

EPFSF Briefing

“Alternative Investment Fund Managers Directive (AIFMD)”

Introduction

The draft Alternative Investment Fund Managers Directive (AIFMD) has been highly debated over the past months. A first draft of the AIFMD was published by the European Commission in April 2009. MEP Jean-Paul Gauzès, Rapporteur on the AIFMD to the European Parliament’s Committee on Economic and Monetary Affairs, has issued his draft report regarding the AIFMD in November 2009. The deadline for the submission of amendments ended on 21 January 2010 and a very large number of amendments have been presented. A draft opinion by MEP Evelyn Regner, the Rapporteur to the European Parliament’s Committee on Legal Affairs was also published in January 2010.

Key Elements of the Commission Proposal

The Commission’s proposal for a Directive encompasses in its scope all categories of alternative investment fund managers (AIFM). ‘Alternative Investment Fund’ (AIF) is in this instance defined as investment fund not already covered by the UCITS Directives. The AIFM are involved in a wide range of asset classes including - among other - non-UCITS retail funds, investment trust companies, real estate funds, hedge funds, venture capital and private equity, commodity funds, as well as funds set up for specific institutional investors. The AIFMD’s main objectives are appropriate investor protection, appropriate transparency and mitigation of systemic risks.

The AIFMD establishes harmonised regulatory standards for the authorization, ongoing operation and transparency of the AIFM. EU AIFM that fulfil specific requirements will benefit from a European passport and will be able to market AIF to institutional investors in all EU Member States or provide management services to AIF domiciled in other Member States.

In addition, the Commission’s draft restricts the possibility of delegation of management, marketing and administrative functions by the AIFM exclusively to other AIFM and prohibits sub-delegation of tasks. It also includes the requirement of the appointment of an independent valuator. Further provisions concern the depositary of an AIF and go beyond the requirements of the MiFID and UCITS Directives, providing among other that the depositary must be an EU credit institution and be subject to a strict liability regime, and bringing a reversal of the burden of proof in case of losses suffered by the investors of AIF. In addition, the Commission’s proposal also addresses the use of leverage, investment in securitisation positions and shortselling by AIF.

As drafted, additional transparency requirements would increase the amount and nature of information that funds are to disclose to investors, supervisors and the public. These provisions raise questions regarding the potential conflict between requirements of existing European and national company law and the requirements of the AIFM Directive. However, these transparency provisions are designed to enable investors to obtain a better understanding of the characteristics of the AIF and to better evaluate the performance of the AIFM in managing client funds.

Finally, the draft Directive establishes particular regimes for fund managers operating outside of the EU to attract European investors; rules on funds domiciled outside of the EU to be managed by European managers; and European funds managed by non-EU managers, while establishing a mechanism for determining equivalence of non-EU regulatory, prudential and fiscal regimes vis-a-vis EU regulation. Additional rules are also proposed on AIF valuation, depositaries, and delegation of portfolio management, risk, and administrative functions from outside the EU.

Questions for consideration by the European Parliament

The amendments proposed by Rapporteur Gauzès already addressed some of the concerns voiced by stakeholders regarding the Commission’s proposal. Nevertheless, important questions remain and should be considered by the European Parliament during further detailed discussion on the AIFMD, hopefully finding common ground with the proposals put forward by the Presidency. The following questions should in particular be discussed:

Coherence with existing European Legislation: The Commission's draft AIFMD shows a lack of coherence with the MiFID, UCITS, Prospectus and Transparency Directives. For AIF and their managers to whom all of these Directives will be applicable, contradictory provisions or regulatory gaps will lead to regulatory uncertainties and important additional costs. While some amendments proposed by the Rapporteur brought alignments with the UCITS Directive, an important number of discrepancies remain, including investor protection related disclosure agreements, financial reporting obligations and shareholder-related disclosure agreements as well as those listed below.

Scope: In relation to the scope of the Directive, the following topics merit particular attention:

- **Definition of AIFM:** The scope of the AIFMD encompasses a broad variety and heterogeneous group of AIF with different legal structures and investment strategies. The definition of AIFM in its current draft does not sufficiently take into account the different existing fund structures and investment strategies and would create legal uncertainty. In order to meet the current definition, AIF and their AIFM will be obliged to undergo widespread and costly restructuring. The definition should therefore ideally be clarified. Although for legal certainty each AIF should have only one AIFM regardless of its legal structure, the AIFM could be the AIF itself or an external manager depending on the legal form.

