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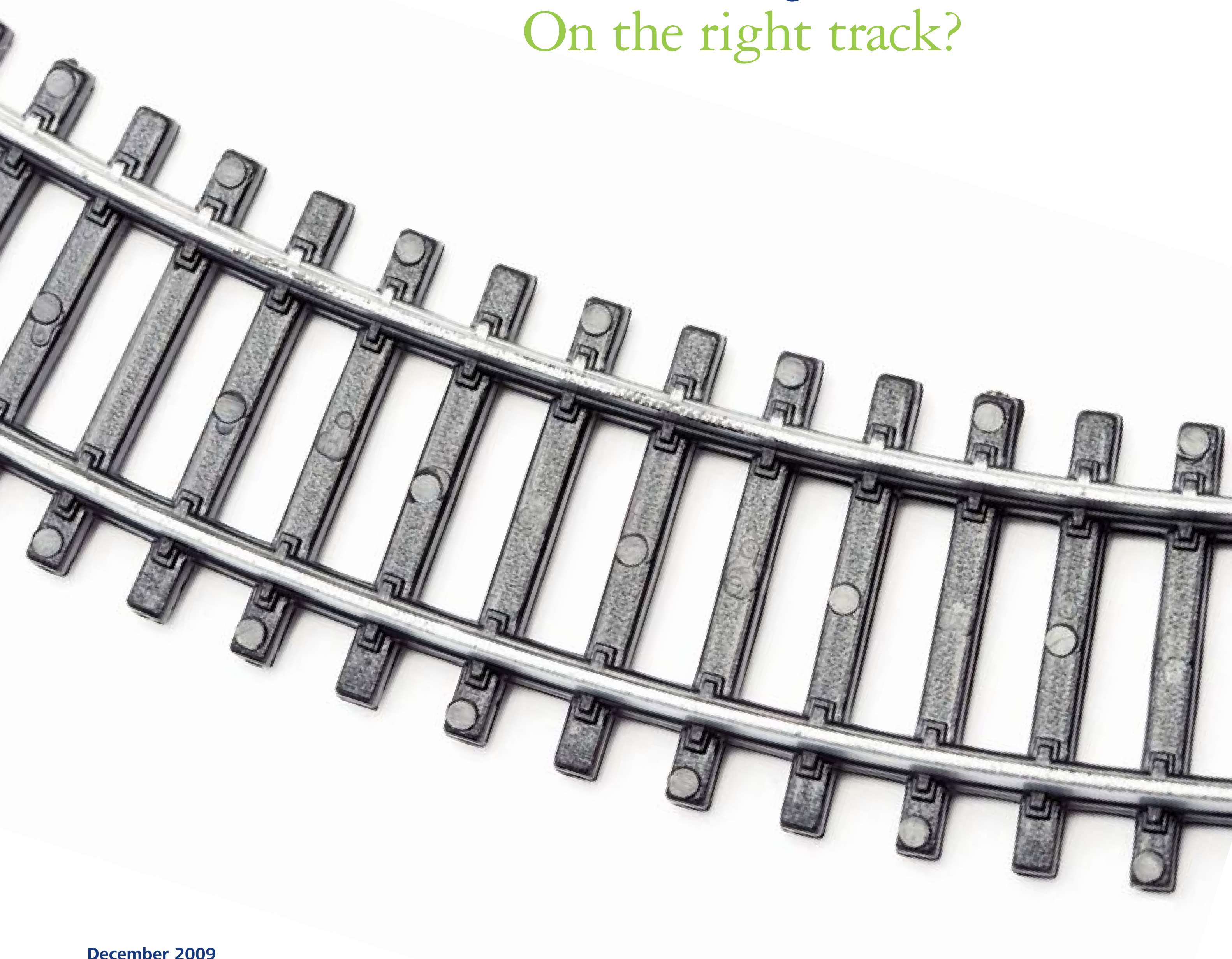
Alternative Investment Fund Managers Directive
On the right track?



December 2009

On 12 and 25 November 2009 the Swedish Presidency issued compromise proposals to the draft of the Alternative Investment Fund Managers ("AIFM") Directive. This was produced after extensive input from the impacted industries, the competent authorities and finance ministries of the 27 Member States.

The Directive has come a long way in six months, as reflected in the compromise proposal, and progress has been made on key issues but material concerns remain, particularly on the recently introduced remuneration annex. The articles will no doubt continue to evolve within the "black box" that is European decision making but there are a few select messages to draw out of the latest draft.

Originally, the European Commission submitted a proposed Directive on AIFM to the European Parliament and Council on 30 April 2009.

