

AIFMD News

A Directive in flux? – Gauzes says a solution and compromise can be achieved

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Introduction

There has been much lobbying by industry participants since the initial Alternative Investment Fund Management Directive, “AIFMD “ text was published in April 2009. The proposals were met with much controversy when first issued and wide debate behind the scenes in Europe. However, the time for lobbying is all but over with the proposed Directive having moved a step closer to finalisation following approval on 17th and 18th May by the European Parliament and the European Council of their respective drafts of the Directive, (separate Directive texts with differing proposals).

Since December 2009, Parliament and Council have worked separately on the Directive draft to consider the proposals and reach an agreed position by which to commence a tripartite dialogue of discussion with all parties, the Commission, Parliament and Council. At Parliament level (ECON), Jean Paul Gauzes, the lead Rapporteur has been working hard in his role to orchestrate compromises between the different political parties represented in the Committee. Gauzes who is widely known for delivering compromise legislation on time, has succeeded in bringing forward an agreed Parliamentary proposal on 17th May by which to commence the tri-party discussions. This draft contains a more stringent approach than that of Council, particularly around the scope of the Directive, third country measures, transparency disclosures, delegation arrangements and liability matters. These measures are further explained in the comparative table on page 3.

Separately, Council have considered the proposals of the Spanish Presidency Text issued in December and having reached agreement on a revised text, also voted and accepted their version on May 18th again paving the way for the commencement of the tripartite process. Council’s text, while not considered to be as stringent as Parliament’s proposals does contain measures which remain a significant concern for the industry. It is hoped that we will start to see a more workable compromise emerge as the negotiation process commences.

The trialogue process

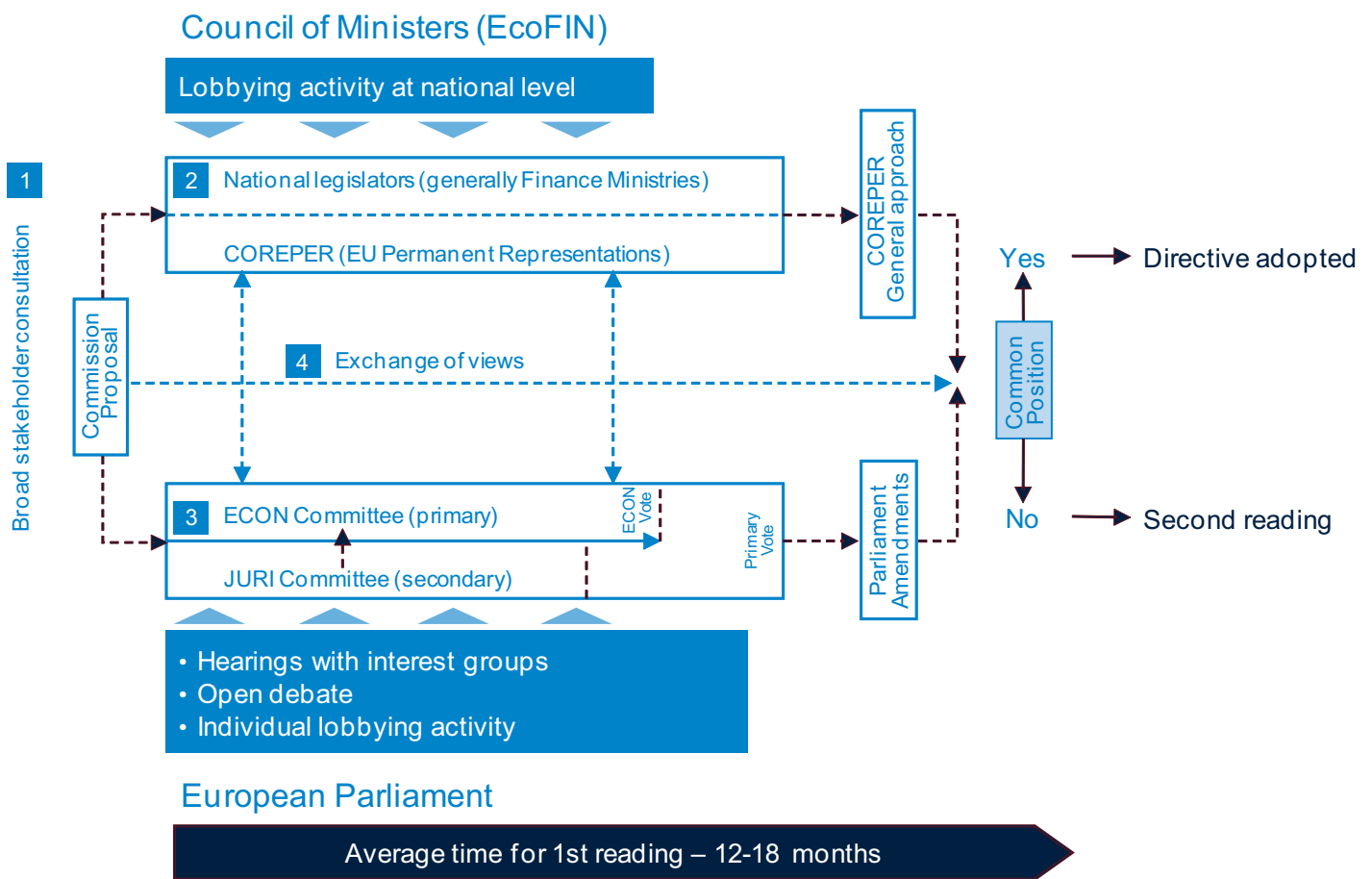
The two bodies - ECON (Parliament) and ECOFIN (Council), together with the European Commission began their discussion process on 31 May to negotiate a final compromise. In a recent press statement, Jean-Paul Gauzes, the Rapporteur, said that he expects the talks to be wrapped up by the end of July and is confident that a compromise agreement can be reached.

