KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

Willys H. Schneider

Partner

Tax

New York

IN THIS ISSUE

IRS Issues Guidance on U.S. Lending Activities by Non-U.S. Investors

A U.S. tax issue of major concern to non-U.S. persons investing in off-shore private equity and hedge funds that hold U.S.-source debt is whether the income from such debt (interest and any gains on sale) will be treated as income effectively connected with the conduct of a U.S. trade or business ("effectively connected income" or "ECI") subject to U.S. net income tax, as opposed to non-ECI, investment income, which generally is exempt from U.S. tax. The answer depends on whether the fund is deemed engaged in a banking, finance or similar business in the United States (in such case subject to U.S. net income tax) or viewed as an investor in debt securities (generally exempt from U.S. tax). A similar, additional, issue arises for sovereign wealth funds ("SWFs"), which are frequently significant investors in off-shore funds and will want to ensure that, by virtue of the funds' debt investments, they are not viewed as engaged in a banking, finance or similar business. SWFs that are so viewed would be treated as engaged in "commercial activities" and, as such, ineligible for exemption from U.S. income tax on a range of U.S.-source investment income. (Note that even if an SWF is only engaged in "commercial activities" *outside of* the United States, its entitlement to such exemption may be jeopardized, depending upon how it is organized and/or its specific functions.)

Unfortunately, there is limited case law or other authority as to when the line is crossed from mere investment to the active conduct of a banking, finance or similar business for purposes of determining the existence either of ECI or "commercial activities." It is largely because of this paucity of authority that a recent memorandum (the "Memorandum") issued by the U.S. Internal Revenue Service (the "IRS") generated a degree of excitement among tax professionals advising off-shore funds that invest in U.S. debt. In the Memorandum, which is a generic pronouncement without binding effect on any specific taxpayer, the IRS concluded that interest income received by a non-U.S. corporation ("Non-U.S. Co.") from U.S. loans originated on its behalf by an agent ("Origination Co.") was ECI, taxable to Non-U.S. Co.

Under the facts set forth in the Memorandum, Non-U.S. Co. had no office or employees in the United States. Rather, Origination Co., a third party acting pursuant to a service agreement for which it was paid an arm's-length fee, solicited loans from U.S. borrowers, negotiated the terms of loans, performed credit analysis with respect to the U.S. borrowers and undertook all other activities relating to loan origination other than the final approval and signing of loan documents. Origination Co. performed such activities through its U.S. office. This approval and signing was done by Non-U.S. Co. employees in a non-U.S. office.

The activities addressed in the Memorandum and performed by Origination Co. clearly evidence a lending business, *i.e.*, solicitation, origination, and negotiation of multiple loans to multiple borrowers. As such, the Memorandum is not very helpful to many private equity or hedge funds whose activities are more nuanced. For example, the Memorandum does not deal with issues raised by investment in distressed debt, obviously a particular focus in the current climate. In such instances, where debt is being restructured and the modified debt is treated for U.S. tax purposes as having been newly originated, there is a concern that the holder of such debt may be viewed as engaged in a banking, finance or similar business for U.S. tax purposes, leading to the adverse U.S. tax consequences noted above. Nor does the Memorandum address whether an investor lending only to a limited number of borrowers might be viewed as so engaged.

The more significant point in the Memorandum is the imputation by the IRS of the U.S. lending activities of Origination Co., as agent, to Non-U.S. Co. The Memorandum specifically states that Origination Co. acts on behalf of Non-U.S. Co. pursuant to a service agreement, and does not have authority to conclude contracts on behalf of Non-U.S. Co. Nevertheless, the IRS found that Origination Co. performs activities that are a "component of Non-U.S. Co.'s lending activities," and, accordingly, the agent's (*i.e.*, Origination Co.'s) activities and office are imputed to Non-U.S. Co., resulting in a finding that Non-U.S. Co. is engaged in a lending business. That Origination Co. has no power to conclude contracts on behalf of Non-U.S. Co. and/or may be viewed as an independent, as opposed to a dependent, agent of Non-U.S. Co., factors that might have given certain non-U.S. investors comfort in the past, did not prevent the finding of ECI. As such, the Memorandum represents an expansive reading of existing relevant case law, and a restrictive reading of certain regulations, each of which could be interpreted to prevent the result described therein on the agency point. This expansive view may also be a potential source of concern for SWFs that operate through agents in connection with debt investments, whether in or out of the United States.

