions of 25%+ holdings as if they were business transfers for the purposes of employee rights protections
- a ban on Member States being allowed to permit retail marketing, even of compliant funds, with a minimum investment of less than €50K (despite the fact that many AIF which will be caught by the AIFMD are very basic, long only listed closed ended funds, such as UK investment trusts)
- additional requirements in relation to the valuator
- additional requirements on leverage, including a hard leverage cap
- expansion of the provisions relating to controlling stakes to include investment in SMEs and lower the relevant limit to 25%.

It is to be hoped that the text that is eventually agreed by the European Parliament will not incorporate these proposals but the fact that they are proposed shows the level of suspicion and hostility in some political quarters relating to funds and their managers.

What changes are proposed in the Spanish Proposal

- The Swedish proposals had left marketing of non-EU funds by non-EU managers to national discretion, which would have meant that individual Member States could continue to permit (or ban) marketing of non-EU funds by non-EU managers to investors in their own territory. The Spanish Proposal is more restrictive and says that individual Member States would only be allowed to permit such marketing, even to professional investors, if "at least":
 - The AIFM complies with all the Directive provisions on reporting to investors and to the regulators in each of the states in which marketing is conducted;
 - The AIFM complies with the Directive provisions on disclosures relating to non-listed companies in which they take controlling interests; and
 - There are "appropriate" co-operation agreements between the competent authorities of each EU Member State in which the fund is marketed and the regulators of the AIFM in its home jurisdiction. The European Commission would determine what amounts to "appropriate" co-operation arrangements but presumably if the non-EU manager is not itself regulated it will not in any event be possible to have such arrangements in place.
- The Spanish Proposal is also more restrictive when it addresses EU AIFM managing non-EU funds. EU AIFM would only be allowed to manage non-EU funds (even if the funds are not marketed in the EU) if they comply with all the Directive requirements apart from those relating to:
 - Depositaries
 - Production of annual reports and their provision to regulators and investors
 - Marketing notifications to the regulators

Other organisational, conduct of business and disclosure obligations to investors, regulators and others would still apply, as well as the valuation and other requirements of the Directive.

- Once an EU AIFM wished to market in the EU a non-EU fund which it managed it would have to comply with all the Directive requirements apart from those relating to depositaries. Moreover they would still have to ensure that each such fund had an entity other than the manager which was responsible for fulfilling the depositary functions. It would only be possible to disapply the detailed further provisions concerning the exact nature and liabilities of the depositary.
- The absence of a satisfactory definition of an AIF is still not fully addressed in the Spanish Proposal. A recital does endeavour to exclude employee participation or savings schemes and also industrial holding companies, but the limited way in which the latter exclusion is phrased tends to confirm the potentially very wide reaching nature of the Directive and the risk of catching a number of normal commercial activities, the only certain exclusion being those funds which are already subject to the UCITS Directive.
- The exemption for small AIFM with FUM below the specified thresholds (€100m or €500m depending on the type of funds) is in the Spanish Proposal only a matter for national discretion (rather than applying automatically) and it adds a new requirement that the managers of such funds must in any event be registered and provide information to the competent authorities on a national basis. Whilst this is preferable to the continuing threat of complete removal of the thresholds, such requirements will add costs for small fund managers in those jurisdictions (unlike the UK) where they are not currently regulated. Moreover any opt-in by such small managers, in order to take advantage of the marketing passport, would require the full application of the whole AIFMD except that the Spanish Proposal would reduce the capital requirements for small AIFM who only manage unleveraged closed ended funds making only non-frequent investments. (This is intended to assist VC funds).
- The Spanish Proposal allows Member States to derogate from the requirement for functional separation of risk

management and portfolio management for managers where it would not be proportionate. Whilst this is subject to further rules to be made by the Commission, which may prove highly restrictive, the possibility of such derogation is welcome and should be supported. For many types of AIF portfolio management and risk management are inextricably intertwined.