While there are some areas of agreement between the two drafts, for example, in relation to heightened transparency and reporting requirements for fund managers, there are several areas which remain contentious and will be the subject of further debate. In particular, the proposals on third-country rules, remuneration, leveraged acquisitions, and those AIFs caught by the provisions of the Directive. It is only through this trialogue process will we see the scope of the final directive take shape.

One thing is certain however, a Directive is taking shape and will be brought forward, the impact of which is likely to be material for alternative investment fund managers operating inside and outside of the EU. We shall continue to keep you apprised of developments as Parliament and Council work their way through the negotiation process.

The Co-Decision Process for AIFMD:

Co-Decision Process (adoption at first reading)



	The Commission Draft	The Council Draft	The Parliamentary Draft
Scope	All collective investment vehicles, whether open or closed ended, subject to de minimis: €100m under management or €500m if ungeared and a 5-year lock in. Exclusions for, amongst others, sovereign wealth funds, insurers, banks and managers of non-EU funds not marketed into EU.	<p>Directive applies to all AIFM established in the EU irrespective of whether the AIF is established inside or outside the EU and whether the AIF is open or closed ended.</p> <p>Also applies to the AIF if there is no designated AIFM and AIF requires establishment of board of Directors.</p> <p>Limited provisions applying to Private Equity schemes Depository requirements not applicable.</p> <p>Partial exemptions available to: non systemically relevant AIFM and:</p> <ol style="list-style-type: none"> 1. AIFs providing management services to parent undertakings only; 2. AIFM in respect of an AIF with up to 3 professional investors which are not other AIFs or UCITS; and 3. AIFM which are internally managed AIF, do not grant shareholders any redemption , invest in transferable securities and shares traded on a regulated market. <p>Requiring the AIFM to comply with the Authorisation, regulatory reporting and leverage requirements only.</p> <p>*ESMA to maintain central public register indentifying the competent authority for each AIFM.</p>	<p>Applicable to all AIFMs but Member States have the option to carve out AIFM whose managed assets are below €100m (if leverage is used) or €500m if leverage not used and closed ended for minimum of 5 years. All AIFMs would be subject to minimum registration and reporting requirements.</p> <p>* While there is general acceptance, by Council members, the opposing delegates would like AIFMD to apply in general to all.</p>
Extension to offshore AIF managed by onshore AIFM	Yes, with 3 year window and, thereafter, by application of equivalence requirements for third countries.	<p>AIFMD applies in full to onshore AIFM and limits ability of AIFM to manage only those AIFs from approved jurisdictions in accordance with 3rd country provisions listed below – 5 specific third country conditions.</p> <p>*Directive seeks to regulate an EU domiciled AIFM and therefore the activities of the AIFM fall whether or not the AIF is domiciled inside or out of the EU.</p>	Yes, selected provisions applicable to offshore funds managed by onshore managers with the exception of Depository requirements (Article 17) and Annual reporting (Article 19). Article 34 (b).
Proportionality	No.	<p>Principle of proportionality - to lighten the burden on small funds but with eligibility to adopt “opt in procedure” of compliance.</p> <p>Partial exemptions available to AIFMs managing closed ended non systemically relevant AIFs with maximum of 3 investors.</p>	<p>Yes – however all AIFMs required to report to local competent authorities on matters of systemic risk.</p> <p>* Many delegations seeking application of Directive to all AIFMs.</p>

