AIFM Directive – The home stretch, but a long way to go

With the European summer recess over, the EU institutions have shifted back into gear and resumed their negotiations on the Alternative Investment Fund Managers Directive. To expedite this process, the Belgian Presidency of the EU has issued a compromise proposal (dated 27 August 2010) containing provisions on the less contentious areas of the Directive on which agreement between the Commission, Parliament and Council now seems likely. The contentious areas that are not addressed by the proposal are the treatment of third-country alternative investment fund managers (AIFM) and alternative investment funds (AIF), the treatment of AIFM managing AIF that acquire control of companies (an area particularly relevant to the private equity industry), and the issue of possible restrictions on short selling by AIFM.

The following is an overview of the main provisions contained in this latest proposal and the status of negotiations in the contentious areas.

Scope

The Directive continues to take a catch-all approach, covering most managers of non-UCITS collective investment undertakings, subject to certain exemptions (relating, for example, to AIFM investing only on own account and holding companies not engaging in collective portfolio management) but apparently including managers of joint ventures, general partners of limited partnerships and managers of investment trusts. Furthermore, the scope has been extended to capture not only AIFM that have their registered office in the European Union, but also all AIFM registered or based outside the EU which manage EU AIF or market AIF to professional investors in the EU.

The exemption from the scope of the Directive of AIFM that manage AIF with assets under management not exceeding €100 million (or €500 million where the fund is non-leveraged and operates a minimum five-year lock-in period) would no longer be optional, but automatic (as in the original Commission proposal). However, as under previous Council drafts, such AIFM would be subject to mandatory registration and could opt into the Directive regime voluntarily.

By contrast, the concept of a "light-touch" regime for certain types of AIFM (such as managers of real estate or private equity funds) proposed by previous Parliament and Council drafts has now been abandoned. Under the Belgian Presidency proposal, no category of AIFM would benefit from the relaxed rules in relation to depositaries and valuation that have previously been suggested.

Another noteworthy feature of this latest draft is that the new European Securities and Markets Authority (ESMA) would play an important role in determining the scope of the Directive, as it would be called upon to issue guidelines on the definition of AIF and of AIFM, and to determine the applicability of exemptions.

Capital requirements

As under previous Commission, Parliament and Council drafts, AIFM would be subject to capital requirements starting at €125,000 for external AIFM and €300,000 for internally managed funds, and there would be a cap on capital requirements at €10m for managers of large-value portfolios (exceeding €250m).

However, reduced capital requirements would no longer apply in respect of AIFM managing non-leveraged AIF with assets of less than €500 million that operate a minimum five-year lock-in period and only make infrequent divestments. Additionally, in a concession to the parliamentary approach, AIFM would be required to have additional own funds or professional indemnity insurance to cover potential professional liability risks.

Remuneration

Remuneration of AIFM staff whose professional activities have a material impact on the risk profile of the AIFM or of the AIF they manage would still be subject to risk-adjustment principles. The latest Presidency draft introduces some additional provisions to achieve alignment with the CRD3 rules on remuneration that will apply to banks, building societies and investment firms as of 1 January 2011. Compliance by AIFM with applicable principles would be subject to the proportionality principle (to take account of the size, internal organisation, and the nature, scope and complexity of the activities of the AIFM), and at least 50% of variable remuneration awarded to relevant staff would need to consist of shares of the AIF concerned, equivalent ownership interests, share-linked instruments or equivalent non-cash instruments. These instruments would also be subject to a retention policy designed to align incentives with the interests of the AIFM and the AIF it manages or the investors of the AIF. It is highly likely that these provisions will make their way into the final version of the Directive.

Valuation

The Belgian draft retains the requirement in previous Council and Parliament drafts for AIFM to ensure independent valuation of the assets of AIF they manage, with managers of closed-ended AIF whose shares or units are traded on a regulated market and for which there is a liquid market being exempt from the obligation to calculate and publish the net asset value of AIF in accordance with the Directive. A new element is that a depositary appointed for an AIF would not be able to act as external valuer of that AIF.

Risk management

The Council and Parliament have previously differed on the point as to whether national authorities or European bodies should be able to impose limits on leverage. Under the latest Presidency proposal, AIFM would themselves need to set limits to the leverage they could employ on behalf of each AIF, as well as limits to their right to reuse any collateral or guarantee granted under a leveraging arrangement. ESMA would be authorised to consult with the new European Systemic Risk Board (ESRB) and issue advice to national authorities regarding measures to be taken to remedy systemic risk, including limits on leverage. This is clearly a concession to the parliamentary position, although it stops short of giving ESMA the final say on leverage caps.

