AIFM Directive – New solutions to old problems

The Belgian Presidency of the EU Council has issued a further compromise draft of the AIFM Directive, dated 30 September 2010 (with some amendments published on 4 October 2010). Contrary to the previous draft (explained in our recent RegZone articleT), which did not contain provisions relating to the contentious areas in which a consensus has yet to be reached between the European institutions and between certain Member States, this latest proposal (the "Proposal") contains a complete set of Directive provisions. Importantly, it takes an entirely new approach to the issue of third countries (thus far the principal bone of contention in the legislative process) and also addresses the thorny issue of how AIFM managing private equity funds should be treated. As in the previous draft however, provisions on short selling have not been included on the basis that a separate European legislative process is currently underway to regulate this area.

The following is a summary of the principal changes introduced by the Proposal.

Third countries

In an attempt to accommodate the highly divergent positions of the Council and Parliament regarding third-country issues, the Proposal introduces a dual solution under which two frameworks will sit alongside each other – one allowing both EU and non-EU AIFM to apply for a management or marketing passport, and another allowing both EU and non-EU AIFM to market AIF in accordance with the private placement rules of individual Member States. The two frameworks will coexist throughout a transitional period of five years, at the end of which the Commission will launch a review of the Directive (including a public consultation) and will, if it deems it appropriate following that review, fully abolish the private placement regimes in favour of the passporting framework.

Marketing by EU AIFM of third-country AIF in the EU via a passport

Under the Proposal, authorised EU AIFM may market third-country AIF (and feeder AIF whose master AIF is not EU-based or not managed by an authorised EU AIFM) to professional investors throughout the EU if the following conditions are met:

- The AIFM must comply with all the Directive requirements except for those relating to the basic EU management and marketing passport.
- There must be arrangements for the exchange of supervisory information between the home Member State of the AIFM, the third country where the AIF is established, and the other Member States where the AIF is marketed.
- There must be OECD-compliant tax information-exchange arrangements between the home Member State of the AIFM, the third country where the AIF is established, and each the other Member State where the AIF is marketed.
- The third country must not be on the blacklist of the Financial Action Task Force (FATF) on anti-money laundering and terrorist financing.

Significantly, it is no longer a condition that the third country must grant EU AIFM equivalent market access.

If the AIFM wishes to market in its own home Member State or in another Member State, it must submit a notification to its home regulator requesting approval for those marketing activities and setting out specific characteristics of the AIF and its depositary. Where the marketing is to occur in the home Member State, the home regulator must inform the AIFM of its decision within 20 working days of receiving the notification. Where marketing is to occur in other Member States, the home regulator may, within 20 working days, approve such marketing by transferring the notification to those Member States, at which point the AIFM may immediately commence the marketing.

However, the home regulator may prevent the domestic marketing, or refuse to transfer the notification to relevant Member States in which the AIFM intends to market the third-country AIF, if it considers that any aspect of the AIFM or its activities does not comply with the Directive. Similarly, where approval to market domestically or in another Member State has been granted, the AIFM must keep its home regulator informed of all planned or present changes to the AIF or depositary that materially alter the information previously submitted, and the home regulator may withdraw its approval if such changes result in non-compliance with the Directive.

Marketing by EU AIFM of third-country AIF in the EU through private placement

In parallel with the passporting framework described above, Member States will be able to allow EU AIFM to market third-country AIF in accordance with domestic private placement regimes. The Proposal envisages that these domestic regimes be kept in place for five years following the date on which the Directive will be required to be transposed into national law by Member States (which will itself be two years after the Directive's entry into force). However, the Proposal acknowledges that the provisions maintaining

private placement regimes are likely to be reviewed as part of the Commission's general review of the Directive, and states that they should be maintained for longer than five years after transposition if the overall review has not taken place by that cut-off date. If, once the overall review takes place, the Commission should conclude that the passporting framework has no negative effects (e.g. on investors, markets or systemic risk), the passporting framework will then apply exclusively and the possibility of marketing third-country funds on the basis of private placement will fall away.

Under the proposed provisions on private placement, Member States will be able to allow authorised EU AIFM to market third-country AIF they manage (and feeder AIF whose master AIF is not EU-based or not managed by an authorised EU AIFM) to professional investors on their territory under the following conditions:

- The AIFM must comply with the Directive requirements, although reduced requirements will apply with regard to the appointment of a depositary.
- Cooperation arrangements relating to systemic risk oversight and information exchange must be in place between the home Member State of the AIFM and the third country.