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Delegation	Detailed preconditions to delegation of functions. Bar against delegation of portfolio management to non- AIFMD authorised firms.	<p>AIFM may delegate responsibility for the performance of some of its functions but AIFM should remain responsible for the proper performance of their functions and compliance with AIFMD rules and with primary liability. AIFM's liability unaffected by the fact it has delegated certain functions to a third party.</p> <p>Restricts delegation arrangements to AIFM managing an AIF of similar type. AIFM must inform home Member State Regulator for each delegation within 1 month.</p> <p>For assets located in a third country, an AIFM shall be allowed to delegate administration tasks to entities located in that 3rd country provided that the requirements for delegation under Article 18 are met, .i.e. appropriately qualified, creditworthiness & similar prudential supervision equivalence.</p> <p>Valuator – ability to use 3rd country valuator for assets located in that third country where valuation requirements under article 16 are met (annual valuation etc) and that 3rd country is deemed to have valuation standards equivalent to those applicable in the community – Liability of AIFM unaffected by such delegation arrangements.</p> <p>Depository may delegate tasks apart from selecting, monitoring and overseeing sub-depositories and sub-custodians. Liability not being affected by these delegation arrangements.</p>	<p>General delegation subject to notification rather than preclearance. Delegation of portfolio management and risk management to non-EU firms permitted, provided prior approval obtained or certain conditions regarding supervision met and there are cooperation agreements in place between relevant supervisors.</p> <p>Liability of the AIFM shall not be affected by delegation of any functions to third parties. 3rd party may sub-delegate provided aforementioned conditions are met.</p>
Annual Report	Requires publication of annual report within 4 months of year end.	<p>Annual report to be made available 4 months after year end, six month where there is reliance on third parties such as the audit of underlying investments of the AIF.</p> <p>Annual report shall contain same disclosures requirements as per Committee ECON, however, additional more onerous disclosures required on controlling influences, referenced under Article 20.</p>	<p>Annual report made available for each AIF no later than 6 months following year end. Shall contain at least the following:-</p> <ul style="list-style-type: none"> • balance sheet or statement of assets & liabilities, • income and expenditure account, • report on activities for the year, • total amount of remuneration for the year, split into fixed and variable remuneration, carried interests etc, • aggregate amount of remuneration broken down by senior management and members of staff whose actions have a material impact on risk profile of AIF.