Whilst the Directive enraged many in the industry and drew much adverse comment, the overriding principles to gather systematically important data, impose restrictions on leverage, protect investors and ensure robust prudential requirements were echoed in many other global publications. In short, the key themes of the Directive were here to stay. Unfortunately after detailed scrutiny, the widely held view was that the articles were unworkable in their initial form and were insufficiently tailored for the industries they were attempting to regulate.

Rapporteur's draft report to the ECON committee – 1 December 2009
Jean-Paul Gauzès is the Rapporteur in the European Parliament for the AIFM Directive. The Rapporteur's draft report to the ECON committee details recommended changes to the Commission's original proposal before it can be accepted.

Gauzès appears to understand the important role of alternative funds within the EU and his report broadly echoes the direction of the Council's text, however there are a few key thoughts which can be drawn out.

- Firstly, it is pleasing to note that he understands that the Directive needs to be better tailored for the various sub-sectors so as to reflect their impact on systemic risk. However, in the same stroke he recommends that the de-minimis thresholds are removed. A consequence of the latter is that relatively small AIFM will have to report leverage where there is minimal chance of systemic risk. Additionally these AIFM will suffer compliance costs which will be a disproportionate drag on returns compared to their larger rivals.
- Secondly, Gauzès also wants more power to be given to the competent authorities and to reflect the new supranational supervisory roles which are being created. Giving significant power to entities far removed from the front line will not make for quality decision making.
- Thirdly, there is a push for equivalence requirements for depositaries located outside the EU. This could curtail the ability of investors to gain access to emerging markets and therefore could affect risk adjusted returns.
- Lastly, the flexibility for some AIFM to adapt to market conditions could be restricted if they are required to determine, in advance, what levels of leverage they intend to use.

Now that it is becoming clearer which way the Directive's provisions are heading, we take this opportunity to survey the current position, noting key recent changes and the European Parliament's commentary thereon. We acknowledge the Directive will remain a moving quantity over the coming months, however much can be gleaned from noting the overall direction of travel.

Who is the AIFM?

The new text has clarified the question, "who is the AIFM?". The recitals make clear that there should only be one AIFM for each Alternative Investment Fund ("AIF"), appointed by the AIF, and who should be in a position to comply with all the requirements of the Directive. There is scope for the AIF to also be the AIFM. The Directive only applies to managers established within the European Community.

Where a fund has multiple managers, such that the portfolio and risk management is spread across the providers, it might not be readily apparent who should be the AIFM, and therefore who needs to comply with all the requirements of the Directive. Once the AIFM has been appointed they will be in a position to delegate activities to other managers if appropriate, but those other managers will not be directly appointed by the AIF as AIFMs. This would represent a significant change to the current multi-manager model.

The process of selection, appointment and delegation of service provider functions will need to be more carefully managed under the new regime.

Restricted Activities?

Once an AIFM is authorised under this Directive, the activities it may perform will be restricted. The newly inserted Article 4a allows some services and activities to be undertaken but not the entire list within Annex 1, Section A & Section B of MiFID. Managers would need to set-up new entities to perform the activities which are not listed, this may be costly and it will be important to keep abreast of any changes to this Article.

Can the AIFM delegate functions?

The AIFM cannot delegate to the extent that they become a "letter box" entity; however where they do delegate portfolio or risk management functions, there needs to be evidence that due-diligence processes have been performed on those other providers, and they must also review the services provided by each third party on an ongoing basis. Although many of the requirements are currently performed by the AIFM, it might not be the case that they can evidence their decision making procedures. This may generate additional process, administrative requirements and costs.

Delegation by the AIFM will now only need to be "notified" to the competent authority, whereas under the previous draft "authorisation" of each delegation was required. Where this applies to entities outside the European Community there needs to be a co-operation agreement between the competent authorities of the home Member State and the supervisory authority of the third country.

Which investment funds are captured?

There is nothing in the current draft to suggest that the AIF itself will be regulated directly, but this eventuality should not be ruled out, especially if we consider that the majority of Member States are familiar with the UCITS operational model. Regulating the AIF directly is unlikely to be a positive step, and could open the door to costly and restrictive requirements. The Directive stipulates disclosure requirements on the AIFM in relation to AIFs, including disclosure both to investors and to the Member State. AIFM will need to understand which of the funds they manage are AIF; broadly these are non-UCITS with more than one investor. The de-minimis thresholds of either €100m or €500m remain within the latest draft. The higher limit applies when the fund employs no leverage and there are no redemption rights within five years.

Managed accounts, which have just one investor, do not fall under the scope of this Directive; neither do funds where the only investors are those within the same group as the AIFM. Where a manager's business materially falls into either of these categories it may even be prudent to cease, or bring forward the cessation of other activities which do fall under this Directive to the extent that the forecast income generated is less than the costs of compliance.