In many instances, private equity and hedge funds either may not qualify for treaty benefits or may, as a practical matter, find it difficult to take advantage of treaties.

The foregoing notwithstanding, the agency point made in the Memorandum may not be particularly relevant where an income tax treaty is involved. Most income tax treaties to which the United States is a party prevent a non-U.S. person from becoming subject to U.S. net income tax on ECI if such person does not earn business profits attributable to a "permanent establishment" in the United States, and a "permanent establishment" typically will *not* be imputed if (i) the non-U.S. person acts in the United States solely through an agent of independent status, whether or not the agent has the power to conclude contracts on behalf of the non-U.S. person, or (ii) even if the non-U.S. person acts here through a dependent agent, if such agent does not have and does not regularly exercise such authority. Accordingly, although not discussed in the Memorandum, it would appear that a conclusion different from that contained therein might obtain where tax treaty benefits can be claimed. On the other hand, in many instances, private equity and hedge funds either may not qualify for treaty benefits or may, as a practical matter, find it difficult to take advantage of treaties. In addition, the "permanent establishment" shield has no relevance to the determination of whether an SWF is properly viewed as engaged in "commercial activities."

The Memorandum indicates that the IRS is taking a hard look at off-shore funds and other entities originating U.S. loans. As such, it is of potential relevance to off-shore funds purchasing portfolios of distressed debt subject to work-out, or acquiring newly originated loans in the secondary market.

Willys H. Schneider
wschneider@kayescholer.com

United Kingdom Introduces "Bank Payroll Tax"

Daniel Lewin

Partner
Tax

London

On December 9, 2009, in his Pre-Budget Report, the United Kingdom ("U.K.") Chancellor of the Exchequer, Alistair Darling, announced that the U.K. would levy a "one-off" bank payroll tax ("BPT") on bonuses paid by certain financial institutions operating in the U.K. Measures to clamp down on bankers' bonuses had been widely trailed in the media in the run-up to the Pre-Budget Report, as a response to general public disquiet that a number of institutions that had received taxpayer support to save them from collapse were nonetheless proposing to pay bonuses as if the financial crisis had never occurred.

In broad terms, BPT is a 50% tax charge levied on the amount of any discretionary bonus over £25,000 that is awarded to "relevant banking employees" of "taxable companies". (BPT has no effect on the employee who is given the bonus, who is taxed in the normal way on the income received.) However, the actual tax cost to the affected institution is higher. As BPT is not deductible against corporation tax, the real cost is the 50% BPT, plus 28% corporation tax on the amount of the tax — at least where the institution is profitable.

BPT applies to bonus awards made between December 9, 2009, and April 5, 2010 (the "chargeable period"), but the U.K. government has indicated that the chargeable period may be extended until the proposed Financial Services Bill governing remuneration within financial institutions comes into force. BPT must be paid by August 31, 2010.

In addition, there will be a reporting requirement for all bonuses awarded in excess of £25,000 by relevant financial institutions (or "taxable companies") during the chargeable period, whether or not BPT applies to the bonus.

How the Charge Works

For an institution to fall within the scope of BPT, a number of elements need to be satisfied:

- the affected institution must be a "taxable company,"
- the employee must be a "relevant banking employee," and
- the employee must receive "chargeable relevant remuneration" in excess of £25,000 awarded in the chargeable period.

Taxable Companies. Taxable companies include all U.K. resident banks, "relevant foreign banks" (non-U.K. resident banks that operate in the U.K. through branches), and companies that are members of a banking group and are U.K.-resident investment companies (companies whose business consists wholly or mainly of making investments and who derive their main income from this activity), or authorized under the Financial Services and Markets Act 2000 ("FSMA") (whether U.K.-resident or non-U.K. resident) to carry on any regulated activity (not simply banking business). Asset management companies that are members of a banking group thus initially

Since the proposals were first announced, the Chancellor has indicated that BPT was not intended as a major revenue-raiser (BPT is estimated to bring in no more than £500 million), but rather as a clear signal that financial institutions need to change behavior.

appeared to fall within this definition. However, any such fund manager that is not operating as a U.K. company (*e.g.,* that is set up as an LLP) would not be caught.

Relevant Banking Employees. A relevant banking employee is an employee whose duties are wholly or mainly concerned with one or more specified activities. Those activities are the lending of money, and "relevant regulated activities" — activities falling within various articles of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, namely:

- accepting deposits;
- dealing in investments (whether as principal or agent);
- arranging deals in investments;
- safeguarding and administering investments; and
- entering into or administering a regulated mortgage contract.