- **AIFM Activities:** The definition of 'management services' of an AIFM as drafted only mentions in a very general manner the 'managing and administering' of AIF and leaves legal uncertainty. The UCITS Directive clearly defines management services (core services of investment management, administration and marketing) in its Annex II and permits additional non-core services of discretionary portfolio management and some ancillary services. A clearer definition of core and non-core functions would be helpful and avoid legal uncertainty in particular for fund managers who already hold licenses under the UCITS Directive or MiFID.

- **Threshold / Proportionality:** While the Commission's proposal excluded from the scope of the Directive AIFM whose assets under management did not exceed a threshold ceiling, the Rapporteur suggests to refrain from the de minimis rule and instead introduces the general principle of proportionality.

- **National AIFM / National AIF:** Purely national AIF are generally retail funds authorised in their Member States in accordance with national law, strictly supervised and not marketed on a cross border basis. These funds and their managers currently fall under the scope of the AIFMD, contrary to the principle of subsidiarity in Article 5 of the Treaty on European Union.

EU Passport / Private Placement: The Commission's proposal provided for an EU passport for AIF managed by European AIFM. Although the draft Report by the Rapporteur leaves the scope of the Directive un-amended, the amendments proposed provide that a European passport should only be granted to European AIF managed by European AIFM. The Rapporteur excludes from the European passport Third-Country AIF managed by European AIFM and grants them market access to individual Member States under information-sharing cooperation agreements in line with relevant international standards. The access by Third-Country Funds to the EU remains one of the most controversial issues in the AIFMD. A compromise preserving the required choice of investment solutions for professional investors could be that Member States have the possibility to allow private placement of non-EU AIF to professional investors within their own jurisdiction, and professional investors be able to continue investing in non-EU AIF at their own initiative. Other voices opt for a reasonably conditioned equivalence coupled with a passport as the only long term solution able to conciliate internal market principles with free movement of capital and to ensure a level playing field both within Member States and within EU based and third country based AIFM.

Depositaries: The rules regarding functions and responsibilities for the AIF depositary as drafted by the Commission do not only differ significantly from the rules for a UCITS depositary but also give rise to a number of issues of legal uncertainty. The amendments proposed by the Rapporteur try to overcome these uncertainties and to make the rules regarding the depositary for UCITS and non-UCITS funds more consistent. The Commission's proposal and the draft report by the Rapporteur were however published too early to take advantage of the results of either the CESR's mapping findings or the Commission's conclusions from its public Consultation on the UCITS depositary function. Also the Council makes a number of helpful proposals, in particular to regulate the functions of the depositary along asset classes. This approach takes into account that AIFs can invest in far more asset classes than allowed for UCITS (for example real estate and private equity). The Council also acknowledges that clearly describing the depositary's duties with respect to each of the asset classes (standards of care) on level 2 is crucial for a meaningful liability regime (responsibility for unjustifiable failure to perform its obligations/ duties). The

problem is that the current UCITS Directive neither describes precisely enough the functions of the depositary nor its duties. For the future discussion it would be helpful to align both approaches (Parliament and Council). In this context, it will be important to take into account the role of prime brokers in relation to certain AIFs. Further, the standard of care that is applied to a depositary should exclude aspects which are out of depositaries' control and the rules should permit depositaries to limit their liability by contract. This is not the case with the Rapporteur's proposal where there are very limited exceptions to the strict liability for the return of assets.

Delegation / Sub-delegation: The Directive's requirement that portfolio and risk management can only be delegated to another authorised AIFM and that sub-delegation is prohibited brings important restrictions for the industry. Risk, portfolio and administrative functions are delegated to entities around the world in order to take advantage of local expertise for the various markets. The current draft of the delegation provision and interdiction of sub-delegation will reduce investor choice, returns and quality of service. The UCITS Directive does not provide for a similar restriction and allows delegation to entities authorised under the MiFID or UCITS Directive or to portfolio managers established and regulated in third countries in accordance with their national law, without requiring them to hold an AIFM license. Sub-delegation is allowed for portfolio management as for valuation and depositary functions. While the Commission's draft proposes an authorisation requirement, the Rapporteur suggests an advance information to the competent authorities which may reject the delegation within one month. Any restrictions on the depositaries' ability to delegate functions to sub-custodians should take full account of good practice in the market.

Valuation: Both the Commission's draft and the amendments proposed by the Rapporteur regarding valuation differ from the existing national laws currently applicable to the AIFs as well as the UCITS Directive. These legal frameworks foresee in most cases that the manager assumes entire responsibility for the valuation, with the valuation function kept independent of the investment management functions. The valuation may be delegated by the manager (who retains the liability) or assigned (including the related liability) to a specialised third party, according to national law. Alignment of the AIFMD with the UCITS framework and the existing national laws would help avoid legal discrepancies.