The latest draft maintains the requirement for AIFM to separate their respective risk management and portfolio management processes, but introduces new provisions on short selling. AIFM which engage in short selling must ensure they have access to securities or financial instruments on the date when they committed to deliver them, and implement appropriate risk management procedures. The draft does not, however, address the issue of a possible ban on short selling, acknowledging that a separate legislative process is underway at a European level to regulate this area.

Private equity

The Belgian proposal expressly leaves out draft provisions on the treatment of AIFM that manage AIF which acquire control of companies – a clear indication that regulation of the private equity industry under the Directive remains a highly contentious topic in Brussels. Previous drafts have provided for notification and disclosure requirements in respect of AIF that acquire control of non-listed companies or issuers, and the most recent Parliament draft contained a controversial provision preventing private equity AIFM from asset-stripping target companies by making the latter subject to ongoing capital adequacy requirements. The issue will be debated in trilogue sessions throughout the coming weeks.

Depositaries

Most of the provisions on depositaries previously contained in Council and Parliament drafts have been consolidated and carried over into the Belgian Presidency proposal. The proposal continues to require AIFM to appoint an independent depositary for AIFs, which in the case of EU AIFs would need to be an EU credit institution or one of the other categories of permitted, regulated firms. The depositary would be established in the home Member State of the AIF and comply with broad requirements. As concerns the issue of liability, the depositary would be permitted to discharge itself from liability in its contractual arrangements with sub-custodians, and to escape liability for losses caused by external events beyond its reasonable control. A new element is that a prime broker acting as counterparty to an AIF would not be allowed to act as depositary for that AIF.

A further important concession has been made to the Parliament on the issue of third-country depositaries. Under the proposal, a depositary in a third country could only be appointed if there are appropriate cooperation and information exchange agreements between the third country and the Member State in which the AIF is marketed and (if different) the home Member State of the AIFM. ESMA would need to confirm that the third-country depositary is subject to EU-equivalent prudential regulation and supervision, and there would be a condition that the third country is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force on anti-money laundering and terrorist financing. Finally, there would also need to be a tax information exchange agreement between the third country and the Member State in which the AIF is marketed and (if different) the home Member State of the AIFM, as well as contractual liability of the depositary to the AIF or to its investors.

Passporting and third countries

Passporting of fund management by EU AIFMs and marketing of EU AIFs throughout the EU has been a non-contentious issue throughout the legislative process and accordingly, the passporting provisions have not been changed materially in the newest Presidency draft.

However, the draft has purposely left out provisions on third-country AIFMs and AIFs, a further sensitive topic and a future cornerstone of the new Directive regime. The Council and Parliament have long-standing differences over the conditions under which AIFM should be permitted to market third-country funds in the EU (with the Parliament demanding stricter controls, notably in the form of extensive international agreements with the relevant third country and equivalent access for EU funds). The debate has also concerned the question whether third-country funds should, once authorised for marketing in a EU State, benefit from a EU-wide passport (advocated by the Parliament but thus far rejected by the Council).

The road ahead

It is clear that the Belgian proposal does not represent a significant improvement over previous drafts of the Directive, and the industry will need to continue to lobby for appropriate amendments as the negotiations enter their final phase. Although the latest proposal largely concentrates on non-contentious provisions of the AIFM Directive, these provisions may yet evolve, given that various elements of the Directive are likely to be used as bargaining tools by the negotiating parties to achieve desired outcomes. The danger, however, is that the contentious issues will not be resolved in the final version of the Directive, but will be deferred to

be decided by the more detailed legislative process that follows and/or the new EU regulatory bodies. The ability of the UK to lobby effectively for sensible changes on some of the more radical proposals will thus be weakened further.

The trilogue talks between the Commission, Council and Parliament will continue in the coming weeks, with agreement on the final Directive possibly to be reached in the week commencing 20 September or, more likely, in the course of October.

Contacts

Simon Morris
Partner, Financial Services
T: +44 (0) 20 7367 2702
E: simon.morris@cms-cmck.com

Ash Saluja
Partner, Financial Services
T: +44 (0) 20 7367 2734
E: ash.saluja@cms-cmck.com