While some of these activities (lending, deposit-taking, safeguarding and administering, mortgage business) are not activities that fund managers are likely to perform, and while the regulated activity of managing investments belonging to third parties (which is the major activity performed by fund managers) is not included, the broad scope of other listed activities would be capable of applying more widely than simply to banking employees. For instance, fund managers in the U.K. are invariably required to be authorized by the Financial Services Authority ("FSA") for the activities of dealing in investments as agent and arranging deals in investments, both of which are "relevant regulated activities" for BPT purposes. Furthermore, because the definition of "bank" in the draft legislation includes institutions that carry on "relevant regulated activities" other than accepting deposits, there has been widespread concern that providers of financial services other than banks would be included within the scope of BPT, such as pension fund managers, prime brokerage firms, and independent fund management businesses (principally, hedge and private equity fund managers).

HM Revenue and Customs ("HMRC") issued a press release on December 18 in response to these concerns (and confusion), clarifying that "the original definition of a 'bank' did not exclude all the groups we intended to exclude." HMRC's new proposal is that a non-deposit taker would only fall within the scope of BPT where its activities consist wholly or mainly of "relevant regulated activities" and it is a full scope BIPRU 730K firm for the purposes of the FSA's capital rules (or would be such a firm if its head office were in the U.K.). Even if a firm were to satisfy this definition, it may still be excluded from BPT by particular exemption (for instance, there is a proposed exemption for prime brokers — although it is not clear whether that exemption would only apply to independent prime brokerage firms, or also to prime brokerage divisions within banking groups).

As BIPRU 730K firms will be authorized to deal in investments as principal, and as the FSA does not usually authorize investment managers to carry on such activity, this change should succeed in rendering BPT academic for most if not all independent fund managers. This result would clearly be consistent with HMRC's pronouncements since December 9 that independent asset managers were not intended to be targeted. Further, while the draft legislation appeared to potentially subject asset managers within banking groups to BPT, HMRC on December 24, 2009, released new responses to "frequently asked questions" suggesting that dealing and arranging deals as agent, rather than for own account, as part of the discretionary management of the assets of external clients would not be a relevant activity (however, proprietary trading would still be caught by BPT). Notwithstanding the publication of the second set of frequently asked questions, the HMRC responses still leave a fair amount of uncertainty over the application of BPT to asset management activities. It is hoped that HMRC will address this in the final form legislation.

The test as to whether the duties are "wholly or mainly" concerned with the specified activities will be one of fact and degree. While the concept of "wholly or mainly" will be familiar to any tax advisor as essential hallmarks in the context of anti-avoidance provisions, here the concept would be applied to physical activities. "Wholly" is easy to determine, but the test for "mainly" is not clear — is it simply more than 50%, or is a higher level (*e.g.,* 75%) required? Existing case law may shed some

> *A further issue left unclear is whether the "chargeable relevant remuneration" of the employee gives rise to BPT on the full amount of the remuneration, even if the bonus concerned was largely given to the employee in respect of work done outside the U.K.*

light on how similar tests were applied in other areas, but presumably HMRC will provide the answer in the revised legislation, scheduled to be published in the new year.

The fact that the "wholly or mainly" test is further qualified as "directly or indirectly" suggests that support staff, operations and legal counsel are also included. Furthermore, the employee concerned does not need to be U.K.-resident for the tax year 2009-10; while the draft legislation suggested that it was sufficient that he performs his duties on a single occasion in the U.K. in the tax year to qualify as a "relevant banking employee," the HMRC responses of December 24 suggest that the revised legislation will only apply to employees who worked in the U.K. on at least 60 days.

Chargeable Relevant Remuneration. While regular salary and benefits fall outside the definition, it is otherwise (as might be expected) drafted very widely. It includes loans, many share arrangements, payments via intermediaries and arrangements for future payment. It does not however include certain approved share incentive and share option schemes, or remuneration where a contractual obligation to pay or provide that remuneration existed before December 9, 2009, and the amount of the remuneration is fixed (even if payment is dependent on the satisfaction of certain conditions). Anecdotal evidence suggests that a number of firms that would otherwise fall within the scope of the BPT may rely on this last provision to escape its effect.