Who can be the depositary?

It remains a requirement under the new text for each AIF to have an independent depositary, but this can now be either an EU credit institution or a MiFID investment firm. The appointed depositary now has the conditional ability to appoint sub-custodians based outside the EU. This is a significant step forward and will allow access to "best in class" service for the benefit of investors by keeping the market for providers open.

> It is important to be clear that the term 'depositary' as referred to in the AIFM Directive text, is anyone who meets the requirements and fulfils the functions contained in Article 17. Depending on the circumstances this could be an administrator, custodian, prime broker, lawyer or other MiFID firm.

Additional flexibility has been built in for funds having a five year lock-up period and where investments are made on a non-frequent basis, which is welcome. Here, other parties can be appointed to fulfil the depositary role who are "subject to prudential regulation and ongoing supervision" or who already carry out the "depositary functions as part of professional or business activities". This is likely to be most relevant to the private equity model, although further clarity will be required to ensure it is in practice a beneficial concession.

Problems with the service provider model?

It is now clear that the depositary is responsible for ensuring its functions are performed with regard to each fund, taken in its entirety. The model envisioned by the Directive appears to be one where there is a "lead" depositary for each AIF who will then sub-delegate functions downwards to other custodians, in the EU or otherwise. However, the tough due-diligence requirements and de-facto strict liability clauses may make delegation of tasks by the depositary unattractive. It is possible that this structure could lead to greater operational or credit risk, to the extent that depositaries are reluctant to delegate tasks as they would still be liable for the actions of the delegate.

Service providers to the fund can crudely be classified into a few key functions: administration, transfer agent, custody, portfolio management, risk management and valuation. Significant problems arise in the current proposal because the administration, transfer agent and custody functions now all fall under the depositary's remit although there are a limited number of firms who have in-depth experience in all three areas.

Many of the largest administrators do not have a custody function and therefore would need to sub-delegate the "safe-keeping" activities. It should be questioned if such companies have the "in-house" skill set required to perform the required due-diligence and, in particular, the ongoing monitoring activities which are laid down in the Directive. It would be understandable for an AIFM to be hesitant to appoint an administrator as "depositary" who does not also have custody experience. A similar situation will apply if a traditional custody provider is appointed with no administration experience. However, there is scope for additional understanding to be gained, on all sides, through the commissioning of controls reports over the activities performed by the "depositary" both on initial sub-delegation and the subsequent monitoring activities, albeit with obvious incremental costs.

A positive point to note is that the valuator can now be "functionally" independent which will allow for "in-house" valuations.

Overall it is unclear what the final service provider structure may look like, who will be performing the roles laid down by the Directive and therefore how the contractual relationships will develop. Where new contracts are established, all members of the value chain will need to assess the additional risks that arise. This is an area to watch with interest.

What is the depositary's liability?

The original strict liability requirements in the first draft Directive would have meant a significant increase in costs for investors, either via the depositary's insurance for providing the additional protection necessary, or through the cost of holding additional capital.

The Presidency's proposal has made extensive amendments to the depositary article (17); unfortunately not resulting in a significant departure from strict liability. Where the depositary sub-delegates functions, it can only contractually discharge itself of liability for certain specific losses. Those are broadly losses incurred as a result of the custodian being unable to immediately return assets (or the corresponding value) to the AIF. The depositary cannot discharge itself of liabilities in relation to other delegated activities, even if it has performed the required due diligence activities.

There may be a reluctance to take on the "lead" depositary role if the current liability requirements remain.

Where can AIF be marketed?

The passport for AIF established in third countries and with EU AIFM to market across the EU would have been welcomed by many in the industry; unfortunately it has not survived into this recent draft and these third country AIF will need to take advantage of the current private placement regimes in individual Member States. However, it is perhaps positive to note that there is now confirmation that these private placement regimes will remain available, which was previously unclear. Member States now have the power to impose additional restrictions on those AIFM who market their AIF to retail investors, although they cannot impose stricter conditions where this is on a cross border basis compared to where it is marketed domestically.

The current text makes no provisions for the authorisation of managers that are established outside the EU. It remains to be seen whether this encourages managers to move outside the EU and make use of private placement regimes, or whether the EU regulated status becomes a strong market preference and the opposite effect is seen. The former is a distinct possibility if compliance costs impact on investor returns (or if the remuneration annex is not well received!). In general the marketing articles remain somewhat opaque and it could be an area where clarifying text will be inserted.

Will leverage be constrained?

The *Turner Review* cites leverage as having been a contributing factor in causing the financial crisis and therefore it is only natural that the commission wants to collect this information to identify where its build up could lead to a systemic risk.