Capital requirements: While the Commission's proposal differed regarding capital requirements from the MiFID and UCITS Directives the Rapporteur tightened capital requirements in his report, with a cap of €10m and half of capital coming from a bank guarantee or professional insurance. Some stakeholders mention critically that it maintains the variable capital requirement which could have a negative impact on smaller funds, and so access to finance for Europe's SMEs.

Level playing field: The AIFMD raises level playing field concerns between AIF and other products not covered under the Directive. These level playing field concerns are particularly relevant to the company law provisions of the Directive, such as the disclosure requirements.

Transitional Provisions: As the AIFMD will require substantial changes to the AIFM business model and the AIF, the transitional period of 12 months after the entry into force of the Directive will be very difficult to meet for the AIF, the AIFM as well as the competent authorities of the Member States. Furthermore, the delay for the changes will in practice for each AIF and AIFM be considerably shorter than one year after entry into force of the Directive as they will for reasons of legal certainty need to await the transposition of the Directive into national law before commencing their restructuring. A longer transitional period starting after the transposition into national law would certainly be helpful to competent authorities, AIF and AIFM. In addition, whereas AIFM should apply the provisions of the new Directive to their firm and to new funds they will establish after the transitional period there could also be a 'grandfathering clause' introduced for some existing AIF, particularly closed-ended funds with set investment periods and fund life.

Conclusions

The key challenge for EU policy-making remains to appropriately modify the proposed Directive in order to achieve the goals of investor protection and systemic risk reduction, while accommodating important differences among products and managers, maintaining coherence with existing European legislation, and avoiding harm to the competitiveness of the European investment management industry.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

Chairman Financial Industry Members

Guido Ravoet, *EBF Secretary General*
Rue Montoyer 10, B-1000 Brussels
Tel: +32 2 508 37 11 / Fax: +32 2 502 13 30
E-mail: g.ravoet@ebf-fbe.eu

Secretariat

Catherine Denis, *EPFSF Director*
Rue Montoyer 10, B-1000 Brussels
Tel: +32 2 514 68 00 / Fax: +32 2 514 69 00
E-mail: cdenis@epfsf.org

Steering Committee

Burkhard Balz MEP
Vilija Blinkeviciute MEP
Sharon Bowles MEP
Vicky Ford MEP
José Manuel García-Margallo y Marfil MEP
Malcolm Harbour MEP
Roger Helmer MEP
Monika Hohlmeier MEP
Gunnar Hökmark MEP
Ivailo Kalfin MEP
Othmar Karas MEP
Wolf Klinz MEP (SC Chair)
Astrid Lulling MEP
Arlene McCarthy MEP
Gay Mitchell MEP
Bill Newton Dunn MEP
Sirpa Pietikäinen MEP
Olle Schmidt MEP
Peter Skinner MEP
Kay Swinburne MEP

Financial Industry Committee

Association of Financial Markets in Europe (AFME)
Association of Mutual Insurers and Insurance Cooperatives in Europe (AMICE)
Association of Private Client Investment Managers and Stockbrokers (APCIMS)
AXA
Banco Bilbao Vizcaya Argentaria
Banco Santander
Barclays
BNP Paribas Fortis
Chartered Financial Analyst – Institute (CFA)
Citigroup
Commerzbank AG
Crédit Agricole
Deutsche Bank AG
Deutsche Börse AG
Euroclear
European Association of Public Banks (EAPB)
European Banking Federation (EBF)
European Federation of Accountants (FEE)
European Federation for Retirement Provision (EFRP)
European Fund and Asset Management Association (EFAMA)
European Insurance and Reinsurance Federation (CEA)
European Mortgage Federation (EMF)
European Private Equity and Venture Capital Association (EVCA)
European Savings Banks Group (ESBG)
Federation of European Securities Exchanges (FESE)
Futures and Options Association (FOA)
Goldman Sachs International
ING
International Swaps and Derivatives Association (ISDA)
Intesa Sanpaolo
JP Morgan
LCH.Clearnet
Lloyds Banking Group
Lloyd's
MasterCard Europe
NASDAQ OMX
Nordea Bank Finland
NVB – Dutch Banking Association
NYSE Euronext
PayPal
Prudential Plc
Royal Bank of Scotland
Société Générale
Standard & Poors
UBS AG
UniCredit Group
VISA Europe
Western Union International Bank