A further issue left unclear is whether the "chargeable relevant remuneration" of the employee gives rise to BPT on the full amount of the remuneration, even if the bonus concerned was largely given to the employee in respect of work done outside the U.K. The draft legislation suggests that BPT on the full amount would be required, which, if correct, seems an overly harsh result.

Anti-Avoidance

Given that the chargeable period extends only until April 5, 2010, it might appear that BPT could be readily avoided by delaying any payment of bonuses until after that date. However, anti-avoidance provisions mean that any arrangements (whether contractually binding or not) made in the chargeable period to avoid BPT by this means will be treated as if the payment had been made in the chargeable period. Anti-avoidance provisions also provide that if a reward is given to the employee that does not qualify as relevant remuneration, but that equates in substance to relevant remuneration, it will be regarded as relevant remuneration. The wide-ranging scope of these provisions suggest that it will be difficult for affected firms to avoid BPT.

* * *

Since the proposals were first announced, the Chancellor has indicated that BPT was not intended as a major revenue-raiser (BPT is estimated to bring in no more than £500 million), but rather as a clear signal that financial institutions need to change behavior. Given this, one wonders whether a regulatory solution (such as increased capital requirements) would have been a better and more permanent way to obtain the desired result. It remains to be seen whether BPT will result in lower bonuses being paid in future years (to which BPT will not presently apply), or whether a more buoyant financial climate will mean a return to "business as usual" in this area

Kaye Scholer LLP London are members of the Tax Committee of the Alternative Investment Management Association, and as such are currently involved in liaising with HM Revenue and Customs and HM Treasury in respect of Bank Payroll Tax and the effects on the U.K. alternative investment management industry.

Daniel Lewin
dlewin@kayescholer.com

"Not Committed" — Contractual Options for GPs and LPs in the Current Market Climate

Timothy A. Spangler

Partner

Corporate & Finance

Chair

Investment Funds Group

New York and London

Thomas A. Jesch

European Counsel

Frankfurt

At the heart of private equity is a relationship of trust between the private equity firm and the institutional investors (such as public pension funds and charitable endowments) who back the firm and its key investment professionals. The limited partnership structure commonly used for private equity funds has as its cornerstone certain fiduciary (and other) duties that partners owe to one another, due to the position of trust that they enjoy.

In the current market, general partners are considering innovative contractual changes to their funds in order to ensure that limited partners receive the returns on their investments that they require for their own ultimate beneficiaries.

Capital Contributions (in the Good Old Days)

Fundraising and investing is a relatively straightforward thing: investors that want to participate in the fund join the fund partnership as limited partners and make capital contributions over a period of time to provide capital to acquire the fund's investments.

The reason for this delayed contribution is that the general partners traditionally choose not to manage excess commitments prior to their deployment, thereby risking a negative impact on the fund's performance. Limited partners contribute their capital immediately before a proposed investment upon receipt of a draw-down notice from the general partner. A limited partner usually must provide the requested liquidity within 10 business days after the draw-down notice.

Investors in Trouble

Investors trying to unburden themselves of uncalled commitments generally also need to sell their invested fund interest, often at a significant discount to net asset value. However, even where an investor finds a willing buyer for its interest, the investor's interest will generally not be assignable or transferable without the prior written consent of the general partner. Alternatively, the general partner might forfeit the future participation of the investor in the fund with the investor retaining a right, subject to cash being available in the limited partnership, to repayment of its draw-down commitment, although under default provisions in the Partnership Agreement, this would occur after the liquidation of the fund and after all other investors have received full repayment of their draw-down commitments.

This approach proved satisfactory in the past, largely because it was rarely invoked. Currently, however, a growing number of investors are unwilling or unable to live up to their original funding commitments. Some investors simply lack the liquidity to contribute further capital. Others, such as endowments and

Investors trying to unburden themselves of uncalled commitments generally also need to sell their invested fund interest, often at a significant discount to net asset value.

pension funds, are suffering from the so-called "denominator destruction effect." With stock indices pummelled in broad sell-offs, institutional investors' public equity holdings (the denominators) have decreased in value. At the same time, the percentage of overall assets devoted to private equity (the numerator) rises, leading to a potential breach of portfolio allocation rules. Cash-strapped and overcommitted private equity investors thus try to reduce their exposure. In some circumstances, even general partners can no longer afford their initial cornerstone commitments to the funds.

Another option for limited partners and the general partner is to reduce the size of the fund, thereby keeping enough dry powder for attractive investment opportunities in the coming months.