While the move towards retaining private placement regimes will undoubtedly be welcomed by large parts of the industry, the solution put forward in the Proposal is likely to be criticised on the basis that the Directive framework (including, for example, its authorisation procedure and capital requirements) will be overlaid onto the private placement rules, and that the requirement for international cooperation agreements will restrict the possibilities for private placement.

Marketing by non-EU AIFM in a given Member State or via a passport

A non-EU AIFM wishing to:

- manage EU AIF; and/or
- market EU AIF in the EU; and/or
- market non-EU AIF in the EU

either in a given Member State or throughout the EU via a passport must first obtain authorisation from its "Member State of reference", i.e. the Member State in which it wishes to market or via which it wishes to exercise a marketing or management passport. There will only be one Member State of reference, which will be determined in accordance with various factors, notably where the AIF will be managed or marketed, where the relevant AIF are established, authorised or registered, which AIF has the largest amount of assets under management, and where the non-EU AIFM intends to develop effective marketing for most of its AIF. A change in the marketing strategy of the non-EU AIFM may require the nomination of a new Member State of reference, in which case the Proposal provides for a mechanism for the transfer of authorisation and supervisory responsibility to that new Member State of reference.

Once authorised, the non-EU AIFM must comply with all the requirements of the Directive, with the exception of those relating to the basic EU management and marketing passport. The relevant provisions explicitly recognise the difficulties that may arise from their extraterritorial scope, stating that the non-EU AIFM need not comply with a requirement in the Directive if (i) it is impossible for it to combine compliance with the Directive and compliance with a rule which the non-EU AIFM, or a non-EU AIF it intends to market in the EU, is subject to in the home state of the non-EU AIFM or AIF; (ii) that third-country rule is equivalent to the Directive rule the non-EU AIFM wishes to opt out of; and (iii) the non-EU AIFM and/or AIF complies with that third-country rule.

In addition to the authorisation and compliance requirements, the following conditions must be fulfilled:

- The non-EU AIFM must disclose its marketing strategy to, and appoint a single legal representative in, the Member State of reference.
- There must be arrangements for the exchange of supervisory information between the Member State of reference and the home state of the non-EU AIFM.
- There must be OECD-compliant tax information-exchange arrangements between the Member State of reference and the home state of the non-EU AIFM.
- The third country must not be on the blacklist of the FATF on anti-money laundering and terrorist financing.
- Effective supervision of the non-EU AIFM by regulators in relevant Member States must not be prevented by the laws, regulations or administrative provisions of a third country governing the AIFM.

The Proposal introduces two separate marketing passports for non-EU AIFM – one for the marketing of EU AIF, and one for the marketing of non-EU AIF. The procedure for requesting approval from the Member State of reference for marketing activities in that state or in another Member State is analogous to the procedure that applies in respect of EU AIFM (described above). However, where the marketing concerns non-EU AIF, the following conditions must also be fulfilled:

- There must be arrangements for the exchange of supervisory information between the Member State of reference, other Member States in which the marketing is to take place and the state in which the non-EU AIF is established.
- There must be OECD-compliant tax information-exchange arrangements between each Member State in which the marketing is to take place and the state in which the non-EU AIF is established.
- The third country must not be on the blacklist of the FATF on anti-money laundering or terrorist financing.

Marketing by non-EU AIFM under private placement rules

Additionally, the Proposal allows Member States to permit the marketing of AIF by non-EU AIFM on the basis of domestic private placement rules. As in the case of the provisions governing private placement for EU AIFM (outlined above), these provisions will only remain in place for five years after the effective date of the Directive, or until the Commission approves the passporting framework as part of its general review of the Directive, if this should occur after expiry of the five-year period. Marketing of AIF by

non-EU AIFM on the basis of private placement rules can only be directed at professional investors. The non-EU AIFM is not required to be authorised under the Directive, but the following conditions must be fulfilled:

- The non-EU AIFM must comply with the Directive requirements on transparency and private equity funds.
- There must be cooperation arrangements relating to systemic risk oversight and information exchange between the non-EU AIFM's home state, the Member State(s) in which the marketing occurs and, if applicable, the Member State of any EU AIF which is being marketed.

Management by EU AIFM of non-EU AIF not marketed in the EU

EU AIFM that wish to manage non-EU AIF marketed outside the EU must comply with the Directive (with the exception of the depositary and annual reporting requirements), and there must be arrangements for the exchange of supervisory information between the home Member State of the AIFM and the third country where the AIF is established. This mirrors the position taken in the Council draft of March 2010. By keeping EU AIFM which neither manage EU AIF nor market AIF in the EU within the scope of the Directive, the Proposal is likely to reignite criticism of the Directive's extraterritorial reach. Furthermore, these provisions risk exposing certain EU-based AIFM which market and manage AIF in jurisdictions outside the EU, such as the U.S., to multiple layers of regulation.