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Depositories	<p>All AIF falling under directive to have external depositories, i.e. AIFM cannot act as Depository.</p> <p>Depositories to be EU credit institutions (including for non-EU AIF managed by an EU AIFM). Depositories to be liable to AIF and investors for losses suffered unless they can prove losses could not have been avoided. Depositories liable for sub- custodians.</p>	<p>Requires appointment of single Depository to undertake specified functions. AIFM cannot act as Depository.</p> <p>Depository shall be either:</p> <ol style="list-style-type: none"> 1. Credit institution in accordance with Directive 2006/48/EC, or 2. Investment firm authorised under Directive 2006/49/EC or 3. Legal person in the home member state of the AIFM authorised by the competent authority to act as a depository. <p>Depository's Liability shall not be affected by the fact that it has chosen to undertake a single delegation to an authorised third party, such as a sub-depository or sub-custodian. In cases where the Depository is legally prevented by the law of a third country or as a result of unforeseeable external event, the Depository should be able to discharge itself of the liability which must be approved by the competent Member State authority. This delegated liability cannot in turn be re-delegated.</p> <p>For AIF managed by an authorised AIFM in a 3rd country, the Depository shall have its registered office in the EU unless there is supervisory cooperation and exchange of information agreements with the home state and AIFM member state.</p> <p>Must meet third country specific conditions; namely, sign up to GAFI requirements on prevention of terrorist financing, compliance with OECD model tax convention, and Depository must be a bank or entity equivalent to those entities specified above.</p>	<p>All EU based AIF must have a depository. AIFM cannot act as Depository.</p> <p>Depositories to be either EU credit institutions or MiFID authorised investment firms, unless AIF has infrequent trading activity and a five year lock in, in which case depository may be a prudentially regulated entity. Other categories of institutions subject to prudential supervision and eligible under UCITS Directive, article 23 of Directive 2009/65/ec.</p> <p>Delegation possible under sub-delegation arrangements and subject to due diligence and regulation in the home state.</p> <p>Liability only where the Depository may hold the assets otherwise ability to contract out and liability passed to third party. Full disclosure to investor and competent authority of AIF & AIFM.</p> <p>Depositories should be established in the home state of the AIF or Member State may allow the depository to be established in another Member State for a maximum period of 4yrs so that they may build the necessary infrastructure to develop the activity of the AIFM.</p> <p>* Many delegations are in agreement with this compromise but require clarification on when the discharge would be possible.</p>
Taxation	Not mentioned.	The purpose of AIFMD should also be to create incentives towards the relocation of offshore funds in the EU, bringing not only regulatory and investor protection advantages but also allowing for a proper taxation of revenues, at manager, fund and investor level.	Text is silent on taxation measures.

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Valuers	Requires all funds to have independent valuers, performing valuations on each redemption or issue and otherwise at least annually.	<p>The process for valuation of assets and NAV calculation should be functionally independent from the management functions of the AIFM. Where relevant, valuation function and NAV calculation may be delegated to a third party.</p> <p>All valuations subject to the oversight and monitoring of the Depository.</p> <p>Where the AIF is a real estate fund, periodic valuation is optional. Frequency for valuation determined by the specific AIF rules.</p>	<p>Valuer does not need to be external, but function needs to be independent of portfolio management. Requires AIFM to implement valuation procedures resulting in the proper valuation of assets of the AIF.</p> <p>Valuation frequency – annual for open ended AIFs. Rules for valuation of assets and calculation of NAV should be laid down in national law.</p> <p>External Valuer subject to professional registration. Professional Indemnity Insurance must be appropriate to the Valuation function.</p> <p>Liability to the investors may be invoked directly or indirectly through the AIFM.</p> <p>*Many delegations have concerns regarding the extent of the liability applicable to the Valuer.</p>
Remuneration	Not mentioned.	<p>Remuneration rules compatible with rules applicable to credit institutions and investment firms – seek at least 50% deferral of variable amount of remuneration over a period / or as appropriate over the life cycle of the AIF, but not less than 4 years. Policies and practices to comply with the provisions set out in Annex II.</p> <p>60% deferral in the case where the total variable remuneration is particularly high.</p> <p>* Parliament text calling for full compliance with Annex II – no scope for interpretation.</p>	<p>AIFM to ensure that remuneration rules are compatible with rules applicable to credit institutions and investment firms.</p> <p>Obligation for managers to put in place sound remuneration policies and practices. These should be proportionate to the nature, scale and complexity of the manager's activities and to the fund it manages. In addition there will also be transparency requirements such as the obligation to include in the annual report of the fund the total amount of remuneration of the financial year. The categories of staff should at least include, senior management, risk takers and control functions.</p> <p>Council text seeks compliance with the principles of Annex II – scope for interpretation.</p> <p>** Many delegations have concerns with regard to the extent and level of these disclosures requirements and citing their inappropriate fit to AIFs.</p>