Options in the Current Market

One option for a concerned investor is to transfer outstanding uncalled commitments to a new investor while keeping the stake in the invested portion of the fund. The benefit for the investor will be the access to a fund in a climate where relatively few new funds are raised, and where prices start to look attractive at the threshold of a relatively promising vintage year 2010.

Another option for limited partners and the general partner is to reduce the size of the fund, thereby keeping enough dry powder for attractive investment opportunities in the coming months. The reduction in fund size takes place in an environment in which buyout firms have recorded a 31% decline in the value of their holdings in 2008, thought to be the biggest drop since the 1980s. In one recent transaction, the reduction was initiated by a departure of senior fund executives that triggered a so-called "key man" clause allowing the limited partners to renegotiate their commitments.

A third option for the general partner is to release the investors from all their commitments to the fund, leaving the general partner with no capital to invest, but also freed from the obligation to fund the money for their own fund commitment.

Outlook

Limited partners in the current vintage of private equity funds are rightly concerned about the value and liquidity of the investments. However, in many circumstances, general partners will have legitimate reasons to consider contractual adaptations for their funds, to ensure that the ultimate returns delivered to limited partners are maximized to the greatest extent possible. As the terms of these innovative solutions become increasingly familiar to the limited partner universe, they could become commonly employed where circumstances warrant.

In light of the unprecedented challenges that the financial markets have faced in the recent past, investors in private equity owe it to their own ultimate beneficiaries to fully and fairly consider reasonable solutions that seek to bridge the funding (and expectations) gap that has arisen, or may arise in the future, in many funds' partnership structures.

Timothy A. Spangler
tspangler@kayescholer.com

Thomas A. Jesch
tjesch@kayescholer.com

The Draft Directive on Alternative Investment Fund Managers: Update

Simon Firth

Partner
Corporate & Finance
London

Owen Watkins

Consultant
Corporate & Finance
London

There is clearly some considerable way to go before either the Council or the Parliament produces a final text, let alone a text that is acceptable to the other side.

Earlier editions of the *Investment Funds Newsletter* have drawn attention to the proposals by the European Commission for a directive regulating alternative investment fund managers ("AIFMs"), which were published in April 2009, and to their implications for AIFMs both inside and outside the European Union ("EU"). These proposals have attracted widespread comment, much of which was highly critical of both the initiative itself (drawing attention to the lack of prior consultation) and of the consequences if the proposals became law.

Unsurprisingly, therefore, there has been an extensive lobbying exercise, as the alternative investment industry has sought to bring about improvements in the text. As the draft Directive is the subject of a "co-decision" procedure, under which the text is simultaneously considered by the Council of the EU (that is, by representatives of the governments of the Member States of the European Union) and by the European Parliament, with both the Council and the Parliament able to suggest amendments and the final text being agreed upon between them, this has involved making representations to both bodies.

Two separate sets of amendments to the original Commission text have appeared. The Swedish presidency of the Council issued a "compromise proposal" on November 12, 2009, with a revised version appearing on November 25, 2009. And the Parliamentary *rapporteur* (that is, the member of the European Parliament tasked with steering the draft directive through the Parliamentary process), Jean-Paul Gauzès, produced a draft report on November 23, 2009, containing some 138 amendments to the original Commission text.

There is clearly some considerable way to go before either the Council or the Parliament produces a final text, let alone a text that is acceptable to the other side. What has become increasingly clear is that matters will not be resolved in the course of the Swedish presidency of the Council, but will be left for their successors in the chair, the Spanish, who take over on January 1, 2010. However, the amendments that appeared in November may give some clues as to where the draft Directive is heading.

Remuneration

The Commission text was silent on this, but both the Swedish proposals and the Gauzès report contain remuneration provisions, so it seems fairly certain that this aspect will appear in the final text.

The Swedish proposal contains a requirement for AIFMs to have remuneration policies and practices that are consistent with and promote sound and effective risk manage-

The Gauzès report would keep the independent "valuator" concept from the Commission text, but AIFs that are private equity funds would be exempt from the requirement. It is left to the Commission in later provisions to specify who would qualify as a "valuator."

ment. For categories of staff whose professional activities have a material impact on the risk profile of the AIFM or the alternative investment fund ("AIF") that they manage, a number of principles must be applied to the remuneration policy, including deferment of a substantial proportion of variable remuneration for at least three years.