Private equity

The private equity provisions in the Proposal generally apply to AIFM which manage one or several AIF which individually or jointly acquire control of a non-listed company ("control" being defined as more than 50% of voting rights in the company), and AIFM which cooperate with other AIFM to jointly manage AIF that acquire control of a non-listed company. As in the March 2010 Council draft, these provisions do not apply where the AIF acquire control of small or medium enterprises (as per the EU definition) or of real estate special purpose vehicles.

An AIFM must notify its home regulator, the non-listed company and the shareholders of the company when the voting rights in the company held by an AIF managed by the AIFM reach, exceed or fall below 10%, 20%, 30%, 50% and 75%. These parties must be provided with information on the AIFM, its conflict of interests policy and its communication policy regarding the company. Additionally, the company, its shareholders and its employees must be provided with information on the AIFM's future intentions regarding the company and the likely repercussions for employees. The AIFM must also procure that the board of the company provides this information to the employees of the company or their representative, and that relevant past and likely future developments are taken into account in the company's annual report.

In a departure from the Council's March 2010 position, the Proposal no longer requires AIFM to disclose the amount of leverage supported by the company or issuer to its home regulator and to the investors in the AIF. The Council draft is also narrower in scope than the Parliament draft published in May 2010, under which the notification requirements generally apply in the case of acquisitions of control of issuers as well as non-listed companies.

On the controversial issue of asset stripping, the Proposal introduces provisions that apply in respect of the acquisition of control of non-listed companies as well as issuers. In the period of 24 months from the acquisition, an AIFM must refrain from facilitating, supporting or instructing, and must use its best efforts to prevent, (i) any capital reduction; (ii) any share redemption; (iii) any distribution to shareholders or own share purchase where the net assets of the company fall short of (or would consequently fall below) its subscribed capital and non-distributable reserves; and (iv) any distribution to shareholders which would exceed the amount of available profits.

The inclusion of provisions on asset stripping in the Proposal represents a concession to the Parliamant, which included such provisions in its May 2010 draft. However, the Council provisions on asset stripping are self-contained while the Parliament provisions require AIFM to ensure that net assets of the target company comply with the capital adequacy requirements of the Second Company Law Directive. Importantly, the Proposal only imposes a two-year moratorium on asset stripping, whereas the Parliament provisions would apply perpetually.

Further new provisions

The Proposal introduces the following additional changes relative to the previous Council draft dated 27 August:

- While the holding company exemption will continue to be available for companies that share a business strategy with their subsidiaries or associated undertakings and which have not established those undertakings for the main purpose of generating returns through their divestment, it will now also exempt companies whose shares are admitted to trading on a European regulated market and which operate for their own account, thus potentially benefiting listed holding companies such as REITs and other types of investment trust.
- The risk management obligations are now generally subject to the principle of proportionality, meaning that smaller or more risk-averse AIFM may benefit from a light-touch regime in this area.
- A prime broker acting as counterparty to an AIF is now allowed to act as depositary for the AIF if it has functionally and hierarchically separated its depositary functions from its tasks as prime broker, properly identified and managed potential conflicts of interest, and disclosed these to investors.
- For non-EU AIF, the depositary must no longer necessarily be established in the third country where the AIF is established, but can also be established in the home Member State of the EU AIFM or, as the case may be, in the non-EU AIFM's Member State of reference.
- The Proposal substantively retains the provisions contained in the previous Council draft on discharge of the depositary's liability for loss of financial instruments by a sub-custodian, but now also allows the depositary to exclude liability for loss

of financial instruments in its contractual relationship with the AIFM or AIF where it has been instructed to appoint third-country entities to hold the instruments.

- The remuneration principles now only apply to staff who are in the same remuneration bracket as senior management and risk takers.
- The European Markets and Securities Authority (ESMA) has been given an advisory role in certain areas of the Directive where Member States will enjoy discretion (such as authorisations and passporting approvals), but Member States will not be bound by the advice issued.

The Proposal is arguably the most industry-friendly draft of the Directive to date, and the third-country provisions in particular reflect a more realistic, pragmatic approach to regulating the activities of AIFM. This is, however, unlikely to be a consolation to the alternative investment management sector (and private equity fund managers in particular), which has yet to be provided with a convincing rationale for the Directive and in any case faces the prospect of heavier compliance.

The following weeks will show whether the Proposal is supported by a majority of Member States in the Council and by the Parliament. If a final draft is not adopted in the plenary vote due to take place in the Parliament later this month, the Directive may go into a second reading and the legislative process may be prolonged until well into 2011.

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