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Liquidity		<p>AIFM will employ an appropriate liquidity management system – Regularly conduct stress testing and the results of these stress tests to be reported to competent authority.</p> <p>Investment strategy & liquidity profile must be consistent.</p>	<p>For each AIF (not unleveraged and closed ended) AIFM must adopt appropriate liquidity management system and adopt procedures to enable monitoring of liquidity risk of the AIF. Regularly conduct stress testing and ensure that the investment strategy, liquidity profile and redemption policy are consistent.</p>
Position reporting – controlling interests	<p>Detailed reporting to regulators, investors and employees triggered by holding interests at or over 30% in listed and unlisted companies regarding fund actions and intentions and identities of major shareholders.</p>	<p>Threshold defined by reference to EU “controlling influence”, but scope of information to be reported remains substantial. Applies to non-listed companies, with in excess of 50+ persons employed and which the AIFM holds a controlling influence. Controlling influence - AIFM is in a position to exercise 30% or more of the voting rights. Obligation on AIFMD to report to home competent authority & disclose holdings in positions exercising 10,20,30, 40, 50% or more of the voting rights within 5 working days on the day on which the AIFM reached the relevant threshold.</p> <p>Prevention of asset stripping measures introduced. Capital Adequacy measures introduced for target company controlled by an AIF.</p> <p>Extended Disclosure reporting to employees of “controlling influence” entity, competent authority and investors.</p>	<p>Reporting obligations confined to holdings in unlisted vehicles where interest is at or exceeds 50%. Scope of information to be reported substantially reduced but introduces requirement for disclosure of debt supported at investee company level.</p>
Short Selling		<p>Short selling should operate in a harmonised regulatory framework.</p> <p>Commission proposes:-</p> <ul style="list-style-type: none"> • measures at Union level to ensure level playing field between AIFM and other users of short selling, and • a ban on naked short selling (requires amendment to Insider trading and market manipulation legislation. <p>Requirement for disclosure reporting to home Member State authority and ESMA. Market Abuse Directive to be amended to include the aforementioned proposals.</p>	<p>AIFM to report to Competent authorities, where relevant, on the use of short selling and Member States authorities shall ensure they have access to information on short selling and for the purposes of identifying the extent to which the use of short selling techniques contribute to systemic risk.</p>

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Marketing	<p>Marketing defined widely and includes any communication between a fund promoter and an investor, regardless of who takes initiative. Funds may only be marketed to Professional Investors.</p> <p>Gives EU AIF a passeport and non-EU AIF similar passport, provided equivalence tests met after a 3 year transition period.</p>	<p>Private placement regime to be defined by the Commission.</p> <p>An AIFM may only market a third country AIF once the following is complied with:-</p> <ol style="list-style-type: none"> 1. There must be supervisory cooperation and exchange of information agreements with the home state; and AIFM member state 2. Sign up to the FATF / GAFI requirements on prevention of terrorist financing; 3. Compliance with OECD model tax convention, tax information exchange agreements between fund domicile and EU marketing jurisdiction; 4. Third country is subject to Commission approval granting effective market access and equivalent market access for EU Funds in 3rd country domicile; and 5. Recognition and enforcement of judgements rendered in the EU on AIFMD matters – principles of 1958 New York convention on foreign arbitral awards. <p>***NB:- restriction:- Investor Access to third country AIFs</p> <p>EU Professional investor shall not invest in a 3rd country AIF (managed by a EU AIFM or third country AIFM) unless the conditions above are met.</p>	<p>Private Placement subject to specific conditions and co-operation arrangements.(Cooperation agreement should take account of AIFM compliance with the Directive).</p> <p>Rules should not impede the marketing of third country funds within Europe.</p> <p>EU Feeder of third country master structure will not automatically gain passport but may avail of local Private placement rules.</p> <p>*Member states may decide not to apply the third country provisions under art 34 & art 35 until 36 months after AIFMD comes into force.</p>
Leverage	<p>Commission to have power to set pan-European Limits on the amount of leverage that Funds and strategies may apply in advance.</p>	<p>AIFM shall be obliged to set leverage limits for each AIF it manages and to disclose information regarding their use and sources of leverage to investors and the ESMA (European Securities and Markets Authority and competent authorities of home member state for information sharing with the ESRB (European Systemic Risk Board).</p> <p>Quarterly disclosure to investors on amount of leverage employed by each AIF, together with details of maximum leverage that AIFM may employ on behalf of the AIF.</p> <p>Detailed analysis to be provided to home Member State authority. ESMA will have the authority to restrict leverage and impose leverage limits where AIF is deemed to pose a substantial risk to the integrity of the financial system.</p> <p>Continued monitoring by home state competent authority for compliance with leverage limits and assessment for systemic risk.</p>	<p>Measure of Disclosures to local competent authority regarding the use and sources of leverage. Individual member state regulators can restrict leverage if exceptional circumstances merit it, or to avoid pro-cyclical activity and must inform CESR & ESRB. Temporary basis only.</p>