The Gauzès report would align the draft Directive with the principles on remuneration agreed at the G20 meeting in Pittsburgh in September 2009. This has been generally thought to be an improvement on the Swedish proposals, which are seen as an inappropriate adoption of provisions drafted with bankers' remuneration in mind.

Scope

Unlike the Commission text (and the Swedish proposal), the Gauzès report would apply the draft Directive to all AIFMs, no matter how small the AIFs that they manage. This has been strongly criticised by the venture capital industry as an unnecessary burden on small firms, particularly given the minimum capital requirement of 125,000 that would apply, although the move has received support in some quarters, notably from the Alternative Investment Management Association ("AIMA").

The AIFM

The original Commission text left it unclear as to who the AIFM is. Both the Swedish proposals and the Gauzès report plainly state that there should be one AIFM per AIF, that the draft Directive applies only to an AIFM within the EU. They also set out in an annex (in virtually identical terms) the functions that an AIFM may perform. However, the Swedish proposal would restrict the activities that an AIFM could undertake, as, apart from managing AIFs and acting as a manager under the UCITS Directive, an AIFM would only be able to carry on administering and marketing activities, and activities relating to the underlying assets of the AIF and to the issue or redemption of units or shares in the AIF. It would thus appear that an AIFM could not act as an investment adviser, for instance. If this proposal is accepted, some AIFMs may need to form group entities to perform the activities they can no longer perform, which is likely to be costly.

Valuation

The Swedish proposal removes the requirement to appoint an independent "valuator." Instead, the AIFM must ensure that appropriate and consistent procedures are in place to provide proper valuation of the assets, and, where appropriate, ensure the functional independence of the valuation and portfolio management function.

The Gauzès report would keep the independent "valuator" concept from the Commission text, but AIFs that are private equity funds would be exempt from the requirement. It is left to the Commission in later provisions to specify who would qualify as a "valuator." It would appear that initially such persons would have to be regulated in the EU, although three years after the Directive came into force it would be possible for a third-country valuator to be appointed, provided that that third country imposed equivalent valuation standards and rules to those of the EU.

Depositary

The Commission text provided that the AIFM had to ensure that a depositary (an EU credit institution) was appointed for each AIF. The depositary could delegate its functions, but only to other depositaries (though three years after the Directive came into force, it would be possible to delegate functions to third-country depositaries, but only if they were in the same country as the AIF and the country concerned had prudential regulation, supervision and standards concerning depositaries that are equivalent to those under the Directive, there is cooperation between that country and the Member State of the depositary, and there are equivalent standards in that country to those in the EU to prevent money laundering and terrorist financing.) In addition, the depositary would be responsible for the acts of any sub-depositary. The restrictive nature of these provisions led many to doubt whether it would be possible for AIFMs to act in frontier markets without sharply increased costs to investors.

Under the Swedish proposals, the depositary provisions are significantly relaxed.

- In addition to a credit institution, the depositary may be a MiFID firm authorized to carry out safekeeping and administration, or any legal 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 safekeeping 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, is 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 Gauzès report would allow the depositary to be a MiFID firm as well as a credit institution. It also allows the depositary to escape liability for the acts of a third party, though only in the very narrow circumstances where the depositary is legally prevented under the law of the country where the AIFM invests on behalf of the AIF from exercising its custodial functions, and there is an all-party agreement to this effect (the parties including the investor) or the Commission has determined that the country concerned has prudential regulation, supervision and standards concerning depositaries that are equivalent to those under the Directive and there are equivalent standards to those in the EU to prevent money laundering and terrorist financing.

Delegation

The Commission text required an AIFM to obtain prior authorization from its regulator before delegating any function to a third party. Portfolio management and risk management could be delegated only to another AIFM; no delegation could be made to a depositary or valuator.

Under the Swedish proposal, the power to delegate is wider than before.

- AIFMs need only inform the regulator prior to the delegation arrangements becoming effective; they no longer need permission to delegate.

- 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 cooperation between the regulator of the AIFM and the supervisory authority of the non-EEA entity. (This is virtually the same provision as in the Commission text, but with the significant change that it applies immediately when 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 other third party, even where the interests of the third party may conflict with the AIF, provided the conflict of interest can be managed.

The Gauzès report is more restrictive. It does not allow delegation of portfolio/risk management, or liquidity management, to anyone other than another EU AIFM authorized to manage an AIF of the same type.

