Swedish Presidency Produces "Compromise Proposal" on the AIFM Directive

The European Commission's directive for the regulation of alternative investment fund managers ("AIFMs"), produced at the end of April 2009, has attracted widespread comment, much of which has been highly critical of the Commission's proposals. On November 12, 2009, the Swedish presidency issued a "compromise proposal," which aims to address these criticisms and to deliver a text on which Member States can agree.

What follows is an analysis of the major changes between the Swedish presidency text and the original Commission draft. Particularly important changes are marked with an asterisk.

Remuneration Policies.* There is a completely new provision on remuneration policies **(Article 9a with Annex II)**. This requires AIFMs to have remuneration policies and practices that are consistent with and promote sound and effective risk management. For categories of staff whose professional activities have a material impact on the risk profile of the AIFM or the AIF that they manage, a number of principles must be applied to the remuneration policy, including deferment of a substantial proportion of variable remuneration (40% or more, or 60% or more where the remuneration is "a particularly high amount") for at least three years.

AUM Threshold. The exemption for AIFMs managing AIFs totaling €100 million or less (€500 million for unleveraged AIFs with a five-year or greater lock-in) remains, but the blanket exemption for credit institutions has been removed. The Swedish presidency recognizes that there is a problem where the value of the AIFs crosses and recrosses the threshold, but that is clearly too difficult for now: a new provision directs the Commission to clarify the position in (later) implementing measures **(Article 2(3)(a))**.

Marketing.* Article 3(1)(e) has been amended to define "marketing" as offerings or placements "at the initiative of the AIFM." This is a major (and welcome) change, as it means that approaches by potential investors to AIFMs will not be classed as "marketing," as they were under the previous definition. **Article 31** (Marketing to professional investors) has been amended to clarify that it applies only to AIFs established in the EEA. It also clarifies that where the AIF is a feeder fund, the right to market is conditional on the master fund being an EEA AIF managed by an authorized AIFM. **Article 32** (Marketing to retail investors) has been amended to make it clear that Member States cannot discriminate between home AIFs and host AIFs when deciding whether to allow marketing to retail investors.

AIFM. Article 4 indicates that each AIF has one, but only one, AIFM, "which shall be responsible for the compliance with the requirements of this Directive." If an AIF does not designate an external entity as its AIFM, then the AIF itself will be the AIFM (what the Directive calls an "internally managed AIF"). Externally designated AIFMs can only act as AIFMs, UCITS managers, and MiFID investment firms.

Capital. The initial capital provisions **(now in Article 6a)** remain in general at a minimum of €125,000. But there is now a cap of €10 million (similar to the UCITS Directive cap), and there is a square-bracketed provision that seems to indicate that it is for discussion whether those AIFMs that manage solely AIFs that are not leveraged, and have a five-year or greater lock-in, should have a lower minimum initial capital requirement of €50,000 or €60,000. If an AIFM is also a management company under the UCITS directive, the initial capital requirements of the AIFM Directive do not apply.

AIFM's Duties. The original draft of **Article 9(1)(b)** required the AIFM to act "in the best interests of the AIF it manages, the investors of those AIF and the integrity of the market." That has now been amended so that the AIFM must act with due skill and diligence in the best interests of the AIF **or** the investors of the AIF, and in the interests of the market. It is not clear how the AIFM is to manage that (for instance, is it acceptable if on one occasion the AIFM acts in the best interests of the AIF, on another in the best interests of the investors in the AIF?), but the Commission is to specify the criteria that apply, which may clarify matters. The new provisions about avoiding conflicts of interest where possible, and fairly treating AIFs where they cannot be avoided, suggests that AIFMs may need to perform a balancing act (that is, just because AIFMs may be acting in the best interests of investors in the AIFs does not mean that they can treat AIFs unfairly).

Short Selling. The short selling provisions in **Article 11** (Risk management) are now requirements applying to competent authorities, requiring them to obtain information for the purpose of identifying the extent to which short selling contributes to systemic risk. (Previously, the short selling provisions had applied in the context of AIFMs' internal risk management procedures.)

Liquidity. The liquidity management requirements in **Article 12** are now limited to open-ended AIFs.

Valuation.* The requirement to appoint an independent "valuator" has been removed from **Article 16**. Instead, there is a general requirement to ensure that appropriate and consistent procedures are in place to provide proper valuation of the assets, and a requirement, where appropriate, to ensure the functional independence of the valuation and portfolio management function. An independent valuer can still be used; where one is not used, the home Member State competent authorities can require independent valuation by a valuer or auditor. This change brings the requirements closer to those of the Hedge Fund Standards Board and will, one suspects, be generally welcomed.