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Third-country provisions	<p>1. Rules binding onshore managers in relation to funds they manage apply to both onshore and offshore funds (e.g. re depositories, valuers).</p> <p>2. Marketing of offshore funds permitted for a three-year period after transposition under existing private placement regimes, but thereafter only permissible if :(a) the fund has an onshore manager, the fund has a depository and the fund's domicile has a TIEA in place; and (b) if the fund has an offshore manager, the manager's domicile satisfies "equivalence" requirements, in which case the fund will benefit from a passport.</p>	<p>1. Rules binding onshore managers in relation to funds they manage apply to both onshore and offshore funds (e.g. re depositories, valuers).</p> <p>2. By implication, private placement regime for offshore managers with offshore funds but there needs to be an information sharing agreement in place between the domicile of the Fund(!) and the home member state where the fund is being sold.</p> <p>Also establishes limits to the marketing of fund of funds investing >30% in third country AIFs to retail investors.</p> <p>Third Country AIFM may seek to "opt-in" to comply fully with the Directive in order to market a third country AIF and avail of the "AIF visa". The Directive should establish a means by which the supervisor of the third country AIFM, in conjunction with the ESMA and member state authorities enforces compliance with this Directive. EU passport is not available even when the AIF meets the above specified criteria but afforded the right to undertake marketing via private placement only.</p> <p>*the extent to which the supervisor of the third country can monitor compliance with an EU Directive will be problematic.</p> <p>Commission is seeking to develop a European private placement regime.</p> <p>As per the marketing provisions, an EU investor is restricted from investing in third country AIFs where that jurisdiction has not signed up to the third country rules and has "opted in" to full compliance with the directive enabling that 3rd country AIF to avail of the EU wide passport.</p>	<p>Authorised EU AIFM managing an offshore / third country AIF may market the AIF within the EU subject to compliance with the requirements of the Directive and with the exception of Depository requirements, Article 17.</p> <p>Also requires cooperation arrangements with competent authorities in line with international standards enabling private placement rules at national level to continue.</p> <p>Those EU AIFMs must ensure the appointment of an entity to carry out the functions of the Depository per Article 17, these may not be undertaken by the AIFM.</p> <p>Managers based outside of the EU (e.g. USA or Switzerland) will be able to distribute their funds into the EU using national private placement regimes in the same way that they do currently provided there is a cooperation agreement in place between the Manager's home regulator and the regulator in the EU jurisdiction in which it is distributed. The Passport regime will not be available to Managers based outside the EU.</p> <p>Third Country AIFM managing third country AIF marketing within the EU must comply with annual report (article 19), regulatory (article 20) and investor reporting (article 21) and controlling interests requirements. (Section 2 of chapter 5).</p> <p>Requirement for appropriate cooperation arrangements in line with international standards.</p> <p>*Many delegations strongly against these measures citing them as protectionist in their nature.</p>
Capital	<p>Self Managed AIF – Initial Capital of €300,000 required</p> <p>Capital levels similar to those for UCITS ManCo - €125,000 + 0.02% of AUM – No cap.</p>	<p>Self Managed AIF – Initial Capital of €300,000 required</p> <p>Capital levels similar to those for UCITS ManCo - €125,000 + 0.02% of AUM and capped at €10m.</p> <p>Lending institutions and prime brokers which are key partners to the AIF should themselves be subject to specific capital requirements considering the risk they incur, depending on their links with the AIF and comply with the provisions of the Capital Requirements Directive (2006/48/EC) & (2006/49/EC) also addressing appropriate conflicts of interest management.</p>	<p>Same capital requirements apply but reduced capital requirement to €50,000 for closed ended funds, not leveraged or reaching threshold of €500m.</p>

If you would like to discuss any of the areas covered in this paper as well as the implications for your business, please speak with your local PricewaterhouseCoopers contact or one of our AIFMD specialists listed below:

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