The Gauzès report is more restrictive. It does not allow delegation of portfolio/risk management, or liquidity management, to anyone other than another EU AIFM authorized to manage an AIF of the same type. Administrative functions can be delegated to non-EU entities, but only three years after the rest of the Directive comes into force and provided that certain conditions are satisfied (such as the entity being authorized and subject to prudential supervision). And while the Gauzès report also provides for advance notification to the regulator of any delegation, the fact that the regulator can reject the delegation within a month suggests that in practice AIFMs will either wait for confirmation from the regulator that the delegation is acceptable, or wait until the end of the period before the delegation becomes effective. This would hardly be an efficient way to proceed.

Leverage

The Swedish proposal largely deletes the Commission text that required AIFMs managing leveraged AIFs to disclose leverage levels both to investors and to regulators. However, 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.

The Gauzès report retains the Commission text. It would also require each AIFM to set leverage limits for each AIF that it manages, which would appear to restrict the AIFM's ability to react to prevailing market conditions.

Passport

Both the Swedish proposal and the Gauzès report clarify that the marketing "passport" — the ability to market AIFs throughout the EU to professional investors on the basis of an AIFM's authorisation in one Member State — applies in respect of EU-based AIFs only. (The Gauzès report would, however, allow non-EU-based AIFs to be marketed in this way three years after the rest of the Directive came into force. See below.)

Third Countries

The Commission text provided that certain "third country" provisions would not apply until three years after the rest of the Directive came into force. These provisions, among other things, provided for the marketing of third-country AIFs by AIFMs to professional investors under the marketing "passport," provided certain arrangements for the sharing of tax information were in place between the third country and the Member State in which the AIF was marketed, and for the authorization of non-EU AIFMs so as to enable them to market non-EU AIFs to professional investors in the EU. Since, however, the conditions that were required to be satisfied for the latter to occur were generally considered virtually impossible to meet, and since the definition of "marketing" included unsolicited approaches by investors, the Commission text appeared to produce the result that non-EU AIFMs would be unable to do business with any EU professional investor.

Recognizing that this would be a deeply undesirable result, the Swedish proposal has deleted all the "third country" provisions. Instead, there is a provision 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 organizations or the AIFM can demonstrate that the AIF in the third country complies with those standards," and appropriate cooperation arrangements exist between the regulator of the AIFM and the supervisory authorities in the country of the AIF. Once again, details of what the relevant standards and "appropriate co-operation arrangements" might be are left to later Commission measures. The Swedish proposal also excludes from the definition of "marketing" unsolicited approaches to AIFMs.

The net result of the Swedish proposal is that an AIFM managing non-EU AIFs cannot take advantage of the passport, and will need to rely on private placement regimes in individual Member States, as now. The status quo is also preserved for a non-EU AIFM managing a non-EU AIF (such as a U.S. manager of a Cayman fund); such an AIFM will be able to market the AIF in the EU, and respond to investor approaches from the EU, provided that local law in the Member State concerned allows.

The Gauzès report would retain the "third country" provisions, apart from that enabling the authorisation of non-EU AIFMs. This would mean that non-EU AIFs could benefit from the marketing "passport," provided that the relevant tax agreement was in place. The position of non-EU AIFMs managing non-EU AIFs would be as described in the previous paragraph.

The Gauzès report also introduces a new provision, which would prevent professional investors from investing in AIFs in third countries that were managed by non-EU AIFMs, and where the third country concerned had not signed "an information-sharing cooperation agreement in line with international standards." It is unclear how this proposal would, or even could, work.

Private Equity Funds

The Swedish proposal clarifies that the additional provisions relating to private equity funds apply only where non-listed companies are concerned. The threshold for "control" that triggers the disclosure obligation has been raised to more than 50%, and the amount of disclosure reduced (though information is still required to be disclosed to employees of the company controlled).

The Gauzès report continues to apply the disclosure requirements to listed as well as non-listed companies. These disclosures (including disclosure of the development plan) would not be required of other market participants, such as family offices and sovereign wealth funds. Unsurprisingly, the venture capital industry has pointed out the discrimination against fund-controlled businesses that would result, in particular the increased costs that they would have to bear.

Simon Firth
sfirth@kayescholer.com

Owen Watkins
owatkins@kayescholer.com

Chicago Office
+1.312.583.2300

Frankfurt Office
+49.69.25494.0

London Office
+44.20.7105.0500

Los Angeles Office
+1.310.788.1000

New York Office
+1.212.836.8000

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1.202.682.3500

West Palm Beach Office
+1.561.802.3230