Depositary.* The depositary provisions in **Article 17** have also been significantly relaxed — again these changes will be welcomed:

- In addition to a credit institution, the depositary may be a MiFID firm authorized to carry out safekeeping and administration.
- If the AIF has a five-year or more lock-in and buys or sells "on a non-frequent basis," the depositary may be any person subject to prudential regulation and ongoing supervision that can offer sufficient financial and professional guarantees that it can perform the depositary functions. (What that means is not entirely clear and is left to the Commission to elucidate.)
- The depositary can delegate safe-keeping and verification of title to any third parties (not just other depositaries, as before), provided that the sub-custodian is subject to supervision in the jurisdiction concerned, subject to periodic audit, and segregates client assets from its own assets.
- If the conditions in the previous bullet are satisfied, and if the depositary exercises all due skill, care and diligence in the selection, appointment and periodic review of the sub-custodian, it may contract out of liability for loss of financial instruments held by the sub-custodian.

The last two bullets will make operating in frontier jurisdictions easier, though the unanswered question is what depositaries are supposed to do when the conditions for delegation are not satisfied.

Delegation.* The power to delegate in **Article 18** is wider than before:

- No longer do AIFMs need prior authorization from regulators in order to delegate: notification only is required (and the text implies that this can be on a 'one-off' general basis, though this needs to be clarified).
- Portfolio management and risk management can be delegated to third parties, provided that they are authorized for asset management and subject to prudential supervision; indeed, delegation can be given to entities who do not satisfy this requirement, on prior authorization of the AIFM's regulator.
- Delegation of portfolio management/risk management can be made to entities outside the EEA, provided that these entities are authorized for asset management and subject to prudential supervision, and there is co-operation between the regulator of the AIFM and the supervisory authority of the non-EEA entity. (This is virtually the same provision as in the previous Commission text of the AIFM directive, but with the significant change that it applies immediately the AIFM directive comes into force, rather than three years later.)
- Delegation cannot be made to the depositary (as before), but it can be made to any third party, even where the interests of the third party may conflict with the AIF, provided the conflict of interest can be managed.
- As before, the AIFM retains responsibility for its delegated functions. It cannot, however, delegate its functions away so that it becomes what the AIFM Directive terms "a letter-box entity": the Commission is to specify the circumstances where such a status arises.

Leverage.* The provisions that apply to AIFMs managing leveraged AIFs, which previously required disclosure of leverage levels both to investors and to regulators, have largely been deleted. However, they have not disappeared entirely: the amended **Articles 20 and 21** indicate that leverage information must be supplied by AIFMs to their regulators where the AIFMs use leverage "on a systematic basis." This phrase is not defined and is left for the Commission to clarify in later provisions.

Third Countries.* The third-country provisions in Chapter VII (Articles 35–39) have all been deleted. Instead, there is a square-bracketed provision providing that AIFMs can only manage non-EEA AIFs if the legislation of the country of the AIF "is in line with the standards set by international organisations, including the IOSCO standards on hedge fund oversight," and an appropriate co-operation agreement exists between the regulator of the AIFM and the supervisory authorities in the country of the AIF. Once again, details of what an "appropriate co-operation agreement" might be are left to later Commission measures.

Passport.* Article 33 of the Directive (with Recital 19) makes it clear that the marketing "passport" only applies in respect of AIFs that are established in the EEA. **Recital 19** makes it clear that the Commission will assess, three years after the AIFM Directive comes into force, whether, and if so, under what terms, the passport is to be extended. This is an interesting change from the previous draft, as Article 35 of that draft provided for such a passport, albeit with a three-year delay and subject to conditions (an agreement satisfying Article 26 of the OECD Model Tax Convention being in place with every EEA country in which marketing was to take place). What we now have is more uncertain: the Commission could set more onerous conditions, less onerous conditions, or decide not to extend the passport at all. One doubts whether this uncertainty will appeal to firms — particularly as any proposals to extend the passport that the Commission does provide will inevitably take effect significantly later than three years after the AIFM Directive comes into force.

Is This "Compromise Proposal" an Improvement?

Yes. It is the sort of considered draft the Commission should have released in the first place, and a much more workable text than its predecessor. It also looks more professional, as the Swedish presidency has corrected various minor slips and omissions in the previous version.

The new provisions regarding delegation, depositaries and valuation will be generally welcomed. But the position of third-country AIFMs managing AIFs needs to be clarified. A square-bracketed provision in Article 4 (1) indicates that once the Directive is in force, third-country AIFMs will not be able to manage EEA AIFs (as in the previous text). But it is not clear what the position of third-country AIFMs managing third-country AIFs would be (*e.g.*, a U.S. manager managing a Cayman fund). It looks as though the AIFM Directive leaves the current position unchanged — that is, marketing of the AIF to investors in an EEA state will continue to be possible, provided that local law allows it. However, it would be helpful if that were clarified.

One other point to note is that this draft, even more than the previous draft, leaves various "too difficult for now" issues as matters that the Commission must resolve in further provisions at a later stage. As a matter of politics, that seems sensible: the Swedish presidency is keen to obtain agreement on what it thinks can be agreed at this stage, rather than risking the whole enterprise by requiring a showdown on more difficult issues before things can move on. However, leaving details to be decided upon at a later stage is not helpful for firms or their advisers.

Although the Swedish presidency text marks a definite improvement, it is generally expected to be subject to further changes before an agreed text is reached. The lobbying efforts by firms and their trade associations will therefore continue.

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