- The Spanish Proposal expands on the organisation requirements to which managers will be subject, in particular internal control mechanisms, transaction recordkeeping, personal transactions by employees and conflicts of interest, and gives the Commission the power to adopt implementing measures specifying the required procedures and arrangements. It is unclear whether the requirements are likely to be similar to or significantly more onerous than those imposed on discretionary managers and other investment firms under the Markets in Financial Instruments Directive.
- A new obligation is imposed to publish the NAV of shares or units in each AIF, except where this is excluded under the AIF rules or instruments of incorporation or the AIF concerned is closed ended and traded on a regulated market.
- Although the Spanish Proposal does not revert to compelling the use of an external valuer it does expand considerably on requirements relating to the independence of the valuation function and the applicable criteria and liabilities when an external valuer is appointed. In addition, the appointment of an external valuer will need to be notified to the relevant competent authority and the Commission is given powers to adopt implementing measures specifying, amongst other things, the criteria for determining whether or not the valuation function is independent and the professional guarantees an external valuer will be required to supply.
- The depositary requirements remain contentious and the Spanish Proposal suggests amendments to:
 - require the segregated accounts to which payments are to be made to be opened in the name of the AIF (or, oddly, the AIFM) at a central bank, EU credit institution or bank authorised in a third country;
 - require the depositary to ensure that financial instruments which can be held in custody are registered in segregated accounts in the name of the AIF in the depositary's books so that they can "at all times" be identified as belonging to the particular AIF;
 - require the depositary to ensure that AIF asset valuations and the NAV of shares or units in the AIF are calculated in accordance with the applicable rules and procedures;
 - make the appointment of a depositary subject to approval by the competent authorities of the home member state of the AIF (or of the AIFM where the AIF is unregulated) and marginally expand the list of eligible depositaries to include EU banks and investment firms which are subject to capital adequacy obligations and certain other categories approved by Member States under the UCITS Directive;
 - allow a rather limited grandfathering under which the competent authorities of the AIF home state (or the AIFM home state where the AIF is not regulated) can allow an EU credit institution (but not other types of depositary) established in another EU Member State to act as depositary for up to 4 years after implementation of the Directive;
 - limit further the circumstances in which depositaries may exclude liability in relation to their delegates;
 - empower the Commission to make further rules in relation to sub-delegation;
 - require disclosure to investors before they invest of the identity of any delegate used for management or depositary functions; and
 - require identification of the depositary in marketing notifications to regulators
- The Spanish Proposal limits the powers given to individual competent authorities to impose limits on leverage, or other restrictions on AIF management, to situations which are intended to "limit the extent to which the use of leverage contributes to the build up of systemic risk in the financial system or risks of disorderly markets".
- The Spanish Proposal suggests disapplying the disclosure and other requirements relating to control of non-listed companies where the investee company concerned is a real estate special purpose vehicle and, more generally, inserts an express statement that the AIFMD requirements apply without prejudice to Member State rules on the acquisition of holdings in companies in their territories.
- A more major addition is that where an AIFM is in a position to control a company (whether or not listed) it must give both its regulators and its investors information on the debt supported by the investee company not only immediately before and after acquisition but also whenever material changes occur to that debt. This obligation clearly puts AIFMs and AIF investors at a significant disadvantage when compared to other types of corporate owner.
- Finally under the Spanish Proposal the various detailed remuneration policy requirements are applied not only to remuneration paid by the AIFM but also to amounts directly paid by the AIF and to transfers of shares or units of the AIF made to benefit staff, including senior management, whose professional activities have a material impact on the risk profile of the AIFM or AIFs it manages. The only disapplications proposed are for:
 - returns paid in connection with liquidation of the funds or when investors have been reimbursed the amounts invested in the funds (this is understood to be intended to cover private equity "fund as a whole" carried interest, although the reference to fund liquidation would seem to have a different, and potentially strange, application);
 - returns to employees from investment in shares or units of the AIF that can be freely bought by the other investors of the AIF.

As is apparent from the summary above the changes made in the Spanish Proposal tend to be more restrictive and onerous than the Swedish proposals. However, apart from the changes listed above, the Spanish Proposal retains most of the clarificatory and other amendments in the earlier Swedish proposals.

This means that in many respects the position is still an improvement on the original Commission draft (for example, defining marketing as limited to marketing at the initiative of the AIFM or on its behalf, lightening the restrictions on delegation by an AIFM, somewhat limiting the disclosures required when holding significant stakes in companies and providing a degree of flexibility on valuation and depositaries). In other respects the position remains more onerous than in the original draft (for example, the

additional disclosures relating to debt supported where controlling stakes are taken in investee companies and the inclusion of a detailed code imposing remuneration restrictions and disclosures).

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