Managers of leveraged funds should, after reading the current draft, have more confidence that inappropriate ex-ante leverage conditions will not be imposed by the Commission; however they may still adopt implementing measures to determine when the Member States may limit the leverage employed by a fund. The scope for such measures is limited; the Member State may only set caps "when it is deemed necessary in order to ensure the stability and integrity of the financial system". While some AIFs are large and generate significant percentage of market trading volumes, individual AIFMs or AIFs deemed to generate systemic risk should be few when compared to leverage and capital ratios of other financial institutions that generate systemic risk.

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There is currently no mention of leverage restrictions being specifically differentiated by asset class; however when the Directive refers to the implementation measures that the Commission may adopt there is reference to "different strategies of AIF" and therefore this could open the door for such provisions at a later stage.

Where an AIFM has funds established outside the EU and with no EU investors they will still be required to disclose the fund's leverage to the competent authorities of the Member State. Such managers may consider moving outside the EU if the majority of their business falls into the above category.

What about "controlling interest" disclosures?

There has been public concern surrounding the non-transparency of Private Equity owned firms and this had predominately focused on takeovers of large and high-profile public companies.

It remains to be seen whether this encourages managers to move outside the EU and make use of private placement regimes, or whether the EU regulated status becomes a strong market preference and the opposite effect is seen.

It was unreasonable to set the controlling interest threshold for disclosure at 30% of the voting rights of the acquired company, not least because it was unclear how 30% could, under normal circumstances, have constituted a "controlling" interest. Private equity managers will be pleased that this threshold is now increased to 50%.

Additionally it was disproportionate to apply blanket disclosure requirements to all investee companies. Progress has been made in this area, and small and medium sized companies are no longer within scope, neither are listed companies or new issues and the current listing rules will apply to the latter.

Broadly the remuneration articles seek to align the interests of investors with those of the investment manager, but this is achieved through prescriptive measures, irrespective of the fund type or investors' preferences.

What are the capital requirements?

Significant clarification was needed to the capital articles and this has been provided in the new text. Capital requirements have been aligned with other EU directives and it has been made clear that they do not apply to management companies authorised under the UCITS Directive and must be at least the amount required under the Capital Adequacy Directive.

It is positive to note that, subject to authorisation, some AIFM may provide up to 50% of the capital required in the form of a guarantee, although managers of leveraged funds will not be able to avail themselves of this. Additionally there will be a €10m cap on the capital required.

Why have remuneration provisions been included?

There was no mention of remuneration (which includes carried interest) within the original proposed Directive. Prior to this recent draft release it was not widely known that such articles, similar to those for bankers' remuneration, would be present. Broadly the remuneration articles seek to align the interests of investors with those of the investment manager, but this is achieved through prescriptive measures, irrespective of the fund type or investors' preferences. These also include requirements for disclosure of individuals' remuneration.

Hedge fund managers may be most impacted by the requirement that variable remuneration is only paid when "sustainable according to the financial situation of the AIFM as a whole". This may limit the ability of managers to reward, and therefore retain, star performers when the overall performance has been poor. The private equity sector in particular already has effective systems for aligning the interests of the above parties, which are arguably more effective than the policies set down in the Directive.

There are many other new remuneration clauses which will present problems if they remain in their current form. The details of these will be a topic of significant discussion over the coming months, particularly in the context of wider corporate governance.

Development of the AIFM Directive in 2010

The timeline below gives an indication of the expected progression of the Directive through to final approval. Particularly in light of the hand over in presidency on 1 January, this may prove to be flexible.

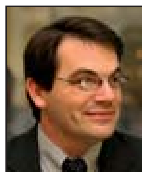
AIFM Directive – Indicative timeline	
Winter 2009/10	• Rapporteur's draft report presented.
Jan-Feb 2010	• European Parliament consideration of 1st & 2nd amendments.
Spring 2010	• Vote in ECON Committee. • Tripartite meetings between the European Commission, European Council and European Parliament.
Summer 2010	• Vote in plenary of the European Parliament. • Vote on the ECOFIN Council to approve the final version of the AIFM Directive.

Conclusion

The above discussion is by no means an exhaustive list of the provisions within (or recent changes to) the Directive, but it does give an indication of the direction of travel for many of the key themes. It is worth keeping in mind that all European directives are politically charged and the eventual outcomes are not always those that would have been made after a rational debate of the facts.

At the time of going to press we were made aware that all further European Council working groups had been cancelled. The implication being, that a general approach from the Council will not be forthcoming before January 2010. Significant power has now been transferred to the Spanish Presidency, although it is unclear what direction they will take the Directive. In summary – the directive is "off track".

Contacts



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